

There has always been a wide consensus among corporate law practitioners that if statistics are taken on existing corporate entities in the Philippines, a vast majority would be what are termed as close corporations, while the rest would be publicly-held corporations. The distinctions between a close corporation and a publicly-held corporation not only has legal significance, but more importantly, such distinctions were, and still continue to have, practical repercussions in the harsh reality of the business world. And yet, with the adoption of the Corporation Law (Act No. 1459) in 1906, no attempt was made to establish different sets of rules to govern the affairs of close corporations and publicly-held corporations; the same sets of rules were made to apply to both types of corporations. Ironically, the provisions of the Corporation Law (Act 1459) applied more to publicly-held corporations than to close corporations. Despite the reality prevailing in the business world, there was a bias against close corporations, as though such entities, or those of similar nature, were mutants of the "perfect corporate structure" that was sought to be made prevalent in the Philippine setting.

As is often true in the business world, what judges, lawmakers and social scientists may consider as ideal or desirable would inexorably give way to the necessary demands of the business world. Investors wanted a business vehicle that would incorporate the best features of a partnership and a corporation. With the enactment of the Corporation Code (Batas Pambansa Blg. 68) in May, 1980, our lawmakers have given formal statutory recognition to close corporations as a valid medium of business enterprise. The acts pertaining to close corporations which formerly were considered as "malpractices" have now been given legal acceptance under Title XII of the Corporation Code.<sup>1</sup>

This paper seeks to analyze how much or how little the present provisions of the Corporation Code have institutionalized close corporations as vehicles for commercial endeavors in the Philippines.

<sup>1</sup>The concept of closely-held corporation was previously given statutory recognition under the National Internal Revenue Code which subjected them to the 10% corporate development tax on their taxable net income. The definition of "closely-held corporation" covered any corporation at least 50% in value of the outstanding stock or at least 50% of the total combined voting power of all classes of stock entitled to vote is owned directly or indirectly by or for not more than five persons, natural or juridical. The tax was deleted by the Batasang Pambansa in March, 1983.

\*Editor-in-chief, *Ateneo Law Journal*, 1980.

### The Corporation Code

The general impression that one gets after reading through the provisions of the Corporation Code is that close corporations are treated more as exceptional cases, while publicly-held corporations are the general rule. Although the Philippine corporate setting has undergone significant changes, the bias against close corporations remains.

The bulk of the provisions of the Corporation Code devotes itself to general and specific rules more applicable to publicly-held corporations. Title XII of the Corporation Code which governs close corporations consists of relatively few sections (Sections 96-105); in fact, the last paragraph of Section 96 provides that "the provisions of other Titles of [the] Code shall apply suppletorily [to close corporations] except insofar as this Title otherwise provide."

As will be shown hereunder, such a statutory attitude has significance, particularly with respect to the legislative intent to ascribe to an entity similar to a close corporation the qualities and conditions of a publicly held corporation.

### The Concept of Close Corporation

Under American jurisprudence, from which much of our own corporate concepts are derived, close corporations are those in which the major part of the persons to whom the powers have been granted, on the happening of vacancies among them, have the right of themselves to appoint others to fill such vacancies, without allowing to the stockholders in general any vote or choice in the selection of such new officers<sup>2</sup>; or where the business policy and activities are entirely dominated for practical purposes by the majority stock ownership of a family whose stock is not traded in any market and is very infrequently sold.<sup>3</sup>

One of the most significant features of a close corporation is the identity of stock ownership and corporate management, whereby all or most of the stockholders are active in the corporate affairs as directors or key officers.<sup>4</sup>

Under Section 96 of the Corporation Code, a close corporation is defined as "one whose articles of incorporation provide" that:

- (1) All the corporation's issued stock of all classes, exclusive of treasury shares, shall be held of record by not more than a specified number of persons, not exceeding twenty (20);
- (2) All of the issued stock of all classes shall be subject to one or more specified restrictions on transfer permitted by Title XII; and

<sup>2</sup>McKim v. Odom, Md., 3 Bland, 407, 416.

<sup>3</sup>Brooks v. Willcuts, D.C. Minn., 9 F. Supp. 19, 20.

<sup>4</sup>Campos and Lopez-Campos, Corporation Code, Comments, Notes and Selected Cases, 1981 ed., p. 10.

- (3) The corporation shall not list in any stock exchange or make any public offering of any of its stock of any class.

However, Section 96 has a provision that notwithstanding the presence of all three (3) requisites in the articles of incorporation, "a corporation shall be deemed not a close corporation when at least two-thirds (2/3) of its voting stock or voting rights is owned or controlled by another corporation which is not a close corporation."

The definition of a close corporation under Section 96 of the Corporation Code offers a serious stumbling block to the delicate growth in Philippine jurisprudence of this type of business vehicle. First, by limiting the applicability of Title XII to corporations having all the three (3) enumerated requisites, a significant portion of what otherwise would be generally accepted close-corporations would not be covered by Title XII of the Corporation Code, and instead would continue to be governed by the same provisions applicable to publicly-held corporations. This would be true even in case of corporations possessing two (2) out of the three (3) enumerated requisites.

Second, by providing in Section 96 that all three (3) enumerated requisites must be stated in the article of incorporation, it would seem that those corporations possessing all the requisites in actual practice would not be covered by the provisions of Title XII of the Corporation Code if their articles of incorporations are silent on the matter.

Third, even for corporations whose articles have provided for all three (3) requisite such would cease to be governed by Title XII of the Corporation Code (i.e., they would be governed by the provisions pertaining to publicly-held corporations) if actual operations show that any one of the requisites has been violated. Hence, in a situation where all three (3) requisites are provided for in the articles of incorporation of a particular corporation, and during its existence, the actual number of shareholders exceeds 20, opinion has been expressed that such facts automatically disqualify the corporation from being a close-corporation. This position seems to be bolstered by the fact that Section 96 itself allows that even if all three (3) requisites are provided for in the articles of incorporation, the corporation ceases to be a close corporation "when at least two-thirds (2/3) of its voting stock or voting rights is owned or controlled by another corporation which is not a close corporation." Thus, the objective test of "what is provided in the articles of incorporation can be defeated by the test of "actual disposition of shares of stock."

This would give rise to instability and downright confusion. A corporation may be a close corporation today, not a close corporation tomorrow and again a close corporation the next day, depending on how many stockholders hold its shares of stock. What may be worse is that a group of stockholders can determine whether or not to place corporate affairs within the ambit of Title XII of the Corporation Code, by the simple expedient of shareholding in a close corporation to exceed the maximum twenty (20) limit provided in issuing shares to more than the maximum number of twenty (20) shareholders provided for in Section 96.

Under Title XII of the Corporation Code, the legal status of being a close corporation carries with it certain rights, obligations, special procedures and rules, as well as legal advantages and disadvantages. It is hard to accept that our lawmakers have built on shaky foundation the legal concept of what should constitute a close corporation. In case of dispute, jurisprudence will uphold the objective test in determining the nature of the corporation, regardless of actual practice. It is proposed that the remedy in case of non-compliance with any of the requisites provided in the articles of incorporation is not the automatic declassification of the corporation but rather for administrative enforcement to ensure that measures be taken by the corporation or its offices to comply with the requisites under pain of penalty as provided in Sec. 144 of the Corporation Code.<sup>5</sup>

However, this position does not address the problem of what would be the legal disposition as to the majority of close corporations which do not comply with the objective test provided in Section 96 of the Corporation Code (hereinafter to be referred to as "*de facto* close corporation").

To state that these *de facto* close corporations can and should now comply with the requisites as provided in Section 96 of the Corporation Code is too simplistic an approach that is not in touch with the harsh realities of the business world. Actual business conditions may prevent them from complying strictly with the 20-stockholder limit or transfer restriction and yet maintaining for all intents and purposes the very close identity of stock ownership and active management. It may also happen that a corporate venture can comply with all the requisites provided under Section 96 of the Corporation Code, but business judgment dictates that it must not do so because the business does not wish to be tied-up with all the legal disadvantages and fluidity offered under Title XII of the Corporation Code. Finally, suppose a business group wishes to adopt some of the schemes allowed under Title XII of the Corporation Code, will it be barred from doing so? And would the group's action be considered a "malpractice" simply because it is not the close corporation as defined under Section 96?

What would be the "legal concessions" that *de facto* close corporations may avail of under the present law? What is the actual policy towards *de facto* close corporations that should guide Philippine tribunals? These are significant questions that have remained unanswered under the Corporation Code.<sup>6</sup>

<sup>5</sup>Sec. 144. Violation of the Code. — Violations of any of the provisions of this Code or its amendments not otherwise specifically penalized therein shall be punished by a fine of not less than one thousand (P1,000.00) pesos but not more than ten thousand (P10,000.00) pesos or by imprisonment for not less than thirty (30) days but not more than five (5) years, or both, in the discretion of the court. If the violation is committed by a corporation, the same may, after notice and hearing, be dissolved in appropriate proceedings before the Securities and Exchange Commission: Provided, That such dissolution shall not preclude the institution of appropriate action against the director, trustee or officer of the corporation responsible for said violation: Provided, further, That nothing in this section shall be construed to repeal the other causes for dissolution of a corporation provided in this Code.

<sup>6</sup>It is ungratifying to know that nearly 30 years ago the issues on "malpractices" relating to close corporations were raised by the late Judge Simeon N. Ferrer in his leading articles pub-

### Why A Close Corporation?

When laymen and lawyers are asked what the available media of business pursuits are in the Philippines, the ready answer is, the single proprietorship, the partnership and the corporation. And yet a close corporation is not in essence simply a corporation; it is the progeny of a marriage of convenience between a partnership and a corporation. A close corporation should be considered in itself a distinct type of business organization embodying what businessmen perceive to be the best features of a partnership and a corporation.

Under a system of free enterprise, businessmen should be left at liberty to adopt a business medium which they feel is best for the pursuit of their commercial affairs, so long as the route chosen by them is not contrary to law, morals, public policy or public order. The separate personality, limited liability and right of succession are all features of a corporate entity which the law upholds and which businessmen may avail of. The feature of *delectus personae*, general management by all partners of business affairs are attractive features of partnership which the law guarantees and supervises. That businessmen take the best features of a corporation and a partnership and combine them in a business organization called the close corporation by itself cannot be considered reprehensible or against any legal norm. In fact, our lawmakers explicitly recognize the acceptability of such a business scheme by giving formal recognition to close corporations under Title XII of the Corporation Code.

When our lawmakers (who are the policy determining body of our Republic) enacted Title XII in the Corporation Code, did they intend the same to be a recognition of the reality that close corporations are here to stay and should be given legal and judicial accomodation? On the other hand, by enacting Title XII of the Corporation Code was it the intention that only the close corporation defined in Section 96 thereof be given "living space", while all others would fall under the broad category of publicly — held corporation?

A review of the deliberations of what was then Cabinet Bill No. 3 does not really shed much light into the legislative intent, for indeed there was practically no discussion on close corporations. Nevertheless, what was stated by the sponsor of the bill, then Minister Estelito Mendoza, about close corporations is worth noting:

"x x x. While a code, such as the proposed code now before us, may appear essentially regulatory in nature, it does not, and is not intended, to curb or stifle the use of the corporate entity as a business organization. Rather, the proposed code recognizes the value, and seeks to inspire confidence in the value of the corporate vehicle in the economic life of society.

lished in Vol. No. 9 of the Ateneo Law Journal entitled "Varying a Shareholder's Statutory Participation in Management by the Use of Non-Statutory Devices. Is it Possible Under Our Corporation statute?" and yet even with the enactment of the Corporation Code, much of those issues have remained uncertain as to *de facto* close close corporations.

"There are those who see a 'curse in bigness.' The corporation code carries no inherent bias against 'bigness.' On the contrary, the code acknowledges 'the economic and technological necessity of bigness in modern industry. It thus seeks to assure that the corporate entity does not only survive but becomes an attractive and effective vehicle for the accumulation of capital and the production of goods. This is not to suggest that corporations must of necessity be big. What I emphasize is that no provision in the code is designed to impede growth: rather, growth is encouraged. *But use of the corporate entity by those groups who do not desire to be public thereby providing for themselves more limited access to resources is not discouraged. A whole new title on closed corporation has in fact been included in the Code. xxx.*"<sup>7</sup>

### Title XII of the Corporation Code

We shall now go into a review of the specific grants under Title XII of the Corporation Code to close corporations (as defined under Section 96 thereof) and compare how much they have been "recognized" previously by corporate jurisprudence. To the extent that such specific grants have been recognized by the Supreme Court prior to the enactment of the Corporation Code, is itself a strong indication that they are available even to *de facto* corporations (and therefore even to publicly-held corporations).

#### (a) Classification of Shares and Restriction on Transfer

Section 97(1) provides that the articles of incorporation of the close corporation may provide for "a classification of shares or rights and the qualification for owning or holding the same and restrictions on their transfers as may be stated there x x x" In turn, Section 98 provides that restrictions on the right to transfer shares must appear in the articles of incorporation, in the by-laws, as well as in the certificate of stock x x x[and] shall not be more onerous than granting the existing stockholders or the corporation the option to purchase the shares of the transferring stockholder with such reasonable terms, conditions or period stated therein. xxx."<sup>11</sup>

The classification of shares or rights and the qualifications for owning or holding the same is not a feature peculiar only to close corporations. Under Section 6 of the Corporation Code, even publicly held corporations may have their shares "divided into classes or series of shares, or both, any of which classes or series of shares may have such rights, privileges or restrictions as may be stated in the articles of incorporation."

The restriction on the transferability of shares of stock in a close corporation is limited to what in general parlance is a "right of first refusal"; and from the wording of Section 98 that is the most onerous restriction allowed. The right of first refusal is a control scheme essential to a close corporation which allows the

<sup>7</sup>Records of the Interim Batasan Pambansa, 5 November 1979, Vol. III, p. 1212.

existing stockholders the power to maintain the character of *delectus personae* and thereby prevent an outsider from coming in and interfering with the affairs of the corporation. Section 98 thus formally puts into statutory form the ruling in the leading American case of *Barret v. King, et al.*,<sup>8</sup> thus:

"As to public policy, we see nothing in the provision contrary to that, at least as between the plaintiff and the corporation. x x x Furthermore, looking at the stock as property, it might be said that as far as appear and probably in fact, it was called into existence with this restriction inherent in it, by the consent of all concerned. x x x. Stock in a corporation is not merely property. It also creates a personal relation analogous otherwise than technically to a partnership. x x x. There seems to be no greater objection to restraining the right of choosing ones associates in a corporation than in a firm."

In the 1925 case of *Fleischer v. Botica Nolasco Co.*<sup>9</sup> a provision in the by-laws of the corporation gave to the corporation a preferential right to buy the shares of stockholders who wished to dispose of their shareholdings. In holding that the provision in the by-laws was void, the Supreme Court held:

"Section 13, paragraph 7, above-quoted, empowers a corporation to make by-laws, not inconsistent with any existing law, for the transferring of its stock. It follows from said provision, that a by-law adopted by a corporation relating to transfer of stock should be in harmony with the law on the subject of transfer of stock. The law on the subject is found in section 35 of Act No. 1459 above-quoted. Said section specifically provides that the shares of stock "are personal property and may be transferred by delivery of the certificate indorsed by the owner, etc." Said section 35 defines the nature, character and transferability of shares of stock. Under said section they are personal property and may be transferred as therein provided. Said section contemplates no restriction as to whom they may be transferred or sold. It does not suggest that any discrimination may be created by the corporation in favor or against a certain purchaser. The holder of shares as owner of personal property, is at liberty, under said section, to dispose of them in favor of whomsoever he pleases, without any other limitation in this respect, than the general provisions of law. Therefore, a stock corporation in adopting a by-law governing transfer of shares of stock should take into consideration the specific provisions of section 35 of Act. No. 1459, and said by-law should be made to harmonize with said provisions. It should not be inconsistent therewith."

Nevertheless, in arriving at such a ruling, the Supreme Court relied upon the following authority which expressly allows such a restriction if authorized in the charter of the corporation, thus:

"The right of unrestrained transfer of shares inheres in the very nature of a corporation, and courts will carefully scrutinize any attempt to impose restrictions or limitations upon the right of stockholders to sell and assign their stock. The

<sup>8</sup>63 NE 934.

<sup>9</sup>47 Phil. 583 [1925].

right to impose any restraint in this respect must be conferred upon the corporation either by the governing statute or by the articles of the corporation. It cannot be done by a by-law without statutory or charter authority." (4 Thompson on Corporations, sec. 4334, pp. 818, 819).

"x x x.

"It follows from the foregoing that a corporation has no power to prevent or to restrain transfers of its shares, unless such power is expressly conferred in its charter or governing statute. This conclusion follows from the further consideration that by-laws or other regulations restraining such transfers, unless derived from authority expressly granted by the legislature, would be regarded as impositions in restraint of trade." (10 Cyc., p. 578).

Moreover, the Supreme Court likewise relied on the non-binding effect of restrictions on transferrability existing only in the by-laws, thus:

"And moreover, the by-law now in question cannot have any effect on the appellee. He had no knowledge of such by-law when the shares were assigned to him. He obtained them in good faith and for a valuable consideration. He was not a privy to the contract created by said by-law between the shareholder Manuel Gonzalez and the Botica Nolasco, Inc. Said by-law cannot operate to defeat his rights as a purchaser.

"An authorized by-law forbidding a shareholder to sell his shares without first offering them to the corporation for a period of thirty days is not binding upon an assignee of the stock as a personal contract, although his assignor knew of the by-law and took part in its adoption." (10 Cyc., 579; *Ireland vs. Globe Milling Co.*, 21 R.I., 9.)

x x x

"A by-law of a corporation which provides that transfers of stock shall not be valid unless approved by the board of directors, while it may be enforced as a reasonable regulation for the protection of the corporation against worthless stockholders, cannot be made available to defeat the rights of third persons." (*Farmers' & Merchants' Bank of Lineville vs. Wasson*, 48 Iowa, 336.)"

In the earlier case of *Lambert v. Fox*,<sup>10</sup> the Supreme Court had already held as valid an agreement between shareholders not to dispose of the shareholdings in the corporation for a designated reasonable period of time. The Supreme Court held that the suspension of the power to sell had a beneficial purpose, resulted in the protection of the corporation as well as of the individual parties to the contract, and was reasonable as to length of time of suspension.

The right of first refusal, therefore, should be available even to *de facto* close corporations provided that the same is delineated in the articles of incorporation

<sup>10</sup>26 Phil. 588 [1914]

and indicated in the certificate of stock (to give notice to third parties) and is reasonable in its operation as not to amount to a deprivation of a stockholders right to ultimately dispose of his shareholdings.

#### (b) Classification of Directors

Section 97(2) of the Corporation Code provides that the articles of incorporation of a close corporation may provide for "a classification of directors into one or more classes, each of which may be voted for and elected solely by a particular class of stock."

The power to classify the directors in ordinary corporations seems to be denied under Section 24 of the Corporation Code which provides for the election of directors in the following manner:

"Sec. 24. *Election of directors or trustees.* — At all elections of directors or trustees, there must be present, either in person or by representative authorized to act by written proxy, the owners of a majority of the outstanding capital stock, or if there be no capital stock, a majority of the members entitled to vote. The election must be by ballot if requested by any voting stockholder or member. In stock corporations, every stockholder entitled to vote shall have the right to vote in person or by proxy the number of shares of stock standing, at the time fixed in the by-laws, in his own name on the stock books of the corporation, or where the by-laws are silent, at the time of the election; and said stockholder may vote such number of shares for as many persons as there are directors to be elected or he may cumulate said shares and give one candidate as many votes as the number of directors to be elected multiplied by the number of his shares shall equal, or he may distribute them on the same principle among as many candidates as he shall see fit: Provided, That the total number of votes cast by him shall not exceed the number of shares owned by him as shown in the books of the corporation multiplied by the whole number of directors to be elected: x x x."

The spirit of democratic or proportionate representation is admittedly inherent in publicly-held corporations. But does the same spirit pervade in a *de facto* close corporation?

#### (c) Provisions for Greater Quorum or Voting Requirements

Under Section 97(3) of the Corporation Code, a close corporation may provide in its articles of incorporation "[f]or a greater quorum or voting requirements in meetings of stockholders or directors than those provided in this Code."

Is the same prerogative granted to ordinary corporations? Admittedly, there is much weight to the argument that the fact that Section 97(3) of the Corporation Code has granted this specially to close corporations is a clear indication that it is not available to other types of corporations. Nevertheless, there are authors who, after a careful review of the specific provisions of the Corporation Code on quorum and voting requirements, would hold that the Corporation Code merely

lays down the *minimum* limit and leaves it up to the corporation to raise such limits as business may so require.<sup>11</sup>

Nevertheless, the Corporation Code has given formal recognition for clarified control devices which essentially pertain to close corporations thus:

- (a) Section 7 as previously discussed, allows a classification and restriction of shares of stock including the deprivation of voting rights;
- (b) Section 24 reiterates the exercise by minority stockholders of the power of cumulative voting;
- (c) Section 44 now expressly recognizes the power of a corporation to enter into management contracts and provides for the procedure in the exercise of such power;
- (d) Section 58 for the first time lays down the requirements for proxies; and
- (e) Section 59 provides the requirements of voting trusts.

#### (d) Stockholders as Managers of the Corporation

Section 97 of the Corporation Code provides as follows: *is*:

"The articles of incorporation of a close corporation may provide that the business of the corporation shall be managed by the stockholders of the corporation rather than by a board of directors. So long as this provision continues in effect:

- "1. No meeting of stockholders need be called to elect directors;
- "2. Unless the context clearly requires otherwise, the stockholders of the corporation shall be deemed to be directors for purposes of applying provisions of this Code; and
- "3. The stockholders of the corporation shall be subject to all liabilities of directors.

"The articles of incorporation may likewise provide that all officers or employees or that specified officers, or employees shall be elected or appointed by the stockholders, instead of by the board of directors."

The feature of a close corporation whereby there is a merger of stock ownership and active management is what significantly distinguishes it from other corporations. An ordinary corporation is managed and controlled by its board of directors. This lies at the very heart of what an ordinary corporation is. Under Section 23 of the Corporation Code, this corporate principle is mandated when it provides that "[u]nless otherwise provided in this Code, the corporate powers

<sup>11</sup> Ferrer, *supra*.

of all corporations formed under this Code shall exercised, all business conducted and all property of such corporations controlled and held by the board of directors or trustees to be elected among the holders of stocks, or where there is no stock, from among the members of the corporation, who shall hold office for one (1) year and until their successors are elected and qualified." In addition, Section 25 of the Corporation Code mandates that it is the board of directors which shall elect the president, treasurer, secretary and such other officers as may be provided for in the by-laws.

In *de facto* close corporations even if there is an actual merger of stock ownership and corporate management in the same group, if the acts are not those of the board of directors, the act would be invalid because of the clear and restrictive provision of Sections 23 and 27. In *Barreto v. La Previsora Filipina*,<sup>12</sup> the Supreme Court held that "contracts between a corporation and third persons must be made by or under the authority of its board of directors and not by its stockholders," and that the action of its stockholders in such matters is only advisory and is not binding on the corporation.<sup>13</sup>

#### (e) Agreements Among Stockholders

Section 100 of the Corporation Code provides the following agreements among stockholders to be valid, binding and enforceable:

1. Agreements by and among stockholders executed before the formation and organization of a close corporation, signed by all stockholders, shall survive the incorporation of such corporation and shall continue to be valid and binding between and among such stockholders, if such be their intent, to the extent that such agreements are not inconsistent with the articles of incorporation, irrespective of where the provisions of such agreements are contained, except those required by this Title to be embodied in said articles of incorporation.

2. An agreement between two or more stockholders, if in writing and signed by the parties thereto, may provide that in exercising any voting rights, the shares held by them shall be voted as therein provided, or as they may agree, or as determined in accordance with a procedure agreed upon by them.

3. No provision in any written agreement signed by the stockholders, relating to any phase of the corporate affairs, shall be invalidated as between the parties on the ground that its effect is to make them partners among themselves.

4. A written agreement among some or all of the stockholders in a close corporation shall not be invalidated on the ground that it so relates to the conduct of the business and affairs of the corporation as to restrict or interfere with the discretion or powers of the board of directors: Provided, That such agreement shall impose on the stockholders who are parties thereto the liabilities for managerial acts imposed by this Code on directors.

Agreements among shareholders even for ordinary corporations essentially fall under the realm of contracts and are governed by the Law on Contracts pro-

<sup>12</sup> 57 Phil. 649

<sup>13</sup> *Ramirez v. Orientalist Co.*, 38 Phil. 634 [1918].

vided in our Civil Code. Under Article 1306 of the Civil Code contracting parties may establish such stipulation, clauses terms and conditions as they may deem convenient provided they are not contrary to laws, morals, customs, public order and public policy. By way of illustration, in the case of *Lambert v. Fox*<sup>14</sup> an agreement whereby the plaintiff and the defendant being both stockholders of the corporation agreed not to dispose of any portion of their shareholdings within a period of one year without previous written consent of the other party, with a penalty clause of ₱1,000.00 in case of violation, was held by the Supreme Court as valid.

On the other hand an agreement among stockholders in an ordinary corporation (including a *de facto* close corporation) that relates to the conduct of the business and affairs of the corporation as to restrict or interfere with the discretion or powers of the board of directors would be invalid because of the restrictive provisions of Sections 23 and 27 of the Corporation Code.

#### (f) Board Meetings Unnecessary

Section 101 of the Corporation Code provides that an action of the board of directors of a close corporation shall be valid even if:

1. Before or after such action is taken, written consent thereto is signed by all the directors; or
2. All the stockholders have actual or implied knowledge of the action and make no prompt objection thereto in writing; or
- 3) The directors are accustomed to take informal action with the express or implied acquiescence of all the stockholders, or
- 4) All the directors have express or implied knowledge of the action in question and none of them makes prompt objection thereto in writing.

For ordinary corporations, it is mandated under Section 25 of the Corporation Code that every decision of the board of directors must be made by "at least a majority of the directors or trustees present at a meeting at which there is a quorum."

Settled jurisprudence even before the enactment of the Corporation Code laid down the basic principle that an ordinary corporation (including a *de facto* close corporation) can be held liable even under the circumstances described under Section 101 or even when the resolution of the board is not within the express powers approved by the Corporation.

In *Republic of the Philippines v. Acoje Mining Company, Inc.*<sup>15</sup> the Supreme Court laid down the principle that a corporation can be bound to a transaction when in fact it has received the benefits therefrom even if the resolution of the board of directors approving it was beyond the powers of the board. In *Ramirez v. Orientalist Co.*<sup>16</sup> it was held that if a corporation knowingly permits one

<sup>14</sup> 26 Phil. 588 [1914].

<sup>15</sup> 7 SCRA 361 [1963].

<sup>16</sup> 38 Phil. 634 [1917].

of its officers, or any other agent, to do acts within the scope of an apparent authority, and thus holds him out to the public as possessing power to do those acts, the corporation will, as against any one who has in good faith dealt with the corporation through such office, be estopped from denying the authority even in the absence of a formal vote on the transaction by its board of directors. In *Acuna v. Batac Producer Cooperative Marketing Association*,<sup>17</sup> the Supreme Court established the principle that subsequent ratification by the board of directors of transactions entered into on behalf of the Corporation cleanses the same of all defects; and that ratification may take diverse forms, such as by silence or acquiescence by the board; any act showing approval or adoption of the contract; or by acceptance and retention by the board of benefits flowing therefrom.

#### (g) Pre-emptive Rights

Section 102 of the Corporation Code provides that the pre-emptive right of stockholders in close corporations shall extend to all stock to be issued, including reissuance of treasury shares, unless the articles of incorporation provide otherwise.

This right is similar to that granted to stockholders of ordinary corporations under Section 39. Said section grants a pre-emptive right to stockholders in respect to all issues or dispositions of shares of any class, unless such right is denied in the articles of incorporation. However under Section 39, the pre-emptive right is not applicable in the following instances:

1. When shares are issued in compliance with laws requiring stock offering or minimum stock ownership by the public; and
2. When shares are to be issued in good faith with the approval of the stockholders representing two-thirds (2/3) of the outstanding capital stock in exchange for property needed for corporate purposes or in payment of a previously contracted debt.

The non-inclusion in Section 102 of the above enumerated exceptions is a clear indication of their non-applicability to close corporations because of the desire to preserve the characteristic of *delectus personae* in close corporations.

#### (h) Deadlocks and Dissolutions

Section 104 of the Corporation Code provides that notwithstanding any contrary provision in the articles of incorporation or by-laws or any agreement of the stockholders of a close corporation, if the directors or stockholders are so divided respecting the management of the corporation's business and affairs that the votes required for any corporate action cannot be obtained, with the consequence that the business and affairs of the corporation can no longer be conducted to the ad-

vantage of the stockholders generally, the Securities and Exchange Commission, upon written petition by any stockholder, shall have the power to arbitrate the dispute. In the exercise of such power, the Commission shall have authority to make such orders as it deems appropriate, including an order: (1) cancelling or altering any provision contained in the articles of incorporation, by laws, or any stockholders' agreement; (2) canceling, altering or enjoining any resolution or other act of the corporation or its board of directors, stockholders, or officers; (3) directing or prohibiting any act of the corporation or its board of directors, stockholders, officers, or other persons party to the action; (4) requiring the purchase at their fair value of shares of any stockholder, either by the corporation regardless of the availability of unrestricted retained earnings in its books, or by the other stockholders; (5) appointing a provisional director; (6) dissolving the corporation; or (7) granting such other relief as the circumstances may warrant.

A provisional director shall be an impartial person who is neither a stockholder nor a creditor of the corporation or of any subsidiary or affiliate of the corporation, and whose further qualifications, if any, may be determined by the Commission. A provisional director is not a receiver of the corporation and does not have the title and powers of a custodian or receiver. A provisional director shall have all the rights and powers of a duly elected director of the corporation, including the right to notice of and to vote at meetings of directors, until such time as he shall be removed by order of the Commission or by all the stockholders. His compensation shall be determined by agreement between him and the corporation subject to approval of the Commission, which may fix his compensation in the absence of agreement, or in the event of disagreement between the provisional director and the corporation.

In addition, Section 105 of the Corporation Code provides that any stockholder of a close corporation may, for any reason, compel the said corporation to purchase his shares at their fair value, which shall not be less than their par or issued value, when the corporation has sufficient assets in its books to cover its debts and liabilities exclusive of capital stock: Provided, that any stockholder of a close corporation may, by written petition to the Securities and Exchange Commission, compel the dissolution of such corporation whenever any of the acts of the directors, officers or those in control of the corporation is illegal, or fraudulent, or dishonest, or oppressive or unfairly prejudicial to the corporation or any stockholder, or whenever corporate assets are being misapplied or wasted.

The above discussion is considered as one of the more unattractive features of a close corporation since power is placed in the hands of one or a few to call upon the dissolution of the corporation.

To say that by adopting a *de facto* close corporation through non-compliance with Section 69 of the Corporation Code one would free the corporation from the "vicissitudes" of a close corporation is to ignore the vast powers granted to the Securities and Exchange Commission under Pres. Decree No. 902-A, as amended.<sup>18</sup>

<sup>17</sup>20 SCRA 526 [1967].

<sup>18</sup>Presidential Decree No. 902-A has been amended by Presidential Decrees Nos. 1653, 1758 and 1799.

Said regulatory agency has been granted the power under reasonable circumstances, to dissolve a corporation thus.

"SECTION 5. In addition to the regulatory and adjudicative functions of the Securities and Exchange Commission over corporations, partnerships and other forms of associations registered with it as expressly granted under existing laws and decrees, it shall have original and exclusive jurisdiction to hear and decide cases involving:

"a) Devices or schemes employed by or any acts, of the board of directors, business associates, its officers or partners, amounting to fraud and misrepresentation which may be detrimental to the interest of the public and/or of the stockholder, partners, members of associations or organizations registered with the Commission.

"b) Controversies arising out of intracorporate or partnership relations, between and among stockholders, members or associates; between any or all of them and the corporation, partnership or association of which they are stockholders, members or associates, respectively; and between such corporation, partnership or association and the state insofar as it concerns their individual franchise or right to exist as such entity;

"c) Controversies in the election or appointments of directors, trustees, officers or managers of such corporations, partnerships or associations;

"d) Petitions of corporations, partnerships or associations to be declared in the state of suspension of payments in cases where the corporation, partnership or association possesses sufficient property to cover all its debts but foresees the impossibility of meeting them when they respectively fall due or in cases where the corporation, partnership or association has no sufficient assets to cover its liabilities, but is under the management of a Rehabilitation Receiver or Management Committee created pursuant to this Decree.

"SECTION 6. In order to effectively exercise such jurisdiction, the Commission shall possess the following powers:

"a) To issue preliminary or permanent injunctions, whether prohibitory or mandatory, in all cases in which it has jurisdiction, and in which cases the pertinent provisions of the Rules of Court shall apply;

"b) To issue writs of attachment in cases in which it has jurisdiction in order to preserve the rights of parties and in such cases the pertinent provisions of the Rules of Court shall apply;

"c) To appoint one or more receivers of the property, real and personal, which is the subject of the action pending before the Commission in accordance with the pertinent provisions of the Rules of Court in such other cases whenever necessary in order to preserve the rights of the parties-litigants and/or protect the interest of the investing public and creditors; Provided, however, That the Commission may, in appropriate cases, appoint a rehabilitation receiver of corporations, partnerships or other associations not supervised or regulated by other government agencies who shall have, in addition to the powers of a regular receiver under the provisions of the Rules of Court, such functions and powers as are provided for in the succeeding paragraph (d) hereof; Provided, further, That the Commission may appoint a reha-

bilitation receiver of corporations, partnerships or other associations supervised or regulated by other government agencies, such as banks and insurance companies, upon request of the government agency concerned: Provided, finally, That upon appointment of a management committee, rehabilitation receiver, board or body, pursuant to this Decree, all actions for claims against corporations, partnerships, or associations under management or receivership pending before any court, tribunal, board or body shall be suspended accordingly.

"d) To create and appoint a management committee, board, or body upon petition or *motu proprio* to undertake the management of corporations, partnerships or other associations not supervised or regulated by other government agencies in appropriate cases when there is imminent danger of dissipation, loss, wastage or destruction of assets or other properties or paralyzation of business operations of such corporations or entities which may be prejudicial to the interest of minority stockholders, parties-litigants or the general public; Provided, further, That the Commission may create or appoint a management committee, board or body to undertake the management of corporations, partnerships or other associations supervised or regulated by other government agencies, such as banks and insurance companies, upon request of the government agency concerned.

The management committee or rehabilitation receiver, board or body shall have the power to take custody of, and control over, all the existing assets and property of such entities under management; to evaluate the existing assets and liabilities, earnings and operations of such corporations, partnerships or other associations, to determine the best way to salvage and protect the interest of the investors and creditors; to study, review and evaluate the feasibility of continuing operations and restructure and rehabilitate such entities if determined to be feasible by the Commission. It shall report and be responsible to the Commission until dissolved by order of the Commission; Provided, however, That the Commission may, on the basis of the findings and recommendation of the management committee or rehabilitation receiver, board or body, or on its own findings, determine that the continuance in business of such corporation or entity would not be feasible or profitable nor work to the best interest of the stockholders, parties-litigants, creditors, or the general public, order the dissolution of such corporation entity and its remaining assets liquidated accordingly. The management committee or rehabilitation receiver, board or body may overrule or revoke the actions of the previous management and board of directors of the entity or entities under management notwithstanding any provision of law, articles of incorporation or by-laws to the contrary.

"The management committee, or rehabilitation receiver, board or body shall not be subject to any action, claim or demand for, or in connection with any act done or omitted to be done by it in good faith in the exercise of its functions, or in connection with the exercise of its powers herein conferred.

"e) To punish for contempt of the Commission, both direct and indirect, in accordance with the pertinent provisions of, and penalties prescribed by, the Rules of Court;

"f) To compel the officers of any corporation or association registered by it to call meetings of stockholders or members thereof under its supervision;

"g) To pass upon the validity of the issuance and use of proxies and voting trust agreements for absent stockholders or members;

"h) To issue *subpoena duces tecum* and summon witnesses to appear in any proceedings of the Commission and in appropriate cases order the examination, search and seizure of all documents, papers, files and records, tax returns, and books of accounts of any entity or person under investigation as may be necessary for the proper disposition of the cases before it, notwithstanding the provisions of any law to the contrary.

"i) To impose fines and/or penalties for violation of this Decree or any other laws being implemented by the Commission, the pertinent rules and regulations, its orders, decisions and/or rulings;

"j) To authorize the establishment and operation of stock exchanges, commodity exchanges and such other similar organizations and to supervise and regulate the same; including the authority to determine their number, size and location, in the light of national or regional requirements for such activities with the view to promote, conserve or rationalize investment;

"k) To pass upon, refuse or deny, after consultation with the Board of Investments, Department of Industry, National Economic and Development Authority, or any other appropriate government agency, the application for registration of any corporation, partnership, or association or any form of organization falling within its jurisdiction, if their establishment, organization or operation will not be consistent with the declared national economic policies;

"l) To suspend, or revoke, after proper notice and hearing, the franchise or certificate of registration of corporations, partnerships or associations, upon any of the grounds provided by law, including the following:

1. Fraud in procuring its certificate of registration;
2. Serious misrepresentation as to what the corporation can do to the great prejudice of or damage to the general public;
3. Refusal to comply or defiance of any lawful order of the Commission restraining commission of acts which would amount to a grave violation of its franchise;
4. Continuous inoperation for a period of at least five (5) years;
5. Failure to file by-laws within the required period;
6. Failure to file required reports in appropriate forms as determined by the Commission within the prescribed period.

"m) To exercise such other powers as may be provided by law as well as those which may be implied from, or which are necessary or incidental to the carrying out of, the express powers granted to the Commission to achieve the objectives and purposes of this Decree."

### Piercing the Veil of Corporate Fiction

It is a well-settled doctrine in our jurisdiction that the separate personality of a corporation may be disregarded under the doctrine of piercing the veil of corporate fiction" whenever the notion of corporate entity is used to defeat public convenience, justify a wrong, protect fraud or defend crime. Nevertheless, a close

reading of the Philippine leading cases on this doctrine<sup>19</sup> would also show that there would be a piercing of the corporate veil whenever the controlling stockholders and officers use the corporate fiction as a mere conduit or *alter ego* or when they do not themselves respect the separate personality of the corporation by considering the assets and transactions of the corporation as their own.

Undoubtedly, when a corporation, including a close corporation, is being used to promote fraud, injustice, illegality or wrong, such circumstances would always warrant a piercing of the veil of corporate fiction.

On the other hand, with the formal recognition of a close corporation under Title XII of the Corporation Code, there can be no application of the above doctrine to a close corporation as defined under Section 96 thereof, when precisely such a close corporation is intended merely as an alter ego or conduit of the stockholders. Consequently, the corporate defenses of limited liability should still be available to stockholders of such close corporations.

On the other hand, for the *de facto* close corporations which have not been given legal recognition, they would be susceptible to the application of the doctrine for being mere conduits or alter egos of their stockholders. This aspect may prove to be the attraction for incorporators to incorporate a close corporation under the provision of Section 96 of the Corporation Code.

### Conclusion

From the foregoing discussions, it can be drawn that although the Corporation Code has not made formal recognition of, and laid down provisions for, the large type of close corporation namely the *de facto* close corporations, by and large, such *de facto* close corporations may avail themselves of some advantages and grants much similar to those afforded to *de jure* close corporations under Title XII of the Corporation Code. Much has yet to be attained towards the full legal acceptance of close corporations as distinct vehicles of business endeavors. But the most significant step has been taken towards that direction with the recognition, albeit in a limited scope, of the close corporation under the Corporation Code. The legal gap that still remains certainly poses a worthy challenge to both Philippine corporate practitioners and lawmakers to fill-up.

<sup>19</sup> Ramirez Telephone Corp. v. Bank of America, 29 SCRA 191; NAMARCO v. Associated Finance Co., 19 SCRA 962; Yutivo Sons Hardware Co. v. Court of Tax Appeals, 1 SCRA 160; A.D. Santos v. Vasquez, 22 SCRA 1156; Liddell & Co., Inc. v. Collector of Internal Revenue, 2 SCRA 632; Palacio v. Fely Transportation Co., 5 SCRA 1011; R.F. Sugay & Co. v. Reyes, 12 SCRA 700; Arnold v. Willits and Patterson, 44 Phil. 634; La Campana Coffee Factory v. Kaisahan Manggagawa sa La Campana, 93 Phil. 160; Emilio Cano Enterprises, Inc. v. C.I.R., 13 SCRA 291; Marvel Building Corporation v. David, 94 Phil. 376; Laguna Transportation Co., Inc. v. SSS, 107 Phil. 83; McConnel v. Court of Appeals, 1 SCRA 722; San Teodoro Development Enterprises, Inc. v. SSS, 8 SCRA 96; Koppel (Phil.) Inc. v. Yatco, 77 Phil. 496; Commissioner of Internal Revenue v. Norton and Harrison Company, 11 SCRA 711.