



**Comptroller of the Currency
Administrator of National Banks**

Washington, DC 20219

June 9, 1997

Interpretive Letter #786

July 1997

12 U.S.C. 59

12 U.S. C. 83

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Re: [] (“Bank”)

Dear []:

This is in response to the Bank’s request for confirmation that it may elect the corporate governance provisions of Iowa law, and complete a reverse stock split in accordance with those provisions. For the reasons described below, we conclude that the Bank may, after filing an application under 12 C.F.R. § 5.46 and receiving OCC’s approval, effect the proposed reverse stock split by following the provisions of Iowa law.

Background

The Bank proposes to elect the corporate governance provisions of Iowa law through amendments to its articles of association (“articles”) and bylaws,¹ and engage in a reverse stock split as provided by Iowa law. The Bank proposes the reverse stock split to enable the Bank to convert to a Subchapter S corporation and to reduce its expenses in conducting shareholder meetings and providing disclosures to minority shareholders.

The Bank desires to reduce the number of its shareholders in order to be able to attain Subchapter S status. Accordingly, it would conduct the reverse stock split to increase []’ (“Holding Company”) ownership to 100 percent of the shares.

The Bank proposes first to decrease the par value of its shares, so that at all stages of the reverse stock split the par value would remain under \$100 per share. The Bank would then replace its outstanding common stock with new shares of common stock at a rate of 232.45 to

¹The Bank’s shareholders would approve an amendment to the articles that would elect Iowa corporate governance law in accordance with 12 U.S.C. § 21a, and the board of directors would adopt similar provisions in the bylaws.

1. As a result, all shareholders other than the Holding Company would own less than one share of the Bank's stock. The Bank would then pay cash to shareholders for fractional shares.²

Applicable Law

National banks may adopt corporate governance procedures that comply with applicable federal banking law and safe and sound banking practices. OCC regulations provide that

To the extent not inconsistent with applicable Federal banking statutes or regulations, or bank safety and soundness, a national bank may elect to follow the corporate governance procedures of the law of the state in which the main office of the bank is located, the law of the state in which the holding company of the bank is incorporated, the Delaware General Corporation Law, Del. Code Ann. Tit. 8 (1991, as amended 1994, and as amended thereafter), or the Model Business Corporation Act (1984, as amended 1994, and as amended thereafter). A national bank shall designate in its bylaws the body of law selected for its corporate governance procedures.

12 C.F.R. § 7.2000(b).

Iowa statutory law expressly permits state banks to conduct reverse stock splits. Iowa Code § 524.1509 (1991). Iowa statutes also contain provisions governing reverse stock split transactions. *See id.* at §§ 490.1302(d)(5) (dissenters' rights for shareholders whose interests are reduced to fractional shares that are acquired for cash), 502.102(f)(2) (stock splits other than reverse stock splits are not offers or sales of securities), 502.203(13) (reverse stock splits exempt from registration and filing requirements of state securities law), and 502.214 (limitations on takeover offers within two years after any of a number of listed transactions, including reverse stock splits).

The National Bank Act does not specifically address the authority of a national bank to effect a reverse stock split. Several sections of the National Bank Act, however, specifically provide for certain aspects of reverse stock splits and, when read together, permit those transactions. Section 59 permits a national bank to reduce its capital upon the vote of shareholders holding two-thirds of its capital stock and OCC approval. 12 U.S.C. § 59. A national bank may engage in a number of corporate combinations, including mergers and consolidations, but it must provide dissenters' rights. 12 U.S.C. §§ 214a-215a. Section 83 generally prohibits a national bank from purchasing, or making a loan secured by, its own stock. 12 U.S.C. § 83. The OCC has interpreted section 83, however, to allow national banks to hold treasury stock

² The Bank originally proposed to cash out minority shareholders at book value, but has amended the proposal to pay fair value, which may be greater than, or less than, book value. *See Security State Bank v. Ziegeldorf*, 554 N.W.2d 884 (Iowa 1996).

for legitimate corporate purposes, after obtaining OCC approval pursuant to 12 U.S.C. § 59. See 12 C.F.R. § 7.2020 and Interpretive Letter No. 660, *reprinted in* [1994-1995 Transfer Binder] Fed. Banking L. Rep. ¶ 83,608 (Dec. 10, 1994).

The OCC routinely approved national bank reverse stock splits until 1990,³ when the Court of Appeals for the Seventh Circuit concluded that a national bank's reverse stock split plan violated 12 U.S.C. §§ 83 and 214a-215a. See *Bloomington Nat'l Bank v. Telfer*, 916 F.2d 1305 (7th Cir. 1990). The OCC had approved the bank's plan to use a reverse stock split to freeze-out minority shareholders and become a wholly owned subsidiary of its majority shareholder holding company. The bank proposed to pay its minority shareholders less than 50% of the stock's fair value and did not provide shareholders dissenters' rights. The court based its decision in large part on the fact that the bank's proposed cash payment to the minority shareholders was below the fair value of the stock, and dissenting shareholder rights were not provided.

The court below had held that the bank's plan violated section 83, which prohibits national banks from purchasing or making loans secured by their own stock. See *Bloomington Nat'l Bank v. Telfer*, 699 F. Supp. 190 (S.D. Ind. 1988). The court rejected the OCC's argument that section 59, which permits a national bank to remit cash to shareholders for the purpose of reducing its capital, took precedence over section 83 and authorized the bank's plan. The court found that the only purpose of the bank's plan was the elimination of minority shareholders, and not a reduction in capital in accordance with section 59.

The court below also found that Congress and the OCC permitted national banks to use sections 214a, 215, and 215a to become wholly owned subsidiaries of holding companies. The proposed reverse stock split, while not technically a merger or consolidation, was the same type of transaction for which Congress had enacted dissenters' rights provisions in sections 214a, 215, and 215a to protect minority shareholders. The court concluded that the bank's attempt to structure a transaction to avoid dissenters' rights provisions was "contrary to the clear intent of Congress." *Id.*, 699 F. Supp. at 194. Because the National Bank Act provides explicit authority for freeze-outs only in sections 214a through 215a, and the Bloomington transaction failed to provide dissenters' rights available under those statutory provisions, the court found that the transaction violated those provisions.

³The OCC formerly allowed national banks to effect reverse stock splits that complied fully with applicable law. See Interpretive Letter No. 275, *reprinted in* [1983-1984 Transfer Binder] Fed. Banking L. Rep. ¶ 85,439 (Oct. 21, 1983). On occasion, national banks effecting reverse stock splits would find it necessary to raise their stock's par value in excess of the statutory limit of \$100 per share. See 12 U.S.C. § 52. National banks can comply with section 52 requirements by establishing a temporary account designated "capital over par." See Interpretive Letter No. 313, *reprinted in* [1985-1987 Transfer Binder] Fed. Banking L. Rep. ¶ 85,483 (Oct. 22, 1984). In this instance, the Bank has chosen to address this issue by decreasing the par value of its shares.

The Seventh Circuit also found that the proposed reverse stock split violated 12 U.S.C. §§ 83 and 214a-215a, after concluding that the transaction had no legitimate business purpose and failed to provide for dissenters' rights. The Seventh Circuit expressly declined to answer whether section 83 prohibits all reverse stock split freeze-outs, noting that its opinion was limited to the facts of the case. *Bloomington, supra*, 916 F.2d at 1308 n.4, 1309.

More recently, two other courts have considered whether the National Bank Act authorized the OCC to approve transactions in which national banks sought to cash out minority shareholders. The Court of Appeals for the Eleventh Circuit found that the OCC lacked the authority to approve bank mergers that required minority shareholders to accept cash for their shares while majority shareholders were eligible to receive stock in the resulting bank, even in cases where the minority shareholders had appraisal rights. *Lewis v. Clark*, 911 F.2d 1558 (11th Cir. 1990), *reh'g denied*, 972 F.2d 1351 (1991). Most recently, the Court of Appeals for the Eighth Circuit distinguished *Lewis v. Clark* and found that a national bank could cash out minority shareholders, consistent with the National Bank Act, as long as there is a valid business purpose for the transaction and the minority shareholders are entitled to dissenters' rights. *NoDak Bancorporation v. Clarke*, 998 F.2d 1416 (8th Cir. 1993).

A bank's decision to reduce the number of its shareholders to qualify for Subchapter S status is the type of business purpose courts have viewed as legitimizing reverse stock split transactions. *See Leader v. Hycor, Inc.*, 479 N.E.2d 173 (Mass. 1985); *Teschner v. Chicago Title & Trust Co.*, 322 N.E.2d 54 (Ill. 1974). Reducing corporate expenses and simplifying corporate procedures are also legitimate business purposes. *Teschner, supra*, 322 N.E.2d at 54.

Discussion

The Bank may adopt Iowa corporate governance procedures, to the extent that those procedures are not inconsistent with applicable Federal banking statutes or regulations. OCC regulation expressly permits a national bank to elect the corporate governance procedures of the law of the state in which the main office of the bank is located. 12 C.F.R. § 7.2000(b). Because the main office of the Bank is located in Iowa, the Bank may elect Iowa corporate governance procedures.

Iowa law allowing reverse stock splits are not inconsistent with applicable Federal banking statutes or regulations. No provision of Federal law expressly prohibits reverse stock splits. Several provisions of the National Bank Act authorize the elements of a reverse stock split, and when read together, allow a national bank to engage in a reverse stock split for a legitimate corporate purpose if dissenting shareholder rights are provided. *See also* Interpretive Letter No. 660, *supra*.

To effect the first element of the reverse stock split, the Bank proposes to amend its articles to decrease the number of authorized shares of common stock and to increase the par value of

each share. Banks may amend their articles by the vote of the holders of a majority of the voting shares of stock to determine the number and par value of bank shares. *See* 12 U.S.C. § 21a; *see also* 12 U.S.C. § 52 (par value may not exceed \$100 per share).

To effect the second element of a reverse stock split, the Bank proposes to replace each of the currently outstanding common stock with new common stock at the rate of one share of new common stock for each 232.45 shares of currently outstanding common stock. The Bank would pay cash for any fractional shares outstanding. National banks have express authority to pay the cash equivalent of fractional shares of stock. 12 C.F.R. § 7.2023(c). The cash equivalent must be based on the market value of the stock or, if no market exists, a reliable and disinterested determination as to the fair market value of the stock. *Id.*

Although 12 U.S.C. § 83 generally prohibits a national bank from purchasing its own stock, this prohibition is not absolute. Section 83 was enacted to prevent a national bank from impairing its own capital, and risking injury to creditors in the event of insolvency, by purchasing and holding its own capital stock. Letter from Donald N. Lamson, Assistant Director, Securities and Corporate Practices Division (March 27, 1992) (unpublished). The OCC has interpreted section 83 to permit a national bank's ownership of its own stock as long as a legitimate corporate purpose for the ownership exists. *See* 12 C.F.R. § 7.2020 and Interpretive Letter No. 660, *supra*.

Judicial authority also provides support for concluding that reverse stock splits for legitimate business purposes can be consistent with the National Bank Act. In *NoDak*, the Eighth Circuit held that national banks could effect freeze-out mergers to allow a holding company to obtain 100 percent ownership so long as the national bank has a valid corporate purpose and observes dissenters' rights. The *NoDak* court found that a national bank may engage in any merger not inconsistent with sections 214a, 215, and 215a, and that freeze-out mergers are not inconsistent with those sections. *NoDak, supra*, 998 F.2d at 1419-20, 1425.⁴ Thus, applicable statutory provisions and certain judicial precedent would permit reverse stock splits for legitimate business purposes, provided dissenters' rights are available.

The Bank has articulated legitimate business purposes in effecting a reverse stock split. The Bank currently has fewer than 75 shareholders and already may qualify for Subchapter S status on that account, but the Bank believes that it cannot currently obtain the unanimous shareholder consent required to become a Subchapter S corporation. *See* 26 U.S.C. §§ 1361(b)(1)(A), 1362(a)(2). Qualification for Subchapter S status requires obtaining unanimous shareholder approval as well as achieving the required maximum number of

⁴Although the Eleventh Circuit in *Lewis* held that national banks may not effect freeze-out mergers that require holders of stock of equal standing to take different forms of consideration, this is a minority view. The Seventh Circuit in *Bloomington* declined to determine if reverse stock splits would be permissible for valid business purposes if dissenting shareholders' rights were provided.

shareholders. Accordingly, the Bank can pursue the reverse stock split in order ultimately to obtain the unanimous shareholder approval for reorganizing as a Subchapter S corporation. Eliminating burdens associated with a large shareholder constituency is a proper business purpose. *Leader, supra*, 479 N.E.2d at 178. It also is a valid business purpose to effect a merger in order to reduce corporate expenses associated with shareholder communications and meetings. *Teschner, supra*, 322 N.E.2d at 58.

To avoid undermining the purposes of 12 U.S.C. §§ 214, 215, and 215a, however, a reverse stock split must provide shareholders reasonable dissenters' rights to ensure that they receive a fair price for their shares. Those dissenters' rights need not be identical to those located in sections 214a, 215, and 215a. Accordingly, the Bank may effect a reverse stock split as long as it has a valid corporate purpose for the transaction and observes appropriate dissenters' rights.

Iowa law governing reverse stock splits provides minority shareholders with dissenters' rights.⁵ Iowa Code § 490.1302(1)(d)(5) (1991). Banks must include notice of dissenters' rights with the notice for the meeting at which the shareholders will vote on the reverse stock split. *Id.* at § 490.1320. Any shareholder who wishes to dissent must give notice to the bank of intent to dissent and may not vote in favor of the reverse stock split at the shareholders' meeting. *Id.* at § 490.1321. After the meeting, the bank must send written notice to all dissenters concerning the procedure for demanding payment. *Id.* at § 490.1322. Dissenting shareholders must then demand payment, and the bank must make payment to the shareholders. *Id.* at §§ 490.1323, 490.1325. Any shareholder who is dissatisfied with the payment offered must provide the bank with an estimate of fair value. *Id.* at § 490.1328. The bank must then either pay the amount requested by the shareholder, or seek an appraisal from the court. *Id.* at § 490.1330. In an appraisal proceeding, the court has substantial latitude to assess fees and expenses of the proceeding against either party. *Id.* at § 490.1331.

The dissenters' rights for Bank shareholders under Iowa law afford comparable protections to the dissenters' rights provisions in the National Bank Act. Under both provisions of law, a minority shareholder in a reverse stock split has the right to dissent and receive fair value for

⁵Similarly, the National Bank Act provides for dissenters' rights. 12 U.S.C. §§ 214a(b), 215(b)-(d), and 215a(b)-(d). A dissenting shareholder must either vote against the merger, or give written notice of dissent prior to or at the shareholder meeting at which the shareholders vote on the merger. The value of the dissenting shareholder's shares is determined by an appraisal made by a committee of three persons: one chosen by the dissenting shareholders, one chosen by the directors of the bank (as it exists after the merger), and one chosen by the other two members of the committee. If the committee fails to determine a value of the shares, or a dissenting shareholder is not satisfied with the value determined, the OCC must make an appraisal of the shares.

the shares.⁶ The corporation makes the first offer of fair value, and minority shareholders may accept the offer or make a counteroffer. If the parties are unable to settle on the fair value of the shares, a state court (under Iowa law) or the Comptroller (under the National Bank Act) ultimately determines the fair value of the shares.

Conclusion

For the above reasons, we conclude that the Bank may, after filing an application under 12 C.F.R. § 5.46 and receiving OCC's approval, effect a reverse stock split. The application should be filed with Ellen Tanner Shepherd, Corporate Manager, Office of the Comptroller of the Currency, 2345 Grand Boulevard, Suite 700, Kansas City, Missouri 64108-2683; Ms. Shepherd can be reached by phone at 816-556-1860. If you have any questions concerning this letter, please contact Frederick G. Petrick, Jr., Senior Attorney, Securities and Corporate Practices Division, at 202-874-5210.

Sincerely,

/s/

Julie L. Williams
Chief Counsel

⁶The National Bank Act requires dissenting shareholders either to give written notice of dissent, or to vote against the merger. Iowa law requires dissenting shareholders both to give written notice of dissent, and not to vote in favor of the merger. This difference is not material because both codes provide a mechanism whereby a nonvoting shareholder may still dissent and receive payment for the shares.