# THE USE OF CORPORATE CONTROL DEVICES

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## INTRODUCTION

One basic principle of international trade, as it has evolved into its present operational framework, is the economic benefit resulting from foreign investments. Many progressive nations today realize the need for inviting foreign capital, a situation which only years ago triggered riots and inflammatory rhetoric from the zealous guardians of "economic nationalism." But experience and balance-of-payments difficulties have a way of driving home the lessons of economics far deeper than can any passing event or temporal political personality. Many rabidly nationalistic governments have reopened their doors to these investments, partly in response to the pressures for closer cooperation generated by economic need and partly due to the realization that astute management of foreign investment programs can build up long-range economic infrastructures at relatively modest expense. The cost benefit of balanced economic development justifies the short-term additional burdens on foreign exchange reserves for profit repatriation and royalty payments.

Nevertheless, foreign investments remain invariably exposed to a host of constraints ranging from foreign law restrictions on equity, double taxation, and manpower requirements to repatriation of foreign exchange, among others. Although setting up the corporate shell and securing the operating license for it pose no difficulty in most cases, the adaptation of management objectives and profit-maximization strategies to local conditions often calls for detailed planning due to variances in market size, preferences and approach, social and cultural characteristics, geographical distribution, and similar

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business considerations. Issues of law and regulatory hazards likewise abound with no less frequency and intensity. Of topmost priority in this regard is the question of corporate control over the local subsidiary as an implementing agency of the overseas parent's policies and as a flawlessly functioning cog in the whole system of domestic and foreign subsidiaries, branches, and offices operating in accordance with the transnational corporation's worldwide master plan. Control being a significant premise of offshore investments in many cases and the assumption of risks attendant to those commitments, proposed devices for that purpose undergo careful study and refinement from local counsel as well as the parent's expatriate representatives.

The preceding scenario is, in varying forms and degrees, probably typical of many foreign investment decisions that are made in boardrooms everywhere. It describes the context in which this paper is written.

This study is divided into four chapters. Chapter I will first characterize the more important mechanisms of corporate control. It will not, however, go into a detailed analysis of each, as the intention is merely to identify the various legal sources and practical applications of these devices. Chapter I will also introduce two particular devices-- voting trust agreements and pooling arrangements. These devices, which will be further discussed in the second and third chapters, will constitute the main subject matter of this paper. Of the different control mechanisms, voting trust agreements and pooling arrangements have been selected for special treatment due to the fact that they, as will be shown elsewhere in this study, are probably the two most effective and powerful devices available. A wealth of jurisprudence surrounds them. Moreover, their use has reached such a sophisticated level of development in corporate practice as to be considered a state of the art while the third will dwell on pooling or voting contracts. The final chapter of this paper will carry the author's conclusion.

## I. THE MECHANISMS OF CORPORATE CONTROL

### The Concept of Control

The concept of corporate control, broadly speaking, refers to the ability to steer the course of a corporation's affairs towards certain predetermined objectives. In their book *The Modern Corporation and Private Property*, Adolph A. Berle, Jr. and Gardiner C. Means described the evolution of the concept or corporate control:

> As the ownership of corporate wealth has become more widely dispersed ownership of that wealth and control over it have come to lie less and less in the same hands. Under the corporate

system, control over industrial wealth can be and is being exercised with a minimum of ownership interest. Conceivably it can be exercised without any such interest. Ownership of wealth without appreciable control and control of wealth without appreciable ownership appear to be the logical outcome of corporate development.

This separation of function forces us to recognize 'control' as something apart from ownership on the one hand and from management on the other. . . Control divorced from ownership is not, however, a familiar concept. It is a characteristic product of the corporate system. Like sovereignty, its counterpart in the political field, it is an elusive concept, for power can rarely be sharply segregated or clearly defined. Since direction over the activities of a corporation is exercised through the board of directors, we may say for practical purposes that control lies in the hands of the individual or group who have the actual power to select the board of directors, (or its majority), either by mobilizing the legal right to choose them -- 'controlling' a majority of the votes directly or through some legal device -- or by exerting pressure which influences their choice. Occasionally a measure of control is exercised not through the selection of directors but through dictation to the management, as where a bank determines the policy of a corporation seriously indebted to it. In most cases, however, if one can determine who does actually have the power to select the directors, one has located the group of individuals who for practical purposes may be regarded as 'the control.'

When control is thus defined, a wide variety of kinds and conditions of control situation can be found -- forms derived wholly or in part from ownership, forms which depend on legal devices and forms which are extra-legal in character.

Five major types can be distinguished though no sharp dividing line separates type from type. These include (1) control through almost complete ownership (2) majority control (3) control through a legal device without majority ownership (4) minority control and (5) management control. Of these, the first three are forms of control resting on a legal base and revolve about the right to vote a majority of the voting stock. The last two, minority and management control, are extra-legal, resting on a factual rather than a legal base.

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**Control Through a Legal Device**

In the effort to maintain control of a corporation without ownership of a majority of its stock, various legal devices have been developed. Of these, the most important among the very large companies is the device of 'pyramiding.' This involves the owning of a majority of the stock of another -- a process which can be repeated a number of times. An interest equal to slightly more than a quarter or an eight or a sixteenth or an even smaller proportion of the ultimate property to be controlled is by this method legally entrenched. By issuing bonds and non-voting preferred stock of the intermediate companies each of which is legally controlled through ownership of a majority of its stock by the company higher in the series, complete legal control of a large operating company can be maintained by an ownership interest equal to a fraction of one per cent of the property controlled. The owner of a majority of the stock of the company at the apex of a pyramid can have almost as complete control of the entire property as a sole owner even though his ownership interest is less than one per cent of the whole.

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This same pyramiding has been extensively employed in building up most of the great public utility systems. By its use legal control can be maintained with an extremely small investment. Through it, legal control can be effectively divorced from legal ownership and factual power can be exercised over great aggregates of wealth with almost no ownership interest therein.

A second legal device for retaining control with a small investment is the use of non-voting stock. This is a comparatively new device but one which has received so much comment as to be thoroughly familiar. It consists in so arranging the rights attached to different classes of stock that most of the stock is disenfranchised (at least so far as the voting for directors is concerned) and only a very small class, or a class representing a very small investment, is permitted to vote. Ownership of just over half of this privileged class is sufficient to give legal control and virtually all the powers of majority ownership. For many years it has been possible in certain states to issue non-voting preferred stock. This has frequently been done without causing serious objection, presumably in part because the issue of common stock is as a rule very much larger than the corresponding issue of preferred stock and in part because the self-interest of the common stockholders has been

regarded as ample protection for the interests of the preferred holders.

Only recently have statutory changes made it possible to issue common stock and such has met with considerable disfavor. Both the New York Stock Exchange and the New York Club have refused to list new issues of non-voting common stock; for practical purposes, this would seem to have eliminated the use of this device on any large scale in the immediate future.

A similar device is, however, being employed which may perhaps be considered a variant of the non-voting stock. This consists of issuing to the controlling group a very large number of shares of a class of stock having excessive voting power, i.e., voting power out of proportion to the capital invested.

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In addition to these ways of securing legal control through direct or indirect ownership of the voting majority, a further device must be considered which does not involve even ownership of a voting majority. This is the familiar practice of organizing a voting trust.

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As in the case of legal control, factual control apart from legal control may involve varying degrees of ownership, though never more than fifty per cent of the voting stock. It may rest to a very considerable extent on the ownership of a large minority stock interest, or, when stock ownership is widely distributed, it may lie in the hands of the management. No sharp dividing line exists between these two situations, but so far as they can be distinguished, they may properly be referred to as minority control and management control.

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### Minority Control

The first of these, minority control, may be said to exist when an individual or small group holds a sufficient stock interest to be in a position to dominate a corporation *through their stock interest*. Such a group is often said to have 'working control' of the company. In general, their control rests upon their ability to attract from scattered owners proxies sufficient when combined with their



substantial minority interest to control a majority of the votes at the annual elections. Conversely, this means that no other stockholding is sufficiently large to act as a nucleus around which to gather a majority of the votes. Where a corporation is comparatively small and the number of stockholders is not great, minority control appears to be comparatively difficult to maintain. A rival group may be able to purchase majority of the stock or perhaps only a minority large enough to attract the additional votes necessary to obtain control in a proxy fight. The larger the company and the wider the distribution of its stock, the more difficult it appears to be to dislodge a controlling minority.

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### Management Control

The fifth type of control is that in which ownership is so widely distributed that no individual or small group has even a minority interest large enough to dominate the affairs of the company. When the largest single interest amounts to but a fraction of one per cent -- the situation in several of the largest American corporations -- no stockholder is in the position through his holdings alone to place important pressure upon the management or to use his holdings as a considerable nucleus for the accumulation of the majority of votes necessary to control.

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In such companies where does control lie? To answer this question, it is necessary to examine in greater detail the conditions surrounding the electing of the board of directors. In the election of the board the stockholder ordinarily has three alternatives. He can refrain from voting, he can attend the annual meeting and personally vote his stock, or he can sign a proxy transferring his voting power to certain individuals selected by the management of the corporation, the proxy committee. As his personal vote will count for little or nothing at the meeting unless he has a very large block of stock, the stockholder is practically reduced to the alternative of not voting at all or else of *handing over his vote to individuals over whom he has no control and in whose selection he did not participate*. In neither case will he be able to exercise any measure of control. Rather, control will tend to be in the hands of those who select the proxy committee by whom, in turn, the election of directors for the ensuing period may be made. Since the proxy committee is appointed by the existing management, the latter can

virtually dictate their own successors. Where ownership is sufficiently sub-divided, the management can thus become a self-perpetuating body even though its share in the ownership is negligible. This form of control can properly be called 'management control'.

Such management control, though resting on no legal foundation, appears to be comparatively secure where the stock is widely distributed. Even here, however, there is always the possibility of revolt. A group outside the management may seek control. If the company has been seriously mismanaged, a protective committee of stockholders may combine a number of individual owners into a group which can successfully contend with the existing management and replace it by another which in turn can be ousted only by revolutionary action.[1]

## Patterns in Philippine Corporate Practice

Corporate legal practice in the Philippines is, in many respects, similar to that existing in the United States. History provides the explanation to this. After three hundred seventy-seven years (1521-1898) under Spanish colonial rule, during which the only recognized legal entity was the *sociedad anonima,*[2] the cession to the United States under the Treaty of Paris[3] paved the way for the introduction of the American corporate concept to the Philippine legal system. Act 1459, the first Philippine Corporation Law, was enacted on March 1, 1906 by the Philippine Commission,[4] and took effect a

[1] A. BERLE AND G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 69-88 (1932).

[2] The *sociedad anonima* was a form of partnership provided for in the Spanish Code of Commerce. "For purposes of general description only, it may be stated that the *sociedad anonima* is something very much like the English joint stock company, with features resembling those of both the partnership and the corporation." Harden v. Benguet Consolidated Mining Company, 58 Phil. 141 (1933).

[3] The Treaty of Paris, signed December 10, 1898, formally ended the Spanish-American War. The treaty, among other things, provided that Spain was to relinquish her sovereignty over to the Philippines (then known as the Philippine Islands), Guam and Puerto Rico in favor of the United States.

[4] The Philippine Commission was the Islands' legislative body whose members were appointed by the President of the United States pursuant to the authority of the US Congress. In 1907, the Philippine Assembly was created to serve as the lower



month later.

Act 1459 was drafted by the Philippine Commission which was composed of five American and three Filipino lawyers. Thus it was that the first Philippine Corporation Law contained many provisions patterned after those of the different state corporation acts in the United States and embodied numerous principles enunciated in American jurisprudence.

Act 1459 was in force in the Philippines from 1906 to 1980. Throughout the seventy-four years that Act 1459 was the applicable Corporation Law, the Supreme Court relied heavily on the interpretation by American courts of many of its provisions.

The principal regulatory agency which oversees the administration and enforcement of the Corporation Code, the Securities Act, and other related laws is the Securities and Exchange Commission[5] whose structure, functions, practices, as well as quasi-legislative and quasi-judicial authority approximate closely those of its counterpart in the United States. Moreover, notwithstanding the lack of statistics, it is believed that a considerable percentage of the top corporation lawyers in the Philippines have pursued graduate legal studies (with emphasis on one or more aspects of corporations) in the United States.[6]

All this can only point to the fact that corporate legal practice in the Philippines does not greatly differ from what it is in the United States, save perhaps in such matters as the size of the corporate market served, stock transaction practices, state law differences, tax implications of corporate

house of the legislature, with the Philippine Commission continuing as the upper house. The Jones Law of 1916 was enacted by the U.S. Congress on August 29, 1916, formally reorganizing the legislature into a Senate and a House of Representatives. In 1935, upon the establishment of the Commonwealth of the Philippines, the legislature came to be known as the National Assembly. In 1946, it reacquired its old names of Senate and House of Representatives. The new Constitution in 1973 provided for a reversion to a unicameral assembly called Batasang Pambansa.

[5] Created by Commonwealth Act No. 83; subsequently, a revised charter for the SEC was drawn up by Presidential Decree No. 902-A, as amended by P.D. No. 1653.

[6] The Philippine Section of Vol. VII of the *Martindale- Hubbell Law Directory* (1982 Ed.), pp. 3032B-3064B, shows that a number of these US-trained corporation lawyers graduated from the LL.M. or the LL.M.-S.J.D. Programs in Harvard, Yale, University of Michigan, University of Pennsylvania, Columbia and Georgetown University. Not listed in the Directory are those with similar postgraduate legal training in the U.S. but who are in the judiciary, government service, private corporations, and legal education.

schemes, and similar considerations.

**Corporate Control in the Philippines**

The development of corporation law in the country has given the bench, the bar, and the corporations themselves valuable insights into what features are most desirable in the legal framework of corporate enterprise in the light of Philippine business practices. When the old Corporation Law (Act 1459) was repealed on May 1, 1980 as a result of the effectivity of the Corporation Code of the Philippines (hereinafter referred to as CCP), most of the provisions of the old Corporate Law which were incorporated into the CCP underwent revision, and new ones had to be worked out to cover the situations that had evolved in the meantime. Some of the statutory provisions to be discussed in this chapter are carry-overs from the old Corporation Law and will thus have the benefit of interpretative decisions of the Supreme Court. The rest are entirely new and will have to be analyzed from the viewpoints of the author and other writers, as well as from the viewpoint of the doctrines formulated in U.S. cases.

## (A) THE CLOSE CORPORATION

Title XII of the CCP on the close corporation is a recent development in the corporate law system of the Philippines in the sense that it was never given any special recognition by the old law. It is a specie of the ordinary corporation, its peculiarity being the maximum number of stockholders it is permitted by law to have.

Under Act 1459, close corporations did in fact exist but they were never legally known as such. Many of their operational characteristics were more the result of the creativity of counsel and general statutory principles rather than specific legal provisions squarely applicable to them.

Sec. 96 defines a close corporation as

> "one whose articles of incorporation provide that: (1) all of 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 this Title, and (3) the corporation shall not list in any stock exchange or make any public offering of any of its stock of any class. . . ."

The close corporation in the Philippines finds its roots in the so-called "family corporation," a concept which referred more to the social custom of



keeping wealth and patrimony within the family while enjoying the legal benefits of limited liability, rather than to some special type of corporation as a juridical personality. Indeed, the usual reasons advanced for the establishment of close corporations include the desire to combine limited liability with the power of absolute control inherent in sole proprietorships, the facilitation of management and sale of property, the circumvention of usury laws that apply only to individuals but not to corporations,[7] and the need for tax shelter under certain circumstances.

Close corporations are of course not limited to those whose stockholders belong to one family; the shareholders can just as well be persons bound together by common business objectives or related interests. In this sense, it is an "incorporated partnership" wherein the connection between the stockholders is often more direct and deliberate than the passive relationships among their counterparts in larger firms. For this reason, Sec. 96 itself states that 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 . . . ." Furthermore, entities like mining or oil companies, stock exchanges, banks, insurance companies, public utilities, educational institutions, and corporations vested with public interest may not be incorporated as close corporations due to their natural propensity to attract public investments.

The substance of corporate control in close corporations lies not so much in the restriction on the maximum allowable number of stockholders (no more than 20) but in the fact that, as provided in Sec. 97, "(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 the by a board of directors . . . in which case the stockholders need not even meet to elect directors as they themselves are "deemed to be directors". Furthermore, Sec. 97 states that "(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;
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> 2. 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, and

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[7] Fuller, *The Incorporated Individual: A Study of the One-Man Company,* HARV. L. REV., 1938, at 1374.

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

In consonance with the foregoing statutory authority, it is entirely possible for the articles to require all future stockholders to be related by affinity or consanguinity to any of the original incorporators within a certain civil degree,[8] or to classify directors in such a way that only certain stockholders or kinds of shares are entitled to vote for certain classes of directors or a specified number of them. Quorum or voting requirements greater than usual may likewise be imposed.

Finally, Sec. 98 requires that

> 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. . . .

The preceding discussion clearly underscores the power of corporate control in close corporations. If properly harnessed and exercised, such power can be wielded indefinitely to serve the desired objectives of the controlling interests, and in this regard, short of illegality or fraud, it can almost absolutely remain unassailable by the minority.

## (B) THE HOLDING COMPANY AND THE PYRAMID

### The Holding Company and the Megasubsidiary Phenomenon

According to Professor Melvin A. Eisenberg of the University of California (Berkeley), the last two decades have seen a transition in the ownership of business assets under the corporate system in the United States. Time was when business assets were held by corporations whose stock was principally owned by investors.[9] Illustrative of this was the very simple corporate structure wherein the stockholders held the shares of the company that owned the business assets (e.g., land, buildings, office equipment,

[8] Provisions of this nature will have to take into account the provisions of the Civil Code of the Philippines (Republic Act 386), especially with regard to the technical rules of the law on Persons and Family Relations.

[9] M. EISENBERG, THE STRUCTURE OF THE CORPORATION -- A LEGAL ANALYSIS 277 (1976).



machinery, and franchises).The process has, however, become more complicated today in that a significant portion of these assets is held by massive subsidiaries ("megasubsidiaries") whose stock belongs not to public investors like they used to but to parent corporations.[10] The typical example is that of a corporate concern ("the subsidiary"), which is one hundred percent owned and controlled by another corporation called the parent or holding company. If the vertical diagram ends with the parent or holding company, the stocks of such firm ordinarily find themselves in the hands of its investors. Matters, however, do admit of exceptions. The parent or holding company may itself be, in reality, just another subsidiary of a still higher parent or holding company in the upright structure. The series can theoretically extend upward indefinitely in a complex network of subsidiaries and parent companies, with the corporation in the top rung being the one owned by its investors. It is, of course, probable, that at any level of the totem pole, an intermediary parent or holding company operates not just one subsidiary but several of them, in which case these co-level "subs" are known as "affiliated companies" with respect to each other and with respect to any other member of that whole conglomerate or group of companies.

What advantages does such an intricate web of structures offer over the uncluttered one-corporation-one-business system of two decades ago?

> The reasons for . . . the megasubsidiary phenomenon as a whole, are grounded in part on *legal and economic considerations unique to each business sector*. . . . These include a desire to diversify into nonregulated businesses; to lessen the grip of the applicable regulatory agency and the applicable body of regulatory law (particularly limitations on capital structure) and to share in the higher stock multiples often associated with the nonregulated area.[11]

To these we may add the need for tax-shelter or tax-haven companies, "drawer corporations" to be used only for particular mergers and acquisitions, "dummy or front corporations" specially useful in certain types of marketing corporations, purely asset-based corporations which serve certain financing purposes, specialized-function and support units of the conglomerate, and similar entities. No listing can adequately cover the entire breadth of business exigencies justifying external expansion of a particular business group within a particular industry.

[10] *Id.*

[11] *Id.* at 280.

### The Mechanics of External Expansion

The traditional method of external corporate expansion is the formation of a subsidiary through the auspices, funding, and direct control of what thereafter becomes the parent or holding company. This is the so-called "downstream holding company" approach. After incorporation by the parent's lawyers or nominees, the shares are endorsed and transferred to the parent company, which then becomes the sole holder of all the outstanding stock of the new subsidiary, with the exception of possibly a few shares ("the qualifying shares") that are allowed to stand in the name of the parent's nominees to qualify them as directors of the new enterprise. In the Philippines, directors are required to be stockholders of record of at least one share each. Some companies, as a matter of practice, request the nominee-directors of their subsidiaries to endorse their qualifying shares in blank, to be kept in the possession of the parent firms, so as to control an unqualified one hundred percent of the subsidiaries and to facilitate any desired changes in the composition of the board.

The above-described process is not exclusive. There is another, though uncommon, way of bringing about the same result. It involves a company creating its own parent and is known as the "upstream holding company" method. In recent years, two companies listed in the New York Exchange, namely, General Acceptance Corporation and R.J. Reynolds Tobacco Co., created parent companies for themselves. Both entities cited as a major reason for adopting the holding-company form the fact that it would permit some activities of the restructured corporate complex to be free from restrictions arising under debt instruments or preferred stock (which were binding the creating corporation). R.J. Reynolds also stated that the restructuring would permit "more appropriate reflection of managerial responsibilities in respect of the diversified activities" of the corporate complex, substantially increase "flexibility in the assignment and deployment of personnel," and would "provide a more advantageous vehicle for future acquisitions and further diversification."[12]

Our discussion thus far should not, however, give the impression that subsidiaries are always wholly owned by their parent or holding companies. The fact is that the number of parent-subsidiary complexes in which the

[12] EISENBERG, THE STRUCTURE OF THE CORPORATION, *citing* Notice of Annual Meeting and Proxy Statement of R.J. Reynolds Tobacco Co., March 16, 1970 and Notice of Annual meeting and Proxy Statement of General Acceptance Corp., April 2, 1968 at 281.



members of the public hold a non-controlling stock interest in the subsidiary is increasing. There are two possible factors that can lead to this condition: the partial take-over and the partial spin-off. If the target corporation of a take-over bid is publicly held and the bidding corporation is either unwilling or unable to acquire one hundred percent of the target company's shares from its stockholders (being satisfied in the meantime with effective majority control), a partial take-over situation occurs. The partial spin-off, on the other hand, represents the converse possibility. Here, it is the parent company (or the subsidiary itself) which decides to distribute a minority interest in the subsidiary, either to the parent's own stockholders or to the public at large. Many reasons may impel such a move: the need of the parent or subsidiary for cash; the issuance of the subsidiary's shares (in lieu of stock dividends) to the parent's stockholders, which is often done to conserve the parent's cash and stocks; the conservation of the bulk of the parent's interest in its assets, considering that the subsidiary's shares represent merely a fraction thereof; and the desire to create a market price, raise the value, or increase the bankability of the subsidiary's shares held by the parent company.[13]

### The Pyramid and its Control Ramifications

> (Pyramiding) involves the owning of a majority of the stock of one corporation which in turn holds a majority of the stock of another -- a process which can be repeated a number of times. An interest equal to slightly more than a quarter or an eighth or a sixteenth or an even smaller proportion of the ultimate property to be controlled is by this method legally entrenched. By issuing bonds and non-voting preferred stock of the intermediate companies the process can be accelerated . . . . The owner of a majority of the stock of the company at the apex of a pyramid can have almost as complete control of the entire property as a sole owner even though his ownership interest is less than one percent of the whole.[14]

In the United States, the corporate pyramid traces its history to the boom period of the public utility industry in the 1920's. What follows is a very interesting description of what actually went on behind the pyramids of that era:

"We have no statistics on how many holding-company magnates

[13] *Id.* at 281,282.

[14] A. BERLE AND G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 69.

began as broker's messenger boys, but not a few were primarily financiers, paper-minded rather than operational in their approach to utility system problems. Some of these, possessing or commanding prime financial and legal talent, bent their efforts to the accumulation of voting control over existing utilities and other enterprises, deprived them of all semblance of independence and smothered them under elaborate paper superstructures. The operating utilities and other businesses at the base of these pyramids furnished all the revenues derived from outside sources and a large percentage of revenues were drained off, in numerous instances, by exorbitant service and construction fees charged against them by 'service companies' belonging to the parent holding company or to the individual interests who controlled the system. [The functions of system-owned and affiliated 'service companies' varied widely. Some furnished engineering advice and construction work, some furnished bookkeeping or auditing services, some performed outright every managerial function that an operating company's officers and board of directors could have performed. Whatever they did, the purpose of many of them was to obtain fees (including profits often running to 100% or more) which would be treated as operating expenses or capital costs in the accounts of the paying utilities, but would be received as income by the controlling persons. Since the companies paying the fees were under the control of the very persons who profited from the fees, the system-owned or affiliated service company was in a position to render 'services' (whether they were needed or not) at prices which were not limited by competitive conditions or even by the independent business judgment of the paying company's officers. . . . These fees, which were passed on to the consumer in the electric and gas rates charged by the utilities, were not subject to ready analysis by state or local regulatory bodies which usually did not have jurisdiction over the service companies or their records.] What was left of the earnings after expenses, fixed charges, and preferred stock dividend requirements of the operating companies, had to percolate upward through tier upon tier of holding companies to pay the interest and dividends on their outstanding securities. In such systems the companies in the superstructure were used for the purpose of retaining the insiders' control while the financial investment and risk were passed on to public investors by the flotation of a myriad of holding-company securities carrying no effective power to control the management. The securities issued to the public were frequently based on inflated 'book value' bearing little or no relation to the amount actually invested in the revenue-producing properties at the base of the pyramid and were issued the most optimistic assumption



as to the earning power of such properties."[15]

What stands out vividly from this is the major vice of pyramiding -- the risk of exploitation of the subsidiary's outside (or public) stockholders. Unfair intercorporate transactions tend to occur owing to the fact that the power of control is tremendously out of proportion to the relatively insignificant investment made by the management. Arthur Dewing, in *The Financial Policy of Corporations*, observed that because of the highly leveraged nature of corporate pyramids, corporations higher up the structure tend to draw excessively from the funds of the companies closer to the base as a means of servicing their own debt obligations. All these unsound financial policies tend to make pyramids unstable since the collapse of any company supporting the framework weakens the whole corporate edifice.[16]

In 1981, the Philippines witnessed one of the most serious corporate failures ever to take place in a long, long time. The victims were not large financial institutions which could have weathered the crisis with little difficulty; rather, they were public investors numbering ten thousand or more (mostly old retirees) who probably only a few weeks before had their life savings safely deposited in the banks.

For more than a year before the bubble burst, the Agrix Group, put together by a former high school teacher, had been attracting considerable attention from the conservative sectors of the financial community. Its operations were reported to be growing by leaps and bounds. Earnings were reported to be phenomenal for such a new venture. Investors, eager to take advantage of the "low, special" offering rates of the "hot" Agrix issues, were only too willing to buy any piece of paper Agrix had to offer, as fast as it could be printed and sold, including its so-called "joint marketing investment contract." In the meantime, the Agrix management, encouraged by the tremendous public response to its securities offerings (all of which later turned out to be unregistered with the Securities and Exchange Commission), continued frenziedly to build up its pyramid with new companies and new investments, that is, until the foundation started to quiver under the stress. And when the cracks finally began to appear, Agrix, in desperation, increased the guaranteed yield of its securities to an effective rate of five percent monthly or sixty percent per annum. The Agrix holding company was being strangled by a dire lack of available cash to meet its maturing obligations. The

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15 Blair-Smith and Helfenstein, *A Death Sentence or a New Lease on Life? A Survey of Corporate Readjustments under the Public Utility Holding Company Act*, 94 U. PA. L. REV. 148 (1946).

16 EISENBERG, *supra* note 9, at 312.

fantastic guaranteed yield, however, only attracted more and more investors. For Agrix to be able to guarantee earnings of five percent per month, they reasoned, its operating subsidiaries had to be extremely profitable. Nothing, however, could have been farther from the truth. The final reckoning came not long after and the collapse of the Agrix pyramid buried deep under its debris the dreams and expectations of thousands of its investors.

### (C) THE MANAGEMENT CONTRACT

Sec. 44 of the CCP provides that:

> no corporation shall conclude a management contract with another corporation unless such contract shall have been approved by the board of directors and by stockholders owning at least the majority of the outstanding capital stock, or by at least a majority of the members in the case of a non-stock corporation, of both the managing and the managed corporation, at a meeting duly called for the purpose: . . . No management contract shall be entered into for a period longer than five years for any one term.
>
> The provision of the next preceding paragraph shall apply to any contract whereby a corporation undertakes to manage or operate all or substantially all of the business of another corporation, whether such contracts are called service contracts, operating agreements or otherwise . . .

The management contract has not yet entered into widespread acceptance and use in the Philippines, although several of the large conglomerates are known to be managed through such a device[17] principally for tax purposes. The extremely personal style of management in the Philippines -- "the personal approach" typical of most Asian societies -- probably accounts for it. The work ethic expects officers of management to be "members of the company family." Hence, a management consultant from the managing firm will probably have to spend a great deal of time in the beginning trying to prove thorough familiarity with the managed company before he can establish his rightful authority to take command of the ship.

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[17] Philippine National Bank v. Producers Warehouse Association, 42 Phil. 608 (1922); Nielson & Co., Inc. v. Lepanto Consolidated Mining Co., 26 SCRA 540 (1968).



Any practice deviating from the customary norm can probably be justified, however, by the corporate group's size and diversity of business investments. In such a case, a "detached and impersonal" management set up becomes not only practical but necessary as well.

Considering, however, the provision of Sec. 23 that "unless otherwise provided in this Code, the corporate powers of all corporations formed under this Code shall be exercised, all business conducted and all property of such corporations controlled and held by the board of directors or trustees" what standards should separate permissible from impermissible delegation of powers to the managing corporation? Can the board validly relinquish its control over the affairs of the corporation to a separate entity by virtue of a management contract? If so, to what extent may this be done? Unfortunately, the Supreme Court has had no occasion to rule on this particular point of law and we therefore have to resort to American cases for guidance. In *Sherman & Ellis, Inc. v. Indiana Mutual Casualty Co.*,[18] the Court stated:

> . . . The line of demarcation between cases which recognize the right of officers of a corporation to delegate certain managerial duties to a stranger and cases which deny such authority is not entirely clear or easy to follow. That corporations may, at least for a limited period, delegate to a stranger certain duties usually performed by officers is clear . . . (Jones V. Williams, 139 Mo. 1, 39 S.W. 486, 40 S. W. 353, 37 L. R. A. 682, 61 Am. St. Rep. 436) . . . On the other hand, it is equally well settled that there are duties, the performance of which may not be indefinitely delegated to outsiders. . . . The case of Jones v. Williams . . . illustrates, perhaps as well as any, the extent to which the courts have gone in upholding such delegations of authority. There the Board of Directors gave an outsider the position of manager for a period of five years . . . . Here it is twenty years. There a large part of the board's official duties was undelegated. Here nothing of importance was left for the board of directors but the unimportant, the ministerial duties.

On the other hand, it is common practice among investment companies to contract with a research organization to provide management (investment advice), but the agreement must be terminable at any time by the board of directors. Furthermore, there may be a business advantage to a group of small corporations if they can contract that each of them shall for a period of years have the expert part-time services of someone who is more expert than the corporation's own officers, who because of the small size of

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[18] 41 F.2d. 588 (7th Cir. 1930).

each corporation cannot be paid high salaries.[19]

*Long Park, Inc. v. Trenton-New Brunswick Theatres Co.*[20] invalidated an agreement signed by the Trenton-New Brunswick Theatres Co. and all its stockholders, granting the management of the corporation to a certain stockholder for nineteen years as an illegal restriction on the directors' statutory powers of management under the New Jersey Business Corporation Act. In the same vein, *Marvin v. Solventol Chemical Products*[21] nullified an agreement entered into by a corporation that would have obliged, in consideration of a loan, the majority stockholders to elect two directors designated by the lender, one of whom was to act as comptroller with full powers over all the finances of the company. The Court in *Marvin* held that such an agreement was an illegal abdication of the board's duty to manage the corporation.

The foregoing cases should not, however, obscure the fact that a management contract drafted carefully in accordance with the requirements of law and jurisprudence remains a desirable mechanism of control over the corporation. As long as the board of directors retains the power to pass upon and, if necessary, to set aside the acts of the managing corporation or individual (specially *vis-a-vis* those matters deposited by the statute in its domain), conduct pursuant to a management agreement is more than likely to successfully weather judicial challenge. The key determinant thus seems to be whether, after the conclusion of the management agreement, it is still the board of directors managing the corporation; if not, the contract invites pronouncement as an *ultra vires* act.

### (D) The Executive Committee

Sec. 35 of the CCP states that

> (the) by-laws of a corporation may create an executive committee, composed of not less than three members of the board, to be appointed by the board. Said committee may act, by majority vote of all its members, on such specific matters within the competence of the board, as may be delegated to it in the by-laws or on a majority vote of the board, except with respect to: (1) approval of any action for which shareholders' approval is also required (2) the

[19] W. Cary, Cases and Materials on Corporations, 220-21 (4th ed. unabr. 1969).

[20] 297 N.Y. 174, 77 N. E. 2d 633 (1948).

[21] 298 Mich. 296, 298 N.W. 782 (1941).



> filling of vacancies in the board (3) the amendment or repeal of by-laws or the adoption of new by-laws (4) the amendment or repeal of any resolution of the board which by its express terms is not so amendable or repealable and (5) a distribution of cash dividends to the shareholders.

With the exception of Sec. 35 (5) on cash dividends, the rest of the provision was patterned after Sec. 712 of the New York Business Corporation Law and has for its purpose the creation of a "mini-board" unhampered by the quorum requirements of the full board of directors.

> (The) principal role played by many executive committees is to relieve the full board of time-consuming detail and repetitive tasks, leaving the board free to concentrate on unique problems and major issues.[22]

The smaller membership of the executive committee enables it to convene promptly and with ease in meeting the exigencies of the business, in between regular meetings of the board. But precisely because of its interim nature, the "excom" is precluded by law from validly acting on certain matters reserved either for the full board or the stockholders themselves.

In *Commercial Wood and Cement Co. v. Northampton Portland Cement Co.*,[23] the Court went so far as to rule that the executive committee's authority to act ceased with the approach of a directors' meeting. The court held in *Commercial Wood* that the executive committee could not validly authorize a contract in the morning of the day a meeting of the board was to take place. And in *Hayes v. Canada, Atlantic & Plant S. S. Co., Ltd.*,[24] the Court pointed out that:

> (it) is certainly intolerable to maintain that the words 'full powers' in the provision for the appointment of the executive committee practically divested the directors of all their functions and built up a new foundation for it in lieu of that formally established. Such an assumed absorption of the powers of the creator by the created is too absurd to receive the approbation of any court of law. . .

This notwithstanding, the executive committee remains in practice as an efficient control device in the hands of corporate officers cognizant of its

[22] McMullen, *Committees of the Board of Directors*, 29 Bus. Law. 775 (1974).

[23] 190 N.Y. 1, 82 N.E. 730 (1907).

[24] 181 F. 289 (1st Cir. 1910).

intricacies and potential uses. "Since the directors who are not officers of a corporation are not expected to give full time to its affairs, the selection committees . . . to execute the policies outlined by the directors becomes specially important . . . "[25] In a corporate environment wherein the directors who are not members of the executive committee are either non-officers or "outside directors," the committee virtually functions as the complete board with full powers. Even in those five instances enumerated in Sec. 35 of the CCP, the committee (since it is made up of the directors who are most actively involved in the day-to-day operations of the company) usually enjoys the deference of the full board with respect to its opinion; thus, it has in its favor more than an even chance of securing the required approval for its recommendations. "In larger companies, the executive committee often assumes a very active role -- deciding, or influencing answers to, even the most major questions, shaping the strategy of the company and charting the future direction of the business."[26]

Within the confines of the executive committee itself, domination may also occur, as it all too often happens in family corporations especially, when one or two individuals owning a sizeable block of the shares impose their wishes directly on the committee and indirectly on the full board and the rest of the stockholders.

Depending therefore on the nature, the structure, and the thrust of the particular entity involved, the executive committee can either be a docile lamb subservient to the dictates of the board of directors, or the proverbial man-with-a-stick capable of exacting obeisance from the board and the stockholders.

### (E) Special Qualifications of Directors

According to Sec. 47, "(s)ubject to the provisions of the Constitution, this Code, other special laws, and the articles of incorporation, a private corporation may provide in its by-laws for:

* * *

5. The qualifications . . . of directors or trustees . . ."

As a device for corporate control, prescribing certain special qualifications for directors hits two birds with one stone by "tailor-fitting" such

[25] H. Hoagland, Corporation Finance 77 (1947).

[26] McMullen, *supra* note 22.



qualification to those possessed by the controlling group, and by disqualifying the disfavored ones at the same time. In the case of *Government v. El Hogar Filipino,*[27] the Supreme Court upheld the validity of a by-law provision that only stockholders with a minimum of twenty shares could qualify as directors, despite the fact that Sec. 3 of Act 1459 (now Sec. 23 of the CCP) required only a minimum of one share for a shareholder to qualify as such. The case of *Gokongkwei Jr. v. SEC, et al.*[28] affirmed the right of a corporation to amend its by-laws for the purpose of disqualifying any stockholder from membership in the board if he is engaged in a competing business. Conceivably, a by-law which requires an elected director to be at least twenty-five years of age or to have had some experience in business, finance or law would be valid, since these qualifications would promote the efficient management of the corporation. In other words, as long as the qualifications imposed are reasonable and not meant to unjustly or unfairly deprive the minority of their rightful representation in the board of directors, they are within the powers of the holders of the majority of the stocks to provide in the by-laws.[29]

Sec. 7 of the CCP now explicitly recognizes the notion of "founders' shares" which are "shares classified as such in the articles of incorporation (with) certain rights and privileges not enjoyed by the owners of the other stocks." The statute, however, imposes the condition that if the prerogative consists of the exclusive right to vote and be voted for in the election of directors,the period of effectivity of such founders' shares should not exceed five years, counted from the date of approval of the Securities and Exchange Commission. The usefulness of holding founders' shares as a prerequisite to directorship is thus limited to a non-extendible term, which is but fair to the ordinary stockholders. Otherwise, the minority can never hope to win even a single seat in the board of directors, notwithstanding the benefit of cumulative voting.

### (F) Classification of Shares

Sec. 6 of the CCP authorizes a corporation to classify its shares as it deems fit:

[27] 50 Phil. 399 (1927).

[28] 89 SCRA 336 (1979).

[29] J. Campos and M. Campos, Corporations 428.

> The shares of stock in corporations may be 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: Provided, that no share may be deprived of voting rights except those classified and issued as 'preferred' or 'redeemable' shares, unless otherwise provided in this Code: Provided, further, that there shall always be a class or series of shares which have complete voting rights. . . .
>
> A corporation may, furthermore, classify its shares for the purpose of insuring compliance with constitutional or legal requirements.

Shares are usually classified into either common or preferred.The usual classifications of shares are common and preferred. In corporations where these two types concur, control normally vests upon whoever controls the majority of the common stock, if only because preferred shares are usually deprived of voting rights.[30] It is thus possible for a group which is a minority *vis-a-vis* the total number of shares outstanding (both common and preferred), to control the corporation simply by cornering the controlling number of the common shares. Stated otherwise, control here depends on the number of voting shares a group has, rather than on the financial investment it has actually made in the corporation. This is not to say, however, that preferred stock is an inferior kind of stock. Making up for the lack of voting rights is the advantage of being paid dividends, assets upon liquidation, or some other benefit from the corporation ahead of the common stock. Within the class of preferred stock itself, the variety of features and conditions depend greatly on the creativity of counsel, the objectives of investors, the funding requirements of the issuing corporation, and the receptivity of the securities market.

Another practical application of the authority granted by Sec. 6 would be to classify shares, for instance, into Class A and Class B, with only Class A being entitled to vote for the members of the board of directors, and Class B

[30] For example, the Securities and Exchange Commission (SEC) customarily requires that the preferred stock be granted the power to vote for directors if preferred stock dividends are not declared for three consecutive years notwithstanding available profits. Petroleum Rights Corp. v. Midland Royalty Corp., 19 Del. Ch. 334, 167 A. 835 (1933); Liese v. Jupiter Corporation, 241 A. 2d 492 (Del. Ch., 1968) and Ellingwood v. Wolf's Head Oil Refining Co., Inc., 27 Del. Ch. 356, 154 A. L. R. 406, 38 A. 2d 743 (Sup. Ct. 1944), are illustrative of contractual provisions which grant voting rights to preferred stockholders upon default in the payment of a certain amount of, or a certain number of periodic, preferred stock dividends.



being given all the rights of Class A except the right to elect directors. This approach need not utilize the preferred share concept if the economics of the enterprise does not justify it. Thus, only Class B shares can probably be issued to the general public. A variation of this classification would be to grant Class B the same right as Class A to elect directors, but to restrict Class B as a whole to vote for either a limited few or, in any event, no more than the minority number of seats in the board. In a fifteen-member board of directors, for example, Class B shares, regardless of the number of its stock outstanding or amount of investment, can elect no more than five or perhaps a maximum of seven directors, thus ensuring the perpetual control of the Class A stockholders who would then have at least eight directors at all times.

There are Philippine laws which restrict foreign equity participation in some industries to prescribed maximum percentages of the capital structure.[31] Sec. 6 is often availed of to categorize shares that can be held by Filipino citizens only, and shares that may be owned either by Filipinos or by foreigners.

### (G) EXTRAORDINARY VOTING AND QUORUM REQUIREMENTS

The Corporation Code of the Philippines prescribes certain minimum voting requirements for particular acts of the corporation. For instance, any amendment to the articles of incorporation requires the approval of at least two-thirds of the outstanding capital stock under Sec. 16. So, too, with any resolution to extend or shorten the corporate term under Sec. 37; or to increase or decrease the capital stock under Sec. 38; or to incur, create, or increase bonded indebtedness, also under Sec. 38. On the other hand, Sec. 46 merely requires the affirmative vote of at least the majority of the outstanding

[31] In most economic activities, foreign equity is restricted to no more than 30% of the outstanding stock. Under the Omnibus Investments Code (E.O. 226) and Board of Investment (BOI) rules, foreign investments are generally allowed up to 40% of the outstanding voting stock of a registered enterprise in any area declared as preferred non-pioneer by the Investment Priorities Plan. One hundred per cent (100%) foreign interest may be allowed if the investment is in a pioneer enterprise or the firm exports at least 70% of its total production. Under the Export Incentives Act (R.A. 6135), the general rules limits foreign participation to 40% for pioneer export producers although, if certain conditions are fulfilled, foreigners may own the enterprise up to 100%, provided it becomes 60% filipino-controlled within 40 years. Other types of industries follow different rules: finance companies may have a maximum of 40% percent foreign equity; commercial and private development banks, 30%; rural banks and mass media corporation must be 100% Filipino owned and not open to foreign investors.

capital stock to adopt, amend or repeal by-laws, or adopt new by-laws. Can these minimum voting requirements be increased to more than those provided by law? Can the 66-2/3% requirement in Sec. 16, 37, or 38, for example, be increased to eighty-five percent or even ninety percent, thus according virtual veto power (and hence, some measure of control) to a minority which accounts for, say, merely thirty percent of the equity? The CCP does not give any express authority for this; however, neither does the law prohibit it. It is the author's view that in the absence of any positive proscription, tacit consent is to be implied from the fact that the statute uses the phrase "at least" when specifying the vote necessitated. Authority for requiring a greater vote than that provided can thus be safely inferred from the statute. It is to be noted, however, that on this particular device, Sec. 97 grants special authority for the articles of incorporation of a close corporation to "provide . . . for a greater quorum or voting requirements in meetings of stockholders or directors than those provided in this Code. . ."

As far as *voting requirements* are concerned, therefore, there seems to be no doubt, whether the meeting is that of directors or that of stockholders, that extraordinary voting requirements over and above the typical simple majority rule may be validly instituted. This holds true for both ordinary and close corporations.

The rather ticklish issue concerns *quorum requirements* departing from the traditional fifty per cent standard. It is clear from the above-quoted provision of Sec. 97 that higher requirements for both directors' and stockholders' meetings in close corporations are permissible. There, however, ends the similarity between close and ordinary corporations. While Sec. 25 states that " . . . unless the articles of incorporation or the by-laws (of the ordinary corporation) provide for a greater majority, a majority of the number of *directors or trustees* as fixed in the articles of incorporation shall constitute a quorum . . ." [underscoring supplied]. There is no other provision in the entire Code which covers the topic of quorum requirements of stockholders' meetings in ordinary corporations. The conclusion emerges that the law allows extraordinary quorum requirements for directors' meetings in both ordinary and close corporations, but, while permitting it for stockholders' meetings in close corporations, denies it to stockholders' meetings in ordinary corporations.

No explanation has ever been advanced for this seemingly inadvertent oversight in the statute. This notwithstanding, the author believes that the omission has been all for the better because shares of ordinary corporations can and often do find their way into the hands of scattered public investors at some point in time. (An extreme example in the United States was AT & T which had over three million stockholders.) Increasing the required quorum will only aggravate the already difficult problems of quorum and attendance



at stockholders' meetings, and entrench more deeply in power any group controlling the proxy-solicitation machine.

### (H) CUMULATIVE VOTING

Sec. 24 of the CCP, which is patterned after Article XI, Sec. 3 of the Illinois Constitution and Sec. 28 of the Illinois Business Corporation Act, provides:

> At all elections of directors or trustees, . . . (the) 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 in the same principle among as many candidates as he shall see fit . . .

While the above-quoted provision is certainly not one such device as would enable the minority to wrest control of the board of directors, it serves the useful purpose of protecting minority interests by the simple expedient of concentrating the minority votes in favor of one or several candidates for director. Professor Alexander H. Frey suggests a formula to determine the number of shares required to elect one director:

$$\text{Number of shares required to elect one director} = \frac{\text{Number of shares voting}}{\text{Number of directors to be elected} + 1} + 1$$

Since, however, in planning pre-election strategy, the minority interest has no way of knowing exactly how many outstanding shares will actually be voted at the stockholders' meeting, Professor Frey points out that the computation of the required number of votes should be based on the shares outstanding rather than on the shares voting. Recasting and redistributing the minority votes has even been propounded as a method of maximizing the minority's cumulative voting effectiveness.[32] But certain objections have been advanced against the validity of this tactic.[33]

What circumstances lead to the employment of cumulative voting as a defensive strategy in stockholders' meetings for the election of directors? According to Professor Charles M. Williams of the Harvard Business School,

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[32] A. FREY, CASES AND MATERIALS ON CORPORATIONS 410 (2nd ed. 1966).

[33] BALLANTINE, BALLANTINE ON CORPORATION 405 (1946).

> . . . the heterogeneous nature of the evidence furnished by these cases [where cumulative voting was employed] does not lend itself to ready summarization; each case presented a distinctive combination of circumstances and results. Still several general observations of significance do appear to follow from the cases considered as a whole. These cases may be roughly grouped as follows:
>
> (1) Cases growing out of conspicuous management or board failures.
>
> (2) Cases grounded in conflicts of important business interests between stockholders, or between stockholders and management.
>
> (3) Cases in which stockholders become convinced on rather general grounds that the board of directors was unrepresentative and generally insensitive to stockholders' interests.
>
> (4) Clashes of strong personalities.
>
> (5) Fights for control of the corporation in which representation through cumulative voting was an intermediate objective in the struggle for control.
>
> (6) Cases of the 'anglers' -- that is, opposition groups whose leaders appeared to seek board membership in order to push some narrow and selfish interests of their own.[34]

As a protective or control device, cumulative voting has been viewed both positively and negatively by legal scholars. Professor Williams summarizes these arguments as follows:

> ARGUMENTS FOR
>
> (1) Perhaps foremost of the varied arguments made by proponents of cumulative voting is that it is *basically fair.* They argue that it is only equitable that stockholders with a large stake in the corporation have the opportunity to gain representation on the board of directors, in proportion to their holdings. (2) Minority representation under cumulative voting does not constitute a breakdown of the principle of majority rule since the number of directors elected by each group will vary with its proportion of ownership. (3) Significant conflicts of interest can develop between stockholder groups (or the stockholders in general) and management and the board of directors. Unless minority groups can gain representation on the board, they may fail to get an adequate voice in policy. [Illustrations of conflict: dividend policy or majority shareholders taking out profits in salaries.] (4) In the case of many larger corporations proponents of cumulative voting argue that the management virtually controls the typical board of directors -- the stockholders merely ratify the selections. Thus cumulative voting represents potential power to assert stockholder points of view. (5) The position of the management and the controlling interests is generally very strong; the balance of power lies heavily with the "ins" who hold great advantages in the event of a proxy fight. (6) Minority representation on the board can be helpful in protecting or advancing the interests of minority groups. If boards are composed of men who think essentially alike and operations are conducted in a private club atmosphere - - as does happen too often -- an intelligent gadfly can prove useful.
>
> ARGUMENTS AGAINST
>
> (1) A basic argument against cumulative voting is that it means the election of directors who are by their very nature partisans of particular interest groups; and the role of a partisan on the board of directors is inherently inconsistent with the proper function of a director, which is to represent all interest groups in the corporation. (2) The board of directors is an integral part of the management team. (3) Disharmony on the board can dissipate and destroy the energy of management and lead to an atmosphere of uncertainty and inaction at the top level. Officers susceptible to unfriendly criticism are likely to avoid action which might result in failure and hostility, even when such drastic and risky action is appropriate and necessary. (4) A director who cannot be trusted may leak such information to the harm of the corporation. (5) Too frequently cumulative voting tends to be used *in practice* by persons who are motivated by narrow, selfish interests rather than by the broader interests of the stockholders (which they may profess to represent). (6) Not infrequently opposition groups use cumulative voting to

[34] C. M. WILLIAMS, CUMULATIVE VOTING FOR DIRECTORS 162-163 (1951). *See also* Williams, *Cumulative Voting*, 33 HARV. BUS. REV. 108, 113 (May-June, 1955).

secure a toe-hold in a long-run fight for control of the company. The result is that each board meeting becomes a skirmish in a continuing battle. Each group keeps trying to get something on the other group that can be used in the next proxy fight. The board neglects its real functions, top management is demoralized and serious harm is done the corporation.[35]

### (I) The Proxy Instrument

Sec. 58 of the CCP provides: "Stockholders and members may vote in person or by proxy in all meetings of stockholders or members. Proxies shall be in writing, signed by the stockholder or members and filed before the scheduled meeting with the corporate secretary. Unless otherwise provided in the proxy, it shall be valid only for the meeting intended". Sec. 58 also sets a maximum allowable term of five years for all proxies, renewable for periods of no more than five years each. All proxies are deemed by the civil law on obligations and contracts to be revocable[36] by the stockholders concerned at anytime and for any reason except if the proxies are "coupled with an interest."[37]

#### Uses of Proxies

In theory, proxies can be used in any kind of corporation. In practice, however, they are often availed of, with some exceptions, only when the shares are widely dispersed among different unrelated stockholders, who are either too busy or too uninterested to attend the stockholders' meetings, or who otherwise reside too far away or are concerned solely with their dividends.

Through proxy forms which accompany the notices calling the stockholders' meetings, the existing management is able to solicit proxies from these stockholders and perpetuate itself in control of corporate affairs, notwithstanding the possibility that it actually owns only an insignificant percentage of the outstanding shares of the company.[38] It is indubitable that the more disseminated the stock ownership, the more effective will be the use

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[35] *Id.*, Ch. 10, *cited in* CARY, CORPORATIONS 287-288.

[36] 2 SEC Opinion 24-25 (Oct. 1968).

[37] Alejandrino v. de Leon, G. R. 49043, December 29, 1943.

[38] J. CAMPOS AND M.C. CAMPOS, THE CORPORATION CODE -- COMMENTS, NOTES AND SELECTED CASES 351 (1981).



of proxies as a control device.

Professor Henry Winthrop Ballantine wrote on this specific point:

> The advantage of the management group, hard to dislodge when shareholders are widely diffused, consists of ready access to the mailing list of the shareholders, the use of corporate funds for solicitation of proxies, and the prestige of the management in office. The system of proxy solicitation has become a species of absentee voting by mail by a one-way ballot for a slate of directors or measures proposed by the management. The ordinary shareholder has practically no alternative to not voting at all except the choice of delegating his vote to a proxy committee of persons selected by the management over whom he has no control and as to whose intended action he may be very poorly informed. The shareholder's proxy serves as a consent that his shares may be counted toward a much needed quorum and authorizes the application of a rubber stamp to the proposals of the management.[39]

#### Proxies and "Proxy Fights"

A "proxy fight" or "proxy contest" refers to a power struggle for control of the corporation wherein the strategy of the conflicting interests is to solicit as many proxies as possible from the stockholders, usually for the purpose of being able to elect the controlling number of directors to the board. Other motives can of course exist. As discussed by Professor Ballantine, the management almost invariably enjoys the upper hand because of built-in aces up its sleeves.

> In a proxy contest, a non-management group (usually referred to as 'insurgents') competes with management in an effort to obtain sufficient proxies to elect a majority of the board of directors and thereby obtain control. Management has several advantages in a proxy fight: (1) it has the current list of shareholders, while the insurgents may have to go to court to get it (2) within a broad range, management may finance its solicitation from the assets of the corporation, while the insurgents must finance their campaign from outside sources and (3) shareholders may have pro-management bias, since those who are dissatisfied presumably have sold their shares previously. However, despite these

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[39] Ballantine, *Voting Trusts, Their Abuses and Regulation*, 29 TEXAS LAW REV. 140.

disadvantages, proxy fights do occur with some regularity.

An insurgent group, desiring to contest management control, usually first purchases a substantial block of shares in the open market before openly announcing their intentions. They must then obtain a list of the shareholders in order to conduct a political campaign to persuade shareholders to cast proxies in their favor. In the United States, specialized proxy contest firms are available to assist either management or the insurgents in the campaign. Large shareholders may be courted individually; with the modern growth of institutional investors, the support of this segment of the financial community may be essential if a bid for control is to have a chance of succeeding. The process can be expensive.

Proxy fights are not really feasible in the very large corporation with hundreds of thousands of shareholders, since the cost of solicitation is prohibitive. Further, if the corporation is profitable, a proxy fight is unlikely to be successful. The experience in the United States is that the most likely candidate for a proxy fight is a small or medium-sized company with a poor earnings record and elderly management.[40]

## II. VOTING TRUST AGREEMENTS

### Statutory Provision of CCP

Sec. 59. Voting trusts. -- One or more stockholders of a stock corporation may create a voting trust for the purpose of conferring upon a trustee or trustees the right to vote and other rights pertaining to the shares for a period not exceeding five (5) years at any one time: Provided, That in the case of a voting trust specifically required as a condition in a loan agreement, said voting trust may be for a period exceeding five (5) years but shall automatically expire upon full payment of the loan. A voting trust agreement must be in writing and notarized, and shall specify the terms and conditions thereof. A certified copy of such agreement shall be filed with the corporation and with the Securities and Exchange Commission; otherwise, said agreement is ineffective and unenforceable. The certificate or certificates of stock covered by the voting trust agreement shall be cancelled and new ones shall be issued in the name of the trustee or trustees stating that they are

[40] R. HAMILTON, CASES AND MATERIALS ON CORPORATIONS -- INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 538 (1976).



issued pursuant to said agreement. In the books of the corporation, it shall be noted that the transfer in the name of the trustee or trustees is made pursuant to said voting trust agreement.

The trustee or trustees shall execute and deliver to the transferors voting trust certificates, which shall be transferable in the same manner and with the same effect as certificates of stock.

The voting trust agreement filed with the corporation shall be subject to examination by any stockholder of the corporation in the same manner as any other corporate book or record: Provided, That both the transferor and the trustee or trustees may exercise the right of inspection of all corporate books and records in accordance with the provisions of this Code.

Any other stockholder may transfer his shares to the same trustee or trustees upon the terms and conditions stated in the voting trust agreement, and thereupon shall be bound by all the provisions of said agreement.

No voting trust agreement shall be entered into for the purpose of circumventing the law against monopolies and illegal combinations in restraint of trade or used for purposes of fraud.

Unless expressly renewed, all rights granted in a voting trust agreement shall automatically expire at the end of the agreed period, and the voting trust certificates as well as the certificates of stock in the name of the trustee or trustees shall thereby be deemed cancelled and new certificates of stock shall be reissued in the name of the transferors.

The voting trustee or trustees may vote by proxy unless the agreement provides otherwise.[41]

### Voting Trust: Its Meaning and Purposes

The case of *Alderman v. Alderman*[42] defined voting trust as one created by an agreement between a group of stockholders of a corporation and the trustee or trustees, whereby it is provided that for a term of years or until the agreement is terminated, control over the stock owned by such

[41] G.R. No. 45911, April 11, 1979.

[42] 178 S.C. 9, 181 S.E. 897 (1935).

stockholders, either for certain or for all purposes, shall be lodged in the trustee or trustees within, without reservation to the owners of the power to direct how such control shall be used. The Securities and Exchange Commission, on the other hand, defines it as

> a contract in writing whereby one or more stockholders of a stock corporation consent to transfer their shares to a trustee or trustees, for the purpose of vesting in him or them voting and other rights pertaining to such shares, for a period not exceeding five (5) years at any one time based upon the terms and conditions stated in the agreement.[43]

In *Abercrombie v. Davies,*[44] the Delaware Court reaffirmed the elements of voting trust as outlined in two previous cases, *Aldrige v. Franco-Wyoming Oil Co.*[45] and *Peyton v. William C. Peyton Corporation,*[46] and in fact added a fifth element: voting control. According to the Court,

> (w)hen we apply these tools to the Agent's Agreement we find: (1) that the voting rights of the pooled stock have been divorced from the beneficial ownership, which is retained by the stockholders (2) that the voting rights have been transferred to fiduciaries denominated Agents (3) that the transfer of such rights is, through the medium of irrevocable proxies, effective for a period of ten years (4) that all voting rights in respect of all the stock are pooled in the Agents as a group, through the device of proxies running to the agents jointly and severally, and no stockholder retains the right to vote his or its shares and (5) that on its face the agreement has for its principal object voting control of [the corporation].
>
> These elements, under our decisions, are the elements of a voting trust . . .

The distinguishing feature of the voting trust is, therefore, the separation of voting and other legal rights from the strictly proprietary (or equitable) interest in the shares of stock. Where no divestiture of voting rights occurs, the existence of a voting trust cannot be presumed despite dilution of

[43] SEC Rules and Regulations Governing the Issuance of Voting Trust Agreements, Sec. 1(a).

[44] 36 Del. Ch. 371, 130 A 2d 338 (Sup. Ct., 1957).

[45] 24 Del. Ch. 126, 7 A 2d 753.

[46] 22 Del. Ch. 187 at 199, 194 A. 106, 111.



voting power.[47] The common law had conflicting rules on the propriety of dissociating voting power from the ownership of the shares. The strict rule held that voting power and ownership were inherently attached to and inseparable from each other and, as a result, voting power could only be delegated by revocable proxy and never by voting trust. The more liberal and certainly more popular view, however, was that the voting trust could pass judicial inquiry provided it had a legitimate business purpose, such as the promotion of the best interests of the corporation or the protection of legitimate minority interests.[48]

The following are some of the purposes for which the validity of voting trusts has been upheld in the United States:[49]

> (1) To assure continuity of policy and management[50] especially of a new corporation desirous of attracting investors;[51]
>
> (2) To enable the owners of the majority of the stock of the corporation to control the corporation;[52]
>
> (3) To vest and retain the management of the corporation in the persons originally promoting it;[53]
>
> (4) To prevent a rival concern from acquiring control of the corporation;[54]

[47] Lehrman v. Cohen, 43 Del. Ch. 222, A 2d 800 (Sup. Ct. 1966).

[48] BALLANTINE, *supra* note 39, at 150-151. *See also* Mackin v. Nicollet Hotel, Inc., 25 F.2d 783; 78 U. S. 618 (1928) (wherein the financing of a hotel was accomplished through the sale of mortgage bonds and preferred shares, conditioned on putting the common shares in a voting trust. Of the three trustees, one was under the effective control of the bondholders, another under the preferred shareholders, and the third under the equitable common stockholders).

[49] 19 Am. Jur. 2d 196.

[50] Boyer v. Nesbitt, 227 Pa. 398, 76 A. 103.

[51] Mackin v. Nicollet Hotel, Inc., 25 F2d 783 (8th Cir. 1928), *cert. denied*, 278 U.S. 618, 73 L.Ed. 541, 49 S. Ct. 22 (1928).

[52] Gumbiner v. Alden Inn, 389 Ill. 273, 59 N.E. 2d 648.

[53] Gray v. Bloomington & N.R. Co., 120 Ill. App. 159.

[54] Hall v. Merrill Trust Co., 106 Me. 465, 76 A. 926.

(5) To carry out a proposed sale of the corporation's assets and to facilitate its dissolution;[55]

(6) To enable two holding companies to operate jointly a corporation controlled by them;[56]

(7) To effect a reorganization of a corporation in financial difficulty;[57]

(8) To establish plans of reorganization in bankruptcy proceedings;[58] and

(9) To aid a financially embarrassed corporation to obtain a loan or to protect its creditors.[59]

According to Professor Ballantine, "among the purposes usually regarded as legitimate, for which voting trusts may be employed are the following:

> . . . (5) to apportion representation and protect minority interests or those with balanced holdings, as in corporations to exploit a patent, by putting the selection of directors in impartial hands (6) in connection with mergers, consolidations or purchase of a business, in order that the predecessors or constituents, though in the minority, may have representation. . . .
>
> A voting trust should be regarded like a dictatorship as a temporary expedient for some special emergency need. . . .[60]

The use of the voting trust to maintain "control by the dead hand" is

[55] Bowditch v. Jackson Co., 76 N.H. 351, 82 A. 1014, *error dismissed*, 239 U.S. 627, 60 L.Ed. 474, 36 S. Ct..164.

[56] Day v. Hecla Min. Co., 126 Wash. 50, 217 P. 1.

[57] Warner Bros. Pictures Inc. v. Lawton-Byrne-Bruner Ins. Agency Co. (CA 8 Mo), 79 F.2d 804.

[58] Bakers Share Corp. v. London Terrace, Inc. (CA 2 NY) 79 F.2d 804.

[59] Thompson-Starrett Co. v. E. B. Ellis Granite Co., 86 Vt. 282, 84 A 1017; Winsor v. Commonwealth Coal Co., 63 Wash. 62, 114 P. 908.

[60] Ballantine, *supra* note 39, at 152-53.



not too prevalent. The will of Cyrus H. K. Curtis, founder of the Curtis Publishing Co., provided for a voting trust for his holdings of stock in his company to remain in existence until the death of the last of his grandchildren.[61]

On the other hand, Professor Ballantine continues,

> (p)urposes improper or of questionable propriety are (1) a 'sign-away your rights trust,' a scheme to establish alien or minority control for a long period,with unrestrained discretionary powers, and without any definite obligations or beneficial purposes, as for the individual benefit of promoters and investment bankers, (2) to secure employment, salaries, contracts, and other individual benefits from a controlled management, or to freeze the control of a group in office as an end in itself. If the only object or purpose of a voting trust is to corner the majority shareholders' right to vote in an arrangement from which they cannot escape and to secure permanency of management and office holding for a scheming group, this would seem clearly contrary to the policy of the law.[62]

The case of *Marvin v. Solvental Chemical Products Inc.*[63] struck down a voting trust agreement for restricting the statutory powers of directors.

It might be timely to point out at this juncture that the Securities and Exchange Commission, under Sec. 6 (g) of Presidential Decree 902-A, as amended, has the power " . . . to pass upon the validity of the issuance and use of proxies and voting trust agreements for absent stockholders . . ." No expensive and prolonged resort to court litigation is necessary.

**Requisites and Form of an Effective Voting Trust Agreement**

Sec. 4 of the Securities and Exchange Commission Rules and Regulation on Voting Trust Agreements[64] lays down the requirements for an effective and enforceable voting trust agreement: it must be in writing, dated, signed by the transferor-trustor and also by the transferee-trustee (as evidence of the latter's express acceptance of the trust), attested by two witnesses, and acknowledged before a notary; it must specify the terms and conditions of the voting trust; its period must not exceed five years at any one

[61] HOAGLAND, CORPORATION FINANCE 86.

[62] *Id.* at 153.

[63] 298 Mich. 296.

[64] *Supra* note 43.

time except where a loan is involved, in which case the trust, even if for more than five years, automatically ceases upon full payment; it must neither be fraudulent, illegal, contrary to public policy nor a scheme to circumvent the law against monopolies and combinations in restraint of trade.

After the terms and conditions of a voting trust have been ironed out between trustor and trustee, and the voting trust agreement executed by them, a certified copy thereof should be filed with both the corporation and the Securities and Exchange Commission within thirty days. The same procedure applies to any subsequent voting trust created by any other stockholder in favor of the same trustee. Note that under Sec. 59, the failure to file a certified copy of the voting trust agreement with the corporation and the Securities and Exchange Commission makes such agreement "ineffective and unenforceable."

The transfer of shares and annotation of the voting trust agreement in the corporate books come next: the certificates of stock in the name of the trustor-stockholder are surrendered to the Corporate Secretary for cancellation and new ones issued to and in the name of the trustee, who, in turn, delivers voting trust certificates to the stockholder-trustor for an equal number of shares transferred under the voting trust.[65] Secret voting trust agreements are prohibited by law on the ground of public policy.[66]

After the voting trust is created, the trustee begins to possess all voting and other rights pertaining to the shares transferred to and registered in his name, subject to the terms and conditions, as well as the period, of his agreement with the stockholder-trustor.[67] Being by law the new legal titleholder of the shares, he is entitled to exercise the rights of ownership, as but not limited to, the rights to inspect all corporate books and records, to vote for directors, to receive notice or information as against the corporation, and to participate in making the most fundamental corporate acts or changes like mergers and consolidations, sales of entire assets, reduction of capital, and by-laws and charter amendments.[68] The right to receive cash or stock dividends and other asset distributions, however, being of a proprietary nature,

[65] SEC Rules and Regulations Governing the Issuance of Voting Trust Agreements, Sec. 4 (10-12) and Sec. 5.

[66] Abercrombie v. Davies, 36 Del. Ch. 371, 130 A. 2d 338 (Sup. Ct. 1957); Corporation Code of the Philippines, Batas Pambansa Bilang 68 (1980).

[67] Clarke Memorial College v. Monaghan Land Co., 257 A. 2d 234 (Del. Ch. 1969).

[68] SEC Rules and Regulations Governing the Issuance of Voting Trust Agreements, Sec. 6.



normally remains with the stockholder-trustor, and is embodied in the voting trust certificates delivered by the voting trustee. These certificates are virtually the same as the ordinary stock certificates, but without the right to vote. The stockholder-trustor likewise retains, jointly with the trustee, the right to inspect all corporate books and records.

**Duration and Termination**

Sec. 59 provides that, except in the sole instance of a voting trust created in consideration of a loan, no agreement shall extend for more than five years. In the case of a loan, the period may be for more than five years, but shall *ipso facto* expire upon full payment.

Generally, a voting trust is irrevocable during its term; however, breach of fiduciary duty or the voting trust agreement by the trustee may justify its rescission despite an irrevocability stipulation. So, too, where the agreement is *void ab initio* or does not comply with Sec. 4 of the Securities and Exchange Commission Rules.[69] In *Moore v. Bowes,*[70] the Court held that a voting trust is irrevocable for the duration of its term provided there is no misconduct or fraud on the part of the trustee.

**Corporate Control Implications and Possible Abuses of Voting Trust Agreements**

The right to vote for a change of the governing board may on occasion become a very important safeguard for the protection of stockholders against mismanagement.[71] In fact, in some extreme instances, it may stand as the only feasible recourse available to them. Unfortunately, this right has been substantially eroded in recent years, owing perhaps to the improvidence of the shareholder himself in his tendency to give away his voting right thoughtlessly, when it may be used by hostile manipulators who seek to establish some form of unshakable control.[72] The abuse of the voting trust device and other methods of corporate control once led Mr. Justice William O. Douglas, then Chairman of the United Sates Securities and Exchange Commission, to declare in 1937 that " . . . the voting trust as currently observed is little more

[69] *Id.* Sec. 7 and Sec. 8.

[70] 8 Cal. 2d 162, 64 P. 2d 423.

[71] Ballantine, supra note 39, at 139.

[72] BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 84, 88-89, *cited in* Ballantine, *supra* note 39, at 1169.

than a vehicle of corporate kidnapping."[73]

According to Professor Chester K. Rohrlick, the voting trust was developed to achieve irrevocable proxies.[74] Proxies of a revocable nature[75] kept the voting representatives within the effective control of the stockholders and were thus found somewhat "too restrictive." To meet business ends, adroit lawyers invented the ingenious device of a voting trust to create what is in essence an irrevocable proxy coated by a protective coloring of trust, thus enabling the trustee to vote as an owner rather than as a mere proxy or agent of the stockholder.[76] The voting trust was described in the leading case of *Warren v. Pim*[77] as

> a masterpiece of professional ingenuity which confides absolute and uncontrolled discretion to a group whose personal stake in the success of the company is so insignificant that it may be disregarded entirely; . . . which leaves them free from responsibility for their mistakes, oversights, forgetfulness or want of prudence, and unhampered by any duty even to supervise the proceedings of their own appointees.

The *Warren* case derided the voting trustee as "only a sham owner vested with a colorable and fictitious title for the sole purpose of voting upon stock that (he) does not own."

One particular area where the abuse of the voting trust has been most alarming is the promotional stage of corporate organization. A voting trust, it is said, offers to promoters the opportunity of seizing and retaining dictatorial control over the investment of others without any investment on their own part, thus by legal magic keeping all the patronage and perquisites control.[78] As pointed out by the United States Securities and Exchange Commission in its Report on Investment Trusts and Investment

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[73] W. Douglas, "Democracy in Industry and Finance", Address before the Bond Club of New York 12 (March 24, 1937), *cited in* BALLANTINE, *supra* note 39, at 141.

[74] C. ROHRLICK, LAW AND PRACTICE IN CORPORATE CONTROL 69 (1933), *cited in* Ballantine, *supra* note 39, at 146..

[75] *See* discussion of proxies as a control device, pp. 48-55.

[76] Ballantine, *supra* note 39, at 146.

[77] 59 A. 773 (1904).

[78] Ballantine, *supra* note 39, at 152.



Companies,[79]

> . . . The voting trust offers to promoters the opportunity for autocratic control without any personal investment. It thus constitutes a means by which sponsors of investment companies may allocate to themselves all the emoluments of control such as salaries, management fees, underwriting and brokerage business and other advantages without any financial loss if the management of the company is unsuccessful. The voting trust agreement is usually prepared by the organizers of the corporation prior to any public offering of its securities and all of the voting stock may be deposited with the voting trustees so that the public is offered only voting trust certificates.

Professor Ballantine condemned the "kidnapping" of voting power and cautioned against the use of voting trusts in the promotion of a new corporation or in making an original offering of non-voting "trust certificates" to investors.[80] The use of voting trusts has time and again proven itself to be an undesirable practice in promoting new corporate ventures.[81]

Abuses of voting trust agreements are perhaps worse in corporate reorganizations, despite the latter's professed objective of creditor protection.

> (I)n order to furnish needed protection to bondholders or other creditors of a corporation, whose claims may be in peril and who have no voice in choosing the directors, the shareholders may agree to surrender their voting power by a trust or agreement, and vest it in reliable voting trustees until the emergency is over. If a corporation finds it necessary to borrow money on bonds or sell preferred stock in order to help the corporation secure the loan or market the stock, the shareholders may assist it by vesting their voting power in trustees satisfactory to the lenders or purchasers of preferred shares, for a term of years sufficient to enable the trustees to safeguard the interests of the senior security holders and provide a conservative management . . .

That well-known corporation lawyer, Samuel Untermeyer, commented

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[79] *Id.* at 152 (citing UNITED STATES SECURITIES AND EXCHANGE COMMISSION, REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES at 1913 (1940)).

[80] *Id.* at 152.

[81] J. A. LEAVITT, THE VOTING TRUST: A DEVICE FOR CORPORATE CONTROL 85-93 (1941).

upon the use made by high financiers of voting trusts to obtain a strangle-hold in connection with reorganizations: 'They have generally been oppressively imposed by large interests upon a prostrate defenseless property in course of reorganization where interests were scattered, unable to protect themselves and virtually forced to surrender their voting power upon the demand of the reorganizers.'

One common form of reorganization is accomplished by forming a new corporation to own and operate the property of the old reorganized company and continue the enterprise with a new set-up. Frequently, the shares of stock of the new corporation, instead of being distributed directly to the former bondholders, are held in voting trust, of which the trustees may be designated by a bondholders' protective committee whose members may be former corporate officers who participated in exploitation of the bondholders. The old management may thus be able to perpetuate their control of the property and capitalize on the inertia of the security holders.[82]

In 1936, the (U.S.) SEC Report on committees for the holders of real estate bonds[83] stated that

> the risk of grave abuse of the tremendous power vested in these trustees is great . . . The history of reorganizations demonstrates the loss and extravagant exploitation which has resulted when there is power without responsibility . . .

The case of *Overfield v. Pennroad Corporation,*[84]

> should demonstrate, even to the extreme advocates of freedom of contract for the surrender of all voting and other safeguards, the dangers of a device by which an inside group may wrest control from the shareholders and manipulate the invested funds of a great enterprise after it has securely 'trussed up' the investors.
>
> The voting trust involves a much more complete surrender of all legal rights and remedies by the shareholders than any other control device. By it the beneficial owner ceases to be recognized as a shareholder of record and may be deprived not only of any right to vote for directors, but also of any right of inspection or

[82] Ballantine, *supra* note 39, at 154-55 (footnotes ommitted).

[83] UNITED STATES SECURITIES AND EXCHANGE COMMISSION, REPORT ON COMMITTEE FOR THE HOLDERS OF REAL ESTATE BONDS, at 205-07 (1936).

[84] 42 Fed. Supp. 586, 607-11 (1941).



> to vote for directors, but also of any right of inspection or information[85] as against the corporation or any voice in the most fundamental changes, such as mergers and consolidations, sales of entire assets, increase and reduction of capital, and by-law and charter amendments which may adversely affect him. The voting trustees, theoretically his representatives, may be a group seeking their own advantage or that of third parties, with complete discretionary power to vote all the shares of stock placed in the trust as if they were absolute owners, which power is beyond the reach of the real owners except upon proof of fraud.[86]

## The Myth and the Reality of Voting Trusts

> In general, the power to control the election of directors and so to manage and control the property, business and patronage of a great corporation, to direct its policies and the expenditures of vast sums of money, indirectly to appoint and fix the compensation of its officials and executives, is a power of great value, even if the corporation is not in a position to pay dividends on its shares. But this power of control is not properly regarded as a species of property which may be reserved or split off, and bought and sold, apart from the beneficial interests in the shares of stock. Voting power is an ancillary or protective right, not an independent species of property which may be used to give dominion over the investments of others.
>
> Voting trusts, like proxies, are signed blindly by credulous investors and a plausible group is often able to seize and continue in the emoluments of corporate control at the shareholders' expense on their own terms. The necessity of greater regulation by statute and supervision by corporate control devices has of late been more fully revealed. The main object of many voting trusts is to prevent a majority of the shareholders, present or prospective, from combining to change the board of directors when a change may be needed. A voting trust does not automatically secure efficiency or

[85] In the Philippines, the stockholder-trustor retains the right to inspect corporate books and records under the third paragraph of Sec. 59 of the Corporation Code.

[86] Ballantine, *supra* note 39, at 158-159. Note, however, that the third paragraph of Sec. 59 of the Corporation Code of the philippines provides that the stockholder-trustor has the concurrent right with the trustee to inspect all corporate books and records.

honesty in management, but only assures fixity of control by the voting trustees often for a needlessly long period, without the rights to information, notice and disclosure[87] and the power to vote for change of management and on fundamental changes which normally belong to corporate shareholders."[88]

## III. POOLING (OR VOTING) AGREEMENTS

### The Mechanics of Pooling or Voting Agreements

As an alternative to voting trusts, shareholders at times agree among themselves to vote their shares in some particular manner to achieve certain purposes. This is usually reflected in what is known as pooling or voting agreements. The shareholders either decide in advance on how exactly to vote their shares for the duration of the agreement or else lay down a procedure by which to arrive at a consensus to vote on issues, in any event contracting with each other to vote their shares as one solid block.[89] The first type may be an agreement to vote for each other or a designated third person for director. The second agreement is to vote for director any stockholder whom the majority of the pooling participants may later decide on, or to designate some knowledgeable and impartial outsider to make the decision for them. Although a pooling agreement can conceivably cover a wide range of subjects, the use of this control device is often limited to the election of directors, the single most distinctive characteristic being always the commitment of the pooling participants to vote as a single unit.

Sec. 100 (2) of the CCP provides that:

> 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.

While Sec. 100 falls within the ambit of Title XII on Close Corporations,

[87] *See supra* note 85.

[88] Ballantine, *supra* note 39, at 168 (footnote omitted).

[89] W. CARY AND M. A. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 390 (5d unabr. 1980).



there is no reason for denying stockholders of corporations other than close ones the right to enter into voting or pooling agreements to protect their interests, as long as they do not intend to commit any wrong or fraud on the other stockholders not parties to the agreement. Of course, voting or pooling agreements are perhaps more useful and more often resorted to in close corporations. But they may also be found necessary even in widely held corporations.[90]

### Nature of Pooling Agreements

Pooling agreements are contractual in nature and as such are valid and enforceable undertakings under the general law on obligations and contracts under the Civil Code of the Philippines.[91] Hence, a breach thereof can give rise to an action for damages against the defaulting participant.

One of the leading American cases on pooling agreements is *Ringling Bros.-Barnum and Bailey Combined Shows v. Ringling.*[92] In that case, two stockholders entered into a pooling agreement, one provision of which read:

> 3. In the event the parties fail to agree with respect to any matter covered by [their obligation to consult and confer with each other in jointly exercising their voting rights], the question in disagreement shall be submitted for arbitration to Karl D. Loos, of Washington, D. C. as arbitrator and his decision thereon shall be binding upon the parties thereto . . .

Subsequently, disagreement did in fact develop between the two pooling agreement participants and the arbitrator Loos's had to step in and resolve the deadlock. One of the parties, Mrs. Audrey B. Ringling-Haley, refused to recognize Loos' decision. A suit was filed and the case ultimately found its way to the Supreme Court of Delaware. The Court held that "(t)he failure of Mrs. Haley to exercise her voting rights in accordance with [Loos's] decision was a breach of her contract."

Pursuing the question of breach of pooling agreement obligations, what remedy is properly due to an aggrieved party? The issue of whether it ought to be damages or specific enforcement has been a particularly thorny one for the courts, considering that sanctions of this nature are often the only

[90] CAMPOS AND CAMPOS, *supra* note 38, at 405.

[91] Civil Code of the Philippines, Republic Act 386 (1949).

[92] 29 Del. Ch. 610, 53 A. 2d 441 (Sup. Ct. 1947).

effective means of assuring compliance with the parties' contractual obligations. Since the award of damages is normally an inadequate remedy for breach of a pooling agreement, the trend has been strongly in favor of granting specific enforcement.[93] In *Weil v. Berseth,*[94] some stockholders, in violation of a voting agreement, increased the number of directors from four to five and elected the son of one of them to fill the new slot. The Court recognized the inadequacy of granting relief in the form of money damages. It therefore issued the injunction sought requiring the defendants to repeal the new by-laws passed in breach of the voting agreement and to revive the original by-laws. The Court likewise authorized the trial judge to compel the resignation of the new director if such was necessary.

### Pooling Arrangements Distinguished from Voting Trusts

Although both pooling and voting trust agreements seek concentrated voting power as their common goal, pooling or voting agreements differ from voting trusts in many respects. While pooling agreements follow the standard form of contracts (being essentially private transactions between the parties), voting trust agreements are required to observe a lot more in terms of legal formalities. Sec. 59 of the CCP and the rules of the Securities and Exchange Commission, appreciating only too correctly the public interest nature of voting trusts, require such agreements not only to be signed by the stockholders-trustors, the voting trustees and two witnesses but also to be acknowledged before a notary; thereafter, a certified copy must be filed with both the corporation and the Securities and Exchange Commission within thirty days of execution, under pain of ineffectivity and unenforceability. Furthermore, as previously discussed in Chapter II, the original stock certificates must be surrendered and cancelled and new ones issued to the voting trustees who shall then deliver voting trust certificates to the trustors. Finally, in addition to the safeguards against secrecy, the term is limited to a maximum of five years except in the case of voting trusts created in consideration of a loan. All the foregoing statutory formalities do not apply to pooling agreements.

The American case of *Abercrombie v. Davies*[95] showed the contrast between pooling agreements and voting trusts. Said the Court:

> We gather that defendants go so far as to say that a pooling agreement may assume any form whatever without running afoul of the voting trust statute. Thus, if we understand defendants' argument, a pooling agreement may through the medium of fiduciaries with exclusive voting powers, lawfully accomplish substantially the same purposes as a voting trust and thus avoid compliance as a voting trust and thus avoid compliance with Sec. 218. We disagree. Obviously, as a pooling agreement in substance and purpose approaches more and more nearly the substance and purpose of the statute, there comes a point at which, if the statute is not complied with, the agreement is illegal. A pooling agreement may not escape the statutory controls by calling the trustees agents and giving to the stockholders receipts instead of voting trust certificates. If this were not so, stockholders could, through the device of an agreement such as the one before us, accept for themselves the chief benefits of the statute: unified voting control through fiduciaries for an appreciable period of time, and escape its burdens: the requirements for making an open record of the matter, and the limitations in respect of time. If the agreement before us is upheld, what is there to prevent a similar agreement for 15 years -- or 25 years?

### Control Implications of Pooling Agreements

Let us consider a theoretical situation wherein one hundred percent of the outstanding capital stock of a corporation is made up of common shares without any special classification or restriction whatsoever. Each share is exactly similar to every other share. Assume further that a pooling agreement exists for the majority shares fifty-one percent and that this requires all the shares so bound together to be voted in accordance with the majority decision. At its simplest, the situation presents the possibility that a twenty-six percent interest will be able to control the majority block of fifty-one percent which in turn will control the entire corporation. Assuming finally that the remaining forty-nine percent belongs to only one interest group, there exists an anomalous situation wherein a twenty-six percent minority is effectively able to dominate the much larger forty-nine percent interest -- all because of that creative-planning device called a "pooling agreement."

## IV. CONCLUSION

In his work *Modern Management and Machiavelli*, Dr. Richard H. Buskirk quotes from *The Prince*:

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[93] CARY AND EISENBERG, *supra* note 89, at 392 (*citing* F. H. O'NEAL, CLOSE CORPORATIONS § 5.30 (2nd ed., 1971)).

[94] 154 Conn. 12, 220 A.2d 456 (1966).

[95] 36 Del. Ch. 371, 130 A.2d 338 (Sup. Ct. 1957).

> . . . thus it comes about that all armed prophets have conquered and unarmed ones failed . . . Let a prince therefore aim at conquering and maintaining the state, and the means will always be judged honorable and praised by everyone . . . A certain prince . . . never does anything but preach peace and good faith, but he is really a great enemy to both, and either of them, had he observed them, would have lost him state or reputation . . .[96]

Business resembles politics in many respects. The stakes are high. Winning often becomes the end in itself. The price of losing is costly and its exaction can be merciless. Those who love it are a different breed of men. Their minds work differently. Their perception of threat, of danger especially, is quick and sanguine. Their instinct for survival is razor-sharp and their ingenuity at exploiting advantage, of itself, is a masterpiece of creation.

The business avocation adheres to the ethical norms of its players. No more than lip-service is paid to compliance with rules. The lustful desire is for money and after money, power, and through power, more money. No quarters are asked and none is given.

Today's "corporate state" of financial omnipotence has not at all changed from Machiavelli's world of the prince and the tyrants. Indeed, the latter have not dwindled in number. They have in fact proliferated, still adhering to the same basic philosophy of extracting too much for too little or nothing at all.

Given this premise of business and its politics, corporate control, as we have seen, has developed a confusing personality in modern management: it can be the investor's protector, but it can just as well be his exploiter. Unfortunately, the line separating one from the other is never steadfast and seems forever obscured by a haze of uncertainties. What is good for an investor one day may not be so the next and the reasons may be as varied, complex, and difficult to understand as understanding why some businesses fail and others succeed. But our task was never to point out where that line should be. Rather it was to affirm the one fundamental axiom of infighting for corporate control: the victor reaps his prize invariably at the expense of the vanquished. But an investor need not risk such a ruthless fate, for there are really just two things he ought never to entrust to another. The first is his life. The second is his money.

[96] R. BUSKIRK, MODERN MANAGEMENT AND MACHIAVELLI 13, 65 (1974).



# BANKING LAWS OF THE PHILIPPINES: A TIME FOR REFLECTION

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Banks play a vital role in our economy. They are moneyed institutes founded to facilitate the borrowing, lending, and safekeeping of money, and to deal in notes, bills of exchange and credits.[1] Ideally, they can be highly efficient financial intermediaries between the providers and the users of funds, funnelling resources into the most beneficial investments in the economy. The more our people deposit their money in the banks, the more banks can lend out money to fund business enterprises. Significantly, banks do not merely deal in, but are actually a source of, money and credit. Indeed when a commercial bank, for instance, lends money by crediting the borrowers' demand deposits, it, in effect, augments the country's credit supply. Consequently, an active banking industry greatly helps in creating a robust and financially active business climate essential to a thriving and productive economy.

Banking is a business activity highly regulated by the government. Although transactions are for private profit, the business is of a pre-eminently public nature[2] in view of the fact that money in banks involves large deposits of people from all walks of life. Since funds of a bank are, in a sense, held in trust,[3] public interest dictates that close monitoring by the proper state authority should be constantly conducted in order that money lent by depositors to these banks will not be carelessly and recklessly invested.

The special governmental attention directed to banking institutions is

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[1] Republic v. Security Credit and Acceptance Corporation, 19 SCRA 58 (1967), *citing* Talmage v. Pell, 7 N.Y. (3Seld) 328; Smith v. Kansas City Title & Trust Co., 41 S. Ct. 243, 255 U.S. 180, 210 (1910).

[2] Farmers & M Bank v. Federal Reserve Bank, 262 U.S. 649, 67 L. Ed. 1157, 43 S. Ct. 651; Engels v. O'Malley, 219 U.S. 128, 55 L. Ed. 128 (1910).

[3] Banco de Oro v. Bayuga, 93 SCRA 443 (1979).