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REVERSE STOCK Splits AND Squeeze-Outs:
A NEED FOR HEIGHTENED ScrUTINy

Reverse stock splits¹ permit direct and relatively inexpensive elimination of minority shareholders in public or closely-held corporations. In public corporations, this technique allows the majority to achieve private status.² When controlling shareholders hold sufficient power to effectuate such corporate change, however, the possibility of minority oppression arises.³ Minority shareholders squeezed out by means of a reverse stock split have challenged the majority’s action as a breach of fiduciary duty. Courts have tested the majority’s use of a reverse stock split against various standards. To uphold its use, some courts require the

1. A reverse stock split is “the conventional stock split in reverse — instead of a company amending its charter so as to have more shares authorized and outstanding, the charter is amended so as to reduce dramatically the authorized and outstanding shares.” Dykstra, The Reverse Stock Split—That Other Means of Going Private, 53 CHI. KENT L. REV. 1, 3 (1976). See infra notes 8-11 and accompanying text. See also Lawson, Reverse Stock Splits: The Fiduciary’s Obligations Under State Law, 63 CALIF. L. REV. 1226 (1975) (specifically discussing reverse stock splits).


Other methods allow majority shareholders to eliminate the minority. A short-form merger, for example, permits the parent company, as majority shareholder holding a certain percentage of stock, to merge with a subsidiary without shareholder approval. Minority shareholders are cashed out in the process. See F. O’NEAL & R. THOMPSON, OPPRESSION OF MINORITY SHAREHOLDERS § 5.05 (2d ed. 1985); Weiss, The Law of Take-out Merger: A Historical Perspective, 56 N.Y.U. L. REV. 624 (1981). A long-form merger can accomplish the same result. In a long-form merger a parent corporation not holding sufficient stock to effectuate a short-form merger merges with a subsidiary. See, e.g., Tanzer v. International General Indus. Inc., 379 A.2d 1121 (Del. 1977) (parent merged with an 81% owned subsidiary and cashed-out minority shareholders). See generally O’NEAL & THOMPSON, supra, at § 5.04. Finally, the majority can make a tender offer for the shares of the minority.

majority shareholders to establish a compelling business purpose. Other courts require only that a legitimate business purpose support the majority’s actions. Reverse stock splits pose different risks to minority shareholders in public as opposed to close corporations in states that do and do not recognize an appraisal remedy when this technique is used. For this reason, courts should consider such factors in establishing an appropriate standard of review.

This note examines reverse stock splits and the varying judicial approaches to their use. Part I explains the mechanics of this technique, and highlights its associated advantages and disadvantages for majority and minority shareholders. Part II analyzes the various judicial standards employed in testing its use. Finally, Part III advocates a compelling business purpose standard and examines the application of this standard in the context of public and close corporations.

I. REVERSE STOCK SPLITS

A reverse stock split is a relatively simple statutory process that permits a corporate recapitalization. Most state corporate statutes provide that a corporation may amend its articles of incorporation to increase or decrease the authorized number of shares or to reclassify or cancel all or part of its share. Assume, for example, that five shareholders each hold 15,000 shares. Another 15,000 shares are distributed among 200 shareholders. By amending the corporate charter, the five majority shareholders can recapitalize the corporation and call for a 15,000 to 1 reverse stock split. Each controlling shareholder will retain one new share, with each minority shareholder retaining only a minute fraction. The ma-

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4. See infra notes 55-64 and accompanying text.
5. See infra notes 44-54 and accompanying text.
6. See infra notes 79-82 and accompanying text. A “close” corporation is one whose shares are not generally traded in the securities market. O’NEAL, supra note 3, at § 1.02.
7. See infra notes 76-78 and accompanying text.
8. See, e.g., DEL. CODE ANN. tit. 8, § 160 (1983) (authorizing corporation to purchase, redeem, exchange or otherwise deal in its shares); REV. MODEL BUSINESS CORP. ACT § 6.03 (1984) (hereinafter cited as Model Act) (allowing “reacquisition, redemption, or conversion of outstanding shares”).
9. Lawson, supra note 1, at 1227.
10. See, e.g., DEL. CODE ANN. tit. 8, § 242(b)(1) (1983) (requiring majority vote to amend articles of incorporation); MASS. ANN. LAWS ch. 156B, § 71 (Michie/Law. Co-op. 1979) (requiring two-thirds vote of each class to amend articles).
11. One share would be split among the 200 shareholders. See generally O’NEAL & THOMPSON, supra note 2, at § 5.10; Dykstra, supra note 1, at 3-4 (citing other numerical examples).
majority can then take advantage of statutory cash-out provisions\textsuperscript{12} and
cause the corporation to repurchase the outstanding fractional shares.
The majority remains in control of a recapitalized closely held corporation.
The process strips minority shareholders of their shares with the
controlling shareholders determining the fractional-share repurchase
price.

\textit{A. An Attractive Alternative}

A reverse stock split provides an attractive method for eliminating the
minority shareholders of a closely held or public corporation. In order to
eliminate the minority, the majority shareholders of a close corporation
need only hold enough votes to pass a charter amendment.\textsuperscript{13} Although
gathering the necessary votes poses some difficulty in a public corpora-
tion,\textsuperscript{14} a reverse stock split provides advantages over other methods
within its repertoire of going private techniques.\textsuperscript{15}

For a public corporation majority, a reverse stock split offers the ad-
vantages of certainty and finality in the elimination of minority interests.
After shareholder amendment of the certificate of incorporation, the di-
rectors merely set a price at which the corporation will repurchase the
outstanding shares.\textsuperscript{16} Unlike a tender offer, which may not attract
enough minority shares to complete the desired squeeze-out, there is no

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\textsuperscript{12} \textit{See}, \textit{e.g.,} \textsc{Del. Code Ann.} tit. 8, \textsection 155 (1983) which provides:
A corporation may, but shall not be required to, issue fractions of a share. If it does not
issue fractions of a share, it shall (1) arrange for the disposition of fractional interests by
those entitled thereto, (2) pay in cash the fair value of fractions of a share \ldots (3) issue
scrip or warrants \ldots which shall entitle the holder to receive a full share upon the surren-
der of such scrip or warrants aggregating a full share. \ldots
\textit{See also Model Act, supra} note 8, at \textsection 6.04 (provisions similar to Delaware). \textit{See generally Lawson, supra} note 1, at 1227 (discussing statutory provisions facilitating reverse stock splits).
\textsuperscript{13} \textit{See} supra note 10.
\textsuperscript{14} The number of shareholders in a public corporation is necessarily larger than in a close
corporation. In addition, if proxies are sought, sufficient information must be disseminated to satisfy
the securities laws. \textit{See infra} note 25.
\textsuperscript{15} \textit{See Dykstra, supra} note 1, at 4-10 (summarizing advantages of reverse stock split to public
corporation). \textit{But see} Robinson, \textit{Elimination of Minority Shareholders}, 61 N.C.L. \textsc{Rev.} 515, 516
(1983) (arguing that mergers are more readily accepted and approved because of the complex nature
of reverse stock splits).

\textsuperscript{16} The corporation is not free to set a grossly insufficient repurchase price. Minority share-
holders may have the right to an appraisal remedy under state law. \textit{See infra} notes 32-39 and accom-
plying text. In addition, courts have required that the minority receive a "fair price" in a going-
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need for a “mop-up” technique. 17 Second, a reverse stock split provides a comparatively inexpensive means of going private. 18 The majority need not offer a premium in excess of the current market price required in a tender offer to attract the minority’s shares. 19 Finally, a public corporation employing a reverse stock split avoids the legal and accounting fees necessary to draft agreement statements and Security Exchange Commission documents required for mergers and tender offers. 20

B. Costs and Minority Protections

A reverse stock split is not, however, without cost. The repurchase of minority-held fractional shares affects the short-term financial position of both public and close corporations. The corporation may have to expend millions of dollars from its capital reserves to eliminate the minority. 21 In addition, only financially sound 22 corporations can successfully effect squeeze-outs by way of reverse stock splits because corporation codes prohibit repurchase if insolvency will result. 23

Statutory protections granted minority shareholders impose additional cost. Securities and Exchange Commission (SEC) proxy regulations and disclosure requirements 24 are examples. To amend the corporate char-

17. Dykstra, supra note 1, at 7. A “mop-up” transaction may consist of a short-form merger or tender offer designed to fully eliminate minority shareholders not reached in the original transaction. A reverse stock split itself may be used as a mop-up technique following another form of going-private transaction. See, e.g., Teschner v. Chicago Title & Trust Co., 59 Ill.2d 452, 322 N.E.2d 54 (1974) (discussed infra notes 44-48 and accompanying text).
18. Dykstra, supra note 1, at 7-8.
19. Id. at 8. This results because of the “involuntary” nature of the reverse stock split with respect to minority holders. Id.
20. Id. at 7-8. Submitting to shareholder vote a merger or other plan of acquisition, other than a reverse stock split and other specifically excluded transaction, is deemed to be an “offer to sell” or “sale” within the meaning of § 2(3) of the Securities Act of 1933. 17 C.F.R. § 230.145(a) (1985). Consequently, a registration statement must be filed and a prospectus distributed before such transactions may proceed. Securities Act of 1933, 17 U.S.C. § 77e (1985).
21. Dykstra, supra note 1, at 17. In Leader v. Hycor, Inc., 395 Mass. 215, 479 N.E.2d 173 (1985), the corporation paid out $5.00 a fractional share for 19% of the outstanding stock. This required an expenditure of approximately $300,000. Id. at —, 479 N.E.2d at 174-5.
22. One article suggests that a corporation would not go private unless it foresees good times ahead, preempting concerns about capital reserves. Brudney & Chiolifstein, supra note 2, at 1369.
23. See, e.g., DEL. CODE ANN. tit. 8, § 160(a)(1)(1983) (prohibiting purchase or redemption of stock when “the capital of the corporation is impaired or when such purchase or redemption would cause any impairment of the capital…”); MODEL ACT, supra note 8, at § 6.40 (prohibiting share repurchase if corporation is unable to pay its debts or if its total assets would be less than its total liabilities plus amounts needed to satisfy all preferential rights on dissolution).
24. See supra note 20 and accompanying text.
ter, a public corporation must prepare and disseminate the necessary proxy materials. In addition, rule 13e-3 imposes substantial disclosure requirements on going-private transactions. The corporation must make extensive disclosures concerning the purpose of the transaction, the alternatives considered and the effects on the shareholders. Further, the corporation must summarize all material reports, opinions and appraisals prepared by legal and accounting sources, state whether the corporation reasonably believes the transaction fair and disclose available remedies. These requirements impose substantial cost in the form of fees paid to appraisers, accountants, lawyers and printers.

State appraisal right statutes where they provide a remedy for minority victims of reverse stock splits also increase the costs of employing this technique. Such statutes grant shareholders the right to dissent from a proposed corporate activity and obtain payment for their shares. If the shareholder is dissatisfied with the payment offered, he may notify the corporation of his estimate of fair value. In the event of disagreement, a court determines the fair price.

27. 17 C.F.R. § 240.13e-100, Item 7 (1985) (Schedule 13E-3).
28. Id. at Item 9. If such opinion or appraisal relates to the fairness of the consideration, the corporation must state whether the corporation or an outside source recommended the amount of consideration and summarize the method used in arriving at the findings. Id.
29. Id. at Item 8. The material must discuss “in reasonable detail the material factors upon which the belief . . . is based.” Id. at Item 8(b).
30. Id. at Item 13(a). The issuer also must disclose whether an appraisal remedy is available. Id. In addition, specific financial data concerning the issuer corporation must be furnished. Id. at Item 14.
31. See Dykstra, supra note 1, at 12.
32. See, e.g., Del. Code Ann. tit. 8, § 262 (1983) (any stockholder who “has neither voted in favor of the merger or consolidation nor consented thereto in writing . . . shall be entitled to an appraisal by the Court of Chancery of the fair value of his shares . . . ”); Model Act, supra note 8, at § 13.02(a)(providing shareholder with right to “dissent from, and obtain payment of the fair value of in shares” in the event of listed corporate actions).
33. See Model Act, supra note 8, at § 13.28.
34. Id. at § 13.30. Under Delaware provisions, each shareholder wishing to take advantage of his appraisal rights must notify the corporation prior to the merger or consolidation. Del. Code
All states provide an appraisal remedy to shareholders squeezed out by merger or consolidation, but none expressly authorizes appraisal in the event of a reverse stock split. Some courts have implied, however, that appraisal is available. In addition, the American Bar Association and other commentators have urged the amendment of appraisal statutes to address this situation. Even if the availability of an appraisal remedy is assumed, the protection afforded close corporation minority shareholders remains inadequate. Fair valuation of close corporation stock is extremely difficult because of the absence of a ready market for close corporation shares. Minority shareholders in close corporations, therefore, must rely on the judiciary to protect their interests from majority oppression.

ANN. tit. 8, § 262(d)(I) (1983). The shareholder and corporation do not have the opportunity, as such, to reach an agreement on price. Rather, the court determines fair value for all wishing to exercise appraisal rights.

35. See Seligman, Reapprasing the Appraisal Remedy, 52 GEO. WASH. L. REV. 829, 831-32 (1984). But see Robinson, supra note 13, at 525 (noting that the 1983 revision of the Delaware appraisal statute was meant to include reverse stock splits).

36. See Leader v. Hycor, Inc., 395 Mass. at __, 479 N.E.2d at 178-79 (court implies that the lower court had used the appraisal statute); Clark v. Pattern Analysis & Recognition Corp., 87 Misc.2d 385, 387, 384 N.Y.S.2d 660, 662 (1976) (courts may intervene where fraud or illegality exists notwithstanding availability of appraisal remedies).

37. See MODEL ACT, supra note 8, at § 13.02(a)(4)(v) which provides for appraisal when an amendment to the articles of incorporation “reduces the number of shares owned by the shareholder to a fraction of a share if the fractional share so created is to be acquired for cash . . . .” See also Lawson, supra note 1, at 1247-48 (urging the amendment of appraisal statutes to include reverse stock splits).

38. See Thompson, Squeeze-Out Mergers and the “New” Appraisal Remedy, 62 WASH. U.L.Q. 415, 433 (1984). See also Comment, Recent Developments in the Law of Corporate Freeze-Outs, 14 B.C. IND. & COM. L. REV. 1252, 1255-56 (1973) (appraisal is insufficient because it provides an exclusive remedy, does not consider shareholder’s desire to remain in the corporation, offers less than true value for shares, provides an inadequate remedy for close corporation shareholders and results in unfavorable tax consequences).

39. Thompson, supra note 38, at 433. Salaries, bonuses and retirement benefits, which significantly affect earnings in a close corporation, influence value. Id. In addition, Professor Thompson notes that close corporation shareholders may consider the corporation as more than a mere investment. Id. Accord Note, Freezing Out Minority Shareholders, 74 HARV. L. REV. 1630, 1640 (1961).

An appraisal remedy, if available, is generally exclusive. This represents an additional deficiency. Appraisal may result in a “minimum fair value” cash-out if the price received approximates the lowest market value, excluding payment for potential future profits expected to result from the reverse stock split or merger. See Vorenberg, Exclusiveness of the Dissenting Stockholder’s Appraisal Right, 77 HARV. L. REV. 1189 (1964). But see Thompson, supra note 38, at 428 (suggesting that judicial application of appraisal has created a standard providing the minority with “at least a portion of the gain created by the transaction.”).
II. JUDICIAL ANALYSIS OF STOCK CONSOLIDATIONS

The first step in a reverse stock split, amending the corporate charter, requires only majority approval.40 Courts have recognized that actions requiring less than unanimous agreement present the possibility of damage to minority interests.41 Consequently, courts have held that controlling shareholders, like directors, owe a fiduciary duty to the minority.42 Judicial interpretations of this duty, while allowing management flexibility, prevent the majority from forcing minority shareholders to relinquish their interests in the absence of a business purpose for the resulting freeze-out.43 Courts have adopted differing standards for analyzing the business purposes offered by controlling shareholders as justifications for their actions.

A. Deferential Standards

In several cases, courts have adopted a deferential approach to the board of director’s decision to employ a reverse stock split. Under this approach, courts do not seriously examine the legitimacy of the business purposes asserted by the directors. In Teschner v. Chicago Title & Trust Co.,44 the majority employed a 600 to 1 reverse stock split as a mop-up technique following a tender offer.45 The majority justified the recapitali-

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40. See supra note 10.
41. See supra note 3.
42. See Pepper v. Litton, 308 U.S. 295 (1939). The Court stated that: [the controlling shareholder] who is in such a fiduciary position cannot serve himself first and his cestuis second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. . . . He cannot utilize his inside information and his strategic position for his own preferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. Id. at 311. See also Donahue v. Rodd Electrotype Co., 367 Mass. 578, 585, 328 N.E.2d 505, 513-15 (1975) (stating that the controlling group in a close corporation owes the minority substantially the same fiduciary duty that partners owe one another); cases cited supra note 3.
43. The Pepper standard generally has been interpreted to prohibit unequal treatment and self-dealing by the majority. See Brudney, Equal Treatment of Shareholders in Corporate Distributions and Reorganizations, 71 Calif. L. Rev. 1072, 1091-98 (1983); O’Neal & Thompson, supra note 2, at § 7.17 (discussing self-dealing — the use of a controlling position to augment the fiduciary’s personal wealth). If self-dealing exists, courts usually require that the fiduciary demonstrate the inherent fairness of the transaction. See, e.g., Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); Berkowitz v. Power/Mate Corp., 135 N.J. Super. 36, 342 A.2d 566 (1975). One commentator concludes that all going-private transactions involve at least tacit self-dealing. Note, supra note 26, at 811.
44. 59 Ill.2d 452, 322 N.E.2d 54 (1954), appeal dismissed, 422 U.S. 1002 (1975).
45. Id. at 454, 322 N.E.2d at 55. Lincoln National Corp., the majority shareholder, offered
zation as necessary to reduce expenses and simplify corporate procedures. The plaintiff, a minority shareholder squeezed out during the process, sought to retain her shareholder status. The Illinois Supreme Court held that in the absence of a claim for fraud a stock reclassification for the purposes stated did not violate the controlling shareholders’ duty to the minority.

In Cross v. Communication Channels, Inc., a closely-held corporation used a reverse stock split to remove five percent of the minority shareholders. The corporation followed this action with a short-form merger that eliminated the remaining minority shares. The majority justified its actions as necessary to save administrative costs, resolve conflicting shareholder desires for growth and dividend distribution, and rid the corporation of a competing minority shareholder. The court approached the problem as a merger case and held that judicial intervention is inappropriate unless the corporation fails to offer a valid business purpose for its action. Accepting the propriety of the purposes offered, the court approved the majority’s action.

shares of its stock for that of Chicago Title. The tender offer netted 99.9% of the outstanding shares. The reverse stock split resulted in 3722 shares outstanding with a par value of $4000 per share. Id.

46. Id. at 459, 322 N.E.2d at 58.
47. Id. at 453, 322 N.E.2d at 55.
48. Id. at 456-58, 322 N.E.2d at 57-58. The court noted that the statutes authorized stock reclassification and cash-out of fractional shares. In addition, the court noted that the opportunity existed to use the short-form merger statute to eliminate the minority. The court deferred to the board’s judgment and concluded that the actions of the majority were valid in the absence of a claim of fraud or challenge to the business purpose. Id. One commentator argues that the court treated the plaintiff’s claim as analogous to a strike suit. Dykstra, supra note 1, at 20.
50. Id. at 1020, 456 N.Y.S.2d at 972.
51. Id.
52. Id. at 1021, 456 N.Y.S.2d at 973. The plaintiff was an officer and principal shareholder of a competing publication. All minority shareholders, except the plaintiff, accepted $3.25 per share for their remaining fractional shares. Id.
53. Id. at 1022, 456 N.Y.S.2d at 974. The court noted that New York merger law allows judicial intervention upon a showing of fraud or illegality, concealment or nondisclosure, breach of duty, or inequitable dealing with minority holders in the absence of a valid business purpose. Id. at 1021, 456 N.Y.S.2d at 973 (citing Tanzer Economic Assoc. v. Universal Food Specialties, 87 Misc.2d 167, 176, 383 N.Y.S.2d 472 (1976)). The plaintiff claimed his elimination from the corporation as inequitable, and the court examined the business purposes cited and stated that the business judgments offered were independently sufficient. Id. at 1022, 456 N.Y.S.2d at 974.
54. Id.
B. The Heightened Business Purpose Test

In several cases, courts have applied a heightened level of review to director decisions to use reverse stock splits. Under this approach, courts require the directors to substantiate the business purposes they assert. In Clark v. Pattern Analysis & Recognition Corp.,\textsuperscript{55} for example, a New York appellate court confronted a corporate recapitalization involving a 4000 to 1 reverse stock split.\textsuperscript{56} The directors asserted that the elimination of non-employee shareholders and the promotion of financial statement confidentiality justified the consolidation.\textsuperscript{57} The court rejected the purposes offered, and noted that only a "strong and compelling" business purpose could justify a reverse stock split.\textsuperscript{58} The court further stated that majority shareholders may not deprive the minority of its shares when allegations of fraud, illegality, or bad faith are coupled with a tenuous showing of corporate purpose.\textsuperscript{59}

In Shivers v. Amerco,\textsuperscript{60} the Ninth Circuit, applying California law, reversed a summary judgment in favor of the directors on a claim alleging breach of fiduciary duty.\textsuperscript{61} The corporation had effected a 100 to 1 reverse stock split for the asserted purpose of preventing purchases by unsophisticated investors who might rely on false or misleading information.\textsuperscript{62} The court remanded and directed the district court to determine whether the majority had offered a compelling business purpose for its action.\textsuperscript{63} The court noted that less drastic alternatives may have been available and that the technique's disproportionate impact on the

\textsuperscript{56} Id. at 386, 384 N.Y.S.2d at 662.
\textsuperscript{57} Id. at 391, 384 N.Y.S.2d at 665. The plaintiffs were former employees who had purchased shares during their employment.
\textsuperscript{58} Id.
\textsuperscript{59} Id. at 390, 384 N.Y.S.2d at 664-65. The court found that equitable intervention is proper when the controlling group breaches its fiduciary duty and the minority sustains damage, even if the corporation complies with the statutes. The court distinguished Teschner on this point, claiming that the Teschner court had not found wrongdoing or improper purpose. Id. at 389, 384 N.Y.S.2d at 664. The court found that the asserted purposes lacked credibility because non-employees remained shareholders after the action and the corporation had never issued financial statements. Id. at 391, 384 N.Y.S.2d at 665.
\textsuperscript{60} 670 F.2d 826 (9th Cir. 1982).
\textsuperscript{61} Id. at 835.
\textsuperscript{62} Id. at 834.
\textsuperscript{63} Id. at 835. The court relied on Jones v. H.F. Ahmanson, 1 Cal.3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969), in which the California supreme court ruled that management actions injuring minority shareholders are a breach of management's fiduciary duty unless a "compelling business reason" is shown. Shiver, 670 F.2d at 833-34.
minority may have been improper.64

C. The Hybrid Approach

In some cases, courts have purported to apply a heightened standard of review but in practice failed to subject the asserted purposes to searching scrutiny. In Leader v. Hycor, Inc.65 the Massachusetts Supreme Court addressed a minority shareholder's challenge to a 4000 to 1 reverse stock split. The directors asserted that limited trading in, and the disappointing market history of, the stock coupled with the absence of significant dividends justified their actions.66 Citing Clark, the court noted the potential for harm to minority shareholders that flowed from the directors' action.67 The court then placed the burden on the minority to prove a breach of duty by demonstrating that less harmful alternatives were available to achieve the desired result.68 Deferring to the lower court's conclusion that the minority had not met this burden, the court easily found the asserted purposes sufficient.69

IV. A Need for Heightened Court Scrutiny

The differing approaches to the validity of reverse stock splits discussed above belie judicial uncertainty concerning the appropriate standard of review for such corporate acts. This Note proposes that courts apply a two-part test to evaluate the legality of reverse stock splits. In all instances, controlling shareholders must assert legitimate business pur-

64. Shiver, 670 F.2d at 833-35. The majority owed 94% of the stock. Following the reverse stock split, the corporation offered to repurchase the fractional shares for 50% of book value and prevented the minority from advertising stock in the company newsletter. Id. at 828. The plaintiff established that the reverse stock split disproportionately affected minority shareholders by destroying the market for their shares while allowing the majority the opportunity to market their stock. Id. at 833.

66. Id. at __, 479 N.E.2d at 178.
67. Id. at __, 479 N.E.2d at 177.
68. Id. at __, 479 N.E.2d at 177. The court followed Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 851, 353 N.E.2d 657, 663 (1976), a close corporation case where the court established a two-part test: (1) did the majority demonstrate a legitimate business purpose; (2) if yes, did the minority establish that the majority could achieve the same result through a less harmful alternative? Leader, 395 Mass. at __, 479 N.E.2d at 177 (also citing Donahue v. Rodd Electrotype Co., 367 Mass. 578, 593, 328 N.E.2d 505, 515 (1975) (requiring the utmost good faith and loyalty)).
69. Leader, 395 Mass. at __, 479 N.E.2d at 178. The court also affirmed the lower court's determination that Leader was a close corporation. The court, however, readily accepted the purposes the controlling shareholders cited as supporting the action, which purposes are consistent with public status. Id. See supra note 6 for a definition of a close corporation.
poses to support the decision to employ this technique.\textsuperscript{70} Under the first part of the proposed test, courts should balance the interests of the majority against the interests of and protections afforded the minority.\textsuperscript{71} If minority interests are affected disproportionately and the court deems existing protections inadequate, the proposed test requires that the majority justify its use of reverse stock splits with substantial and compelling business purposes.\textsuperscript{72} The result of this initial balancing will differ depending upon whether a public or a closely held corporation employs the technique. In addition, the availability of an appraisal remedy will affect the outcome of the balancing test.

\textbf{A. Balancing Interests}

Majority shareholder interests in flexible management and business judgment, unencumbered by dissenting minority views, justify some discrimination against the minority. Such discrimination is an inherent consequence of minority status.\textsuperscript{73} The majority may, however, utilize this flexibility to eliminate minority shareholders,\textsuperscript{74} thus threatening minority interests in continued shareholder status, future returns from the enterprise, and the marketability and value of their shares.\textsuperscript{75}

State law provides some measure of protection for minority shareholders' interests. Appraisal statutes are designed to ensure that the minority receive fair value for their shares.\textsuperscript{76} However, because most state appraisal statutes, at present, offer a remedy only in the event of mergers, sales of assets and situations provided in the articles of incorporation,\textsuperscript{77}

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\textsuperscript{70} A legitimate business purpose is any valid business purpose that the corporation asserts as necessary. The proposed standard is similar to that adopted by courts applying a deferential standard to reverse stock splits. See \textit{supra} notes 44-59 and accompanying text.

\textsuperscript{71} See \textit{infra} notes 73-82 and accompanying text.

\textsuperscript{72} See \textit{infra} notes 83-85 and accompanying text.

\textsuperscript{73} See \textit{Note, supra} note 39, at 1646 (author also argues that a plaintiff challenging a freeze-out should have the initial burden of showing the controlling group's actions as discriminatory). \textit{But see} Brudney & Chirelstein, supra note 2, at 1365-70; \textit{Note, supra} note 26, at 811 (arguing that because of the potential for unequal treatment or tacit self-dealing, all going-private transactions are discriminatory).

\textsuperscript{74} See Thompson, \textit{supra} note 38, at 433.

\textsuperscript{75} Various commentators have noted the potential for harm to minority interests in a freeze-out. See, e.g., Thompson, \textit{supra} note 38, at 427 (loss of the option to participate in the new enterprise and reap future profits); Lawson, \textit{supra} note 1, at 1235-38 (reduction in stock liquidity resulting from decrease in the number of shares and increase in price of those remaining); Brudney, \textit{supra} note 43, at 1095-98 (potential for undervaluing shares).

\textsuperscript{76} See \textit{supra} notes 32-33 and accompanying text.

\textsuperscript{77} See \textit{supra} notes 35-37 and accompanying text.
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this protection may not be available. In addition, appraisal provides an inadequate remedy for close corporation minority shareholders. Therefore, even if the appraisal remedy becomes available in reverse stock splits, it would weight the balance in favor of the majority only in the context of challenges to actions by public corporations.

The federal securities laws also provide protection to the minority shareholders in a public corporation. Rule 13e-3 requires disclosure sufficient for minority stockholders to vote intelligently on necessary amendments to the articles of incorporation. This information does not, however, guarantee fair value for repurchased shares. In the absence of an available appraisal remedy, protections remain inadequate. When state statutes require appraisal, courts may find that sufficient protection exists to safeguard the interests of minority shareholders in public corporations. In such a case, courts should hold that the majority need only support its decision to employ a reverse stock split by offering a legitimate business purpose.

B. Substantial and Compelling Business Purpose

In most instances, the initial balancing will suggest the existence of substantial risks to minority interests. Under the second part of the proposed test, courts then should require the majority to support its use of a

78. See supra notes 38-39 and accompanying text.
80. 17 C.F.R. § 240.14a-1 to -12 (1985).
81. See supra notes 25-31 and accompanying text. If the majority possesses the statutory requisite number of votes to pass the needed amendments, however, disclosure offers little value. Rule 10b-5 also offers minimal protection to public and close corporation minority shareholders in the form of a prohibition on all fraud in connection with the purchase or sale of any security. 17 C.F.R. § 240.10b-5 (1985). See generally O'NEAL & THOMPSON, supra note 2, at § 5.34.
82. See Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983). Weinberger involved a short-form merger and cash-out of minority shareholders. Former minority shareholders challenged the action as a breach of fiduciary duty. The court found that, in the absence of fraud, illegality or self-dealing, appraisal provides sufficient protection of minority interests. Id. at 715. In Weinberger, the court rejected a business purpose test in favor of an “entire fairness” test. Id. at 715. The first part of this test encompasses a showing of “fair dealing,” requiring informed voting by the minority. Id. at 711. The court found that appraisal satisfies the second part of the test, “fair price.” Id. For a discussion of Weinberger, see Steinberg & Lindahl, The New Law of Squeeze-Out Mergers, 62 WASH. U.L.Q. 351 (1984).

In the absence of appraisal, courts should presume that reverse stock splits inherently discriminate against the minority. If the actions of a close corporation majority are at issue, the presence of appraisal does not, however, offer sufficient protection. See supra notes 38-39 and accompanying text. Appraisal, therefore, should not tip the balance in favor of a close corporation majority.
reverse stock split with substantial and compelling business purposes.\textsuperscript{83} This standard requires the majority to substantiate the justifications tendered. The majority must show a nexus between its action and the asserted justifications and demonstrate that a less intrusive alternative was unavailable.\textsuperscript{84}

Under a substantial and compelling business purpose test, majority shareholders cannot rely on a laundry list of potentially viable purposes. The court should scrutinize the business reasons advanced in the context of the particular facts of the case and accept only those purposes which the court determines compel the action. Only those purposes which normally aid the profitability and efficiency of a viable corporation should be accepted.\textsuperscript{85} Because each corporation is unique, the same purpose may not be compelling in all circumstances. The requirement of a compelling business purpose, however, provides needed protection for minority shareholders threatened by a reverse stock split.

V. Conclusion

A reverse stock split provides a relatively simple and direct method of eliminating minority shareholders. The use of such a technique, however, may harm the interests of minority shareholders. State appraisal statutes do not expressly encompass this technique and provide an inadequate assurance of fair value for squeezed-out close corporation minority shareholders. In addition, federal regulation reaches only public corporations. This Note proposes a two-part test considering the protections afforded. In most instances, this test would require that the majority shareholders support their decision to use a reverse stock split with substantial and compelling business purposes. Judicial use of this test would

\textsuperscript{83} A substantial and compelling business purpose is any purpose that the majority substantiates and the court finds compels the action. The proposed standard is similar to that adopted by courts applying a heightened level of review to reverse stock splits. See supra notes 55-64 and accompanying text. Accord Note, supra note 39, at 1646-47; Lawson, supra note 1, at 1248-49 (arguing for a compelling-business-purpose test if minority interests are disproportionately affected).

\textsuperscript{84} See supra note 68 and accompanying text.

\textsuperscript{85} See, e.g., Cross v. Communication Channels, Inc., 116 Misc.2d 1019, 456 N.Y.S.2d 971 (N.Y. Sup. Ct. 1982) (discussed supra notes 49-54). Cross exemplifies a fact pattern in which compelling purposes supported the reverse stock split in a close corporation. The majority took the action to rid the company of an "obstreperous" shareholder, who wished to retain his shareholder status merely to aid his own company and bedevil the corporation. See O'NEAL & THOMPSON, supra note 2, at § 2.11.
ensure a proper balance between the interests of majority and minority shareholders.

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