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DEAR CREDIT UNIONS: IN THIS CHALLENGING ENVIRONMENT, CAREFUL PLANNING IS ESSENTIAL TO SUCCESSFULLY EXECUTING A MERGER WITH ANOTHER CREDIT UNION

By Jeff Cardone, Partner, Luse Gorman, PC

Difficult economic conditions, increased funding costs and competition from larger institutions will continue to drive credit unions to combine to sharpen their competitive edge. The number of mergers of credit unions with assets of $500 million and above has increased in recent years, notably two of the largest credit unions in Minnesota, Firefly and TruStone, and New York, SEFCU and CAPCOM, recently joined forces. Despite the possibility of more mergers among large credit unions, mergers among small and midsize credit unions are likely to make up the bulk of the merger activity in the months ahead, as these institutions need scale to combat declining loan volumes, margins, and membership.

While credit union mergers of all sizes remain a sound growth strategy, there have been three credit union mergers since 2020 that have been voted down by members. Such risk of failure is a reminder that inadequate planning for a merger, including failing to negotiate and enter into a comprehensive merger agreement that sets forth in detail the terms and conditions of the merger and protects the rights of both the merging and continuing credit union, can lead to a failed transaction.

The current environment – intensified activism from members who may oppose a merger with a larger credit union and increased regulatory scrutiny – warrants parties to thoroughly plan for all aspects of their merger, which should include a shared vision that ensures the parties are aligned on cultural and operational matters as a combined entity and how the merger is in the best interests of members.

Keys to a Successful Credit Union Merger

1. A merger is a true partnership and should only be entered into with mutual commitment from the management teams and board members of both credit unions.

Boards of both the merging and continuing credit unions have a fiduciary duty to evaluate the merger and its benefits to members and must act accordingly. Boards should also recognize that other stakeholders – employees and other businesses and organizations in the communities served – will be indirectly impacted by an announcement of a merger. A merging credit union in a failed merger suffers greatly with potential runoff of members and employees and diminished goodwill in its local community. The same holds true for an acquiring credit union due to waste of time and resources and damaged credibility as a viable merger partner with other credit unions, particularly if the merger is voted down by members of the merging credit union.

Recognizing this, a credit union should not enter into a merger agreement unless it is wholly committed to the partnership. Dissident directors and executive officers who are not aligned with management and other board members on the merits of the merger increase the likelihood that a merger will fail.

2. A letter of intent should address key operational, social and personnel matters with specificity.

A letter of intent – a non-binding written agreement or term sheet between the parties outlining the principal terms of the prospective merger - should specify important operational and social matters in the combined credit union, including management roles, board and supervisory committee composition, name and branding, community commitments and the treatment of any CUSOs.

It should also thoroughly address key personnel matters to avoid any confusion or misunderstanding of the parties. The success of a credit union merger often depends on the retention of key employees of the merging credit union, particularly when an acquiring credit union is entering into a new market area or desires officer retention for succession planning purposes. Continuing and merging credit unions should consider the following personnel matters: (1) how/if compensation and benefit plans will be "right-sized" as a larger institution relative to its new peer group and when these discussions will take place; (2) the manner in which key employees will be incentivized, i.e., retention bonus pool and severance, the eligibility of which should be contingent upon their continued employment until the closing of the merger or the systems conversion date; and (3) a new employment agreement for the merging credit union's chief executive officer and other essential officers, the terms of which should be negotiated/finalized before the execution of the definitive merger agreement.

In sum, not addressing these operational, social and personnel matters sufficiently in the letter of intent may create deal risk for the merger that could have been avoided with careful planning.

3. A letter of intent is non-binding. Therefore, it is necessary to have a comprehensive merger agreement.

The best planned credit union mergers can still be jeopardized following the execution of a letter of the intent by a failure of the credit union parties to prepare and negotiate a definitive merger agreement that is legally binding on the parties. Unfortunately, many credit unions and their consultants fail to fully understand that the NCUA Form 6304 – Merger Agreement does not replace the need for a legally binding merger agreement, as the form is merely a certificate filed with the NCUA to effectuate the combination of the two institutions on the date provided therein.

While obvious that the merger agreement should reflect the terms of the letter of intent and other key business points, it should also provide for detailed representations and warranties (colloquially referred to as the "reps") and covenants, which are essential parts of a well-drafted merger agreement.

Reps are statements of fact (past, present and sometimes future) regarding all material aspects of each credit union party to the merger agreement, including their business, assets, liabilities, operations, and corporate authority to enter into the agreement. The reps serve two primary functions. First, they serve as an extension of the due diligence process by requiring disclosures of information that legally supplement the merger agreement. This enables credit unions to make meaningful discoveries of missed or unavailable information during due diligence that could affect the value proposition of the merger, which is especially significant when the parties desire to accelerate the merger process due to the nature of the merger – no deal consideration is paid - by reducing the scope of due diligence.

Second, the reps, if materially breached, may provide the non-breaching credit union with a walk-away right to terminate the merger before the closing. Because there will be a gap period – the period between the execution date of the merger agreement and the closing date to allow the parties to obtain the requisite regulatory and membership approvals for the merger - it is customary for the agreement to provide, as a closing condition, that the reps are true at closing, subject to applicable materiality standards. Thus, the reps effectively enable the parties to continue due diligence during the gap period, as any intervening event or condition that adversely impacts the merger must be disclosed and may provide the basis for a party to terminate the merger agreement.

A covenant is a contractual provision that obligates a party to undertake (an affirmative covenant) or refrain from taking (a negative covenant) a particular action for the benefit of another party. A credit union merger agreement should provide detailed pre-closing and post-closing covenants of the parties. Noteworthy pre-closing covenants include:

(1) the parties will continue to operate their businesses in the ordinary course during the gap period;

(2) the parties will work expeditiously to complete and file the NCUA merger plan and other required applications and notices, including for large credit union mergers the premerger notification to the U.S. Federal Trade Commission and the U.S. Department of Justice pursuant to the Hart-Scott Rodino Act;

(3) the merging credit union (and the continuing credit union if required by applicable law) must as soon as practicable hold a special meeting of members to approve the merger and will provide the requisite special meeting notice and ballot to members;

(4) the merging credit union will not solicit or enter into competing negotiations with another credit union (the "no shop provision"); and

(5) each party's board (as applicable) must recommend that the credit union's members vote in favor of the merger, which should be carefully written such that a breach would include any direct or indirect lobbying of members by a director or executive officer to vote against the merger. This has the two-fold effect of (1) providing the non-breaching party legal recourse – termination of the merger agreement or other legal or equitable remedies – against the breaching party and its representatives for engaging in such conduct; and (2) disincentivizing a dissident director or executive officer from undermining the voting process during the gap period. Additionally, a termination fee or expense reimbursement payable by the merging credit union for failure to obtain the member vote may be warranted, particularly if the merger is not unanimously supported by its board.

The post-closing covenants should address key business terms to occur after the merger, such as the appointment of new members to the board and supervisory committee, the name, headquarters and rebranding of the continuing credit union, treatment of CUSOs (merged v. remaining separate entities), the data processing conversion, and implementing new or modified compensation and benefits arrangements, base salaries, and bonus structures.

4. Planning for membership approval is paramount.

The NCUA and members will be focused on the disclosures and communications related to the merger. Therefore, continuing and merging credit unions should be cognizant of and plan for the following:

(1) A notice of the special meeting of members to vote on the merger (the "member notice") must be received at least 45 days but no more than 90 days before the special meeting date by members of the merging credit union. The board of the merging credit union should adopt resolutions

establishing the meeting date in advance of the mailing date of the member notice and consider appropriate communications to individuals who become members of the merging credit union after the mailing date but before the special meeting.

(2) A copy of the member notice must be provided to the NCUA at least 15 days before the mailing of the member notice (or equivalent state document). The NCUA will post the member notice on its website, which provides members with an opportunity to submit public comments on the proposed merger. Any comments received or comments posted on other social media forums should be closely monitored and evaluated from a public-relations standpoint as to whether a response is warranted.

(3) Certain merger-related financial arrangements for directors and certain executives (each a "covered person") of the merging credit union must be disclosed in the member notice, the completeness and accuracy of which must be certified to the NCUA by the presiding board officer and CEO of the merging credit union. As such, it is imperative to fully understand the scope of this disclosure, which will require quantifying the dollar amount of any merger-related compensation that will or *may* be payable to each covered person. For example, if the merger agreement provides all employees, including a covered person, is entitled to severance if he or she is terminated by the continuing credit union without cause within six months after the merger, the member notice must disclose the dollar amount that a covered person is *eligible to* receive.

(4) To ensure the integrity of the member vote (which could be questioned by dissident members and then investigated further by the NCUA), it is prudent to have appropriate documentation demonstrating that member notices were duly mailed to each eligible member within the prescribed time period before the member meeting and the ballot tabulations were done independently in compliance with NCUA rules and applicable state law.

Looking Ahead – Credit Union Mergers

With the pressure to achieve scale to withstand increased competition from other financial institutions and higher compliance costs, credit union mergers will continue to be a prevailing growth strategy. As such, adherence to the concept of careful merger planning, particularly being united on key cultural and operational matters, having a thorough letter of intent and comprehensive merger agreement, and adequately preparing for the regulatory approval process and member vote, is critical to successfully executing a credit union merger. It is also important that credit unions work closely with legal counsel that has a strong understanding of all phases of the merger process and with a financial advisor that can appropriately forecast the continuing credit union's pro forma net worth and risk-based capital and goodwill to be recorded upon the closing of the merger and how it will be amortized thereafter, which in this current regulatory environment will be scrutinized by the NCUA as part of its review of the merger.

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