LAW ON CORPORATION

TITLE XII
CLOSE CORPORATIONS

CORPORATION CODE OF THE PHILIPPINES
Sec. 96-105

Sec. 96. ***Definition and applicability of Title.*** – A close corporation, within the meaning of this Code, is 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 the issued stock of all classes shall be subject to one or more specified restrictions on transfer permitted by this Title.

3. The corporation shall not list in any stock exchange or make any public offering of any of its stock of any class. Notwithstanding the foregoing, a corporation shall not be deemed 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 within the meaning of this Code.

Any corporation may be incorporated as a close corporation, except mining or oil companies, stock exchanges, banks, insurance companies, public utilities, educational institutions and corporations declared to be vested with public interest in accordance with the provisions of this Code.

The provisions of this Title shall primarily govern close corporations: *Provided*, That the provisions of other Titles of this Code shall apply suppletorily except insofar as this Title otherwise provides.

Sec. 97. ***Articles of incorporation.*** – The articles of incorporation of a close corporation may provide:

1. For a classification of shares or rights and the qualifications for owning or holding the same and restrictions on their transfers as may be stated therein, subject to the provisions of the following section.

2. For a classification of directors into one or more classes, each of whom may be voted for and elected solely by a particular class of stock.

3. For a greater quorum or voting requirements in meetings of stockholders or directors than those provided in this Code.

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 the purpose of applying the provisions of this Code.

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.

Requisites of Close Corporation
Within the meaning of a close corporation under the Corporation Code the following are its attributes:
1. Its stockholders are limited not exceeding 20 persons.
2. Its shares of stock are subject to one or more restrictions on transfer.
3. Its shares of stock are not listed in any stock exchange.

Salient Feature of Close Corporations
1. It has only a few stockholders, who if not related by blood or marriage, know each other well and are aware of each other's business skills.
2. All or more of them are active in the corporate business, either as directors, officers or as key men in management.
3. The stocks of the corporation are not listed on the exchange nor is there trading in them outside the stock market.

*It would seem that base on these features many corporations in the Philippines would be close corporations.

Reasons for formation of close corporations
"The existence of close corporations can be attributed to the desire of intimate groups of business associates to obtain the advantages of a corporate organization, like that of limited liability. However, the identity and personality of each shareholder are important to his associates, so that although they may consider their business as corporation in their dealings with third persons, among themselves the stockholders act and feel as partners."

Entities which may not be organized as close corporations
- Mining or oil companies
- Stock exchanges
- Banks
- Insurance companies
- Public utilities
- Educational institutions
- Corporations declared to be vested with public interest

Stockholders authorized to manage close corporations
As a rule, management of stock corporation is normally given to board of directors or trustees. However, the Corporation Code provides: *"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."* Also, *"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."*

Sec. 98. ***Validity of restrictions on transfer of shares.*** – Restrictions on the right to transfer shares must appear in the articles of incorporation and in the by-laws as well as in the certificate of stock; otherwise, the same shall not be binding on any purchaser thereof in good faith. Said restrictions 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. If upon the expiration of said period, the existing stockholders or the corporation fails to exercise the option to purchase, the transferring stockholder may sell his shares to any third person.

Sec. 99. ***Effects of issuance or transfer of stock in breach of qualifying conditions.*** –
1. If stock of a close corporation is issued or transferred to any person who is not entitled under any provision of the articles of incorporation to be a holder of record of its stock, and if the certificate for such stock conspicuously shows the qualifications of the persons entitled to be holders of record thereof, such person is conclusively presumed to have notice of the fact of his ineligibility to be a stockholder.

2. If the articles of incorporation of a close corporation states the number of persons, not exceeding twenty (20), who are entitled to be holders of record of its stock, and if the certificate for such stock conspicuously states such number, and if the issuance or transfer of stock to any person would cause the stock to be held by more than such number of persons, the person to whom such stock is issued or transferred is conclusively presumed to have notice of this fact.

3. If a stock certificate of any close corporation conspicuously shows a restriction on transfer of stock of the corporation, the transferee of the stock is conclusively presumed to have notice of the fact that he has acquired stock in violation of the restriction, if such acquisition violates the restriction.

4. Whenever any person to whom stock of a close corporation has been issued or transferred has, or is conclusively presumed under this section to have, notice either (a) that he is a person not eligible to be a holder of stock of the corporation, or (b) that transfer of stock to him would cause the stock of the corporation to be held by more than the number of persons permitted by its articles of incorporation to hold stock of the corporation, or (c) that the transfer of stock is in violation of a restriction on transfer of stock, the corporation may, at its option, refuse to register the transfer of stock in the name of the transferee.

5. The provisions of subsection (4) shall not applicable if the transfer of stock, though contrary to subsections (1), (2) of (3), has been consented to by all the stockholders of the close corporation, or if the close corporation has amended its articles of incorporation in accordance with this Title.
6. The term "transfer", as used in this section, is not limited to a transfer for value.

7. The provisions of this section shall not impair any right which the transferee may have to rescind the transfer or to recover under any applicable warranty, express or implied.

Restrictions on transfer of shares of stock
The corporation may provide in its articles of incorporation, in its by-laws as well as in the certificate of stock restrictions on the right of stockholders to transfer their shares of stocks. *If not so provided as aforesaid the same "shall not be binding on any purchaser thereof in good faith."* Charter restrictions on the transfer of shares are binding on all who become shareholders, as they become parties to the charter contract and take their shares subject to it. Considerable latitude allowed incorporators and shareholders in imposing transfer restrictions in the articles of incorporation and they will not usually be declared against public policy unless palpably unreasonable under the circumstances.
"Stock in the corporation is *not merely property*. It also creates a personal relation analogous otherwise than technically to a partnership. There seems to be no greater objection to retaining the right of choosing one's associates in a corporation than in a firm."

Reasons for restriction on shares of stock
In a close corporation, the identity of the other stockholders is important to each; the incorporators have confidence in one another which they may not have in an outsider. Furthermore, the incorporators may feel that the success of the enterprise depends upon the

retention of the personnel who formed it, or they may be manufacturing under secret processes which they do not want outsiders to learn. In the family corporation it is often the desire of he father to pass the corporation to his son without interference from other outside the family. Any one of these factors may induce the incorporators to attempt to restrict the transfer of stock.

Effect of the transfer of stock in breach of qualifying conditions
Unless "consented to by all the stockholders or if the close corporation has amended its articles of incorporation," a transfer of shares of stock in breach of qualifying conditions would justify the corporation through the corporate secretary to refuse to register the transfer of stock. Such transfer need not be for value, hence it may be the result of a donation.

Sec. 100. ***Agreements by stockholders.*** –
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.

5. To the extent that the stockholders are actively engaged in the management or operation of the business and affairs of a close corporation, the stockholders shall be held to strict fiduciary duties to each other and among themselves. Said stockholders shall be personally liable for corporate torts unless the corporation has obtained reasonably adequate liability insurance.

Effect of the Stockholders' agreement before and after formation of corporation
Stockholders' agreements before and after formation and organization of the corporation survive incorporation and shall be *valid* and *binding* for as long as they are not inconsistent with the articles of incorporation. Agreements made prior to incorporation require fairly literal performance. There must be an actual contractual relation. Given such relation, the *pre-incorporators* are promoters and may arrange agreements to form and manage the corporation.

Sec. 101. ***When board meeting is unnecessary or improperly held.*** – Unless the by-laws provide otherwise, any action by the directors of a close corporation without a meeting shall nevertheless be deemed valid if:

1. Before or after such action is taken, written consent thereto is signed by all the directors.

2. All the stockholders have actual or implied knowledge of the action and make no prompt objection thereto in writing.

3. The directors are accustomed to take informal action with the express or implied acquiescence of all the stockholders.

4. All the directors have express or implied knowledge of the action in question and none of them makes prompt objection thereto in writing.

If a director's meeting is held without proper call or notice, an action taken therein within the corporate powers is deemed ratified by a director who failed to attend, unless he promptly files his written objection with the secretary of the corporation after having knowledge thereof.

Sec. 102. ***Pre-emptive right in close corporations.*** - The pre-emptive right of stockholders in close corporations shall extend to all stock to be issued, including reissuance of treasury shares, whether for money, property or personal services, or in payment of corporate debts, unless the articles of incorporation provide otherwise.

Exceptions in Section 39, not applicable
It is submitted that in a close corporation, the exceptions provided in Sec 39 are not applicable. The first exception mentioned therein regarding the shares issued in compliance with laws requiring stock offerings or minimum stock ownership by the public cannot by its very nature refer to a close corporation. The pre-emptive right of shareholders in close corporation is thus broadened to include all issues without any exception, unless of course, restricted by the articles of incorporation and printed in the stock certificates. It may be mentioned however, that any prior waiver of pre-emptive right must be expressly provided for in the articles of incorporation and not in an ordinary agreement executed by the parties. This rule however, would not militate against the unanimous agreement of all the stockholders.

Sec. 103. ***Amendment of articles of incorporation.*** – Any amendment to the articles of incorporation which seeks to delete or remove any provision required by this Title to be contained in the articles of incorporation or to reduce a quorum or voting requirement stated in said articles of incorporation shall not be valid or effective unless approved by the affirmative vote of at least two-thirds (2/3) of the outstanding capital stock, whether with or without voting rights, or of such greater proportion of shares as may be specifically provided in the articles of incorporation for amending, deleting or removing any of the aforesaid provisions, at a meeting duly called for the purpose.

Rule and Exceptions when board meeting unnecessary

General Rule: the directors of a corporation cannot act individually or separately in order to bind the corporation. They must act as a board at a meeting duly called for the purpose.

Exception: Section 101. It enumerates the instances when a board at a meeting is unnecessary or even if improperly held would be valid. The by-laws, however, may provided otherwise or a stockholder may file his written objection in writing after having knowledge of the action taken by the directors.

Pre-emptive right in close corporations; Issuance of new Stock

A stockholder in a close corporation has a right to purchase his pro rata share of the new stock. If the pre-emptive right is *violated* he can sue the corporation for damages, enjoin the stock issue, obtain an order permitting him to subscribe, or obtain cancellation of the issue. But even where the stockholder's pre-emptive right is preserved. The right may be inadequate as a protective devise for the stockholder in a close corporation because the lack of a market for his stock leaves him with the alternatives of investing more capital or having the value of his stock diluted.

Sec. 104. ***Deadlocks.*** - Notwithstanding any contrary provision in the articles of incorporation or by-laws or agreement of 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 advantage 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 order as it deems appropriate, including an order:*

1. Canceling or altering any provision contained in the articles of incorporation, by-laws, or any stockholder's agreement.

2. Canceling, altering or enjoining any resolution or 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.

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.

Deadlock – Deadlock signifies a standstill in the management of the corporate affairs resulting from the evenly divide action of directors or stockholders in a close corporation.

In the event of deadlocks SEC may arbitrate

In the event of a deadlock in a close corporation, the SEC has the power to arbitrate the deadlock "upon written petition of any stockholder." In close corporations that are subject to a checks and balances system because of control devices there are bound to be deadlocks, and some steps must be taken to cope with them. Many of the problems that arise can be settled by arbitration, Arbitration (the determination of a matter of difference between contending parties) may be provided either for directorial disputes or for stockholder disputes. Although there are some disadvantages of arbitration proceedings, nevertheless, the advantages of arbitration, in saving both money and hard feelings, would seem to outweigh the disadvantages in most cases.

Provisional director and SEC supervised management
In accordance with Section 104, the SEC may in case of deadlocks in the close corporation appoint a provisional director. "A **provisional director** shall be an impartial person who is neither a stock-holder nor a creditor of the corporation and whose other qualifications, may be determined by the SEC."
Under Section 2 (Pres Decree No. 1653), the **SEC** has the *power* "to create and appoint a management committee, board, or body to undertake the management of corporations, partnership or other associations in appropriate cases wherein there is imminent danger or dissipation, loss or wastage or destruction of assets or other properties or paralization of business operations of such corporations or entities prejudicial to the interest of the minority, party-litigants or the general public."

Sec. 105. ***Withdrawal of stockholder or dissolution of corporation*****.** – In addition and without prejudice to other rights and remedies available to a stockholder under this Title, 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 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.
• Appraisal rights in regular corporations can be opted by the dissenting stockholder only in cases where the fundamental change in the corporate structure or operations is involved, whereas a stockholder of a close corporation may, for any reason, compel the said coporation to purchase his shares at their par value, when the corporation has sufficient assets in its books to cover his debts and liabilities exclusive of capital stock. (In Appraisal right, fair value of shares is given but in Withdrawal Right, the fair value cannot be less than the par or issued value of the shares; In Appraisal right, there must be present unrestricted retained earnings in the books of the corporation)
• The corporation is not a close corporation even if the shares belong to less than twenty if not all the requisites are present. San Juan Structural and Steel Fabricators v. CA (1998)

EDUCATIONAL CORPORATIONS
For Educational corporations, where the trustees should be divided into multiples of five. So you should have five, ten or fifteen trustees if they are organized as non-stock corporation. And unless otherwise provided in the articles of incorporation or by-laws, the terms of the trustees should be five years, and every year only one fifth (1/5) is elected, again to provide for continuity in policies. But you can provide that they will be all elected instead for a term of one year, everybody has to be elected.