



CUES Complete Guide to
MERGERS
SECOND EDITION



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By
Styskal, Wiese & Melchione, LLP



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This is not intended as legal advice. This manual is not intended to constitute nor be received as legal advice. No representation or warranty is made as to its accuracy or completeness. If you have any specific questions regarding credit union mergers, please contact your credit union's attorneys for assistance.

The views presented in this manual are those of the author. They do not necessarily represent CUES' views.



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About the Author

Styskal, Wiese & Melchione, LLP, was founded in 1974 by bringing together three of the leading practitioners of general corporate, commercial, and consumer law. Since 1987, the firm has devoted itself exclusively to the representation of credit unions and offers a full range of legal services.

As an AV-rated law firm that represents over 300 credit unions on a nationwide basis, the firm's services include advice regarding general corporate matters, real estate acquisitions and leasing, contract negotiations and drafting, the preparation of lending and savings documentation, personnel matters, and the representation of our clients in litigation. The firm's advice emphasizes its philosophy of preventative law.

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For more information about **Styskal, Wiese & Melchione, LLP**, please visit the firm's Web site at www.law4cus.com or call 818.241.0103.

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01

Introduction

This manual is written as a guide to assist your credit union in evaluating and acting upon one of the most important transactions that a credit union may consider—a merger with another credit union. A merger can be considered to have a life of its own. It has a cycle from inception as the thought or dream of one or more individuals through “closing the deal” and the actual merging of the credit unions. A merger can also be a tremendously emotional experience for volunteers, employees and members of a credit union.

Our goal is to review the steps in the “life cycle” that you may encounter through the merger process and to raise pertinent legal, regulatory, accounting, and business issues that you may wish to consider in your credit union’s journey through the merger process. Indeed, the various issues raised below are based on our observations of literally hundreds of credit union mergers and credit union conversions on which we have provided advice and counsel. To protect confidentiality and privacy, please note that cited examples are based upon a compilation of observed merger experiences and do not reflect any one specific merger.



Of course, this manual cannot anticipate every legal, regulatory, accounting, or business issue and it is not intended to provide legal, regulatory, accounting, or business advice for any particular transaction or merger. Moreover, because federal and state laws and regulations affecting mergers are constantly evolving, the discussion herein cannot be relied upon for up-to-the-minute, comprehensive coverage of the subject matter or your credit union's responsibilities under the law. Consultation with appropriate professionals—including your credit union's attorneys, accountants, business advisors, and, of course, your directors, volunteers, and your senior management team—throughout the merger process—is well advised. Even so, it is our hope and belief that our guidance will assist your credit union and its directors, volunteers and senior management employees in their merger journey. If nothing else, we believe that this manual will provide you with a road map and some comfort that you are headed in the right direction in evaluating and properly acting upon the issues that arise during your merger process.

Beyond this, we realize that different groups of constituents within each credit union may very well be affected—for good or bad—by the merger. This would include, for example, directors, volunteers, employees, the members, and other groups such as employer group sponsors, associational groups, and, on occasion, groups or entities seeking to represent the interests of the members. We have, at certain points, presented our observations of these various perspectives of the merger process. As you read this manual you may be tempted to turn to the sections that you believe are the most pertinent to your circumstances. We suggest, however, that you take a look at each of the presented perspectives to allow for appropriate context as you journey through the merger process.

We very much enjoy assisting credit unions in identifying, dealing with and resolving the legal issues that arise during the merger process. We hope that this manual will be of assistance to you and facilitate your credit union's merger process.

1.2 *A Word About State Law and Regulation*

The scope of this manual does not attempt to address the laws or regulations of any particular state. Rather, aspects of federal law, including the Federal Credit Union Act (FCUA) and Regulations of the National Credit Union Administration (NCUA) are referred to as the model most commonly known throughout the United States for credit unions. This does not mean that we have ignored aspects of state law which may play a very important part in your credit union's merger. To this extent, where state law issues arise, we have presented the issues from the perspective of the “common law” (that is, the general concepts shared by courts in many states). Consultation with counsel familiar with your state's law is therefore well advised when state law issues arise.

02

Types of Mergers/ Alternatives

As we begin our journey, it is important to establish early on the concept of a merger. Webster's Dictionary defines merger as "a merging; specifically the combination of several companies, corporations, [to] act as one..." This is a good starting point, although merger transactions can take a number of forms. For example, a merger can contemplate a "merger of equals," where two credit unions, essentially equivalent in size and complexity, merge together into the corporate structure of one of the credit unions or, on rare occasions, a new credit union charter is formed and both credit unions are merged into it. More typically, a merger refers to the combination of two credit unions where one of the credit unions (the Merging Credit Union or MCU) is merged with or into the continuing organization of another credit union (the Continuing Credit Union or CCU). As such, very often we discuss aspects of a merger from an MCU's perspective separately from a CCU's perspective. Even so, in a merger of equals each credit union should consider the MCU's perspective *and* the CCU's perspective, given the separate responsibilities for each credit union. This allows for a balanced evaluation of the merger for each of the equals.



As you read this manual, keep in mind that the hallmark of a merger is that the CCU obtains the advantages of the MCU's members and assets but also undertakes the MCU's liabilities and obligations.

2.2 *Voluntary Mergers*

This manual is primarily written from the context of a voluntary merger between credit unions with the consent of their respective boards, the MCU's members, and the appropriate regulatory authorities. This is due to our observation that voluntary mergers are the most typical type of merger for credit unions.

Various alternative transactions might contemplate the merger of a credit union or, in some cases, the assignment of only selected assets, selected liabilities, and the field of membership of a credit union into another credit union. These transactions range from charter conversions and merger into a bank to joint marketing agreements with other credit unions. Some of these transactions may be involuntary and due to regulatory action. As a rule of thumb, we refer to involuntary transactions in this manual as involuntary mergers.

2.3 *Involuntary Mergers*

Governmental authorities such as the NCUA, which regulates federal credit unions and federally insured state chartered credit unions, have a number of tools available to them to address troubled credit unions. Such tools may be applied when a troubled credit union is unable or unwilling to address its problems. For example, the regulator may apply administrative action such as a cease-and-desist order, a conservatorship, and/or an involuntary liquidation. Regardless of the form of the administrative action, the NCUA, as the overseer of federal share insurance, will more than likely act primarily to prevent or minimize loss to the federal share

insurance fund (i.e., the National Credit Union Share Insurance Fund (NCUSIF)).

Pursuant to this mandate, the NCUA has the power to force an involuntary merger. Such an involuntary merger may arise as a "supervisory merger," an "emergency merger," or as an agreement for the purchase and assumption of assets and liabilities (P&A agreement) by another credit union. While each of these three types of involuntary mergers are discussed in detail at Chapter 19, there is a significant difference between supervisory mergers and emergency mergers on the one hand and a P&A agreement transaction on the other. Simply put, a supervisory merger or an emergency merger will contemplate a merger in the classic sense, where the CCU undertakes the assets and the liabilities of the MCU. By contrast, a P&A agreement is a negotiated agreement with the governmental regulator whereby the CCU undertakes *only specified* assets and *only specified* liabilities of an MCU. The CCU is not responsible for the MCU's liabilities that are not specifically undertaken. A P&A agreement will be particularly important to a CCU when the MCU is insolvent or otherwise has liabilities and/or legal claims that are likely to exceed the assets of the MCU.

Consider just how this issue may affect a CCU. All parties to a merger, whether voluntary or involuntary, should keep in mind that the CCU will continue to serve the members of the MCU and the CCU following completion of the merger. As such, the members of both credit unions are best served if the CCU takes on liabilities for the MCU only to the extent that it is reasonable to do so and provided that such undertaken liabilities do not threaten the safety and soundness of the CCU. Failing this, the board of directors and senior management of a CCU may choose to seek an alternative candidate or consider whether a P&A agreement or other assistance may be forthcoming from a regulator, such as the NCUA (or a private share insurance company if the MCU

is a privately insured, state chartered credit union). Again, please refer to further, detailed discussions on involuntary mergers in Chapter 19.

Another type of possible involuntary merger, unheard of in the credit union industry until recently, is what is commonly known as a “hostile takeover.” With the first credit union hostile bid in 2007, regulators and credit union boards across the country have now had to deal with complex new merger related issues (even if a “targeted” credit union is not interested in a merger!). Chapter 20 discusses a number of issues raised by and some possible defenses to hostile merger offers.

2.4 *Consider Alternatives to a Merger*

Credit unions contemplating a merger should consider the reasons and goals for undertaking a merger and whether a merger or other alternative will be the best means of achieving the credit union’s strategic goals and meeting the needs of its members. While typical reasons for pursuing a merger are discussed in greater detail in Chapter 3, a credit union should perhaps first consider its alternatives and options before proceeding with or even considering a merger. That is, what is the gain to the credit union and what is the downside (assumed liabilities, for example) if the merger is completed? If the merger goes through, how will it affect the CCU’s operations and financial condition? Will the CCU be able to pursue other merger opportunities, or will it be able to pursue other strategic goals and opportunities that are contemplated under its strategic plan? What are the pros and cons to the MCU if it does nothing?

Particularly from the MCU’s standpoint, are alternatives available through networking opportunities that will allow the credit union to provide a broader array of services to its members without necessarily requiring a large capital investment? Examples might involve, for

example, participation in shared branch and shared ATM networks, loan participation agreements, and the use of other credit unions, and/or CUSOs to provide member services under a contractual arrangement.

Perhaps a credit union is experiencing difficulty in obtaining expanded opportunities under its current charter and a potential merger candidate has the right field of membership “fit.” This may be true, but due diligence should at least raise considerations of whether the desired field of membership expansion can be obtained through an alternative, such as conversion of the credit union’s charter from state to federal or federal to state.

Some believe that conversion to another type of financial institution might be something to consider in lieu of considering a merger—for example, conversion to a mutual savings bank or thrift. While a conversion to a bank charter might allow for opportunities for growth, a conversion also has the downside of taking the credit union away from the credit union cooperative movement and starts it on a well-worn path toward becoming a stock institution dominated by those with a majority of (or even a plurality of) shares. Bank conversion is briefly discussed in Chapter 21.

For potential MCUs that are very well capitalized, we have on occasion observed close consideration to a voluntary liquidation with distribution of “excess capital” (net of liabilities and obligations) to the members. Voluntary liquidation of an otherwise healthy and well-capitalized credit union is extremely unusual and perhaps a drastic event as continuing operations of the credit union essentially cease when the board makes the decision to voluntarily liquidate.

However, in lieu of a voluntary liquidation, the distribution of an “extraordinary dividend” should be considered by credit unions who are considering a merger as an MCU but find their net worth ratio to be far in excess of the net worth ratio of the

potential CCU merger partner. The point of an extraordinary dividend by a well-capitalized MCU is to bring its net worth ratio to a mutually agreeable point for purposes of a merger of the credit union into a CCU. In such case, the MCU's members have the benefit of a tangible return of some of their "retained" earnings and the CCU is not "unjustly enriched" by the excess capital of the MCU. (As noted in Chapter 11.4, please keep in mind that probable asset/share ratios are reviewed very carefully by credit union regulators during the merger process.) On the other hand, the CCU may argue that there should not be an extraordinary dividend to the MCU's members as the CCU's members have paid for the infrastructure for the services that the MCU's members will enjoy post merger. Ultimately, there is not a right or wrong decision on this issue. Rather, it is but one of many business decision points that will need to be negotiated and mutually agreed upon by MCU and CCU officials (and ultimately approved by the regulatory authorities) through the merger process.

As an alternative to liquidation or an extraordinary dividend, a credit union might also receive a proposal for a merger into a bank or other type of financial institution. While there is regulatory and industry resistance, it may be possible to merge instead into a bank. This option opens the door to sizable capital distributions to the members (a bank may very well pay a premium for credit union assets), but carries the downsides of loss of cooperative structure, loss of ownership or control for the members, loss of the credit union's unique culture, and likely the loss of jobs for employees and management. Thus, merging into a bank might provide a one-time benefit for the members, but it may not serve their interests in the long run. We discuss the "sale" of a credit union to a bank in Chapter 21.8.

Consideration of some or all of these alternatives may be a part of any merger. Many of the alternatives will likely be eliminated quickly due to the credit

union's circumstances. However, as discussed in Chapter 4, consideration of various alternatives will assist the credit union's board and management team in meeting their obligation to care for the interests of the members.