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Comptroller of the Currency  
Administrator of National Banks

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Washington, DC 20219

August 10, 1999

**Conditional Approval #323  
August 1999**

Mark E. Aldrich, Esquire  
Aldrich & Bonnefin  
18200 Von Karman Avenue, Suite 730  
Post Office Box 19686  
Irvine, California 92623

Re: Merchants Bank of California, N.A., Carson, California ("Bank")  
Application Control Number: 98-WE-12-124

Dear Mr. Aldrich:

This responds to the Bank's application under 12 C.F.R. § 5.46 to elect the corporate governance provisions of California law and complete a reverse stock split in accordance with those provisions. Based on the representations and commitments made by the Bank, the proposed application is hereby approved, subject to the conditions set forth below.

**Background**

The Bank proposes to amend its bylaws to elect the corporate governance provisions of California law, and proposes to engage in a reverse stock split as provided by California law. The Bank proposes the reverse stock split to reduce corporate expenses associated with shareholder communications and meetings. In addition, the reverse stock split would facilitate a possible decision by the Bank to become a Subchapter S corporation.

The Bank proposes to conduct the reverse stock split through a multi-step process. First, the Bank intends to decrease the par value of its shares from \$0.10 to \$0.005 to ensure that the reverse stock split complies with the \$100 legal limitation on par value of common stock contained in 12 U.S.C. § 52. That reduction in par will reduce the Bank's common stock account from \$4,355,575 (43,555,750 shares at \$0.10 par) to \$217,778.75 (42,655,750 shares at \$0.005 par). The Bank would continue to meet its statutory minimum capital requirement by transferring the amount "in excess of par," \$4,137,796.25, from the common stock account to surplus.<sup>1</sup> The Bank will complete a reverse stock

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<sup>1</sup>See 12 U.S.C. § 51.

split at a ratio of 10,000:1 and increase par value to \$50. The Bank will pay \$0.035 per pre-split share, which it believes to be fair value, for fractional shares. The reverse stock split will reduce the number of shareholders of the Bank's stock from 237 to 68.

### **Applicable Law**

National banks may adopt corporate governance procedures that comply with applicable federal banking law and safe and sound banking practices. An OCC regulation provides 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.<sup>2</sup>

You have represented that California law authorizes corporations to effect reverse stock splits.<sup>3</sup> California law expressly provides for dissenters' rights in mergers and consolidations, but not in reverse stock splits.<sup>4</sup> You have represented that the Bank has agreed to provide the dissenters' rights provided in California Corp. Code § 1300 *et seq.* and to pay the costs of any resulting appraisal.<sup>5</sup> You have also represented that the Bank will provide for binding arbitration if a court declines to accept jurisdiction in any action seeking appraisal.<sup>6</sup>

### **Discussion**

The Bank may adopt California 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.<sup>7</sup> Because the main office of the Bank is located in California, the Bank may elect California corporate governance procedures.

California laws allowing for reverse stock splits are not inconsistent with applicable Federal banking statutes or regulations. No provision of Federal law expressly prohibits reverse stock splits. Several

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<sup>2</sup>12 C.F.R. § 7.2000(b).

<sup>3</sup> See also Cal. Corp. Code § 409(a)(2).

<sup>4</sup> See *id.* at § 1300 *et seq.*

<sup>5</sup> See Letter from Mark E. Aldrich to Mr. Frederick G. Petrick, Jr. (Mar. 25, 1999).

<sup>6</sup> See *id.*

<sup>7</sup>12 C.F.R. § 7.2000(b).

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 the bank provides dissenting shareholder rights.<sup>8</sup>

After reducing the par value of the Bank's shares to ensure compliance with 12 U.S.C. § 52, the Bank proposes to amend its articles of association to decrease the number of authorized shares of common stock and to increase the par value of each share. Banks may amend their articles of association 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.<sup>9</sup>

The Bank then proposes to replace each of the currently outstanding shares of common stock with new common stock at the rate of one share of new common stock for each 10,000 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.<sup>10</sup> 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.<sup>11</sup>

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.<sup>12</sup> 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.<sup>13</sup>

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 Bancorporation v. Clarke*, 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

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<sup>8</sup>See Interpretive Letter No. 786, *reprinted in* [1997 Transfer Binder] Fed. Banking Law Rep. (CCH) ¶ 81-213 (June 9, 1997), and Interpretive Letter No. 275, *reprinted in* [1983-1984 Transfer Binder] Fed. Banking Law Rep. (CCH) ¶ 85,439 (Oct. 21, 1983).

<sup>9</sup>See 12 U.S.C. § 21a; *see also* 12 U.S.C. § 52 (par value may not exceed \$100 per share).

<sup>10</sup>12 C.F.R. § 5.67(c).

<sup>11</sup>*Id.*

<sup>12</sup>Letter from Donald N. Lamson, Assistant Director, Securities and Corporate Practices Division (March 27, 1992) (unpublished).

<sup>13</sup>See 12 C.F.R. § 7.2020; Interpretive Letter No. 786, *supra*; Interpretive Letter No. 660, *reprinted in* [1994-1995 Transfer Binder] Fed. Banking Law Rep. (CCH) ¶ 83,608 (Dec. 10, 1994).

those sections.<sup>14</sup> 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. Eliminating the responsibilities associated with a substantial shareholder constituency is a proper business purpose.<sup>15</sup> It also is a valid business purpose to effect a merger in order to reduce corporate expenses associated with shareholder communications and meetings.<sup>16</sup> The Bank may also wish to become a Subchapter S corporation. Qualification for Subchapter S status requires obtaining unanimous shareholder approval as well as achieving the required maximum number of shareholders.<sup>17</sup> Accordingly, the Bank can also pursue the reverse stock split in order ultimately to obtain unanimous shareholder approval for reorganizing as a Subchapter S corporation.

To avoid undermining the purposes of 12 U.S.C. §§ 214a, 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.<sup>18</sup>

Although California law does not provide for dissenters' rights in reverse stock splits, the Bank has agreed to provide dissenters' rights under California law that are comparable to those under the National Bank Act.<sup>19</sup>

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<sup>14</sup>*NoDak Bancorporation v. Clarke*, 998 F.2d 1416, 1419-20, and 1425 (8<sup>th</sup> Cir. 1993). Although the Eleventh Circuit in *Lewis v. Clarke* 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. 911 F.2d 1558 (11<sup>th</sup> Cir. 1990), *reh'g denied*, 972 F.2d 1351 (1991). The only Federal Court of Appeals case to address reverse stock splits directly, *Bloomington Nat'l Bank v. Telfer*, 916 F.2d 1305 (7<sup>th</sup> Cir. 1990), decided on the facts that the transaction before it violated the National Bank Act. It declined to determine if reverse stock splits would be permissible for valid business purposes if dissenting shareholders' rights were provided. *Id.* at 1308 n.4, and 1309. The court also specifically noted that the decision was limited to the facts. *Id.*

<sup>15</sup>*See Leader v. Hycor, Inc.*, 479 N.E.2d 173, 178 (Mass. 1985).

<sup>16</sup>*See Teschner v. Chicago Title & Trust Co.*, 322 N.E.2d 54, 58 (Ill. 1974).

<sup>17</sup>*See* 26 U.S.C. §§ 1361(b)(1)(A) and 1362(a)(2).

<sup>18</sup>California law neither requires nor prohibits corporations from providing shareholders with advance notice of the right to dissent. Advance notice of dissenters' rights is important to allow minority shareholders to decide whether to exercise dissenters' rights.

<sup>19</sup>Under the National Bank Act, 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. 12 U.S.C. §§ 214a(b), 215(b)-(d), and 215a(b)-(d). Under California law, a dissenting shareholder may not vote in favor of the action. Within 30 days after the corporation sends a post-meeting notice of dissenters' rights, the shareholder must make a written demand on the corporation for fair value of the shares. If the dissenting shareholder and the corporation cannot agree on the fair value of the shares, the dissenting shareholder may, within six months after receiving the post-meeting notice, file a petition for appraisal in the appropriate state court. *See Cal. Corp. Code* § 1300 *et seq.*

Because California law does not provide for dissenters' rights in reverse stock split transactions, a California court might decline to hear any resulting appraisal action that may arise. However, the Bank has agreed to provide for binding arbitration if the court declines jurisdiction. Thus, dissenting shareholders (if any) will have access to a forum for the impartial valuation of their shares.

## **Conclusion**

For the above reasons, including the representations and commitments made by the applicant, we find that the reverse stock split application is legally authorized and meets the other statutory criteria for approval. Accordingly, this application is hereby approved, subject to the following conditions:

1. The Bank will elect the corporate governance provisions of California law.
2. Notwithstanding the corporate governance provisions of California law, the Bank will provide for dissenters' rights as described in Cal. Corp. Code § 1300 *et seq.*
3. Before completing the reverse stock split, the Bank will obtain shareholder approval of the transaction after disclosing to shareholders the dissenters' rights described in Condition No. 2.
4. If any shareholders dissent from the reverse stock split, the Bank will pay the cost of any appraisal that may occur.
5. If the appropriate court(s) decline to accept jurisdiction of an appraisal action, the Bank will provide for binding arbitration to conduct an appraisal.

Please be advised that the above conditions of this approval shall be deemed to be conditions "imposed in writing by the agency in connection with the granting of any application or other request" within the meaning of 12 U.S.C. § 1818(b)(1).

Please notify the OCC when the change in capital has been completed in accordance with this approval. The notification should state the date of the change, and the dollar amount of the reduction in the common stock and surplus account associated with the payment for fractional shares. The notification should include a certification that shareholders approved the change in capital structure according to law, regulations, and the Bank's Articles of Association. A secretary's certificate of shareholder approval and a certified copy of the amendment to the Articles of Association should be included. The notification should also include a statement that the change in the capital structure complies fully with all applicable laws and regulations. Upon receipt of the notification, the OCC will review the reduction in capital attributable to the payment for the fractional shares.

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Both statutory schemes provide mechanisms whereby a nonvoting shareholder may dissent and receive payment for the shares. Under both provisions of law, a minority shareholder in a reverse stock split has the right to dissent and receive fair value for the shares. If the parties are unable to settle on the fair value of the shares, a state court (under California law) or the Comptroller (under the National Bank Act) determines the fair value of the shares.

The reverse stock split should be completed within one year of the date of this letter. If you have any questions, please contact Frederick Petrick, Senior Attorney, Securities and Corporate Practices Division at 202-874-5210, Stephen Lybarger, National Bank Examiner, Bank Organization and Structure at 202-874-5060, or Scott Duncan, Special Supervision Analyst, Special Supervision/Fraud Division, at 202-874-4463.

Sincerely,

/s/

Julie L. Williams  
Chief Counsel