handiest and most often availed of stock-in-trade of an enterprising criminal investigator. It is the accomplishment that wins for him supremacy in the competition for crime detection. Disregard all involuntary confessions and you strip the practice of extracting involuntary confessions of all claim of potency. Do this, and the door to greater efficiency in the detection of crimes will be thrown wide open.

To conclude: We do not believe that we are vulnerable to the charge of being irrationally sentimental with criminals in adopting the course of action proposed. We are not here dealing with criminals alone. The forced confessions which we should guard against are extracted from persons accused of crimes — not necessarily criminals. Besides, the victims of forced confessions are often not the die-hard offenders but merely those neophytes in crime still unschooled in the art of evading responsibility. Hardened criminals do not usually yield even to the battering-ram type of investigations. We accept that there is a drawback to our proposal. Some criminals may evade punishment. But, as Alfonso El Sabio well puts it, "Mass vale que quedan sin castigar diez reos presuntos que se castigue uno inocente."

It is with a view to all the foregoing considerations that we maintain that the only acceptable solution to the question here presented is to disregard as inadmissible in evidence all confessions extracted by compulsion or improper inducements and all facts subsequently discovered in pursuance thereon.

VARYING A SHAREHOLDER'S STATUTORY PARTICIPATION IN MANAGEMENT BY THE USE OF NON-STATUTORY DEVICES: IS IT POSSIBLE UNDER OUR CORPORATION STATUTE?†

*Simeon N. Ferrer**

THE exercise by the shareholder of the right to vote is the principal medium by which he is able to participate in the management of the corporate business. In the long history of private corporations, various devices have been developed affecting the shareholder's right to vote or his right to participate in corporate management. Some of these devices are designed to protect or insure the exercise of his right to vote or even to enlarge it. On the other hand, others would have the effect of restricting or even doing away with it entirely. A few of these devices have gained statutory recognition. Some of these are proxy voting, cumulative voting,[2] voting trust agreement,[3] and disfranchisement of shares.[4]

† This article is actually Chapter XII of the doctoral dissertation entitled "A Treatise on the Law of Philippine Private Business Corporations" (twenty chapters) submitted by the author to the University of Pennsylvania Law School. With the aid of Prof. William R. Veto, the dissertation has been updated, revised, and adapted for use as a local textbook under the title of "Philippine Law on Private Business Corporations" by Ferrer & Veto.

* LL.B., Ateneo de Manila, 1951; LL.M., Indiana University, 1954; S.J.D., University of Pennsylvania, 1956. Associate of Ross, Selph & Carrascoso.

[1] CORPORATION LAW (Act No. 1459, as amended) §§ 21, 25, 31, 36. For a comprehensive discussion, see BERLE & MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 81-88, 139, 207, 244-245 (1932); Axe, **Corporate Proxies,** 41 & 42 MICH. L. REV. 38, 225 (1942); Dean, **Non-Compliance with Proxy Regulations,** 24 CORNELL L. Q. 483 (1939); Bernstein & Fisher, **The Regulation of the Solicitation of Proxies: Some Reflections on Corporate Democracy,** 7 U. CHI. L. REV. 226 (1936); Comment: **Regulation of Proxies by the Securities and Exchange Commission,** 33 ILL. L. REV. 914 (1939), 13 ST. JOHN'S L. REV. 297 (1939).

[2] CORPORATION LAW § 31. For a comprehensive discussion, see Bowes & De Bow, **Cumulative Voting at Election of Directors of Corporations,** 21 MINN. L. REV. 351 (1937).

[3] CORPORATION LAW § 36. For a comprehensive discussion, see CUSHING, VOTING TRUSTS (1915); Gose, **Legal Characteristics and Consequences of Voting Trust,** 20 WASH. L. REV. 129 (1945); Ballantine, **Voting Trusts, Their Abuses and Regulation,** 21 TEXAS L. REV. 139 (1942); Burke, **Voting Trusts Currently Observed,** 24 MINN. L. REV. 347 (1940); Dougherty & Verry, **The Voting Trust — Its Present Status,** 28 GEO. L. J. 1121 (1940); Wormser, **Legality of Corporate Voting Trusts and Pooling Agreements,** 18 COLUM. L. REV. 123 (1918); Anno: **Validity of Voting Trust or Similar Agreements for Control of Voting Power of Corporate Stock,** 105 ALR 123 (1936).

[4] CORPORATION LAW § 5; cf. Gen. Inv. Co. v. Bethlehem Steel Corp., 87 NJ Eq. 234, 100 A 347 (1917).

From the individual or minority shareholder's point of view, the cumulative voting device seems the most effective in helping him obtain a "voice" in management by facilitating his representation on the board of directors.

The proxy device, intended to protect and help insure to the shareholder the exercise of his right to vote, has, as shown by experience in some publicly-held corporations in the United States, been prostituted to serve the ends of scheming groups desirous of perpetuating themselves in management.

The voting trust device involving the complete surrender by the shareholder of his voting rights to a trustee or trustees appears to have been effective in the rehabilitation of insolvent corporations, as well as in irrevocably committing groups of shareholders to the continuation of fixed business policies.

The creation of voting shares, it seems, would not entirely attain the purpose of limiting participation in management to the holders of voting shares, since our statute appears to give the holders of voting and non-voting shares alike the right to approve certain corporate acts.

The creation of a class of shares with multiple voting rights appears to be effective where the purpose is to unequally distribute voting power so as to confer larger participation in management on a shareholder or class of shareholders.

In this article, we shall confine our discussion to other devices and transactions, non-statutory in nature, which may be so designed as to vary the individual shareholder's normal statutory participation in management. To make our discussion meaningful, we shall take up the situation of shareholders in a close corporation, the type of corporation which now preponderates in our jurisdiction and will continue to so predominate in a long time to come.

One salient feature of this type of corporation is that ownership of its shares is limited either to the members of a family or to a group of friends or business associates. Unlike publicly-held corporations, where membership is open to anyone willing to pay the price, in close corporations membership is restricted and acceptance as a member often becomes a matter of personal consideration. Another peculiar feature of a close corporation is the identity between ownership and management — the shareholders are themselves the directors and officers. With these two features, one is immediately reminded of a partnership with its element of "delectus personae"[5] and the authority of any of its general partners to act for the

[5] Art. 1804 CIVIL CODE OF THE PHILIPPINES (hereinafter cited as NEW CIVIL CODE): Every partner may associate another person with him in his share, but the associate shall not be admitted into the partnership without the consent of all the other partners, even if the partner having an associate should be a manager."

partnership in the absence of a designated manager.[6] Indeed, the associates in a close corporation desire to have some kind of a "partnership cake with corporate frosting" to paraphrase one American writer.[7] While they intend to operate as partners, they, however, choose the corporate form of organization because it promises insulation against unlimited liability or probably because it would afford them some calculated tax advantage.

The main problem then for counsel is how to tailor the corporate form of organization as outlined in our statute so as to fit the business needs of associates desirous of operating as partners.[8] The problem becomes realistic where the venture is not a family affair, but one where each associate is carefully determined to protect and get the most out of his investment. Counsel will find that the principal obstacle to the solution of his problem is our corporation statute itself. Our statute was designed to meet the needs of publicly-held corporations, not close corporations. Despite the fact that the latter type prevails in our jurisdiction, neither our Legislature nor our Judiciary has openly recognized its existence nor appreciated the economic reasons for such existence.

Assume that counsel is consulted by A, B, and C, who want to form a stock corporation for the purpose of manufacturing and selling furnitures. It is agreed that each will initially invest ₱3,300 in the venture in exchange for 33 shares of ₱100 par value each. All three intend to devote their entire time to the business for which reason they want to be directors and officers at equal amounts of compensation. Each is especially interested that counsel formulate such guarantees or devices that will protect the interests of one shareholder against any combination of the other two. In short, each shareholder wants to wield a veto power on transactions which under the statute should come before the board of directors or before the shareholders acting as a body.

Our statute centralizes the powers of management in a board of directors leaving to the shareholders the power to approve certain corporate acts

[6] Art. 1803 NEW CIVIL CODE: "When the manner of management has not been agreed upon, the following rules shall be observed: (1) All the partners shall be considered agents, and whatever any one of them may do alone shall bind the partnership, without prejudice to the provision of article 1081...."

[7] Hayes, **Corporation Cake With Partnership Frosting (Part III of a Study of Iowa Incorporation Practices)**, 40 IOWA L. REV. 157 (1954).

[8] On this topic several illuminating articles have been written recently: Hornstein, **Judicial Tolerance of the Incorporated Partnership**, 18 LAW AND CONTEMP. PROBS. 435 (1953), **Giving Shareholders Powers To Veto Corporate Decisions: Use of Special Charter and By-Law Provisions**, 18 LAW AND CONTEMPT. PROBS 451 (1953); Cary, **How Illinois Corporations May Enjoy Partnership Advantages: Planning For the Closely-Held Firm**, 48 NW ULR 1427 (1953); O'Neal, **Restrictions on Transfer of Stock in Closely-Held Corporations: Planning and Profiting**, 65 HARV. L. REV. 773 (1952); Israels, **The Sacred Cow of Corporate Existence — Problems of Deadlock and Dissolution**, 19 U. CHI. L. REV. 778 (1952); Israels, **The Close Corporation and the Law**, 33 CORNELL L. Q. 488 (1948); see also Rohrlich, **Organizing Corporate and Other Business Enterprises**, § 4-2-4, 20 (1949) Ballard.

of an organic or extraordinary nature. Under such an operational procedure let us examine the possibilities under our statute whereby counsel may afford to each of A, B, and C the exercise of a veto power on transactions subject to the approval of the board as well as on those subject to approval by the shareholders acting as a body.

(1) *The Board of Directors — affording to each shareholder in a close corporation the power to exercise a veto to enable him to check the board's activities.* Section 28 of our statute provides: "Unless otherwise provided in this Act, the corporate powers of all corporations formed under this Act shall be exercised, all business conducted and all property of such corporation controlled and held by a board of not less than five nor more than eleven directors to be elected from among the holders of stock. . ." Under such a provision, it appears to have been contemplated that the board of directors be the governing as well as the policy-making body for the corporation. It also appears to have been intended that the board be the agency through and by which the corporation as a legal entity may act. Thus with respect to ordinary business transactions, it is generally the board which has authority to contract with third persons on behalf of the corporation. As was pointed out by our Supreme Court in *Barretto v. La Previsora Filipina*, "The law is settled 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. Hence the action of its stockholders in such matters is only advisory and not in any wise binding on the corporation."[10] Pursuant to its policy-making powers, the board, in practice, may lay down its policies with respect to methods of production, marketing, advertising, distribution, as well as expansion. It may also set its policy with respect to employer-employee relations, financing methods and techniques, and distribution of profits by way of dividends, So also, the board elects at least the president and secretary and such other officers as provided in the by-laws[11] who attend to administrative details and in general execute the policies set by the board. In the absence of any provision in the by-laws the board as the central governing body may fix the qualifications, duties and compensation of directors, officers and employees, as well as the tenure of all employees and officers other than the directors. The manner of election and the terms of all officers elected by the directors may not be fixed in the by-laws[12] but should be left to the discretion of the board.[13]

In the exercise of its powers and in the performance of its functions, the board, as a rule, must act as such in a meeting duly called and not

[9] 57 Phil. 649 (1932).
[10] **Id.** at 655.
[11] CORPORATION LAW § 33.
[12] **Id.** § 21.
[13] **Id.** § 33.

through its individual directors acting separately. Under section 33 of our statute it is provided that: "A majority of the directors shall constitute a quorum for the transaction of corporate business, and every decision of a majority of the quorum duly assembled as a board shall be valid as a corporate act."

Concentrating managerial powers in a board of directors and prescribing the procedure by which it is to operate as set forth above is typical of a great majority of statutes which have been originally designed to meet the needs of publicly-held corporations. In such corporations where ownership of shares is widely dispersed there is no doubt that such a statutory pattern of management results in a more efficient and economical transaction of the corporate business. But would such a statutory scheme respond to the needs and business practices of shareholders in a close corporation?

Let us see how A, B, and C in our example will have to operate under the pattern prescribed by our statute. In the first place, there must at least be five directors on the board.[14] This means they have to take in at least two other persons besides themselves to act as directors. As we saw above, the board has tremendous powers. It sets policies, makes contracts on ordinary business transactions, elects officers, and declare dividends. In a partnership, A, B, and C may perfectly stipulate that all of them shall be the managing partners and none shall act without the unanimous consent of all.[15] Because of their equal financial investment, they are desirous of operating under a similar managerial scheme in a corporate form of organization. Our corporation statute, however, says that a quorum of the board is constituted by a mere majority of the directors. The decision of a mere majority of that quorum shall be valid as a corporate act. May counsel modify this statutory operational procedure so as to afford to each of A, B, and C the power to exercise a veto on matters calling for decision by the board?

A pre-incorporation agreement to be made a part of the articles and by-laws could produce the desired results if the following suggestions are considered:

(a) Each of A, B, and C should qualify one other person so that there will be a six-man board. Under a system of cumulative voting where six directors are to be elected, each of A, B, and C will have sufficient votes to elect at least two directors — himself, and such other person he may choose. A, B, and C will therefore have equal representation on the board.

(b) Four directors will constitute a quorum and the decision of three would be valid as a corporate act under our statute. This would leave open the possibility that eventually either one A, B, or C may be entirely disregarded, so far as board decisions are concerned, by any two combining against one. To guard against such a contingency it becomes necessary to

[14] **Id.** §§ 6(6) & 28.
[15] Art. 1802 NEW CIVIL CODE.

vary such statutory procedure. Clearly, if it is stipulated that 5/6 of the directors shall constitute a quorum, the absence of either A, B, C, and the director he has elected with his shares will prevent the board from having a quorum. Similarly, if it is stipulated that the concurrence of 5/6 of the directors shall be necessary for the validity of any board decision, the dissent of either A, B, or C and the director he has elected with his shares will prevent the board from arriving at any valid decision. In other words, by such stipulations, each of A, B, and C is afforded a veto power in transactions calling for approval by the board.

(c) Under section 33 of our statute, the directors elect the president and secretary and such other officers as may be provided for in the by-laws. The by-laws should be so drafted as to confer on the directors the power to elect all officers. Where such a power is conferred on the directors, section 21 of our statute impliedly allows them to agree upon the manner of election and the term of office of such officers. A, B, and C could then stipulate that no officer shall be elected unless he receives the votes of at least five directors. This would assure each of them a veto power in the election of officers, assuming each controls two director votes. They should also stipulate and agree as to the position to which each of them is to be elected, as well as the term thereof. The fact that each wields a veto power and that none can be elected if such power is exercised is probably a fair assurance that such an agreement will be carried out. Since they are desirous of receiving equal amounts of compensation, the respective amounts of their salaries may be fixed in the by-laws as authorized by section 21.

The question of importance, however, is whether a stipulation requiring 5/6 of the directors to constitute a quorum of the board and a similar percentage to concur on board decisions is valid in view of the scheme prescribed by section 33 of our statute. In other words, may shareholders in our jurisdiction contract, either in a pre-incorporation agreement, in the articles or the by-laws for higher quorum or voting requirements for board action than that provided in the statute?

Initially, counsel is beset by doubts in view of the absence of a provision in our statute which would permit him, either expressly or by implication, to vary the operational procedure of the board as prescribed in section 33. Section 7 of our statute prescribing the contents of articles of incorporation makes no mention of a provision, allowed by many corporation statutes in the United States, "which the incorporators may choose to insert for the management of the business and for the conduct of the affairs of the corporation, and any provisions creating, defining, limiting, and regulating the powers of the corporation, the directors and the stockholders, or any class of the

stockholders... provided, such provisions are not contrary to the laws of this state."[16]

So, also, section 33 by its terms would seem to allow no room for variation unlike corresponding provisions in a number of statutes in the United States.[17] The possibility remains that contractual provisions varying the statutory operational procedure prescribed for the board might be validly incorporated in the by-laws. Section 13 provides, however, that "Every corporation has the power: ... (7) To make by-laws, *not inconsistent with any existing law*[18] for the ... administration of its business, and the care, control, and disposition of its property. ..." In a similar vein, section 20 states that "Every corporation formed under this act must... adopt a code of by-laws for its government *not inconsistent with this Act*.[19] So also section 21 provides that "A corporation may, *unless otherwise prescribed by this Act*,[20] provide in its by-laws for... such other matters not otherwise provided for by this Act as may be necessary for the proper or convenient transaction of the business of the corporation." The presence of the phrases, "not inconsistent with any existing law," "not inconsistent with this Act," and "unless otherwise prescribed by this Act" in the foregoing provisions appears to make doubtful the validity of by-

[16] DELAWARE REV. CODE § 5, as amended by L. 1941, c. 132 §§ 2 & 3; L. 1949, c. 136; L. 1951, c. 352 § 3 and 353 § 18; see also CALIFORNIA CORP. CODE § 305, "The articles may include any desired provisions: . . . (c) Imposing any limitations and requirements authorized by this division, and otherwise regulating the business and affairs of the corporation and the powers of the directors and shareholders in a manner not in conflict with law."; ILLINOIS BUSINESS CORPORATION ACT § 47, as amended by L. 1949 p. 604, "The articles of incorporation shall set forth: . . . (1) Any provisions, not inconsistent with law, which the incorporators may choose to insert for the regulation of the internal affairs of the corporation"; INDIANA LAWS CONCERNING CORPORATIONS FOR PROFIT § 17, which permits articles of incorporation to include "Any other provisions, consistent with the laws of this state, for the regulations of the business and conduct of the affairs of the corporation, and creating, defining, limiting or regulating the powers of the corporation, of the directors or of the shareholders or any class or classes of shareholders." See also MICHIGAN GEN. CORP. ACT § 4, as amended by L. 1951, Act No. 239; MINNESOTA REV. ST. § 301.04, as amended by L. 1951, c. 98; OHIO GEN. CODE § 8624-4, as amended by L. 1945, S. B. 82; PENNSYLVANIA BUSINESS CORP. LAW § 204, as amended by L. 1949, P. L. 1773 § 3.

[17] Typical are: ILLINOIS BUSINESS CORPORATION ACT § 37: "A majority of the board of directors shall constitute a quorum for the transaction of business unless a greater number is required by the articles of incorporation or the by-laws. The act of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors unless the act of a greater number is required by the articles of incorporation or the by-laws." OHIO GEN. CODE § 8623-58, "Unless the articles or regulations shall otherwise provide, a majority of the board of directors shall be necessary to constitute a quorum for the transaction of business. The act of a majority of directors present at a meeting at which a quorum is present shall be the act of the board of directors unless a greater number is required by this act or the articles or regulations."

[18] Emphasis supplied.

[19] **Id.**

[20] **Id.**

law provisions varying the statutory operational procedure prescribed for the board. Coupled with these doubts raised by the phraseology of our statute are those arising from unfavorable American decisions holding that provisions requiring a unanimous or higher percentage vote than that prescribed by statute for board or shareholder action is invalid either because they are repugnant to the legislative scheme or corporate management[21] or are offensive to public policy.[22] The oft-cited New York case of *Benintendi v. Kenton Hotel, Inc.*[23] presents an interesting study of shareholders in a close corporation attempting to vary the statutory norm of corporate management by means of by-law provisions, so as in effect to create a partnership within a corporation. At the time of this action, section 27 of the New York General Corporation Law provided in part: "The business of a corporation shall be managed by its board of directors... Unless otherwise provided a majority of the board at a meeting duly assembled shall be necessary to constitute a quorum for the transaction of business and the act of a majority of the directors present at such a meeting shall be the act of the board. The by-laws may fix the number of directors necessary to constitute a quorum at a number less than a majority of the board, but not less than one-third of its number..." Section 28 of the same law also provided: "Whenever, under the provisions of any corporate law, a corporation is authorized to take any action by its directors, action may be taken by the directors, regularly convened as a board, and acting by a majority of a quorum, *except when otherwise expressly required by law or the by-laws*,[24] and any such action shall be executed in behalf of the corporation by such officers as shall be designated by the

[21] Benintendi v. Kenton Hotel, Inc., 294 NY 112, 60 NE 2d 829 (1945) followed in **Christal v. Petry,** 275 App. Div. 550, 90 NYS 2d 620 (1949) **affd.** in 301 NY 562, 93 NE 2d 450 (1950) and **Eisenstadt Bros. v. Eisenstadt,** 89 NYS 2d 12 (1949). See also Jackson v. Hooper, 76 NJ Eq. 592, 662-3, 75 A. 568, 570: "The law never contemplated that persons engaged in business as partners may incorporate with intent to obtain the advantages and immunities of a corporate form, and then, Proteus-like, become at will, a copartnership or a corporation, as the exigencies or purposes of their joint enterprise may from time to time require . . . They cannot be partners **inter se** and a corporation as to the rest of the world."

[22] Kaplan v. Glock, 183 Va. 327, 31 Se 2d 893, 896, 897 (1944). In this case, both the corporate charter and by-laws required board action to have unanimous ratification of all outstanding voting shares. Said the court in striking down these provisions as invalid: "In construing corporate charters, by-laws and powers granted, their validity is determined not by what has been done under them, but also by what may be done. A recalcitrant director who is also a stockholder may embalm his corporation and hold it helpless: it can do none of those things noted as authorized by general law. It cannot be dissolved, and it must remain forever in a state of suspended animation. A treasurer, who chanced to own a share of stock, might pocket its assets and leave his associates without civil remedy. These regulations, if folowed out, violate both common and statute law and are suicidal of corporate existence. A board of directors whose every act must be endorsed by every stockholder is no board at all." See also Benintendi v. Kenton Hotel, Christal v. Petry, and Eisenstadt Bros. v. Eisenstadt, **supra** note 21

[23] **Supra** note 21.

[24] Emphasis supplied.

board. Any business may be transacted by the board at a meeting at which every member of the board is present, though held without notice."

Note that section 28 of the above-quoted New York Law, unlike section 33 of our statute, would seem to authorize shareholders to vary in the by-laws the majority-of-a-quorum rule prescribed for board action. Under these provisions, the two shareholders of Kenton Hotel, Inc. adopted by-laws, one of which required that no action could be taken by the directors except by unanimous vote of all of them. The Court of Appeals of New York in a close 4-3 decision struck down the by-law as invalid primarily because in construing the afore-quoted sections 27 and 28 of the New York General Corporation Law, it was of the opinion "that there never was a legislative intent so to change the common-law rule as to quorums as to authorize a by-law like the one under scrutiny..."[25] The Court said that "At common law only a majority thereof (of the board) were needed for a quorum, and a majority of that quorum could transact business."[26] Furthermore it called the by-law in question as "unworkable and unenforcible."[27]

Our courts have not yet spoken on the matter of whether or not it is lawful to vary the statutory operational procedure prescribed for the board by requiring either a higher than statutory percentage or unanimous representation or vote for board quorums and decisions. Is the simple majority rule set forth in Section 33 so inflexible and mandatory such that any variation thereof will be held invalid. Was it the intention of our Legislature to hold shareholders to a rigid observance of the statutory norm as a price of incorporation? Many corporate writers have pointed out that the division of corporate powers between directors and shareholders need not be a mandatory or essential feature of the corporate form of organization.[28] They point out further that to hold that directors acting as a board have absolute statutory prerogatives beyond the power of shareholders to modify or take away is to disregard historical fact.[29] Indeed they point to the corporation statute of the

[25] 294 NY 120 (1945).

[26] **Id.** at 119.

[27] **Ibid.**

[28] Hornstein, **op. cit. supra** note 8 at 442: "The theory that the corporation conducts its normal operations only through directors is based upon the unfounded assumption that there is a traditional division of corporate functions. Unfortunately for the theory some of today's so-called norms are the precise reverse of earlier practices and others at this time are not uniform in all states." See also Ballard, **Arrangements for Participation in Corporate Management Under the Pennsylvania Business Corporation Law**, 25 TEMPLE L. Q. 131 at 132.

[29] Hornstein, **op. cit. supra** note 8 at 442: "Shareholders in the eighteenth century voted directly on certain matters of corporate policy (such as the declaration of dividends) and by vote themselves appointed the executive officers, the latter practice surviving to this day in a dozen states. In England shareholders are regarded as the source of the directors' power; for a score of years, England, in fact, did not require a board of directors at all in a 'private company', their form of organization which best approximates our close corporation." See also Ballard, **op. cit. supra** note 28 at 132, 133.

state of Iowa which makes no provision for a board of directors. As Stevens puts it: "Boards of directors do not exist because of a statutory recognition of a practical business requirement. There is no fundamental reason why corporations must have boards of directors; it is conceivable that they might be managed without directors, and the possibility exists under the English Companies Act. The efficient and economical management of the corporate business is promoted by centralization of control in a small group... When the membership of the corporation is large, the board of directors will embrace but a small proportion of all the shareholders, but, in a corporation with small membership, the board of directors may include all shareholders. The board of directors must therefore be regarded as actually representing the body of shareholders and as exercising authority derived from them.[30] With such a historical and functional background, it is difficult to see why under section 33 of our statute the simple majority rule prescribed for quorums and decisions of the board of directors may not be so varied by the shareholders "as to effect a more responsive, stable, and efficient management". Particularly is such variation necessary in the case of a small corporation which "is fundamentally the will and effort of a few individuals."[31] The fact that close corporations preponderate in our jurisdiction underscores the necessity for a liberal and tolerant judicial attitude towards shareholder attempts to formulate and enjoy desirable partnership features under a corporate form of organization. Our courts ought to be critical of such attempts only when they have been subverted to a purpose injurious to other shareholders, the creditors, or the public generally. It may be argued that public policy as expressed in the statute is opposed to a requirement either of unanimity or a qualified, rather than a simple majority for board quorums or decisions because such a rule exposes the board to eventual deadlock and stoppage of business. Such an argument seemed evident in the *Benintendi* decision when the court cited an English decision holding that "prima facie in all acts done by a corporation, the major number must bind the lesser, or else differences could never be determined."[32] The fact that a

[30] STEVENS, CORPORATIONS § 143, pp. 648-649 (1950); "The board of directors of a corporation is a creation of the stockholders and controls and directs the affairs of the corporation by declaration of the stockholders." Angeles v. Santos, 64 Phil. 697, 806 (1937). See also Ballard, **op cit. supra** note 28 at 132, 133: "It is apparent therefore, that other than as a matter of convenience and policy nothing in the nature of the corporation requires having a board of directors or committing to such a board the management of corporate affairs, and even where the existence of the board is required by statute a considerable variation in its authority and function may be expected . . . Policy and convenience, such as uniformity of corporate organization, and the advantages of centralization, of administrative and policy-forming authority and responsibility, are the basis for the requirement of the board, not an inherent legal or factual 'inability' of the shareholders to act corporately and by resolution to direct corporate officers and agents in corporate affairs."

[31] Cary, **op. cit. supra** note 8 at 428.

[32] 294 NY 112, 119, 60 NE 829 (1945).

number of American state legislatures have seen fit to permit variation of the simple majority rule for board action[33] belies the existence of such public policy. In all probability the "shareholder-partner" would not have invested in the enterprise unless he were afforded a veto power to enable him to enforce a previously determined and agreed course of action. Generally, deadlocks will result only from major differences. Such differences arise mainly because one or more of the "shareholders-partners" seeks to obtain advantage at the expense of his associate or to violate a mutual agreement. As was said by one writer, "it may be that at the time of the agreement between the parties some or all of them would prefer deadlock to departure from the agreement..."[34] On the whole, however, self-interest and the desire to make the enterprise profitable and successful may, to a large extent, be relied upon to smooth out these differences.[35] Finally, it is important to note that whatever public policy argument was supposed to have been expressed in the *Benintendi* decision has already been thrown overboard by the New York legislature. In 1948, a new section 9[36] was introduced in the New York Stock Corporation Law providing in part as follows: *Provisions of certificates of incorporation; requirement of greater than majority or plurality vote of directors or shareholders.* 1. The certificate of incorporation as originally filed, or as amended by certificate filed pursuant to section 36 of the stock corporation law, may contain provisions specifying any or all of the following: (a) that the number of directors who shall be present at any meeting of the directors in order to constitute a quorum for the transaction of any business or of any specified item of business shall be such number greater than a majority as may be specified in such certificate; (b) that the number of votes of directors that shall be necessary for the transaction of any business or of any specified item of business at any meeting of directors shall be such number greater than a majority as may be specified in such certificate..." The foregoing provisions are evidently intended to rectify the construction placed on sections 27 and 28 of the New York General Corporation Law by the *Benintendi* decision insofar as it would invalidate a provision requiring a unanimous vote of the directors for board decisions.

[33] See **supra** notes 16 & 20. Consider also the following dictum in **McQuade v. Stoneham,** 263 NY 323, 189 NE 234 (1934): "Public policy is a dangerous guide in determining the validity of a contract and courts should not interfere lightly with the freedom of competent parties to make their own contracts."

[34] Ballard, **op. cit. supra** note 28 at 152.

[35] To provide for a situation where a deadlock is inevitable, the associates may stipulate in the pre-incorporation agreement as well as in the articles and by-laws that each will vote all his shares for dissolution. See Israels, **The Sacred Cow of Corporate Existence — Problems of Deadlock and Dissolution, supra** note 8 at 792.

[36] Added L. 1948, c. 862 § 1; amended L. 1949, c. 261; L. 1951, c. 717 § 1 eff. Sept. 1, 1951 (McKinney's); see also Israels, **The Close Corporation and the Law, supra** note 8.

(2) *Shareholder decisions — affording to each shareholder in a close corporation a veto power.* Affording to each of A, B, and C, as directors, a veto power over board decisions would ordinarily not be sufficient to protect their respective interests for the reason that our statute allocates a share of corporate management to the shareholders as a group. The shareholders as a body are empowered to approve certain corporate acts, mostly of an extraordinary and organic nature. A and B or A and C, or B and C holding a controlling 66 voting shares between them representing 2/3 of the total number of shares outstanding would, under our statute have voting strength sufficient to approve any of such corporate acts. Thus two shareholders could force upon the third the amendment of the articles or by-laws possibly to do away with the provisions giving the latter a veto power over board decisions. So, also, two shareholders in our example could, against the wishes of the third, validly invest or sell the corporate assets[37] or force a dissolution, among others. Naturally, because of their equal financial investment, A, B, and C would like counsel to formulate such devices as would insure to each a veto power over shareholder decisions. The pre-incorporation agreement to be made a part of the articles and by-laws should consider the following suggestions:

(a) The number of directors should be fixed at six to insure equal representation. Under section 13 of our statute, "Every corporation has the power: . . . (7) To make by-laws, not inconsistent with any existing law, for the fixing . . . of the number of its officers and directors within the limits prescribed by law..." Where such a stipulation is allowed to be made a part of the by-laws, there seems to be no valid reason why it should not be similarly allowed in the articles despite the silence of section 7 of our statute on the matter.

(b) The quorum should be fixed as the shareholders owning at least 5/6 of the total number of shares outstanding. This would give each of A, B, and C, holding or controlling at least 2/6 or 1/3 of the total number of shares outstanding the power to prevent a quorum by his absence and that of the shareholder he has qualified.

(c) All decisions of the shareholders as a body should be subject to the approval of shareholders holding at least 5/6 of the total outstanding shares. Each of A, B, and C controlling 2/6 or 1/3 of the total outstanding shares would therefore have voting strength sufficient to veto any proposal requiring shareholder approval.

Again the question of importance is whether or not a provision in the articles and by-laws requiring unanimity or even a qualified rather than a simple majority for shareholder quorums and decisions is valid in our jurisdiction. To date our Supreme Court has had no occasion to speak

[37] Assuming the sale has been initiated and already approved by the board, see CORPORATION LAW § 28-1/2.

on this point and at best we can only examine the arguments for and against the validity of such a provision. With respect to shareholder quorum requirements, section 21 of our statute provides: "A corporation may, unless otherwise prescribed by this Act, provide in its by-laws for... the number of stockholders or members necessary to constitute a quorum for the transaction of business at meetings of stockholders or members..." There is this definite statutory authority for including a quorum provision in the by-laws. Although Section 7 of our statute is silent on the matter, there appears to be no valid reason against similar inclusion of such a provision in the articles. Note that section 21 of our statute contains no limitation on the number of shareholders necessary to constitute a quorum for the transaction of corporate business other than the qualifying phrase "unless otherwise prescribed by this Act." The only specific instance for which the statute prescribes a quorum is at the election of directors when "there *must* be present, either in person or by representative authorized to act by written proxy, the *owners of the majority of the subscribed capital stock entitled to vote.*"[38] In our illustrative case, the presence of A and B or A and C, or B and C holding or controlling 66 voting shares or 2/3 of the total voting shares outstanding would be sufficient to constitute a quorum for the election of directors since the foregoing provision requires a simple majority of voting-share ownership. Would a charter or by-law provision, generally requiring a quorum constituted by shareholders holding more than a simple majority of the total voting shares outstanding, be valid in the face of such a provision of law? Or does section 31 merely set up a mandatory *minimum* quorum requirement? This writer believes that it does and that the requirement of a stricter or greater quorum such as is constituted by shareholders owning 5/6 of the total voting shares outstanding does not offend the aforementioned section 31. It may be argued that public policy is offended by a requirement of a quorum constituted by shareholders owning more than a simple majority of the total voting shares outstanding. Such an argument is often advanced against charter or by-law provisions requiring a unanimous or higher than statutory vote for shareholder decisions and it is in this connection that we shall take up this argument shortly.

Under our statute, five corporate acts require the approval of a simple majority of the total shares outstanding whether voting or non-voting.[39] One requires the approval of a simple majority of the total *voting* shares outstanding.[40] Still another one requires a simple numerical majority of

[38] CORPORATION LAW § 31, emphasis supplied.

[39] **Id.** §§ 5, 6 (increase or decrease number of directors), 17 (incur, create, or increase any bonded indebtedness), 20 (adopt original by-laws), 22 (amend, repeal, or adopt new by-laws), 45 (sale or other disposition of purchased delinquent shares).

[40] **Id.** § 5 (determine consideration for no par shares).

the shareholders.[41] Five corporate acts require the approval of two-thirds of the total shares outstanding, whether voting or non-voting.[42] Four require the approval of two-thirds of the total *voting* shares.[43] Again we ask, would a charter or by-law provision requiring shareholder decision to be approved by at least 5/6 of the total number of shares outstanding be valid in the face of such provisions of law requiring merely a simple majority or at most 2/3 of the total shares outstanding? Or are these differing percentages of shareholder vote specified by our statute merely *minimum* requirements? An examination of the phraseology of five sections of our statute unequivocally indicates that the percentages therein specified are definitely minimum requirements. Thus section 16 specifies *"not less* than 2/3 of all stock then outstanding and entitled to vote;[44] section 17-1/2, *"at least* 2/3 of the subscribed capital stock;[45] section 18, *"at least* 2/3 of the subscribed capital stock";[46] section 28-1/2, *"at least* 2/3 of the voting power";[47] and section 62, *"at least* 2/3 of all shares of stock issued or subscribed."[48]

But how about the other sections in which the specified percentages of shareholder vote necessary are not qualified by either the phrase "not less" or "at least"? Are such unqualified statutory percentages inflexible and mandatory?

Let us turn again to the New York case of *Benintendi v. Kenton Hotel, Inc.*[49] Besides the by-law requiring unanimity for board action which we have already discussed, the individual defendants also questioned the validity of three other by-laws as follows: (1) No action could be taken by the shareholders except by unanimous vote of all shareholders; (2) No director shall be elected except by unanimous vote of all shareholders; (3) No by-law may be amended except by unanimous vote of all shareholders. By-law No. 1 was struck down as invalid because it was "obnoxious to the statutory scheme of stock corporation management."[50] The court said: "...this State has decreed that every stock corporation chartered by it must have a representative government, with voting conducted conformably to the statutes, and the power of decision lodged in certain fractions, always more than half of the stock. That whole concept is destroyed when the stockholders, by agreement, by-law or certificate of incorporation provision as to unanimous action give the minority interest an absolute permanent, all-inclusive power of veto."[51] Similarly, by-law No. 2 was declared invalid for "a requirement, wherever, found, that there shall be no election of directors at all unless every single vote be cast for the same nominees, is in direct opposition to the statutory rule — that the receipt of a plurality of the votes entitles a nominee to election."[52] Although it did not elaborate, the court seemed to be invoking some kind of public policy when it said "The device is intrinsically unlawful because it contravenes an essential part of the State policy, as expressed in the Stock Corporation Law.[53] By-law No. 3 was declared valid because there was no specific statutory provision for the amendment of by-laws.

As we have already seen, the foreging decision has already been overruled by statute. Section 9 of the New York Stock Corporation Law now provides in part: "(c) that the number of shares of the corporation, or the number of shares of any class having voting power, the holders of which shall be present in person or represented by proxy at any meeting in order to constitute a quorum for the transaction of any business or of any specified item of business at a meeting of the stockholders shall be a number greater than the majority or plurality prescribed by law in the absence of such provision; (d) that the number of votes or consents of the holders of shares of the corporation, or of the holders of shares of any class of stock having voting power that shall be necessary for the transaction of any business or of any specified item of business at a meeting of the stockholders, including amendments to the certificate of incorporation, or the giving of any consent, shall be a number greater than the proportion prescribed by law in the absence of such provision."[54] By the foregoing provisions the New York State Legislature made it plain that no public policy was offended by provisions requiring unanimity or a higher-than-statutory representation or vote for shareholder quorums or decisions. By the foregoing provisions the Legislature indirectly told the Court of Appeals that it was not the legislative intent that the various percentages specified in the statute were to be so inflexible and mandatory as to forbid unanimity or a greater than majority or plurality representation or vote for shareholder quorums or decisions. Indeed the introduction of the new section 9 in the New York Stock Corporation Law was an unequivocal recognition of the peculiar operational needs of close corporations.[55] Even before the legislature spoke, one New York court had al-

[41] **Id.** § 22 (revoke power delegated to board to amend, repeal, or adopt new by-laws).
[42] **Id.** §§ 17 (increase or diminish the capital stock), 18 (amend the articles), 22 (delegate to board power to amend, repeal or adopt new by-laws), 62 (dissolution, judicial or extrajudicial).
[43] **Id.** §§ 16 (issuance of stock or bond dividends), 17-1/2 (invest corporate funds in other corporations or businesses), 28-1/2 (sell all of corporate assets), 34 (remove directors).
[44] Emphasis supplied.
[45] **Id.**
[46] **Id.**
[47] **Id.**
[48] **Id.**
[49] **Supra** note 21: see also Christal v. Petry and Eisenstadt Bros. Eisenstadt, **supra** note 21.
[50] **Id.** at 294 NY 118.
[51] **Ibid.**
[52] **Id.** at 117.
[53] **Ibid.**
[54] Added L. 1948, c. 862 § 1; amended L. 1949, c. 261; L. 1951, c. 717 § 1, eff. Sept. 1, 1951 (McKinney's).
[55] Israels, **The Close Corporation and the Law, supra** note 8.

ready validated a provision in the articles of a New York corporation calling for a higher-than-statutory vote for shareholder decisions.[56] Specifically, this particular provision required a quorum consisting of shareholders holding 85% of the total issued and outstanding shares as well as the approval of all shareholder resolutions and motions by the holders of a similar percentage of shares. The *Benintendi* decision was invoked against its validity. The court said: The case of *Benintendi v. Kenton Hotel*... upon which defendants rely is distinguishable. In the *Benintendi* lawsuit no action could be taken by the stockholders of the corporation except by the *unanimous* (emphasis supplied) vote of all and the by-laws could not be amended except by the unanimous vote of all the stockholders... No such required unanimous action is present..."[57] The Court went further to say that "In the absence of fraud or bad faith courts have nothing to do with the internal management of business corporations provided they keep within their corporate powers."[58] Insofar as it was intended to secure equality of control by the charter provision in question the court found that such a provision is not "positively forbidden by statute or contrary to public policy or inconsistent with law."[59]

Conclusion: The foregoing discussion has been confined to a critical problem in close corporations — the allocation of participation in management by the use of agreements, charter and by-law provisions fixing mainly quorum and voting arrangements. Our simple illustrative fact situation was quite limited in that the parties involved were desirous of equal participation. Other complicated fact situations may doubtless arise calling for unequal sharing of management, and under a statutory framework such as ours, originally designed to meet the needs of publicly-held corporations, it may take all the ingenuity of counsel to formulate such valid devices as will carry out the intent of the "shareholder-partners." We have also left out a discussion of a very important desideratum among associates in a close corporation — that of restricting the transferability of shares so as in effect to capture and preserve the "delectus personae" feature of a partnership.

Our examination of the relevant provisions of our statute has seemed to indicate that on the surface they are less flexible than similar provisions of many American statutes for the purpose of affording veto devices to associates in a close corporation. Particularly is this true of section 33 laying down the simple majority rule for board quorums and decisions. The phraseology of that portion of section 21 permitting the by-laws to determine the requirement for shareholder quorums lends to more flexibility. So also, we found that the percentages of shareholder vote specified in sections 16, 17-1/2, 18, 18-1/2 and 62, necessary to approve the issuance of stock or bond dividends, investment of corporate funds in another business, amendment of the articles, sale or disposition of all or substantially all the corporate assets and judicial dissolution respectively are unequivocally mere minimum requirements.

[56] Kronenberg v. Sullivan County Steam Laundry Co., 91 NYS 2d 144 (1949).
[57] **Id. at 155.**
[58] **Id. at 156.**
[59] **Id. at 157.**

The fact that section 7 of our statute is silent on the matter of including in the articles optional provisions for the internal management of the corporation appears to be of no moment. Section 20 of our statute requires that a copy of the by-laws "duly certified to by a majority of the corporation, shall be filed with the Securities and Exchange Commissioner, who shall attach the same to the original articles of incorporation..." So also, section 23 requires that a copy of any amendment or new by-law "shall be filed with the Securities and Exchange Commissioner, who shall attach the same to the original articles of incorporation and original by-laws on file in his office..."

Because of this statutory filing requirement (not generally found in American corporation statutes), which would make of by-laws public records open to the inspection of any interested party, in our jurisdiction third persons would be charged with constructive notice of them as they are with respect to the articles of incorporation. In other words, in our jurisdiction articles of incorporation and by-laws have as a rule the same binding effect insofar as third persons dealing with the corporation are concerned. So that veto and other management devices made a part of the by-laws alone would have the same binding effect as those included in the articles alone. It would be best however to incorporate such devices in both the articles and the by-laws.

Finally, the importance of a realistic approach to the solution of legal problems arising from the desire of associates in a close corporation to operate as partners cannot be overemphasized. The significant fact is our corporate economy is built on a foundation of close corporations. The enactment of legislation similar to section 9 of the New York Stock Corporation Law which we discussed above would conclusively settle the question of whether or not our statute may be so validly molded as to meet the business needs of "shareholder-partners." It is urged however that desirable as such legislation may seem, it is not necessarily indispensable since the intent behind such legislation may be fully brought out by a realistic judicial application of the relevant provisions of our statute however inflexible some of them may on the surface appear. To insist, as one writer said "upon unnecessary conditions as the price of limited liability seems unfairly discriminatory..... It is utterly inconsistent with the government's desperate efforts to strengthen the free enterprise system and to alleviate the problems of the small business corporation even at the cost of making tax concessions to it."[60]

[60] Hornstein, **op. cit. supra** note 8 at 449.