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Recent Developments in CU Mergers

By Kent M. Krudys, Esq., and Eric Luse, Esq.
Luse Gorman Pomerenk & Schick, P.C., Washington, D.C.

Director Briefing Series

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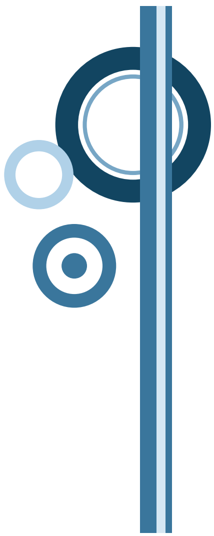
Introduction

Credit unions are facing the dual challenges of rising competition and increased regulatory burdens—taken together, these challenges have tempered growth opportunities for a vast number of credit unions. Many have looked to the prospect of mergers as a means of building asset size, adding members, increasing capital and/or expanding market share. Mergers also enable credit unions to increase the geographical area they serve, enhance their technological capabilities, build their branch location infrastructure or solve various human resource challenges, such as management succession issues.

While mergers in the credit union sector have traditionally involved two or more credit unions voluntarily entering into a cooperative agreement with one another, recent transactions or proposed transactions have drawn attention to the fact that mergers can go beyond this traditional model. This briefing discusses key aspects of the traditional merger process and addresses several new developments in potential merger partners for credit unions, including state mutual cooperative banks, federal mutual savings banks and stock banks/savings banks. As we discuss, non-traditional mergers can put the credit union's duty to uphold the best interests of its members at odds with voices from within the credit union movement.

Another issue that this briefing considers is the potential that not all merger offers are welcomed merger offers. A 2007 case involving $1.9 billion Wings Financial Federal Credit Union, Apple Valley, Minn., and $208 million Continental Federal Credit Union, El Segundo, Calif., brought to the foreground the topic of an unsolicited merger offer. The unwanted suitor may actually challenge the fiduciary duty of the credit union's board of directors in order to move the merger offer forward, and this may involve direct solicitation of the credit union's members. This briefing discusses that possibility and how credit unions can handle such situations.



Chapter 1: The Lay of the Land

Facts and Figures

The number of U.S. credit unions has been steadily declining in the 21st century. According to National Credit Union Administration figures, there were more than 10,600 credit unions doing business in the U.S. at the start of the new millennium. By the beginning of 2008, that figure had shrunk to about 8,100 credit unions.

This 24 percent decline in just an eight-year span is primarily attributable to the rapid pace of mergers occurring among credit unions. There were more than 2,100 credit union mergers from 2000 to 2007. There has been an average of nearly 300 credit union mergers per year over the past several years (2004-2007), which means that the NCUA has been approving almost a merger a day. Many of these mergers involve very small credit unions with asset sizes of $5 million or less.

The following charts, using data from the NCUA's 2007 Annual Report, shows trends in mergers from 1997 to 2007 and how they have impacted the total number of credit unions.

Number of Insured Credit Unions, 1997–2007

As of December 31	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Federal Credit Unions	6,981	6,815	6,566	6,336	6,118	5,953	5,776	5,572	5,393	5,189	5,036
State Credit Unions	4,257	4,180	4,062	3,980	3,866	3,735	3,593	3,442	3,302	3,173	3,065
Total	11,238	10,995	10,628	10,316	9,984	9,688	9,369	9,014	8,695	8,362	8,101

Number of Credit Union Mergers, 1997–2007

Fiscal Year	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Assisted	8	5	8	9	5	1	5	7	5	4	5
Unassisted	164	217	315	284	295	271	166	331	260	281	237
Total	172	222	323	293	300	272	171	338	265	285	242

Source: 2007 Annual Report of the National Credit Union Administration

These statistics indicate a bit of a slowdown. 2001 was the last year there were 300 credit union mergers. However, financial industry experts expect the pace of mergers to pick up again through the end of 2009.

According to survey statistics provided by the Filene Research Institute, Madison, Wis., in 2007, 50 percent of all credit unions report that they are actively pursuing merger opportunities. Those that are proactively seeking a merger are looking to be the acquirer by a margin of 3-to-1.

Identifying Merger Partners

There are a variety of ways to identify and approach a potential merger partner. Some credit unions engage a third-party consultant to seek out likely candidates and gauge their interest in a potential merger. Other credit unions prefer to seek out and approach potential partners themselves. Often, they will use a “softer” sell approach. This could be something as simple as two CEOs having a conversation over lunch.

Having the CEOs involved in such conversations can be a plus, since the CEOs have an intimate knowledge of their respective credit union’s products and services. They also can speak to the corporate culture and gauge whether they see a compatible fit between the two credit unions.

In the case of credit union mergers, having a good corporate fit takes higher priority than it does in most other types of mergers. Credit unions typically serve a membership that has some sort of common bond—i.e., members of the same trade, industry or profession (TIP-chartered credit unions), members who work for the same company (SEG-based credit unions), or members who live, work, reside or worship in the same community (community-chartered credit unions). In most credit union mergers, there is no stock involved and no cash changing hands. Credit unions are not-for-profit entities, and thus social issues frequently take a higher priority in this type of merger, compared to mergers between for-profit entities where monetary considerations are the highest priority.

The Good, the Bad and the Ugly

As credit unions move forward in the 21st century, it's important to assess the current position of credit unions as it relates to mergers—looking at not only the good but also the bad and even the ugly.

The Good

First, let's review the good. One important fact to note is that despite the decrease in the number of credit unions, total assets are increasing. Over the six-year period from 2000 to 2007, NCUA reported an increase in insured member deposits from $353 billion to $560 billion. In addition, credit union capital levels are at an all-time high, and loan growth is generally seen as good. Another positive is that there has been an increase in new accounts.

The Bad

However, the not-so-good news is that there has been a slowdown in share growth as well as new members. Fifty percent of credit unions are reporting declines in membership. While it is true that industry figures show a significant increase in new accounts, the disheartening counterbalance to that news is that there are not a lot of new individuals being attracted to the credit union movement. Credit union members are getting older, and credit unions overall are finding it a challenge to attract young people. SEG-based credit unions are not attracting young employees as they did in the past—perhaps because younger employees are not as likely to take a job and hold onto it for 40 years as many in previous generations have done. Therefore, there are not as many people with an attachment to a single employer as there used to be 20 or 30 years ago.

Also having an impact is the fact that many credit unions have transitioned to community charters. This gives credit unions the potential of attracting members from a larger pool of consumers. However, at the same time, it means that credit unions are facing increased competition. This requires credit unions to spend more budget dollars on marketing in order to keep their name in front of potential members and to retain or grow business with existing members.

The Ugly

The "ugly" part of the credit union future has to do with the prospect of unwelcome merger offers. Such a merger attempt occurred in the first quarter of 2007, when Wings Financial FCU attempted to acquire Continental FCU in what some have characterized as the first "hostile takeover attempt" in the credit union movement. A more neutral term is "unsolicited merger offer." Some say that credit unions should brace themselves for additional merger attempts of this nature. We will discuss more about this prospect in Chapter 4.

A Few Common Reasons for Mergers

There are a variety of reasons that credit unions are finding it more desirable to seek out merger partners. Many of these reasons fall into two broad categories: the challenges brought about by the economic environment and considerations related to human resources.

Economic Environment

The economic environment and the rising cost of doing business have brought about a number of challenges that credit unions must face, including:

- inability to compete (especially difficult for small credit unions);
- increased regulatory burdens, specifically the rising cost of compliance;
- the explosion in member usage and expectations regarding credit union technology; and
- shrinking net interest margins.

The economic reality is that credit unions are facing rising costs in virtually every facet of their business, including payroll, employee benefits, operations, product development, branch infrastructure, advertising and technology. Mergers can provide economies of scale that will enhance the overall efficiency and profitability of the newly combined organization.

Economic conditions are particularly being felt by smaller credit unions. The competitive nature of the financial institutions market has risen to the point that smaller credit unions are having difficulty making their presence known. They lack the critical mass to stand out in a crowded marketplace. By joining with a larger, more prominent credit union, they can "hitch their wagon" to an entity that already has greater clout in the marketplace.

Another difficulty for smaller credit unions is the ability to keep pace with members' expectation when it comes to technology. Almost every year, a new technological expectation comes to market. In the 1980s, it was the rising usage of ATMs. In the 1990s, financial institutions were expected to develop a Web presence. That segued into the demand for online banking and bill pay. Now, members expect to be able to apply for loans on line and find out if they have been approved within a matter of seconds.

Technology provides opportunities for credit unions, such as the ability to provide point-of-sale auto loans at auto dealerships through indirect lending programs. However, all technological solutions come with an accompanying investment that smaller credit unions and sometimes even mid-sized credit unions cannot afford to make. A merger can give these credit unions the ability to meet technological expectations by joining resources and ultimately providing the technological solutions that members expect.

The regulatory burden that faces credit unions today is another reason for credit unions to seek a merger. Again, it is the smaller credit unions in particular that may find regulatory requirements too costly and overwhelming to handle on their own. They may not be able to afford a full-time compliance officer, so their next best option is to look for a merger partner that is capable of handling regulatory requirements.

Human Resources Considerations

Another factor that drives much of merger activity is the challenge of developing adequate human resources to manage and staff the credit union, specifically:

- difficulty in attracting talented management personnel,
- concerns about management succession, and
- lack of experienced personnel in areas that the credit union has targeted for growth and expansion (such as member business loans).

Given that an increasing number of credit union CEOs are reaching retirement age, executive-level resources are especially concerning. According to Credit Union National Association statistics, nearly one-quarter of credit union CEOs will retire within the next five years and nearly half will retire in the next 10 years. Credit unions don't always have a viable candidate to replace the CEO. In fact, many do not have any sort of succession plan in place. A merger can help solve a succession problem. If a credit union's CEO is retiring, the time might be right to merge with a credit union that has a proven CEO who can lead the newly merged organization.

Undoubtedly, smaller credit unions are having difficulty in attracting talented management, because they don't have the financial resources to spend on compensation and benefits. For example, the salary that many top compliance officers command may actually rival the salary that a small credit union is paying its CEO. And what if a credit union would like to plan for growth by starting a business services program? This plan may not be viable if the credit union cannot find and attract a qualified business services manager. If they find a qualified person, they will have to pay that person the going rate in the marketplace, and smaller credit unions might find that to be cost-prohibitive.

A merger, however, will expand the credit union's pool of qualified job candidates who can take on newly created duties at the newly consolidated organization. At the same time, a merger may permit the credit union to pay the type of salary and benefits that attract a higher caliber of job candidates who can head up new programs that are key to the organization's future growth path.

Regulatory Considerations

Whenever undertaking a merger, both parties must be aware of the regulatory requirements that govern the proposed transaction. As the governing body of the credit union movement, the NCUA must approve direct mergers. Here are the steps for conducting a merger, as outlined by the NCUA.

The credit union must:

- develop a merger plan,
- submit the merger plan to NCUA for approval,
- receive NCUA approval of the merger plan and
- present the membership with an opportunity to vote on the merger proposal. (In the case of the merging credit union, an affirmative vote of a majority of those voting on the proposal is required.)

According to NCUA rules and regulations, a merger plan must include the following:

- current financial statements for both credit unions;
- current delinquent loan summaries and analyses of the adequacy of the allowance for loan and lease losses;
- consolidated financial statements, including an assessment of the generally accepted accounting principles net worth of each credit union before the merger and the GAAP net worth of the continuing credit union after the merger;
- analyses of share values;
- explanation of any proposed share adjustments;
- explanation of any provisions for reserves, undivided earnings or dividends;
- provisions with respect to notification and payment of creditors;
- explanation of any changes relative to insurance;
- provisions for determining that all assets and liabilities of the continuing credit union will conform with the requirements of the Federal Credit Union Act (in instances where the continuing credit union is a federal credit union); and
- proposed charter amendments (again, in instances where the continuing credit union is a federal credit union). These provisions, if any, will usually pertain to the name of the credit union and the definition of its field of membership.

Once the merger plan has been submitted and approved, the merging credit union (if it is a federal credit union) must give the members the right to vote on the proposal, either at the credit union’s annual meeting, if it is within 60 days of NCUA approval, or at a special meeting to be called within 60 days of NCUA approval, or by mail ballot received no later than the date and time announced for the annual meeting or the special meeting. The board of directors of the merging federal credit union must certify the results of the vote within 10 days after the vote is taken. (Refer to NCUA Rules and Regulations, Part 708b, for more information.)

Regulatory Approval

The NCUA doesn't merely rubber-stamp any merger proposal. There are several considerations that the governing body looks at. Specifically, the merger may not present an undue risk to the National Credit Union Share Insurance Fund. Also, any proposed charter amendments are subject to NCUA approval.

If a credit union converts to an interim savings bank and then merges into a savings bank, no NCUA approval is required. However, the NCUA must approve methods and procedures of the charter conversion.

A Look at the Future

When looking at what lies ahead for credit unions in the area of mergers, it's important to consider the two primary forces that are at work:

(1) the duty that credit unions have to the credit union movement and

(2) the duty that credit unions have to their members.

Sometimes, these two forces can be in conflict. If so, the credit union must navigate through these competing duties.

Consider first the credit union's duty to the credit union movement. For the most part, the credit union movement is a political entity. It is well-organized, politically connected and very savvy when it comes to protecting credit unions' interests. However, the credit union movement is also interested in preserving its share of the financial institutions market.

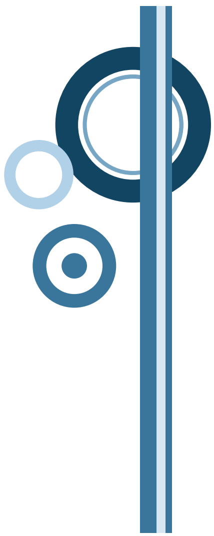
As such, the movement is opposed to anything other than a traditional credit union-to-credit union merger. However, credit unions that are adhering to their duty to their members might wish to "think outside the box" when it comes to mergers. If they cannot find a viable merger partner within the credit union movement, they may wish to consider a merger with a mutual bank if it provides various benefits, such as expansion of geographic market area, expansion of products and services, the convenience of additional branches and ATMs, and/or more attractive rates than what the credit union is able to offer.

The credit union movement generally has shown opposition to such a merger idea, but the reality is that such mergers are occurring. There is an understanding among these credit unions that the brand loyalties of yesteryear are going away. Part of this is because of the commoditization of financial institutions' products and services. Consumers are looking more intently at the bottom-line promise of what their financial institution can do for them.

Chapter 3 explores merger options that exist outside of the credit union arena.

Considerations for Credit Union Merger Planning

1. Has your credit union previously pursued a growth strategy that has included mergers? What were some of the advantages that you were able to achieve by pursuing such a merger?
2. What type of merger strategy does your credit union have for the future? What are the economic and/or human resource considerations that are driving this strategy?
3. How do you feel your credit union can reconcile its duty to its members and its duty to the credit union movement when it comes to pursuing a merger?



Chapter 2: Why Consider a Merger?

Advantages of a Merger

In the previous chapter, we identified several of the reasons for increased merger activity in the credit union sector. In this chapter, we lay out some of the advantages that credit unions can experience by going through with a merger. Many of them relate to improving the financial well being of the credit union, as follows:

- shared costs and overhead (i.e., IT, compliance, risk management, human resources);
- expansion of branch locations and ATMs for improved member access;
- operating efficiencies (which lead to economies of scale);
- greater critical mass to support new services and technology/online banking, etc.;
- greater capital/critical mass to support business lending and administration;
- increased capital and lending limits;
- greater career opportunities for employees, leading to improved employee retention;
- as a defensive strategy (to prevent others in your market from merging with your potential partner); and
- to gain management expertise.

Greater capital and lending limits can immediately help the newly merged organization to support its operation. As an example, if a $100 million institution with $10 million in capital undertakes a merger with a $50 million credit union with $10 million in capital, the newly merged credit union goes from 10 percent capital to 13.3 percent capital.

Another consideration is the idea of using a merger as a defensive strategy. For instance, if you are one of five financial institutions in your market and you merge with one of them, then you have not only removed one of your competitors but you've also made it impossible for one of your three remaining competitors to merge with that organization.

Keep in mind, too, that a merger will allow you to bring additional management expertise into your organization. All of the management expertise will now be working to increase your standing in the marketplace.

Potential Risks of a Merger

When considering the idea of a merger, you also should consider what potential risks may be associated with it. Notice how we use the term "potential risks" as opposed to "disadvantages" of a merger. That is because these issues are challenges that can have an upside if handled positively, but they do have the potential of having a downside that must be addressed if the merger is to be successful.

Among the potential risks are:

- social issues: incompatibility of management, officers and board members from the two merging credit unions;
- loss of board seats, particularly among those from the merging credit union;
- different corporate cultures of the combining credit unions;
- poor asset quality or regulatory problems of merger partner (proper due diligence can offset this risk);
- difficulties in integrating the two credit unions and their fields of membership;
- loss of identity, autonomy and control of the merging credit union;
- rarely a merger of equals (one credit union usually ends up on top); and
- employee dislocations.

Of the risks spelled out in this list, the social issues and loss of board seats are potentially the most difficult to deal with. Mishandling the social issues can lead to a disruptive internal atmosphere that is destructive to the overall organization. What is particularly challenging for the board of the smaller credit union is the fact that they are most likely voting themselves out of a job (albeit a volunteer one) if they approve the merger—and that includes the prestige and the sense of pride that come with it. However, the board's approval and cooperation is essential in order for the merger to be successful.

Keep in mind, too, that regulatory problems can also thwart a merger. The NCUA may decline approval of the merger if the credit unions do not get their financial houses in order. For the sake of your members and your credit union, you need to ensure that the due diligence process is handled properly. Beyond the due diligence process, both institutions should get to know each other as well as possible, understanding each other's corporate cultures as well as having a thorough knowledge of all products and services. In order for the merger to go smoothly, it is important that there be no surprises.

Also be aware that there is very rarely something called "a merger of equals." In almost all merger situations, one of the credit unions is acquiring, and the other credit union is being acquired. They will likely emerge under a single name and brand identity. In most instances, the name is that of the surviving credit union (though it is possible to assume a new name for the entire organization, especially if the old name no longer fits the new entity due to geographical or member base expansion). For the merged credit union, this will mean a loss of identity and autonomy. But the eventual outcome is that the merged organization will become integrated to the point that members from each credit union will eventually feel part of one organization, as will the employees and management of the newly formed organization.

A key issue that concerns many employees of the merged credit union is the apprehension that they will lose their jobs. The reality is, however, that many credit union mergers are completed with no employee dislocations at all. If there are some redundancies in staff titles, the issue can be addressed through departmental expansions and some reassignments. Typically, the newly merged credit union will be adding departments, functionalities, products and services so that additional hiring may actually occur, dispelling the worry that some individuals will be laid off.

While there are many potential risks when considering a merger, many of these risks can be proactively identified and managed. Both partners in the merger must agree to be open and flexible in addressing these challenges, and then, most importantly, both partners must commit to a stated goal that addresses each challenge. Adhering to stated goals will assist both credit unions in mitigating risk and help the credit unions' stakeholders adjust to the merger.

Traditional Merger Partners

The question of who might be a compatible merger partner for you is best addressed ahead of time so that there are less potential snags in the merger process itself. In a traditional merger in the credit union sector, both of the parties are credit unions.

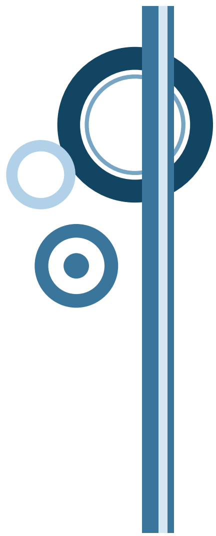
When two credit unions merge, the compatibility of fields of membership is an important consideration. The fields of membership should be similar or complementary—as in the case of TIP-chartered credit unions or SEG-based credit unions. TIP-chartered credit unions may look for credit unions in a similar field—such as teachers, hospital employees or government workers. SEG-based credit unions may look for credit unions that are also SEG-based and possibly serving similar industries. Community charters may seek out credit unions that have community charters in contiguous geographic areas.

Credit unions also will want to look for synergist compatibility with a potential merger partner. For instance, if one credit union is strong in deposits, perhaps the other is strong in loans. If a credit union would like to expand into business member services, then finding a merger partner with those pre-existing capabilities can be a very good idea. Another consideration is whether there is dynamic management from either of the merging partners that can be tapped to benefit the newly merged organization as a whole.

Beyond traditional merger partners, there are other possibilities for credit unions to consider. We will explore specifically what types of financial institutions might be a viable possibility for merging with a credit union in the following chapter.

Considerations for Credit Union Merger Planning

1. What advantages could be achieved by your credit union entering into a merger with a traditional merger partner?
2. What are the potential risks for your credit union in merging with a traditional merger partner?
3. Can you identify any potential traditional merger partners that would be a good fit for your credit union? What are the attributes that make these potential partners a good fit?



Chapter 3: New Developments in Merger Partners

In this chapter, we will explore the potential that credit unions have for merging with partners outside of the credit union movement. Among the potential merger partners are mutual savings banks, mutual savings and loans, stock banks and stock savings banks.

As of 2008, mergers between banks and credit unions are still relatively rare. In many ways, these are uncharted waters. However, just because something is not the norm doesn't mean that it shouldn't be done. Competitive and regulatory pressures require the creation of fewer, leaner and more efficient financial institutions. Efforts to protect consumers have resulted in additional expensive regulatory safeguard requirements. A key benefit of a merger is the ability to pool resources related to operations, technology, regulatory compliance, human resources and other costs of doing business. If no viable merger partner exists within the credit union sector or if there is a more compatible partner that is a mutual bank, a merger outside the industry may be a reasonable alternative for the credit union to explore.

In this chapter, we will look at several recent examples of mergers in these categories and discuss the ramifications for the specific institutions involved.

Case Study:
State-Chartered Mutual Cooperative Bank's Acquisition of a State-Chartered Credit Union

Acquiring Institution: Haverhill Bank

Merging Institution: Northeast Community Credit Union

Market: Haverhill, Mass.

A recent proposal that has sparked a lot of interest amongst credit union executives would merge a state-chartered credit union, Northeast Community Credit Union, into a state mutual cooperative bank, Haverhill Bank. This is the type of merger that the credit union movement has shown little comfort with, given that the credit union would cease to operate as such and would be absorbed into Haverhill Bank. In this highly unusual type of merger, the newly merged organization would be chartered as a bank, and the members of the former credit union would become the bank's customers.

Haverhill Bank, which was founded 130 years ago, is now the oldest cooperative bank in Massachusetts. Northeast Community CU is a community-chartered credit union serving Essex and Middlesex counties. Both institutions are located in Haverhill, Mass. The merged organization would have combined assets of $260 million, deposits of $220 million and capital of $30 million, giving it the second largest market share in Haverhill.

With its added heft, the newly merged financial institution would have the ability to offer larger loans. The merger proposal also involves the complete pooling of equity and retained earnings, with no payout to members of the credit union. The combined organization would expect to see strong economies of scale, especially given the fact that they already share many of the same vendors and systems, which would allow significant cost savings as well as a smooth transition.

Both organizations had specific reasons to pursue the merger. Haverhill Bank had found itself in a more vulnerable position due to increased competition in the banking industry, and the merger with Northeast Community CU would allow it to shore up its position. While some may perceive the merger as rescuing the credit union from an untenable position, one could make the case that it is actually the credit union that would be assisting the bank.

The merger would allow the new organization to achieve greater efficiencies and provide a greater array of products and services, which was an important consideration in Northeast Community CU's decision to move forward with the merger. As a result of the merger, the newly combined organization would be able to maximize efficiencies in such areas as information technology, insurance, auditing and other operating expenses. However, no layoffs would be planned, and all branches are expected to remain open.

A closer look at both organizations provides plenty of insights into why they would want to merge. First and foremost, each financial institution is owned by the people who entrust their savings there. As a Massachusetts cooperative bank, Haverhill Bank has many characteristics of a credit union. Just as credit unions have member-owners, Haverhill Bank's depositors are member-owners of the cooperative bank. As is the case with credit unions, each account-holder at the bank has one vote.

Because of the local member-ownership, both financial institutions have strong ties to their communities. They both have an interest in identifying community needs and supporting the local area's civic organizations and charities. They have deep roots in the community.

Another similarity is in the governance structure of the bank. Both a credit union and a Massachusetts mutual cooperative bank have a board of directors. The proposed merger had provisions for combining members of both boards to make one governing body that would set policies and directions for the newly merged financial institution. Northeast Community CU's credit union leadership, meanwhile, would play an important role in the day-to-day management of the institution. It was announced that Northeast Community CU's treasurer/CEO would take the role of president/COO, while Haverhill Bank's president would move into a position as chairman/CEO.

The merger proposal was announced in July 2007 and just recently received regulatory approval. The merger is scheduled to take effect in January 2009. This proposed merger raises the issue that was discussed in Chapter 1: Namely, is the credit union putting its members'

interests first or the credit union movement's interests first by going forward with the merger? It gets back to the question of duty to the credit union movement versus duty to the members.

Case Study:
Stock/Savings Bank Acquiring a Federal Credit Union

Acquiring Institution: Nationwide Bank

Merging Institution: Nationwide Federal Credit Union

Headquarters: Columbus, Ohio

This merger involved a savings bank, Nationwide Bank, acquisition of a federal credit union, Nationwide Federal Credit Union. Nationwide FCU initially converted to a mutual bank, an interim step that allowed the newly formed Nationwide Bank to acquire the credit union.

Nationwide Bank is a wholly owned subsidiary of Nationwide Financial Services Group (known for its slogan, "Nationwide is on your side"), which had been the credit union's sole sponsor. At the time of the merger, Nationwide FCU had assets of $567 million.

By a margin of 9-to-1, the members of the credit union voted to accept the merger proposal in November 2006. Of the 42,152 members eligible to vote, 16,718 cast ballots with 14,872 in favor of the merger. The merger was subject to regulatory approvals from the NCUA as well as the FDIC and the Office of Thrift Supervision prior to its finalization in early 2007.

A key consideration in this merger proposal was that Nationwide Bank agreed to pay each member a premium, which was distributed on a pro-rata basis according to deposit balances as of the end of March 2006. In total, Nationwide FCU's members were paid $79 million for their ownership interests. For a member with $10,000 in deposit balances from savings, checking, CDs, money markets, IRAs and/or holiday accounts, the amount of the premium was $1,526.

The payment of a premium is seen as a rarity in other credit union-to-bank conversions. Some industry analysts saw this as a positive, while others opined that the credit union was undervalued and that a premium of much higher percentage would have been appropriate. However, as justification for the premium figure, the credit union had received an independent assessment of its worth, performed by an outside firm.

The Nationwide FCU board and CEO say their primary focus was on the members' best interests. The contention is that the newly merged organization will have the resources to offer a first-rate lineup of products and high-quality service and to make one, strong financial institution.

Non-Traditional Mergers "Under the Radar"

The Nationwide merger and the pending transaction between Haverhill Bank and Northeast Community Credit Union are two high-profile cases involving credit unions looking beyond their industry for merger partners. Instances such as these are generally viewed as a rarity in the credit union movement. However, there have been several mergers involving banks and credit unions that have been occurring "under the radar," so to speak, over the past several years.

Beacon Federal Savings Bank based in New York has acquired several credit unions since 2000, including Caney Fork Cooperative Credit Union (2000), Roper Federal Credit Union (2000), Professional Teachers Credit Union (2001), Salt City Hospitals Federal Credit Union (2003) and Marcy Federal Credit Union (2007).

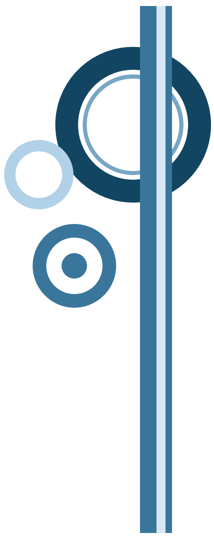
These transactions involved the merging of the credit unions into Beacon Federal Savings Bank either directly or immediately following the intermediate step of converting to a savings bank. Each of these mergers was subject to approval from the credit union's board of directors, the NCUA, the Office of Thrift Supervision and the credit union's members.

Another point of interest is that Beacon Federal Savings Bank was itself a credit union before converting to a federal mutual savings bank. In the fall of 2007, Beacon Federal reorganized as a stock savings association.

None of these transactions were high profile, but they are indicative of the fact that financial institutions are thinking beyond the usual parameters when it comes to seeking a merger partner.

Considerations for Credit Union Merger Planning

1. What are some of the potential advantages for credit unions merging with non-traditional partners?
2. What are some of the potential risks for credit unions merging with non-traditional partners?
3. What are some of the long-term ramifications of non-traditional mergers for the credit union movement? What do you see as a positive course of action that the credit union movement could undertake to counter any negative effects?



Chapter 4: Unsolicited Merger Offers

When we first mentioned the prospect of unsolicited merger offers in Chapter 1, we said that this represents the "ugly" side of merger activity in the credit union sector. Certainly, any form of an unwanted but unrelenting merger offer is "ugly" from the perspective of the target. The recent case involving Wings Financial Federal Credit Union's unsolicited merger offer of Continental Federal Credit Union brings that point home. We will discuss that case later in this chapter after first laying the groundwork regarding the reasons and ramifications of an unsolicited merger offer.

First, let's explore why an unsolicited merger offer would occur. There are several reasons:

- "Conventional" merger partners and methods have failed or have not proven feasible for the suitor.
- Those contacted initially have been dismissive of any real strategic discussions.
- The target board has said "thanks, but no thanks."

The perspective of the targeted credit union is that an unsolicited merger offer is a "hostile takeover attempt." Credit unions are used to "conventional" methods for advancing a merger—where two CEOs discuss the idea over lunch or where one credit union expresses interest in merging with the other. It's almost like a courtship, in which one credit union must be won over by the other.

Challenging the Target Credit Union's Fiduciary Responsibility

When conventional methods have failed, a potential acquirer may decide to continue to pursue its merger goal. Because management and the board of the target credit union are resistant to the merger, the acquirer will begin looking for "soft" spots in its merger target. One potential strategy is to challenge the board of directors at the target credit union on the subject of its fiduciary responsibility.

The acquirer's reasoning will essentially follow these lines: The board's fiduciary responsibility requires that it act in the best interest of the credit union's members. Dismissing a merger offer that may provide your members with better rates, better fees and better service is not in the members' best interest. Therefore, by not considering the

merger further—including the step of bringing the merger to a vote of your membership—the board is not upholding its fiduciary responsibility.

Because of this, it's best for the credit union board to have a clearly defined sense of its fiduciary responsibility. Is it to maintain the status quo? Is it to be reactionary to the forces in the marketplace, or is it to take a leadership position? Is it to focus on growth? Certainly, it is important to act in the members' best interest, but what if that is in conflict with what is best for the credit union movement? How does the credit union board reconcile those conflicts?

The acquiring credit union's challenge of the target credit union could be very sophisticated. The potential acquirer may bring in experts to explain the benefits of a potential merger, such as: the strength of the newly merged organization through the combining of assets; the advantages of economies of scale; the enhanced ability to meet regulatory burdens; the broadening of products and services; the expansion of the branch and ATM infrastructure; and an overall improvement in the organization's ability to withstand competitive forces. They'll bring up the fact that the new organization whole is greater than the sum of its parts. And if the targeted credit union still says no, the potential acquirer will emphasize the idea that the merger is in the members' best interest and, at the very least, the targeted credit union owes it to the members to allow them to vote on the issue.

If the target credit union stands firm, the potential acquirer may begin contacting the members of the target credit unions as a means of forcing a vote. At this point, certain questions come into play: What will the members do? How well does the suitor know the membership of the target credit union? How well does the target credit union know its own membership? Can members be enticed with financial incentives? As we mentioned earlier, the Nationwide Bank "premium" received a favorable vote by a 9-to-1 ratio.

To convince a board of directors to reconsider the merger proposal, the suitor needs allies. The suitor may instruct members of the target credit union to urge its board of directors to consider the potential merger. If the board is not receptive, the suitor can try to force a special meeting. According to NCUA rules and regulations, it takes a petition to request a special meeting of members. For a federal credit union, the requirement is 750 signatures or less (depending on the size of the credit union).

At the special meeting, the suitor would need to provide evidence that the merger would provide the members with better rates, fees, member services, branch infrastructure, etc. This will force the board of the target credit union to document why it's not in the best interests of the members to pursue the merger. This documentation process could be a very time-consuming and cumbersome task. It cannot be avoided with the argument that the board members are just volunteers. The board's fiduciary responsibility requires that the board counter the suitor's argument effectively to illustrate to members why the merger proposal has been rejected.

Many of these questions came into play during the Wings Financial FCU/Continental FCU case of 2007. We will go into greater depth about this case here and then draw lessons from the situation, which credit unions can use as a safeguard against potential unsolicited mergers that may arise in the future.

Case Study: Unsolicited Merger Offer

Potential Acquirer: Wings Financial Federal Credit Union

Target Credit Union: Continental Federal Credit Union

Wings Financial Federal Credit Union, based in Apple Valley, Minn., is currently the 53rd largest credit union in the country. The credit union was previously Northwest Airlines Employees Credit Union. While its original charter was specific to Northwest Airlines employees and family members, the charter was expanded in 2003 to include all airline employees, which opened the door for acquisition of other aviation-based credit unions.

After the expansion of its charter, Wings Financial FCU targeted Continental Federal Credit Union as a potential merger target and made several overtures to the credit union. On March 9, 2007, Wings Financial FCU sent a merger proposal to the board of directors of Continental FCU. At the time, Wings Financial FCU was $1.6 billion in assets, serving 110,000 members with 17 branches across the country. Continental FCU, based in El Segundo, Calif., had $177 million in assets and more than 25,000 members, who are primarily employees or former employees of Continental Airlines and US Airways.

The March 9 offer represented Wings Financial FCU's fourth unsolicited offer in an 18-month period to merge the two credit unions. Continental FCU had turned down the three previous offers, but this fourth effort made it clear that Wings Financial FCU would not be dissuaded by another rejection.

As part of its solicitation effort, the chair of the Wings Financial FCU board sent a letter to his counterpart at Continental FCU. The letter raised the question about the Continental FCU board's fiduciary responsibility and asked that credit union members be allowed to vote on the proposal. The letter stated:

> "Our proposal is clearly in the best interest of the Continental membership to whom you and your fellow board members each hold a duty of fiduciary responsibility. We trust that after you review the proposal, you will move expeditiously to act on that responsibility by allowing Continental members their right to vote on the proposed merger."[1]

On March 20, Continental FCU's board of directors voted unanimously by a vote of 7–0 to reject the merger proposal. However, Wings Financial FCU continued its merger solicitation, which included the promise of a $200 payment to each Continental FCU member, if the deal went through.

Well into the next month, Wings Financial FCU continued its efforts by visiting employees of Continental Airlines at its hub locations and making the case that the merger would be a positive development for members of Continental FCU because it would offer members lower loan rates, higher savings rates, lower fees and better service. Wings Financial FCU also established a Web site, at which Continental FCU employees could sign an online petition urging their credit union to move forward with the merger.

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1 Source: Press Release issued by Wings Financial, March 9, 2007, quoting Wings Financial FCU Board Chairman Donavan Mayer in a letter sent to Continental FCU Board Chair Alan Cooper.

As these actions were unfolding, there was a great hue and cry among those in the credit union movement who saw Wings Financial FCU's efforts as setting a dangerous precedent. The prospect of a "hostile takeover" was something that for-profit organizations, including banks, had had to contend with for years. But such a notion was considered antithetical to what the credit union movement was all about.

Several influential credit union organizations urged the NCUA to act in a way that would put an end to Wings Financial FCU's aggressive solicitation of Continental FCU's members. By mid-April 2007, NCUA came out with a ruling that stated the $200 payment per member was not permitted under the Federal Credit Union Act. Premiums could only be paid by the targeted credit union, not by the proposed acquirer in direct opposition to the targeted credit union's wishes. Wings Financial FCU expressed disagreement with the decision but agreed to withdraw the payment from the proposal.

On April 20, 2007, Wings Financial FCU officially withdrew its merger proposal and ceased its effort to take over Continental FCU. At this point, the post-mortem of the controversy began. Who would be able to take credit for stopping what had become widely known as the first-ever hostile takeover attempt in credit union history? Was it Continental FCU itself for standing firm and strong in face of an unwanted attempt to usurp its board of directors' authority? What is the NCUA, which asserted its regulatory muscle? Was it the credit union movement overall, which decried the attempt as damaging and dangerous? While it might seem at first glance that all of these entities could take credit for halting Wings Financial FCU's effort, surprisingly, the answer to that question is: none of the above.

What actually put an abrupt halt to the proceedings was the revelation that Continental FCU's membership base was not really who Wings Financial FCU thought they were. This was revealed in the visits to Continental Airlines' major hub locations, during which Wings Financial FCU representatives found out that only a small percentage of active Continental employees were actually members of Continental FCU. Wings Financial FCU's one-on-one conversations with employees indicated that members of Continental FCU were primarily older and, in many cases, retired workers of the airline. While Continental employees who listened to the Wings Financial FCU sales pitch liked what they heard, the merger would not bring these non-members into the Wings Financial FCU fold.

There was no way that Wings Financial FCU could have known this ahead of time. Wings Financial FCU had no access to information that would have revealed the composition of Continental FCU's employees. It was only through the direct solicitation of Continental employees after the merger proposal had been presented that Wings Financial FCU was able to determine the composition of Continental FCU and realize that its efforts would be better served elsewhere. So, Wings Financial FCU shifted strategies and decided to solicit Continental employees who were not currently members at Continental FCU to join Wings Financial FCU directly.

This is an ironic conclusion to an unsolicited merger attempt that has had lasting repercussions for the credit union movement. For its part, Continental FCU used the Wings Financial FCU experience to shore itself up against any future unwanted takeover attempts. What made Continental FCU vulnerable in the first place was that it was under performing in some key areas. The credit union had recognized this and was in the process

of taking corrective action, but the Wings Financial FCU overture caused Continental FCU to accelerate its plans.

Now, the credit union has substantially improved its numbers in such key areas as loan-to-share ratio and capital-to-assets risk. The credit union also has upgraded its services, adding access to 40,000 surcharge-free ATMs through its partnership with Credit Union 24, Tallahassee, Fla., and CO-OP Financial Services, Rancho Cucamonga, Calif., as well as adding 2,400 shared branches through a partnership with Financial Service Centers Cooperative, San Dimas, Calif. Continental FCU has put stronger emphasis on serving its members, which ultimately will protect it against unsolicited merger offers in the future. Within one year of the aborted Wings Financial FCU merger attempt, Continental FCU is a better-operating credit union.

Lessons Learned

There are several lessons that can be taken from this controversy. Credit union experts agree that the best defense against an unsolicited merger attempt is to make sure that you are serving your members to the best of your ability. It's a good idea to review your bylaws and also have a good strategic plan that outlines a growth path for the future.

As a direct result of the Wings Financial FCU/Continental FCU case, NCUA may act to establish guidelines addressing the subject of unsolicited merger offers. The governing body is in the process of gauging interest in the establishment of such guidelines. At this point, the only rule currently acting as a deterrent is that the solicitor cannot pay a dividend. This had ramifications in the Wings Financial FCU/Continental FCU situation, since Wings Financial FCU had offered to pay a $200 premium to members in the event of a successful merger. Wings Financial FCU could not pay that premium; only Continental FCU could. But since Continental FCU was obviously not in favor of the merger, the premium proposal died on the vine.

Several league boards have adopted resolutions outlining guidelines should an unsolicited merger attempt take place. An underlying theme in all these resolutions is the re-assertion of the right of the credit union board to approve or disapprove a merger proposal, since the board members are duly elected representatives of the credit union membership who are acting in the members' best interests.

Aside from the national and state credit union entities taking action to help protect credit unions in the event of an unsolicited merger offer, there are several safeguards that credit unions can take. They include:

- reviewing charter, bylaws and policies;
- making sure to draft your board minutes to be truly informative to your members (Drafting board minutes is an "art." Don't use "boilerplate" approach.);
- knowing your membership base (This is what doomed the merger of Wings Financial FCU and Continental FCU.); and
- communicating with members and assessing their satisfaction with products and services.

The key for your credit union to weather an unsolicited merger offer is to maintain a positive

relationship with members. If there is any underlying hostility that members have toward your credit union, such a sentiment could be enough to force a meeting to consider a merger, even if it is in direct conflict with the vote already taken by the board of directors.

To ensure that you are aware of your members' feelings, there is a need to stay in tune with the member base. You can do this in a number of ways—for instance, conducting member surveys, holding town hall meetings, soliciting their opinions during branch visits, etc.

Unsolicited merger offers can only be successful if a vote is forced by the members. If members are on your side, a vote will not happen and the threat will be avoided.

Merger Incentives

Merger incentives is one topic that came into question in both the successful Nationwide bank and credit union merger and the unsuccessful Wings Financial FCU/Continental FCU one. In the case of the Nationwide merger, the premium was acceptable because it was offered with the approval of the merging credit union. In the Wings Financial FCU/ Continental FCU merger, it was the potential acquirer offering the premium over the objection of the targeted credit union and thus it did not pass regulatory muster.

On the subject of cash distribution to members, NCUA currently prohibits per capita distributions for FCUs but may allow pro rata, which is based on share balance. Members are paid pro rata on relative deposit balances. In some transactions, members of credit unions were financially compensated a couple hundred dollars per person.

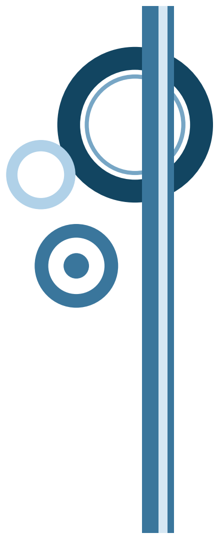
The idea of proposed merger incentives is an interesting one, however. NCUA has opined that a credit union member has rights that are similar to that of a stockholder of a corporation. This could be turned around and used against a credit union. Suitors are now looking to mergers of stock banks for ideas on paying members for their interests as part of the deal, while at the same time challenging the directors' fiduciary duties. The board has to come out and explain how it is upholding its fiduciary responsibility to the members.

The stakeholders in a merger are frequently compensated. So, the question arises: Should members of a target credit union likewise be compensated? If so, how and by how much? Who should be allowed to provide the compensation? Currently, incentives can only be paid with the approval of the targeted credit union. Will it always remain that way? Given the fact that banks are now potential merger partners, how will this affect the question of compensation?

At this point, there is much that we do not know. As stated previously, it is "uncharted" territory. Exactly what will happen in the future is yet to be decided. So, all we can do at this point is "stay tuned" for future developments.

Considerations for Credit Union Merger Planning

1. How "at risk" is your credit union as a potential target of an unsolicited merger offer? What actions could you undertake to lessen that risk?
2. How well do you currently know your credit union's member base? What actions could you take to strengthen the ties between your credit union and its members?



Chapter 5: Recent Regulatory Developments for Credit Unions

Inspection of Credit Union Records

As a safeguard against potential unsolicited merger offers, it is important for the credit union's motives to be transparent to members. If the credit union is perceived as having something to hide, there is less trust between the members and those who are running the credit union. This can be detrimental in the event of an unsolicited merger, making the credit union more vulnerable to such activities.

A recent regulatory action enhances the ability for credit union members to access information about their credit union's activities. On November 2, 2007, the NCUA finalized a new rule that significantly expands the ability of credit union members to inspect the corporate documents and records of a federal credit union. The new rule allows a group of members to petition their credit union to inspect and copy non-confidential portions of the credit union's books, records and minutes. This includes accounting information and meeting minutes of the board of directors and its committees.

Access to this information requires a petition that must be signed by not less than 1 percent of the membership, subject to the limitation of a minimum of 20 members and a maximum of 500 members. Each petitioning member must have been a credit union member for at least 180 days. The credit union must respond to the request within 14 days. Generally, regulation requires disclosure of all non-confidential materials upon request.

All corporate records regarding a potential merger (or any other transaction) should be properly documented and protected. This should not deter a credit union from discussing difficult but important issues. Protecting confidentiality is the key.

There are several potential pitfalls that may occur as a result of the new rule, including potential invasion of member privacy as well as potential interference with various business relationships that the credit union has with vendors, other credit unions, etc. Therefore, it is vital that the credit union thoroughly review any member petitions for hidden agendas on the part of the petitioning members.

In addition, credit unions would be wise to take precautions prior to the receipt of any petitions by doing an upfront inspection of their books, records, policies and procedures, including charter and bylaws, to make sure that they are up-to-date and capable of withstanding any scrutiny required by a member petition. It is also important that the credit union clearly identify those records that are confidential and thus should not be scrutinized by anyone other than authorized officers of the credit union.

Reincorporation of Bylaws into Federal Rules

Another major regulatory change is the reincorporation of bylaws into federal rules, which went into effect on November 30, 2007. This is a reversal of a 1982 decision, when NCUA determined that state and federal judicial systems were best positioned to handle bylaw disputes. It was a time-consuming pursuit for the NCUA to settle bylaw disputes, so the 1982 decision was allowed to stand for the next 25 years.

However, due to recent high-profile bylaw disputes between credit unions and their members, the NCUA has reincorporated the bylaws into its rules. NCUA now has jurisdiction over such disputes. This returns the jurisdiction to the NCUA, as it was before 1982. While the NCUA can enter disputes, the question arises if the NCUA has opened up Pandora's box. Will it become a time-consuming bureaucratic effort that will, once again, become too unwieldy for the governing body to manage?

Another negative that arises over both the inspection of credit union records and the reincorporation of bylaws into federal rules is the potential for abuse from a disgruntled member. Credit unions must be wary of members using their ability to seek a special meeting of the membership for their own personal gain. Perhaps they are seeking a board seat. Perhaps they are opposing a proposed transaction. Perhaps they are seeking to force a transaction or other board action (such as a special dividend payment). Make sure you are aware of a member's motives in calling the meeting and be prepared to respond in order to mitigate any potential abuse.

Fiduciary Duties of a Board in a Business Combination

We wanted to conclude our discussion of regulatory issues by reinforcing mention of the fiduciary responsibilities that credit union boards of directors must uphold. The general duties include duty of care and duty of loyalty.

Duty of Care

Duty of care requires that the board practice due diligence and be well-informed when it comes to making any decision related to the wellbeing of the credit union.

The duty of care can best be met by the business judgment rule, which essentially states:

> *If the board acts on an informed basis, in good faith, with a reasonable belief the action is in the credit union's best interests, with no conflicts, then the business judgment rule will protect decisions, even if they prove to be bad decisions.*

The duty of care also requires that the board act with the diligence and competence of a reasonably prudent person faced with the same decision. The board must make informed decisions based on all information that is reasonably available.

It may be necessary for the board to rely on others in order to exercise its duty of care—for instance, officers, experts, professional advisors, etc. This is allowed as long as the board has a good faith belief that the subject matter or material is within the competence of the expert and that the expert was selected with care.

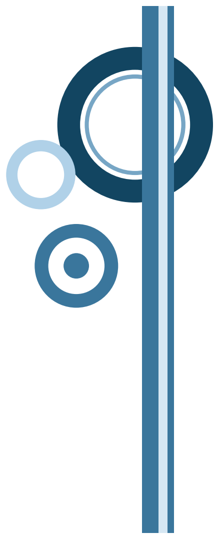
Duty of Loyalty

Duty of loyalty requires that the board put the interests of the credit union and its members before a board member's personal interests.

Conflicts may occur when a director is deriving personal benefits from a transaction. Loans, shares or existing business relationships may not necessarily result in a conflict, but all potential situations should be disclosed to the board and, if material, require recusal from voting or discussion.

Considerations for Credit Union Merger Planning

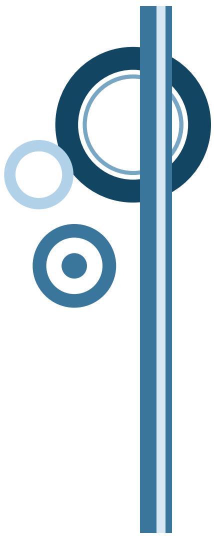
1. What is the current condition of your books, records and minutes? Could they withstand the scrutiny of a member petition? What could you do to improve them?
2. Consider the definition of duty of care. How well is the board of directors currently upholding this duty? What could be done to improve it?
3. Consider the definition of duty of loyalty. How well is the board of directors currently upholding this duty? What could be done to improve it?



Conclusion

As a board member, your responsibilities to your credit union continue to grow in complexity. Challenging economic conditions and human resources issues make the job of managing the credit union an increasingly difficulty task. For some credit unions, a merger is the solution to these challenges. Whether a merger proposal is right for your credit union or not, the issue of mergers is one that must be considered in your strategic outlook. Your credit union may be the target of a merger, you may seek out a merger partner, an unsolicited merger offer may be made or a merger may never come across your desk—whatever the case, your credit union should be prepared to take the course of action that will best serve your members.

The following planning worksheet is a compilation of the "Considerations for Credit Union Merger Planning" questions listed at the end of each chapter. Use the worksheet to begin evaluating your credit union's merger options. As your credit union works to develop a specific strategic plan, consider using *CUES Complete Guide to Mergers, Second Edition (cues.org/mergers/)*, an in-depth guide to rules and regulations that govern mergers.



Planning Worksheet: Considerations for Credit Union Merger Planning

I. The Lay of the Land

1. Has your credit union previously pursued a growth strategy that has included mergers? What were some of the advantages that you were able to achieve by pursuing such a merger?

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2. What type of merger strategy does your credit union have for the future? What are the economic and/or human resource considerations that are driving this strategy?

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3. How do you feel your credit union can reconcile its duty to its members and its duty to the credit union movement when it comes to pursuing a merger?

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II. Why Consider a Merger?

1. What advantages could be achieved by your credit union entering into a merger with a traditional merger partner?

2. What are the potential risks for your credit union in merging with a traditional merger partner?

3. Can you identify any potential traditional merger partners that would be a good fit for your credit union? What are the attributes that make these potential partners a good fit?

III. New Developments in Merger Partners

1. What are some of the potential advantages for credit unions merging with non-traditional partners?

2. What are some of the potential risks for credit unions merging with non-traditional partners?

3. What are some of the long-term ramifications of non-traditional mergers for the credit union movement? What do you see as a positive course of action that the credit union movement could undertake to counter any negative effects?

IV. Unsolicited Merger Offers

1. How "at risk" is your credit union as a potential target of an unsolicited merger offer? What actions could you undertake to lessen that risk?

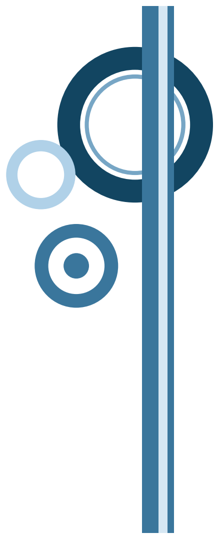
2. How well do you currently know your credit union's member base? What actions could you take to strengthen the ties between your credit union and its members?

V. Recent Regulatory Developments for Credit Unions

1. What is the current condition of your books, records and minutes? Could they withstand the scrutiny of a member petition? What could you do to improve them?

2. Consider the definition of duty of care. How well is the board of directors currently upholding this duty? What could be done to improve it?

3. Consider the definition of duty of loyalty. How well is the board of directors currently upholding this duty? What could be done to improve it?



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The Credit Union Executives Society is a Madison, Wisconsin-based independent membership association for credit union executives worldwide. Its mission is to educate and develop credit union CEOs, directors and future leaders.

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