

## OFFICE OF THRIFT SUPERVISION

### Denial of Application to Amend Bylaws

**Order No.: 2008-47**

**Date: December 5, 2008**

**Docket No.: H-4048**

Clifton MHC, Clifton, New Jersey (MHC) has submitted an application to the Office of Thrift Supervision (OTS), pursuant to 12 C.F.R. § 575.9(a)(4), proposing to amend its bylaws to establish a perpetual prohibition on service as a director if a person has been subject to a cease and desist order related to certain matters, issued by a banking agency, and to prohibit a person who is not qualified to serve as a director from nominating a director.

#### **Background**

Clifton Savings Bank (Bank) is a federally chartered stock savings association that completed its reorganization into a mutual holding company structure in 2004. Clifton Savings Bancorp, Inc. (Company), a federally chartered subsidiary mutual holding company, holds all of the Bank's stock. The MHC, a federally chartered mutual holding company, owns 61.49 percent of the Company's common stock. The members of the MHC, who are depositors in the Bank, have voting rights.

#### **Discussion**

Section 575.9(a)(4) requires that mutual holding companies have bylaws that conform to section 12 C.F.R. § 544.5 (the bylaw provisions that are applicable to federal mutual savings associations). Section 544.5 permits deviations from the model bylaws in certain circumstances, with OTS approval. OTS has discretion to disapprove bylaws that would render more difficult or discourage a merger, proxy contest, the assumption of control by an account holder of a mutual association, or the removal of incumbent management, and to disapprove bylaws that are inconsistent with the requirements of applicable laws, rules, regulations, or an association's charter.<sup>1</sup>

In this case, OTS must determine whether or not to permit the MHC to impose director qualification requirements of the type they have proposed. The proposed bylaw includes director integrity requirements that are more restrictive than are currently permitted pursuant to OTS's pre-approved optional integrity bylaw.<sup>2</sup> The OTS pre-approved optional bylaw does not restrict nominations for directors by persons who are subject to the integrity factors set forth in the pre-approved optional bylaw, while the proposed bylaw prohibits a disqualified person from nominating anyone. In addition, the pre-approved optional bylaw contains a ten-year restriction prohibiting service on a board of directors if a person has been subjected to certain cease and desist orders issued by a banking agency. The proposed bylaw makes the restriction perpetual.

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<sup>1</sup> See 12 C.F.R. § 544.5(c)(1) (2008).

<sup>2</sup> See Section 410 of the Applications Handbook.

Management can choose not to nominate any particular person for a seat on the board of directors. Therefore, even without adoption of the proposed bylaw, management may choose not to nominate a person who it finds unacceptable. Thus, the proposed bylaw would have the effect of limiting the ability of persons who are not aligned with management from being nominated or from nominating persons in opposition to management. Accordingly, it is appropriate to treat the proposed bylaw as an antitakeover provision. In doing so, the agency may consider the proper balance between the management and the voting members of the MHC.

The MHC has asserted that OTS should approve the proposed bylaw because: (1) OTS approved such a bylaw for another mutual holding company; (2) such a provision is not prohibited under either Delaware or New Jersey law or the Model Business Corporation Act (Model Act);, and (3) the bylaw would increase the public's trust in the MHC.

We have analyzed the justifications provided by the MHC for the proposed bylaw amendments and are not persuaded by those arguments. OTS has discretion to deny adoption of any proposed bylaw for a mutual holding company that is inconsistent with OTS's regulations. Similarly, OTS has discretion to deny applications to adopt proposed bylaws for policy reasons, when the agency has already set forth what is permissible by regulation or other written opinion, or for reasons of safety and soundness, or because the proposed bylaws are inconsistent with the purposes underlying OTS's regulations.

Federal savings associations and federally chartered mutual holding companies already may adopt a pre-approved bylaw that addresses the integrity of directors. The proposed bylaw differs from the pre-approved optional bylaw in two significant ways. First, the bylaw that the MHC has proposed would prohibit persons who are themselves prohibited from serving as a director from nominating an otherwise-qualified person to serve. Second, the bylaw that the MHC has proposed would establish a lifetime prohibition on director service, rather than a ten-year prohibition, for someone who has been subjected to certain banking cease and desist orders.

In 2005 OTS permitted a mid-tier mutual holding company to adopt a bylaw provision like the one sought by the MHC. See OTS Order 2005-13 (March 17, 2005). At the time, OTS indicated that it was approving the proposed bylaw because OTS believed that the institution should, in the first instance, make its own judgment concerning what was needed to protect it from risks that might be associated with persons of questionable integrity. Id. at 2. Such prior OTS action, however, does not compel the conclusion that the MHC's proposed bylaw must be approved. Rather, OTS may change its view, provided that it explains its reasons for its change of approach.<sup>3</sup> In this case, OTS subsequently received the MHC's and a number of other requests for approvals of

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<sup>3</sup> See National Home Equity Mortgage Ass'n v. OTS, 373 F.3d 1355, 1360 (D.C. Cir. 2004); Michigan v. Thomas, 805 F.2d 176, 184 (6<sup>th</sup> Cir. 1986).

similar bylaw provisions, and OTS determined to undertake a broader review of the relevant issues. In 2006, OTS proposed changing its regulations to permit savings associations to adopt an optional pre-approved bylaw that contained the same two features as provided in the MHC's proposed bylaw.<sup>4</sup> With regard to the restriction on nominations, OTS in its 2006 proposal expressed concern that an institution might suffer reputational risk in such a scenario, since the tainted person might be thought to have chosen nominees who he or she believes will pursue the same objectives as their sponsor, and this might engender the same reaction from the public as would the election of the subject person himself.

After further consideration, including a review of the comments submitted on this proposal, OTS withdrew its 2006 proposal in December 2007.<sup>5</sup> OTS concludes that the views the agency expressed when it issued OTS Order 2005-13 and the proposed rule were overstated, and that the proposed bylaw would, in any event, not be a particularly effective way to address those concerns.

The prohibition on nominating a director diminishes the property rights that members obtain when they become members of a mutual holding company that draws its members from an association that had member voting rights before the reorganization. Such a diminution raises serious questions, particularly where the membership-related documents do not reveal that those persons might be deprived of their right to nominate persons to serve on the board of directors. OTS is not persuaded that imposing this restriction is consistent with affording members a fair opportunity to nominate candidates for the board.

In addition, it appears that the proposed restriction on nominations would not be effective in preventing a member from presenting a nominee for election to the board. All the member would have to do is get any other member to make the nomination.

Furthermore, it is doubtful that a member with "bad" character would, simply by nominating a person of "good" character, damage the reputation or otherwise adversely affect the MHC. It appears that adoption of a prohibition regarding nominations exhibits management's lack of trust of the members, and we must be cognizant of the fact that management is supposed to serve the interests of the MHC and its members, not their own interests.

The other change from the pre-approved integrity bylaw is the removal of the ten-year limitation on the provision restricting service on the board of directors for a person who had been subjected to certain cease and desist orders issued by a banking agency. As noted above, OTS proposed in 2006 (and later withdrew) an optional bylaw containing this same perpetual prohibition. At that time, OTS noted that the perpetual

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<sup>4</sup> 71 FR 7695, February 14, 2006.

<sup>5</sup> 72 FR 72264, December 20, 2007.

prohibition was partly derived from OTS regulations at 12 C.F.R. § 563.39(b)(1), which permit a thrift's board to terminate an officer for cause, including personal dishonesty or breach of a fiduciary duty involving personal profit, and that it seemed reasonable to hold board members to at least a comparable standard of integrity. The agency observed that people need to be able to trust the institution that holds their money, and that a director whose reputation is tainted may injure an institution simply by being a member of the board.

The common law recognizes a corporation's right to impose reasonable qualifications on those who stand as candidates for a position on the board of directors. OTS now believes, however, that such a perpetual prohibition precludes the possibility of rehabilitation and ignores the fact that over time the governmental sanctions may become less relevant to a person's suitability as a director.<sup>6</sup> OTS concludes that a perpetual prohibition is inappropriate to protect the institution or its holding companies.

Finally, the MHC asserted that the proposed limitations on directors' qualifications would not be prohibited by either New Jersey law or Delaware law or the Model Act. It appears, however, that while the laws of those states and the Model Act might not explicitly prohibit such a provision, they might not permit it either. For example, the MHC, in its application, cited Section 109(b) of the Delaware General Corporation Law for the proposition that bylaws may contain "any provision, not inconsistent with law or the certificate of incorporation. . . ." But the MHC has failed to demonstrate that the proposed bylaw is consistent with either applicable law or the MHC's charter.

There must be a balance between the need for a board of directors of suitable integrity and a provision that would tend to entrench management. In weighing that balance, OTS concludes that the proposed bylaw would not promote significantly greater integrity among potential board members than the already existing pre-approved optional bylaw provision. In addition, OTS concludes that the proposed bylaw inappropriately entrenches management.

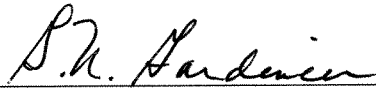
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<sup>6</sup> See OTS Order No. 2008-34, September 26, 2008.

**Conclusion**

Based on the foregoing, OTS concludes that denial of the application is appropriate, and the application is hereby denied.

By order of the Director of the Office of Thrift Supervision, or his designee, effective December 5, 2008.



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