PENNSYLVANIA CREDIT UNION ASSOCIATION

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May 28, 2010

Ms. Mary F. Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

*Sent via email*

***Re: PCUA Comments on Notice of Proposed Rulemaking (Fiduciary Duties at Federal Credit Unions; Mergers and Conversions of Insured Credit Unions)***

Dear Ms. Rupp:

PCUA is a statewide trade association that represents the majority of the 554 credit unions located within the Commonwealth of Pennsylvania. PCUA and its member credit unions appreciate the opportunity to provide comments on the proposed rule intended to: i) document and clarify the fiduciary duties and responsibilities of federal credit union (FCU) directors, ii) add new provisions establishing the procedures for insured credit unions merging into banks, and iii) amend some of the existing regulatory procedures applicable to insured credit union mergers with other credit unions and conversions to banks.

The comments included in this letter are the views of PCUA's Regulatory Review Committee (the Committee) and PCUA staff. The Committee consists of twelve credit union CEOs who lead the management teams of Pennsylvania federal and state-chartered credit unions of all asset sizes.

**Background and Prior Comments:**

As a matter of background, this proposed rule is related to an Advance Notice of Proposed Rulemaking and Request for Comment (ANPR) from January of 2008. PCUA submitted comments on the ANPR in a letter dated April 28, 2008. In that letter we commented that inconsistency in the standard of care owed by officers and directors to the credit union and the members they serve is a problem. We encouraged NCUA to develop a standard fiduciary duty for officers and directors of *all* federally-insured credit unions.

The underlying theme of our 2008 letter on this topic was that our member credit unions (CUs) seek guidance and standards upon which they and the CU directors may confidently rely upon in administering their duties and responsibilities to the CU and the CU members they serve. We suggested that NCUA refer to Pennsylvania state law, which sets a standard for the fiduciary duty owed by directors of Pennsylvania for-profit and not-for-profit corporations. A copy of 2008 letter is attached for your convenience.

It is against the above backdrop that we raise the following concerns regarding the current proposal.

**Fiduciary Duties:**

Under the current proposal, the directors of a CU have a fiduciary duty to act in the best interests of the CU members. The proposed new subsection § 701.4(b) includes four paragraphs describing the duties of a FCU director. We note that the proposed rule regarding fiduciary duty standards applies generally to all of the actions of a FCU director, but imposes a higher standard of care for actions by the CU board that affect the members' ownership interests in the FCU and other fundamental rights.

Upon first impression, the general standards set forth in the proposal, which are expressly modeled, in part, on the existing rule on the powers and responsibilities of the board of directors of the Federal Home Loan Bank promulgated by the Federal Housing Finance Board and, in part, on the Model Business Corporation Act (MBCA) §8.30, appear reasonable. Notwithstanding the reasonableness of the standards, our group expressed concerns regarding the application of the standards.

Specifically, our concerns are related to the proposed revisions to the indemnification regulation. Section 701.33(c) states that a FCU may provide indemnification for its officials and employees and that indemnification shall be consistent with either the standards applicable to credit unions generally in the state in which the principal or home office of the FCU is located, or with the relevant provisions of the MBCA.

The commentary provided in the rule states that: "[t]he power to provide indemnification does not relieve a [FCU] of its responsibility to determine whether indemnification is appropriate under the circumstances. NCUA will monitor indemnification provisions for consistency with the indemnification standards chosen, for the safety and soundness implications for the institution, and for their application in a given case." (citations omitted).[1]

The proposal further states: "[t]he NCUA Board desires to ensure that FCU officials and employees are held personally accountable, where appropriate, for violations of their fiduciary duties. Accordingly, NCUA will not permit a [FCU] to indemnify officials and employees against liability based on an aggravated breach of duty of care when such a breach may affect fundamental member rights and financial interests." [2]

Accordingly, NCUA is proposing to amend § 701.33 by adding a new paragraph that limits a FCU's ability to indemnify an official or employee for personal liability related to any decision made by that individual on a matter significantly affecting the fundamental rights and interests of the FCU's members where the decision giving rise to the claim for indemnification is determined by a court to have constituted gross negligence, recklessness, or willful misconduct.

It is noted that existing provisions of the Federal Credit Union Act (FCU Act) hold directors and officers personally liable for monetary damages in civil actions brought by the NCUA Board as conservator or liquidating agent of an insured credit union for gross negligence. However, the proposed limitation to indemnification applies to the personal liability of directors or officers, whether to the NCUA Board (not necessarily as conservator or receiver) or other parties.

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[1] *See*, Fed Reg., Vol 75, No. 59, page 15578.
[2] *Id*.

It appears that NCUA is equating CU members to shareholders of for-profit companies. Shareholders certainly have the legal standing to challenge the actions of officers and directors of for-profit companies for deals gone bad, which are most commonly related to a decline in shareholder value.

However, under the proposal, there is the potential for NCUA to place itself in the shoes of the CU members and be the arbitrator of whether the decisions of the CU officials and employees were made in the best interest of the members with the only criteria being whether the "deal" put the most money in the pockets of the CU members.

Under Pennsylvania state law, both for-profit and not-for-profit corporations are permitted to consider the impact of other groups in making business decisions. A board of directors is entitled to a presumption that it acted in good faith. The presumption must be overcome in order to hold an individual director or officer personally liable.

As noted in the 2008 letter, Pennsylvania law generally provides the board of directors of a corporation with wide discretion to consider the interests of corporate stakeholders other than shareholders, and expressly provides that maximizing shareholder value is not necessarily the primary duty of the board. Directors may, in considering the best interests of the corporation, consider the impact on a number of corporate stakeholders, including shareholders, employees, suppliers, customers, creditors of the corporation and communities in which the corporation is located. The board is not required to deem any particular corporate interest as dominant and is allowed to determine the extent to which any interest should be factored into the equation for purposes of taking an action.[3]

The proposal potentially gives the executive branch, in this case, NCUA, an imbalance of power to promulgate the standards regarding the fiduciary duties of CU officers and directors and then encroaches on the judiciary branch's power to find them personally liable when the agency (not necessarily the members of the CU) determines that a transaction was not in the members' "best interest."

We also note for the record that the financial and accounting literacy requirements included in the proposed rule go beyond that of what is expected of the directors of other types of entities. Directors of FCUs are volunteers. Recruitment of qualified FCU directors is already a problem for many CUs, especially those of smaller asset sizes.

In conclusion, with regard to the fiduciary duties of officers and directors of CUs, we submit that NCUA should adopt standards that follow relevant state law. The proposed standards go too far and are not supported by a body of case law to assist CU officials and employees in applying them. In addition, for the reasons stated above, we do not believe that NCUA should place itself in the shoes of a CU member, thereby substituting the agency's judgment for that of the officers, directors and members, in determining whether the officers or directors of the CU acted in the members' best interest and are therefore entitled to indemnification.

[3] *See, Doing Public M&A Deals in Pennsylvania: Mindsweeper Required*, William G. Lawlor, Peter D. Cripps, and Ian A. Hartman, Dechert LLP (September 2005).

**New and Amended Procedures:**
**Enhanced Disclosures:**

Fundamentally, our group supports transparency in communications to CU members generally, and especially in transactions that affect the fundamental rights of CU members. Our group agrees and submits that the goal of the final rule should be: 1) to protect the rights of the CU members, which includes their right to increased and better financial products and services; and 2) to ensure that officers and directors of the CU are not unjustly enriched by personally benefiting at the expense of the CU membership.

While our group believes that the current disclosures required in CU conversion and merger transactions are adequate, our Committee did not object to the additional disclosure requirements included in the proposed rule for CU conversions to mutual savings banks and mergers with banks. In those instances, it is clear that the CU members' ownership and voting rights are potentially compromised. We agree that it is appropriate to require more and additional disclosures in those contexts versus mergers with other insured credit unions.

In addition to providing transparency, the conversion/merger-related disclosures should work to evidence that a credit union's board and management team have discharged their fiduciary responsibilities. At the same time, the disclosures should facilitate approval of the transaction. The content of the Notice of Intent to Merge and Request for NCUA Authorization (NIMRA) paints a vivid picture of the safety and soundness issues as well as the significant terms of a proposed transaction. Further the member disclosures outlined in sections 708a.305; 708a.306; 708a.310-312 fully alert the membership of their rights and privileges connected to the transaction.

Conversely, sections 708a.304(g) and 708a.308 give Regional Directors broad discretion when reviewing the NIMRA, member communications, the membership vote and related procedures to complete a transaction. Transparency must be a two-way street. The sections identified in this paragraph create significant potential for NCUA to micromanage a proposed transaction. For example, section 708a.304(g)(ii) states that approval of a NIMRA is not approval of a merger. This section combined with section 708a.308 can work unfair surprise to the credit unions and hurt consumer confidence if the NCUA approves a NIMRA, the membership approves the transaction and then NCUA denies the merger or orders another vote. NCUA's disposition of a NIMRA or its ultimate decision on a merger or conversion could actually or unintentionally expose a board and management team to allegations of culpability or breach of fiduciary duty. Therefore, some safeguards must be articulated in these rules.

The safeguards should include:

- Amending section 708a.304(g) to require that a Regional Director's denial or modification of a NIMRA be supported by written findings of fact and conclusions of law that specifically address any factual, operational or legal deficiency; and

- Amending section 708a.308(a)-(c) to require that a Regional Director's denial of merger be supported by written findings of fact and conclusions of law, which constitute final agency action pursuant to the Administrative Procedure Act, that specifically articulate where member communications, the vote or related procedures failed to comply with the regulation or the Federal Credit Union Act.

**Mergers:**

We suggest that merger plans to merge two insured CUs should include an explanation as to why the officers and directors of the CUs believe that a merger is in the best interest of the CU members. However, we submit that the impact of the merger on a CU's regulatory ratios is not an appropriate measure of determining whether the merger of the CU into another CU is in the best interest of the CU members. The calculation and impact of ratios is an accounting function. The ratios do not necessarily equate to whether the merger translates into value to the CU members.

In particular, we object to the provisions of the proposal that appear to mandate share adjustments if one CU has a higher net worth ratio than the other. For example, ownership value is only realized by a CU member if the CU liquidates, thereby ceasing to provide financial products and services to the CU members. We agree that a share adjustment *may* be included in a merger plan to increase value to the CU member where such an adjustment is appropriate. We also agree that the merger plan should include an analysis and explanation as to why a share adjustment was determined not to be in the best interest of the CU members.

We refer you again to our 2008 letter in which we commented that a requirement that a merger dividend be paid would dissuade, if not eliminate, mergers of CU of similar sizes. In those cases, the capital of the merging CU is often necessary to meet the regulatory capital requirements of the resulting CU. However, when there is clearly excess capital, the decision of the directors not to return the capital to the merging CU members should be substantiated and documented in the plan of merger to be voted upon by the membership. Again, if such analysis and explanation is disclosed, we submit that it should absolve officers and directors from culpability related to that aspect of the merger transaction.

Importantly, our members strongly agree that the criteria for determining whether a CU merger into another CU is in the best interest of the CU membership is much broader than contemplated in the proposal and necessarily includes whether the CU member gains access to broader CU products and more CU services. Often, the CUs involved in merger transactions use the excess capital to improve the products and services of the resulting CU and to make it more financially sound.

**Independent entity to tally and certify votes:**

We agree that CUs should use independent entities to prevent CU staff from accessing interim vote tallies during the balloting and to ensure that members learn the results of the membership vote for mutual savings bank conversions. We also support the use of secret ballots in the conversion context as well. However, we do not support requiring CUs to incur the additional expense of independent entities in less controversial transactions such as a merger of two insured CUs. At minimum, an exception to this requirement should be included for smaller CUs.

In conclusion, we encourage NCUA to continue to develop guidance regarding the fiduciary duties and responsibilities of federal credit union (FCU) directors and to improve the procedures for protecting CU members in transactions that affect their fundamental rights and interests. However, we question whether NCUA should attempt to legislate prudent behavior. Rather, it is our position that NCUA's focus should remain on safety and soundness and ensuring the stability of the CU movement for the members the CUs serve.

Thank you again for this opportunity to provide comments on this important proposal. Please feel free to contact me or any of the PCUA staff at 1-800-932-0661 if you have any questions or if you would like to discuss the contents of this letter.

Sincerely,

PENNSYLVANIA CREDIT UNION ASSOCIATION

Richard T. Wargo, Jr., Esq.
Executive Vice President/General Counsel

RTW:LSK:llb

cc: Association Board
Governmental Affairs Committee
Regulatory Review Committee
State Credit Union Advisory Committee
M. Dunn, CUNA