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## VALIDITY OF A CORPORATE BY-LAW RESERVING TO THE CORPORATION THE OPTION TO PURCHASE ITS OWN SHARES BEFORE THEY COULD BE OFFERED TO THIRD PERSONS

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### PART I

#### INTRODUCTION

The subject into which the writer has chosen to concentrate his endeavor in this humble work had been, and still is one of the bones of many controversies of lawyers and courts in England and in most of the states of the American Union, especially before the enactment of the Uniform Stock Transfer Act, and I venture to say that it will also be one of the live issues between corporations and corporation lawyers in the Philippines in the future.

The question as to whether it is legal for a corporation to reserve to itself in the form of an option within a definite period of time the right to purchase the shares of its own stockholders, and to impose such right on its stockholders in its by-laws, has aroused a great many troubles not only in the business of corporations but also in dealing with shares of stock of corporations in England and the United States. It had been unsettled for a long time in those great countries, and it is still a live problem in many states of the Union which have not adopted the Uniform Stock Transfer Act.

The Philippine Corporation Law is just beginning to set its foot on the threshold of commercial jurisprudence. It is still in the making. Since the enactment of our Corporation Law on March 6, 1906 by the Philippine Commission, and its enforcement on April 1, 1906, and its subsequent amendment in 1928, there are only about fifty-five Philippine cases decided by our Supreme Court dealing particularly with corporation law, the first of which was adjudicated in Volume IX of the Philip-

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pine Reports, page 145, in the case of *Capellania de Tambobong vs. Cruz*. Among these decided cases but one is exactly at all fours with our problem in this thesis, and which the writer shall presently criticize.

In deciding the case of *Fleischer vs. Botica Nolasco Co.* (47 Phil. Rep. 583), our Supreme Court sought the guidance of common law authorities, for as we intimated above, there is not a single precedent on the case in our jurisdiction.

Our Supreme Court, in the case of *U. S. vs. Cuna* (12 Phil. Rep. 241), held that "While it is true that the body of the common law as known to Anglo-American jurisprudence is not in force in these Islands, nor are the doctrines derived therefrom binding upon our courts save only in so far as they are founded upon sound principles applicable to local conditions and are not in conflict with existing law; nevertheless many of the rules, principles, and doctrines of the common law have, to all intents and purposes, been imported into this jurisdiction as a result of the enactment of new laws and the organization and establishment of new institutions by the Congress of the United States or under its authority." And in the case of *Arnalot vs. Johnson* (42 Phil. Rep. 980), after citing the case of *U. S. vs. Cuna*, our Supreme Court continued: "Many of these laws can only be construed and applied with the aid of the common law from which they are derived, and, to breathe the breath of life into some of the institutions introduced in these Islands under American sovereignty, recourse must be had to the rules, principles, and doctrines of the common law."

Our Corporation law is patterned after those of the United States as may be inferred from the fact that the Philippine Commission was composed of five Americans and three Filipinos, and from the similarities between their provisions. From the foregoing considerations, the writer also feels justified in resorting to Anglo-American authorities in treating this subject, from which he shall draw his unbiased conclusions and propose recommendations with the ultimate end in view to have our people and our law-making body see the best method adoptable in the Philippines which has been tested in the anvil of experience.

The writer decided it wise to present the subject by following these divisions: (A) General Considerations, under which follow: (1) By-laws; (2) Shares of Stock; (3) Transferability of shares of stock; (4) Modes of transferring shares of stock;

(5) Negotiability of shares of stock; and (6) Assignability of shares of stock or acquisition of membership in the corporation; (B) Main Considerations, under which follow: (1) Right of stockholders to transfer their shares; (2) Power of a corporation to prohibit the transfer of shares; (3) Power of a corporation to regulate transfer of shares; and (4) Power of a corporation to restrain transfer of shares; (C) The Heart of the Subject under discussion, under which follow: (1) Right of a corporation to purchase its own shares; (2) Right or power of a corporation by its charter to reserve to itself the right of option to purchase the shares of its stockholders; (3) Right or power of a corporation by its articles of incorporation to reserve to itself the right of option to purchase the shares of its stockholders; (4) Right of a corporation by agreement with its stockholders to reserve to itself the right of option to purchase the shares of its stockholders; and (5) Right or power of a corporation by its by-laws to reserve to itself the right of option to purchase the shares of its stockholders; (6) Effect of a by-law reserving for the corporation the right of option to purchase the shares of its stockholders when such option is written on the certificate of stock; (D) Recapitulation and Conclusion; (E) The Doctrine of the case of *Fleischer vs. Botica Nolasco Co.*; (F) Recommendations.

## PART II GENERAL CONSIDERATIONS BY-LAWS

*Its definition and nature.*—A by-law is a permanent rule of action for the government of the members of the corporation in the conduct of the corporate affairs. As defined by one court, “a by-law is a permanent and continuing rule for the government of the corporation and its officers.”<sup>1</sup> Another court said that by the term “by-laws” is meant “the orders and regulations which a corporation, as one of its legal incidents, has power to make, and which is usually exercised to regulate its own actions and concerns and the rights and duties of its members among themselves.”<sup>2</sup> The Texas court of civil appeals approves Mr. Cook’s definition where he says: “A by-law is a permanent rule of action, in accordance with which the corporate affairs are to be conducted.”<sup>3</sup>

<sup>1</sup> *North Milwaukee Town Site Co. vs. Bishop* (79 N. W. 785).

<sup>2</sup> *Commonwealth vs. Turner* (1 Cush. [Mass.] 493).

<sup>3</sup> *Stegger vs. Davis* (27 S. W. 1068).

*Purpose and Function of By-laws.*—The office and purpose of by-laws is defined by the supreme Court of Massachusetts: "The office of a by-law is to regulate the conduct and define the duties of the members toward the corporation and between themselves. So far as its provisions are in the nature of contract, the parties thereto are the members of the association as between themselves; or the corporation upon one side, and its individual members upon the other."<sup>4</sup> The function of a by-law is to prescribe the rights and duties of the members with reference to the internal government of the corporation, the management of its affairs and the rights and duties existing between the members inter se.<sup>5</sup> A by-law is of such a peculiar nature and so much a part of the corporation law that it enters into the contract between the corporation and the members with reference to the particular subject covered by such by-laws.<sup>6</sup> The Rhode Island court said: "The proper office of by-laws is to regulate the transaction of the incidental business of a corporation. They should not affect rights of property or create obligations unknown to the law."<sup>7</sup> And the Maine court said: "By-laws are simply the rules of corporate government. While they aid in the orderly transaction of the corporate business, they also serve sometimes as a protection of the corporation itself, or of minority members, against ill-advised or illegal acts of the majority."<sup>8</sup>

#### ESSENTIAL REQUISITES OF BY-LAWS

*By-laws must not be contrary to law.*—Generally speaking, a by-law which is contrary to any general law of the state, or any settled principle of the common law, or repugnant to the law of the land, is void.<sup>9</sup> For stronger reasons a by-law is void if it is contrary to the constitution of a state.<sup>10</sup> As has been reasoned, that the legislative power cannot be delegated, so the legislature cannot confer on a moneyed corporation power to enact by-laws contravening, or in any wise changing, the statu-

<sup>4</sup> Flint vs. Pierce (99 Mass. 68).

<sup>5</sup> Bornstein vs. District Grand Lodge, (84 Pac. 271).

<sup>6</sup> Kent vs. Quicksilver Min. Co. (78 N. Y. 159).

<sup>7</sup> Ireland Globe Min. Co. vs. Ireland (21 R. I. 9).

<sup>8</sup> Flaherty vs. Portland & Ben. Soc. (99 Me. 253).

<sup>9</sup> Vance vs. Little Rock (30 Ark. 435); People vs. Crockett (9 Cal. 112); Bornstein vs. District Grand Lodge (2 Cal. App. 624).

<sup>10</sup> State vs. Cincinatti (23 Ohio St. 445).

tory or common law of the land.<sup>11</sup> A corporation has no power to enact a by-law inconsistent with the statute under which it was created.<sup>12</sup>

*By-laws must not be contrary to the articles of association.*

—The articles of incorporation are regarded as the constitution of the corporation. It exists by virtue of the statute and must conform strictly to all legal requirements. As compared with such constitution the by-laws are in the nature of subordinate regulations. It follows, therefore, naturally and logically, that the by-laws must not be contrary to the articles of association. This doctrine was strongly asserted by the supreme court of Minnesota, in speaking of the articles of association and conflicting by-laws, in the following language: "Those articles are its charter, and subject to the constitution and general laws of the state, its fundamental and organic law. Among other things, they fix the rights of stockholders. They are in the nature of a fundamental contract, in form between the incorporators, and in practical effect between the association and its stockholders—a contract which, as in other cases, neither party is at liberty to violate. This can no more be done through the form of by-laws and resolutions of the stockholders adopted and acted upon, than it can in any other way. The authority to pass by-laws, is, as a matter of course, authority to pass such as are consistent with the articles of incorporation, and not a power to subvert the law of corporate existence. The by-laws of a corporation are only rules and regulations as to the manner in which the corporate powers shall be exercised. Any attempt on the part of the defendant, by by-laws or otherwise, to deprive an unconsenting stockholder of a right secured to him by the corporate articles is an excess of the defendant's authority, or, in legal parlance, *ultra vires*."<sup>13</sup> To this point the supreme court of Tennessee said: "But the by-laws of a corporation must not be inconsistent with its charter, for this instrument creates it an artificial being, imparts to it its powers, designates its objects, and usually prescribes its mode of operation. It is, in short, the fundamental law of the corporation, and in its terms and spirit is a constitution to the petty legisla-

<sup>11</sup> Seneca Co. Bank vs. Lamb, (26 Barb. [N. Y.] 595); Lighall Mfg. Co. (47 Hun. 258).

<sup>12</sup> King vs. International Bldg. Union (170 Ill. 135); Weirman vs. International Union (67 Ill. 550).

<sup>13</sup> Bergman vs. St. Paul Mut. Assn. (29 Minn. 275).

ture of the body acting by and under it; hence, all by-laws in contravention of it are void."<sup>14</sup> The stockholders cannot by the adoption of by-laws or amendments thereto extend or enlarge the power of the corporation beyond the scope authorized by its charter.<sup>15</sup> So an attempt on the part of a corporation, by its by-laws or otherwise, to deprive an unconsenting stockholder of a right secured to him by the corporate articles, is in excess of the power of the corporation.<sup>16</sup>

*By-laws must not be in excess of corporate powers.*—The rule that by-laws cannot be contrary to the articles of association supplemented by the further rule that by-laws can neither be in excess of the corporate powers, nor can they be for purposes other than those enumerated in the charter or articles of association, even where there is express authority to enact by-laws. There is no implied power to enact such by-laws. Under any other rule a corporation might by its by-laws extend its corporate powers and indefinitely broaden or extend the purposes of its organization. Where the exercise of a corporate power has been regulated by statute, the corporation cannot, by its by-laws, resolutions, or contracts, either extend or take it away.<sup>17</sup> Where the statute is silent as to a particular matter, it is within the power of the corporation to regulate or control such matter; but the statute having expressly regulated a particular matter, its provisions are imperative upon the corporation, and constitute a part of the law of its being; and the corporation has no authority to extend or limit the right as regulated by the statute.<sup>18</sup> It is also the rule that the corporation is not permitted to enact by-laws for any other purpose than those enumerated in the articles of association. Thus, where, by the provisions of the particular charter, or by a general statute relating to corporations, power is conferred upon the corporation to enact by-laws for certain specified purposes, its power of legislation is limited to the cases and objects enumerated in the charter, others being excluded by implication.<sup>19</sup> It is also the rule that where both general and special

<sup>14</sup> *Martin vs. Nashville Bldg. Assn.* (2 Coldw. [Tenn.] 418).

<sup>15</sup> *Steiner vs. Steiner Land Co.* (26 So. 494).

<sup>16</sup> *Bergman vs. St. Paul Mut. Bldg. Assn.* (supra).

<sup>17</sup> *Brewester vs. Hartley* (37 Cal. 15).

<sup>18</sup> *Id.*; *Great Falls Ins. Co. vs. Harvey*, (45 N. H. 292); *State vs. Utter* (34 N. J. L. 489); *Railway Co. vs. Allerton*, (21 L. Ed. 902).

<sup>19</sup> *Ireland vs. Globe Milling Co.* (37 Atl. 921); *New Orleans vs. Philippi*, (9 La. Ann. 44).

powers are granted by the act of incorporation, the power to pass by-laws under the general grant does not enlarge nor annul the power granted by the special clause in relation to its various matters, but gives authority to pass reasonable by-laws upon all other matters within the scope of municipal authority.<sup>20</sup>

*By-laws must be reasonable.*—Corporations must exercise their powers in a reasonable manner.<sup>21</sup> A by-law must not be unreasonable, oppressive, or extortionate.<sup>22</sup> Unreasonable by-laws will not be enforced by the courts.<sup>23</sup> It has long been the principle of the common law that by-laws of a corporation would be set aside when deemed unreasonable.<sup>24</sup>

*By-laws must operate equally.*—Every by-law must operate equally upon all persons of the class which they are intended to govern. This rule has been applied more frequently to municipal ordinances than to by-laws of corporations. So it is said in a Missouri case: "But by-laws must be certain, must be directed to all within the sphere of their operation, and must operate equally."<sup>25</sup> In a Michigan case the rule was stated as follows: "It is plain, however, that all corporation by-laws must stand on their own validity, and not on any dispensation granted to members. They cannot be subjected to any conditions which do not apply to all alike, and cannot be compelled to receive, as matter of grace, anything which is a matter of right; neither, on the other hand, should there be personal exemptions of a general nature from any valid regulations that bind a mass of corporators."

*By-laws must not disturb vested rights.*—As statutes which impair the obligation of contracts and disturb vested rights are unconstitutional and hence void, so, for stronger reasons, the by-laws of a corporation which operate to disturb the vested

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<sup>20</sup> Huesing vs. Rock Island, (21 N. E. 558); Cairo vs. Bross (101 Ill. 475); State vs. Ferguson (53 N. H. 424).

<sup>21</sup> Commonwealth vs. Worcester (3 Pick 462).

<sup>22</sup> Hagerman vs. Ohio Bldg. Assn. (25 Ohio St. 186); Citizens' Loan Assn. vs. Webster (25 Barb. 263).

<sup>23</sup> Palmetto Lodge vs. Hubbell (2 Strob. [S. Car.] 457).

<sup>24</sup> Sutton's Hospital Case 10 Co. 1; London vs. Vanackep 1 Ld. Rym. 496; Rex vs. Spencer (3 Burr. 1827); Norris vs. Staps, Hob. 210b.

<sup>25</sup> Goddard vs. Merchants' Exchange (3 Mo. App. 290).

<sup>1</sup> People vs. Young Men's Soc. (1 N. W. 931).

rights of parties will be held void.<sup>2</sup> A corporation has not capacity, as the legislative power from which it derives existence has not competency, by laws of its own enactment, to disturb or divest rights which it created, or to impair the obligation of its contracts, or to change its responsibilities to its members, or to draw them into new and distinct relations.<sup>3</sup> This rule applies with equal force to any attempt to alter, amend, or repeal the by-laws of a corporation which would impair rights which have already become vested under such by-laws. In a New York case this principle was put as follows: "There is a power in this charter to alter, amend, add to or repeal, at pleasure, by-laws before made. The power to make by-laws is to make such as are not inconsistent with the constitution and the law; and the power to alter has the same limit, so that no alteration would be made which would infringe a right already given and secured by the contract of the corporation. Nor was the power to alter, to the extent of affecting the contracted relative value of a share, reserved when the share was sold to the stockholder, so as to enter into and form a part of the contract."<sup>4</sup>

*By-laws must not be in restraint of trade.*—It may be asserted as a general rule that if a by-law is oppressive, or if it interferes with the freedom of a person in making contracts, or is an unlawful interference with the business right to contract, or if its tendency is improperly to restrain trade and thereby to create a monopoly, or if it restricts the liberty of the press, it will be illegal. But on the other hand, if a by-law is an actual and reasonable restraint upon the members of the association or corporation, and an appropriation regulation, or is intended to regulate their conduct as members thereof with respect to the business which the association or corporation was specially organized and incorporated to transact, then it is not subject to this infirmity.<sup>5</sup> A by-law may be subject to the charge of being in restraint of trade if it trammels com-

<sup>2</sup> *People vs. Crockett* (9 Cal. 112); *Gray vs. Portland Bank* (3 Mass. 364); *People vs. Fire Dept.* (31 Mich. 458).

<sup>3</sup> *Peck vs. Elliot* (79 Fed. 10).

<sup>4</sup> *Kent vs. Quicksilver Min. Co.* (78 N. Y. 159).

<sup>5</sup> *Matthews vs. Associated Press* (136 N. Y. 333); *Long Island R. C. In re* (19 Wend. [N. Y.] 37); *Tailors of Ipswich* (11 Col. 53); *Wooley vs. Idle* (4 Burr. 1951).

petition and prohibits an individual from contracting and engaging in business, and from using such agencies and means as he may desire which are not hostile to general law.<sup>6</sup>

*By-law releasing stockholder from payment.*—As against the rights of creditors the corporation cannot enact a by-law permitting the stockholders, on the payment of a certain per cent of their subscriptions, to forfeit their stock. Such a by-law may be held void as a fraud upon creditors. This entire question was fully covered and settled by the judge in an early New York case where he says: "Now could the trustees pass a by-law having effect to deprive a creditor of the company of his only means of satisfaction, by a resort to the stockholders ratably, until his debt was paid? I answer without hesitation that such a by-law or resolution is entirely inoperative. It is an attempt to get rid of a responsibility which the law and common justice imposed on them; the trustees who assented to this resolution must have known at the time, from the report of their committees and the state of their affairs, that thirty per cent was inadequate to pay the appellant. The trustees had antecedently made calls to the amount of fifty per cent; and on the eighteenth of August, 1817, the appellant had assented to a resolution that on payment of all the arrears of call (which, in fact, then amounted to fifty per cent), with costs, the prosecutions should cease, and no proceeding should be had against any subscriber, other than by way of forfeiture. These calls had been made expressly to satisfy the appellant's debt; and on the third of November we find the same trustees, who were themselves interested in the question, discharging the stockholders, on payment of thirty per cent, conscious at the time that the appellant must go unpaid forever. I do not stop to inquire by what means this resolution was obtained; I pronounce it to be against the fundamental principles of law and equity, legally fraudulent, and therefore void and inoperative."<sup>7</sup>

*By-laws must be in consonance with the charter.*—In so far as its by-laws are inconsistent with the object of the corporation and the spirit and terms of its charter, or attempt to authorize the corporation to perform acts beyond its charter powers, they are void, although adopted with unanimous con-

<sup>6</sup> American Live Stock Co. vs. Chicago Live Stock Exchange (32 N. E. 274).

<sup>7</sup> Slee vs. Bloom (19 Johns [N. Y.] 546).

sent of the stockholders.<sup>8</sup> Stockholders or members are not estopped by consent or acquiescence to object to a by-law on the ground that it violates the charter of the corporation, or is contrary to the law or to public policy.<sup>9</sup> A by-law can neither enlarge the right and powers conferred by the charter nor restrict the duties and liabilities imposed thereby, and in case it attempts so to do, the charter will prevail.<sup>10</sup>

*By-laws must be consistent with the nature, purposes and objects of the corporation.*—Every by-law of a corporation must have for its object the furtherance of the company's business or undertaking, otherwise it is invalid. An industrial or business corporation has no right to legislate for the spiritual health or moral welfare of the community at large, or even of its own members.<sup>11</sup> And where there is nothing in the articles of incorporation which suggests powers in the corporation to control, regulate or interfere with its stockholders in the conduct of their separate, individual business, by-laws which assume to do this are beyond the scope of the corporate purposes and are void.<sup>12</sup>

*By-laws must not restrict the right to sue.*—The right to appeal to the courts for the redress of injuries is open to all persons and is carefully guarded by the courts themselves. Parties by mere agreement cannot confer jurisdiction upon the courts or oust them of their jurisdiction over the subject matter of a particular case.<sup>13</sup> A corporation cannot by a by-law provide that any suit against it shall be brought in a certain county or within a particular jurisdiction; and a by-law is void which undertakes, not to deprive members of the right to sue in the courts of the state, but to change the jurisdiction of courts.<sup>14</sup> In general, a by-law attempting to impair the right

<sup>8</sup> Steiner vs. Steiner Land & Lumber Co. (120 Ala. 128).

<sup>9</sup> Durkee vs. People (155 Ill. 354).

<sup>10</sup> Steiner vs. Steiner Land & Lumber Co. (supra); Brewster vs. Hartley (37 Cal. 15).

<sup>11</sup> Kolff vs. St. Paul Fuel Exch. (50 N. W. 1036); People vs. Board of Trade of Chicago (45 Ill. 112).

<sup>12</sup> Kolff vs. St. Paul Fuel Exch. (supra).

<sup>13</sup> Insurance Co. vs. Morse (22 L. Ed. 365); Scott vs. Avery (5 H. L. Cas. 811); Spears vs. Ward (48 Ind. 541); Manson vs. Grand Lodge (16 N. W. 395).

<sup>14</sup> Nute vs. Hamilton Ins. Co. (6 Gray [Mass.] 174); Amesbury vs. Bowditch Ins. Co. (6 Gray [Mass.] 596); Anacosta Tribe vs. Murbach (71 Am. Dec. 625).

of a shareholder to resort to the courts for redress in any case properly cognizable by the judiciary is void.<sup>15</sup> Under this rule, which is said to have existed ever since and even before the time of Lord Coke, the courts which held that by-laws which attempt to deprive the courts of any and all jurisdiction over the property rights of the stockholders or members of the corporation are invalid. Thus, the by-law of a mutual insurance company or a benefit society making final and conclusive the action of a tribunal created by it in regard to the allowance of a claim, will not ordinarily be sustained.<sup>16</sup>

*By-laws cannot compel its members to submit to arbitration.*—On the principle just noticed, that a corporation cannot oust the jurisdiction of courts by a by-law, it may also be said that a corporation by its by-laws cannot compel its members to submit their disputes and controversies to arbitration. The reason of this rule is, as in the other instance, that it has the effect of taking away the right which every person has of seeking redress of grievances in the courts, according to the law of the land.<sup>17</sup> But a by-law looking to the adjustment of difficulties between the association and its members may provide a system of amicable arbitration, even to the exclusion, until it has been exhausted, of the right to suit.<sup>18</sup>

*By-laws must be in consonance with public policy and public welfare.*—By-laws must also be consistent with public policy and not in conflict with public welfare.<sup>19</sup>

*By-laws must not operate retrospectively.*—A by-law which attempts to operate retrospectively, disturbing existing rights or creating new penalties, and being hence in the nature of an *ex post facto* law, is of course void.<sup>20</sup> A by-law, like any other

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<sup>15</sup> Hope vs. International Fin. Soc. (4 Ch. D. 327); Daniher vs. Grand Lodge, (10 Utah 110); State vs. Union Merchants' Exch. (2 Mo. App. 95).

<sup>16</sup> In Cotter vs. Grand Lodge \* \* \* Montana (23 Mont. 82); Munson vs. Straits of Dover S. S. Co. (99 Fed. 787); Grimbly vs. Harrold (125 Cal. 24).

<sup>17</sup> State vs. Merchants' Exch. (2 Mo. App. 96).

<sup>18</sup> State vs. North American Land Co. (31 So. 172).

<sup>19</sup> Weatherly vs. Medical & Surgical Society (76 Ala. 567); People vs. Chicago Live Stock Exch. (170 Ill. 556); National League Commission vs. Hornung (76 Misc. 181).

<sup>20</sup> 10 Cyc. 357, sec. 10.

law, is a rule prescribed to regulate future conduct, not to act retrospectively, by which a forfeiture is incurred, or onerous conditions imposed amounting to a forfeiture.<sup>21</sup>

#### EFFECTS OF BY-LAWS

*Effect as a law.*—While a by-law, from its nature, is applicable to the particular corporate body, yet in a certain sense it is regarded as a law, and is to be applied in the government of such body whenever the circumstances arise for which it was intended to provide.<sup>22</sup> It is generally conceded that where a by-law is enacted in conformity with the governing statute or the charter, it is as binding upon the individual members of the corporation as any public law of the state.<sup>23</sup> And it has been held that by-laws have the force and effect of laws as to third persons dealing with the corporation, who know of such by-laws and are acquainted with the method of transacting the business of the corporation.<sup>24</sup>

*Effect as a contract.*—A by-law may operate as a contract among the members of the corporation, a principle which is constantly brought into play in determining the rights in mutual benefit societies; and it may equally operate as a contract between the corporation on the one side and the members on the other.<sup>25</sup> So in purely voluntary associations the constitution and by-laws have been held to be the contract between the members, and, if their provisions are not illegal, immoral, or contrary to public policy, they must be upheld, whether reasonable or not; since parties have the right to enter into unreasonable and unwise contracts, so long as such contracts are not illegal and are fairly made.<sup>1</sup> But a by-law that is not valid because of some defect in its adoption, or for illegality or unreasonableness, may nevertheless, be incorporated into a contract with the company and so, as to that particular transac-

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<sup>21</sup> Illinois Conference Female College vs. Cooper, (25 Ill. 148).

<sup>22</sup> Gosling vs. Veley (19 L. J. Q. B. 111); Hopskins vs. Mayor (4 Mees. & W. 621).

<sup>23</sup> Weatherly Med. Soc. (supra).

<sup>24</sup> Cummings vs. Webster (43 Me. 192).

<sup>25</sup> 10 Cyc. 315, sec. 4.

<sup>1</sup> Maxwell vs. Theatrical Mech. Assn. (54 Misc. N. Y. 619); Ulmer vs. Minister (37 N. Y. 697); Shafer vs. United Brotherhood of Carpenters (49 N. Y. S. 151).

tion, have the same effect as if it were valid.<sup>2</sup> The principle of the maxim, "allegans contraria non est audiendus", may sometimes be invoked to prevent a party from disputing the validity of a by-law upon which he must rely in order to establish his title.<sup>3</sup>

*Effect on Stockholders.*—The members of a corporation are conclusively presumed to have knowledge of its by-laws and cannot escape a liability arising thereunder on a plea of ignorance of them.<sup>4</sup> Authorized by-laws if, regularly adopted, are binding upon all the stockholders, whether they have signed them, or otherwise expressly assented to them or not. They are chargeable with notice of them.<sup>5</sup> And a stockholder is bound by by-law adopted before he became a member, though he may not have had actual knowledge of them.<sup>6</sup> Of course, invalid by-laws do not bind the stockholder. Mere failure of a stockholder to object to by-laws that are void because unauthorized under any of the above rules, until an attempt is made to enforce them against him, does not estop him to object to them.<sup>7</sup>

*Power of the Corporation to Adopt By-laws.*—The internal government of corporate affairs and the management of the corporate business affairs is usually left almost wholly to the corporation. In the conduct of such business, the corporation has power to enact reasonable by-laws for the regulation of its members, officers, agents and employees. From the very nature of the case this power is inherent in corporations. This is regarded as a power that is included in the grant of the capacity of being a corporation, and is generally said to be an incident of corporate being.<sup>8</sup> This power, while usually conferred by statute, is implied in the charter whether it is expressly given or not.<sup>9</sup> In a New York case this principle was stated as follows: "The power of making rules and regulations is necessarily incident to a corporation; and it is generally inserted in

<sup>2</sup> *Muirhead vs. Forth Mut. Ins. Assn.* (A. C. 72); *Skelly vs. Private Coachmen's Soc.* (13 Daly [N. Y.] 2).

<sup>3</sup> *Rex vs. College of Physicians* (5 Burr. 2740).

<sup>4</sup> 10 Cyc. 350, sec. 2.

<sup>5</sup> *McFadden vs. Board of Sup'rs.* (16 Pac. 397); *Palmetto Lodge No. 5 vs. Hubbell* (49 Am. Dec. 604).

<sup>6</sup> *Matthews vs. Assoc. Press* (32 N. E. 981).

<sup>7</sup> *Kolff vs. St. Paul Fuel Exch.* (50 N. W. 1036).

<sup>8</sup> *Cunningham vs. Alabama Ins. Co.* (4 Ala. 652).

<sup>9</sup> *Thomas vs. Dakin* (22 Wend. [N. Y.] 9).

the act of incorporation, to define its nature and limit its extent." <sup>10</sup> In a very early case the principle was declared by Judge Hobart thus: "I am of the opinion that though the power to make by-laws is given by special clause in all incorporations, yet it is needless; for I hold it to be included, by purchase, and the like. For as reason is given to the natural body for the governing of it, so the body corporate must have laws, as a politic reason to govern it; but those laws must ever be subject to the general law of the realm, as subordinate to it. And therefore, though there be no proviso for that purpose the law supplies it." <sup>11</sup> The Wisconsin court said that "the power to make by-laws is incident to the corporation itself, and results from the necessity of such a power to enable the body politic to answer to the purposes for which it was created by inference or implication." <sup>12</sup> The moment a corporation is created, the right to make ordinances for its good order and government is tacitly annexed to it as a legal incident. <sup>13</sup> But where this power is granted by statute it is regarded as a limitation rather than a grant of power to enact by laws, and the grant is by its terms limited to specified cases or peculiar purposes; the grant will operate as a restriction upon the power of legislation possessed by the corporation in this respect and will by implication exclude all other objects. <sup>14</sup>

#### WHO MAY ENACT BY-LAWS?

*Stockholders.*—Laws governing the internal operations and business of a corporation are necessarily matters of such a character that they can only be made by the corporation at large; that is, the stockholders in their constituent character at a general meeting of the corporation, must enact by-laws, in the absence of a statute otherwise providing. The rule stated by Angell and Ames and adopted by the supreme court of Indiana was stated thus: "Unless by the charter, or some

<sup>10</sup> *Mechanic's Bank vs. Smith* (17 N. Y. 115).

<sup>11</sup> *Norris vs. Staps* (1 Wilgus' Cases 1156).

<sup>12</sup> *North Milwaukee Town Ship Co. vs. Bishop* (79 N. W. 785).

<sup>13</sup> *Taylor vs. Griswold* (27 Am. Dec. 33n).

<sup>14</sup> *Ireland vs. Globe Milling Co.* (32 Atl. 921); *Kennebec R. Co. vs. Kendall* (31 Me. 470); *Chouteau Spring Co. vs. Harris* (20 Mo. 382); *State vs. Ferguson* (33 N. H. 424); *State vs. Morrystown* (33 N. J. L. 57); *Child vs. Hudson Bay Co.* (2 P. Wms. 207).

general statute to which the charter may be subject, or by immemorial usage, this power is delegated to particular officers or members of the corporation, like every other incidental power, it resides primarily with the stockholders. They have few functions to perform, and this right to enact by-laws is an essential and an important one. It is a power that the director have no inherent right to exercise. This is the rule laid down by the text-writers and finds ample support in the authorities."<sup>15</sup>

*Directors.*—The general rule is that unless expressly authorized by statute or by the charter the board of directors have no power to enact by-laws, neither can such directors alter, amend, nor repeal existing by-laws.<sup>16</sup> Where directors are not authorized to adopt by-laws, any effort on their part to enact by-laws is futile.<sup>17</sup> And on the same principle, by-laws adopted by the stockholders are invalid where the power is vested in the directors.<sup>18</sup> But the power to enact by-laws may be delegated. As the right is inherent in the stockholders, they can exercise it as they may see fit, or may delegate the power to a committee or to the board of directors; either body would simply be acting as the agent of the stockholders. Another reason is that the delegation of this power by the stockholders does not necessarily deprive them of their right to enact by-laws.<sup>19</sup>

#### SHARES OF STOCK

*Definition.*—A share of stock may be defined as a right which its owner has in the management, profits and ultimate assets of the corporation.<sup>20</sup> By the court of appeals of New York it is said that "the right which a shareholder in a corporation has, by reason of his ownership of shares, is a right to participate according to the amount of his stock in the surplus profits of the corporation on a division, and ultimately, on its dissolution, in the assets remaining after payment of its

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<sup>15</sup> North Milwaukee Town Site Co. vs. Bishop (103 Wis. 492); Brinkerhoff-Fariss Trust Co. vs. Home Lumber Co. (118 Mo. 447).

<sup>16</sup> United States Fire Assn. vs. Benseman (4 W. N. C. [Pa.] 1); Thayer vs. Herrick (23 Fed. Cas. 3863).

<sup>17</sup> Morton Gravel Rd. De. vs. Wysong (51 Ind. 4).

<sup>18</sup> In re Klaus, (29 N. W. 582).

<sup>19</sup> Rex vs. Westwood (2 Dow & C. 21).

<sup>20</sup> Cummings vs. People (211 Ill. 392).

debts." <sup>21</sup> In England, a share means the same as it does in the United States; but the word "stock" there signifies either paid-up shares or a debt, so united that the owner may divide it and transfer it in large or small quantities, irrespective of the number and par value of the shares of debt which have been thus merged into "stock." <sup>22</sup> The Supreme Court of the United States has said that while the words "stock" and "shares" are sometimes used synonymously, yet the former means capital stock which is the capital upon which the business is undertaken and is represented by the corporate property, while the shares merely measure the interest of the stockholders in the capital stock and their contribution thereto. <sup>23</sup>

*Their nature.*—It is well settled that shares of stock are personalty and not realty. A share of stock is not real estate, has nothing to give it the character of real estate, is not land, nor an hereditament, nor an interest in any of them. <sup>24</sup> In some of the earlier cases, upon the theory, perhaps, that the stockholders had a direct interest in the tangible property of the corporation, shares were held to be real estate where the corporate property consisted wholly or chiefly of realty. <sup>25</sup> But as a result of all the authorities it is clearly settled that shares of stock are to be regarded as personalty, a view which has frequently found expression in declaratory statutes both in England and the various states of the Union. <sup>1</sup>

Stock, though personalty, is not a chattel; it is rather a chose in action, or, as some older authorities declare, property in the nature of a chose in action. <sup>2</sup> It is, moreover, of such a nature that it cannot ordinarily, either by act of the law or act of its owner, be taken into tangible possession, although, of course, its representative—the certificate of stock—may be. It is an English doctrine that shares of stock are not "goods, wares, or merchandise," as those terms are to be understood in

<sup>21</sup> *Plimpton vs. Bigelow* (93 N. Y. 592).

<sup>22</sup> *Morrice vs. Aylmer* (7 H. L. 717).

<sup>23</sup> *Wright vs. Georgia etc.* (216 U. S. 420).

<sup>24</sup> *Cummings vs. People* (211 Ill. 392); *McKane vs. Burke* (132 Fed. 688).

<sup>25</sup> *Price vs. Price* (6 Dana [KY] 107).

<sup>1</sup> *Watson vs. Spratley* (10 Exch. 222); *Ex Parte Vallance* (2 Deacon (354).

<sup>2</sup> *Rex vs. Capper* (5 Price [Exch.] 217).

<sup>3</sup> *Jermain vs. Lake Shore R. R. Co.* (54 Cal. 339).

construing that section of the statute of frauds which requires delivery, payment or memorandum in writing of a sale thereof. In this country (United States), however, the courts have taken the opposite view. Furthermore, it is said that shares are not money, nor are they security for money, nor a credit.<sup>4</sup>

#### DEFINITIONS AND DISTINCTIONS

*Capital stock.*—From the above definitions and nature of shares of stock, they can be differentiated from capital stock in that the latter is the amount stated in the articles of incorporation, and which, ordinarily, is to be subscribed and paid by those who wish to join in the enterprise and become members of the corporation. Usually, it represents the estimated amount of capital believed by the incorporators to be necessary for the proper prosecution of the proposed corporate undertaking.<sup>5</sup> By capital stock is meant the aggregate amount of the funds of the corporation which are combined together in a charter for the attainment of some common object of public convenience or public utility, and the amount is usually fixed in the articles of incorporation. On the other hand, it is thus limited for the convenience and for the determination of the rights and powers of the intended incorporators, and, on the other hand, for the information and security of the public at large.<sup>6</sup>

*Capital.*—The capital of a corporation is the fund with which it transacts business, and embraces all its property, real and personal. It is the property or the means contributed by the stockholders as the fund or basis for the business enterprise, for which the corporation was formed, plus corporate gains and less corporate losses. It signifies the actual estate, whether in money or property, which a corporation owns. It is the aggregate of the sum subscribed and paid in, or secured to be paid in, by the stockholders, with the addition of all gains or profits realized in the use and investment of those sums, or, if losses have been incurred, then it is the residue after deducting losses.<sup>7</sup>

*Certificate of stock.*—A certificate of stock is a written acknowledgment by the corporation of the interest of the stock-

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<sup>4</sup> *Nightingale vs. Devisme* (5 Burr. 2589); *Jones vs. Brinley* (1 East 1); *Douglas vs. Congreve* (1 Keen 10); *Hotham vs. Sutton* (15 Ves. 319).

<sup>5</sup> *Commercial Fire Ins. Co. vs. Montgomery Co.* (14 So. 490).

<sup>6</sup> *Cooke vs. Marshall* (191 Pa. St. 316).

<sup>7</sup> *Elliott*, Vol. 1, page 387.

holder in the corporate property and franchises. While the shares of stock are the substance, the certificates of stock are the evidence.<sup>8</sup> Certificate of stock is from one point of view a mere muniment of title, like a title deed. It is not the stock itself, but evidence of the ownership of the stock; that is to say, it is a written acknowledgment by the corporation of the interest of the stockholder in the corporate property and franchises; it operates to transfer nothing from the corporation to the stockholder, but merely affords to the latter evidence of his rights.<sup>9</sup> Accordingly, it follows that shares of stock have no ear-marks,—that one share cannot be distinguished from another share,—and that it is only the certificates which are distinguishable one from the other by their number and in other ways.<sup>10</sup>

*Transferability of Shares of Stock.*—That shares of stock in a corporation are transferable the same as other personal property is a principle of law coeval with the existence of stock itself. The few decisions holding that shares of stock are real estate were exceptional rulings, and are no longer considered good law. Courts of law and of equity have guarded jealously the facilities for the transfer of title to stock, and all unreasonable attempts to restrain the right of passing title have been declared void as against public policy. The right to transfer stocks is of vital importance, since the two chief causes of the phenomenal growth of corporation in recent times are the limited liability of the members and the facility of buying or selling an interest in the corporation by a transfer of the stock a person has therein. The common law regards shares of stock as personal property, capable of alienation or succession in any of the modes by which personal property may be transferred.<sup>11</sup>

*Negotiability of Shares of Stock.*—Certificates of stock are not negotiable instruments either in form or character, although they are often said to be quasi-negotiable. The general consequence of this doctrine is that whoever takes them subject to the equities and burdens which attend them, as in the case of the purchase of any other non-negotiable paper, and that, although

<sup>8</sup> Elliott, Vol. 1, page 393.

<sup>9</sup> Higgins vs. Lansingh (154 Ill. 301); Kennedy vs. Hodges (215 Mass. 112).

<sup>10</sup> Hubbell vs. Drexel (11 Fed. 115).

<sup>11</sup> Mobile Mut. Ins. Co. vs. Cullon (49 Ala. 558); Cole vs. Ryan (52 Baro. 168); Heart vs. Bank (2 Dev. Eq. 111).

ignorant of such equities and burdens, his ignorance does not relieve the paper thereof, or enable him to hold it discharged therefrom. They are non-negotiable in the sense that a complete transfer of title, good not only between the parties but also against the corporation itself, can only be made with the concurrence of the act of the corporation in pursuance of its character, governing statute or operative by-laws.

But they are assignable as between the vendor or purchaser, or pledgor and pledgee, by mere delivery, when properly indorsed; for when indorsed in blank by the person named therein as the owner of the shares, they pass by mere delivery of the certificate, without the owner of the further indorsement, and without transfer on the books of the corporation, although the certificate is not a negotiable security; and this equitable title is perfected into a full legal title by the transferee procuring the transfer to him to be registered on the books of the corporation.<sup>12</sup> Before the enactment of the Uniform Stock Transfer Act it was universally held, both in England and in the United States, that a certificate of stock is not negotiable. But stock certificates are a peculiar kind of property, although not negotiable paper, strictly speaking, they are the basis of commercial transactions, large or small, and are frequently sold in open markets as negotiable securities are. Consequently the courts of the United States have conferred upon stocks certificates many of the elements and characteristics of negotiable instruments, and for want of a better expression have frequently called them quasi-negotiable. But under the Uniform Stock Transfer Act, while it has not made stock certificates fully negotiable when indorsed in blank, it at least has gone so far as to protect a bona fide purchaser of a stolen certificate.<sup>13</sup> However, under the Philippine Corporation law, shares of stock are also personal property and may be transferred by delivery of the certificate indorsed by the owner or his attorney in fact or other person legally authorized to make the transfer,<sup>14</sup> which is similar to the above cited rule before the enactment of the Uniform Stock Transfer Act in many of the states of the American Union.

*Modes of transferring Shares of Stock.*—In the absence of express charter or statutory provision to the contrary, shares of stock may be transferred in the same manner as any other per-

<sup>12</sup> 10 Cyc. 589, 590.

<sup>13</sup> 27 Michigan Law Review, page 93.

<sup>14</sup> Philippine Corporation Law, Sec. 35.

sonal property.<sup>15</sup> At common law, the delivery of a stock certificate with a written transfer of the same to the purchaser is sufficient to transfer the title to the shares represented thereby, and this is now the rule in many states by statute.<sup>16</sup> So it is provided frequently that the delivery of a stock certificate to a bona fide purchaser or pledgee, for value, together with a written transfer of the same, or a written power of attorney to sell, assign and transfer the same, signed by the owner of the certificate, shall be a sufficient delivery to transfer the title as against all parties. In the absence of any provision requiring a transfer on the books or otherwise providing the manner of sale, the legal title passes by a transfer and delivery of the certificate by the person to whom it was issued.<sup>17</sup> A transfer and delivery of the certificate is the ordinary mode of transferring stock.<sup>18</sup> Ordinarily the transfer may be made by indorsing on the certificate of stock, or by writing on a separate paper, an assignment and power of attorney to a particular person, or the assignment and power of attorney may be executed in blank.<sup>19</sup> Where the assignment and power of attorney are executed in blank, the certificate may be transferred from hand to hand by delivery, like a note indorsed in blank, and any holder thereof has authority to fill in his own name as transferee, and his own name or another's as attorney, and cause the transfer to be registered on the books of the corporation.<sup>20</sup> To constitute transfer there must be delivery.<sup>21</sup> Delivery is defined by the Uniform Stock Transfer Act to be a "voluntary transfer of possession from one person to another." A share of stock being intangible, is not susceptible of manual delivery, but delivery of the certificate is a symbolical delivery of the stock which it represents.<sup>22</sup>

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<sup>15</sup> McGowin vs. Dickson (62 So. 685); Mobile Mut. Ins. Co. vs. Gullom, (49 Ala. 558); Allen vs. Stewart (44 Atl. 786); People vs. Devin (17 Ill. 84).

<sup>16</sup> Bank of Commerce vs. Bank of Newport (63 Fed. 898); Scott vs. Pequonock Nat. Bank (15 Fed. 494).

<sup>17</sup> Condit vs. Galveston City Co. (186 S. W. 395).

<sup>18</sup> Brinkerhoff-Farris Trust & Sav. Co. vs. Home Lumber Co. (24 S. W. 129).

<sup>19</sup> Masury vs. Arkansas Nat. Bank (93 Fed. 603).

<sup>20</sup> Johnston vs. Laflin (103 U. S. 800); MaAllister vs. Kuhn (96 U. S. 87).

<sup>21</sup> Weber vs. Bullock (35 Pac. 183).

<sup>22</sup> MaAllister vs. Kuhn (supra); De Nunzio vs. Nunzio (97 Atl. 323).

*Transfer on the Books of the Corporation.*—Registration of a transfer of shares on the books of the corporation is not necessary to the validity of the transfer, or the substitution of the transferee for the transferrer as a stockholder, either as between the parties themselves, or as against the corporation or its creditors, or as against a subsequent attaching creditor of the transferrer, unless such a formality is expressly required by or under the charter of the corporation or some general law, or by a valid by-law of the corporation.<sup>23</sup> Frequently, however, the charter of a corporation or the general law under which it formed expressly provides that its shares shall be transferrable only on the books of the corporation; and similar provisions are often found in the corporate by-laws.<sup>24</sup>

Our Corporation Law requires that the transfer must be entered and noted upon the books of the corporation so as to show the names of the parties to the transaction, the date of the transfer, the number of the certificate, and the number of shares transferred, in order that such transfer may be valid as against the corporation and third persons.<sup>25</sup>

All courts agree that such a requirement is intended for the protection of the corporation, so that it may have the means of knowing at any time who are its stockholders, and as such entitled to receive dividends, vote at corporate meetings, and otherwise participate in the management of the corporation, and so that it may take advantage of charter or statutory provisions giving a lien on shares for debts to it from stockholders, or acquire such a lien by contract with stockholders.<sup>1</sup> According to some courts, such a requirement is also intended, according to the weight of authority, for the benefit and protection of persons who may deal with the corporation and become its creditors, so that they may know who are stockholders, and as such liable to its creditors.<sup>1</sup> According to some courts such a requirement is also intended for the benefit and protection of persons who may purchase or take a pledge of the shares of the corporation, so that they may have the means of ascertaining whether a

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<sup>23</sup> *Bates vs. Androscoggin \* \* \* Co.* (49 Me. 491).

<sup>24</sup> *Johnston vs. Laffin* (supra); *People's Home Savings Bank vs. Stadtmuller* (88 Pac. 280).

<sup>25</sup> *Philippine Corporation Law*, Sec. 35.

<sup>1</sup> *Bridgewater Iron Co. vs. Lissberger*, (116 U. S. 8); *Johnston vs. Laffin* (supra); *O'Neil vs. Wolcott Min. Co.* (174 Fed. 527).

person offering to sell or pledge shares is the owner of them.<sup>2</sup> And where this is held to be true an unregistered transfer is ineffectual as against a bona fide purchaser or pledgee from one who appears as owner on the books of the corporation, if he has no notice of the transfer.<sup>3</sup> Such a provision is not intended to prevent the alienation of corporate stock, or to prescribe an exclusive method whereby a stockholder may divest himself of his title or may assign it to a third party; and hence a failure to comply with it does not affect the validity of a transfer as between the parties thereto.<sup>4</sup> Our Supreme Court also held that purchase of stock transfers to the purchaser only an equitable title, and in order for him to acquire the legal title he must follow the charter or the by-laws of the corporation regarding making the transfer.<sup>5</sup> However, an unregistered transfer is valid as between the parties to the transfer,<sup>6</sup> in spite of such provision. The title passes to the purchaser by contract and not by the record.<sup>7</sup> The transferrer cannot impeach the transferee's title under such circumstances, and is estopped from claiming any further title to the stock as against subsequent bona fide purchasers for value, especially where he has clothed the assignee with the apparent title to the stock, or apparent authority to transfer the same.<sup>8</sup> The transferee acquires a perfect equitable title as between him and the transferrer, or any person standing in the shoes of the transferrer.<sup>9</sup> Even prior to the transfer on the books, the transferee is entitled, as against the transferrer, to all the benefits attached to or growing out of their ownership. Either the transferrer or the transferee may request and compel a transfer on the books.<sup>10</sup>

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<sup>2</sup> O'Neil vs. Wolcott Min. Co. (supra); Bank of Commerce vs. Bank of Newport (63 Fed. 898).

<sup>3</sup> Fletcher, Vol. 6, page 6318.

<sup>4</sup> Fletcher, Vol. 6, page 6318.

<sup>5</sup> Uy Piacó vs. McMicking (10 Phil. Rep. 286).

<sup>6</sup> Philippine Corporation Law, sec. 35; Johnston vs. Laflin (supra); West vs. Empire Life Ins. Co. (242 Fed. 605); Masury vs. Arkansas Nat. Bank (93 Fed. 603); Hubbell vs. Houghton (86 Fed. 547); Horton vs. Mercer (71 Fed. 153).

<sup>7</sup> Scripture vs. Francestown Sopastone Co. (50 N. H. 571).

<sup>8</sup> Muray vs. Arkansas Nat. Bank (supra).

<sup>9</sup> Leyson vs. Davis (170 U. S. 36); Black vs. Zacharie (11 L. Ed. 690); Hubbard vs. Manhattan Trust Co. (87 Fed. 51).

<sup>10</sup> Webster vs. Upton (91 U. S. 65).

*Acquisition of membership in a Corporation.*—Membership in a corporation is the result of contract, express or implied. A person cannot be made a member or stockholder of a corporation without his consent. Nor can he acquire membership without his consent and the consent of the corporation, as the representative of all the members. Membership, therefore, is the result of a contract between the individual and the corporation. It is sometimes said that membership is the result of a contract between the incorporators, but this is inaccurate. Such is the case in a partnership, but in a corporation the contract of membership is a contract with the incorporators in their collective capacity; that is, with the corporation.<sup>11</sup> On the other hand, after the corporation has become organized, no one can become a member without its consent, and by compliance with its charter, and its authorized by-laws. In an Illinois case the question arose whether the complainant was a member of the Chicago Live Stock Exchange, a corporation organized by commission merchants engaged in buying and selling live stock for others at the stockyards. A by-law of the corporation provided that members should be admitted upon written application, indorsed by two members, and approved by at least seven directors, and payment of an initiation fee or presentation of a certificate of membership duly transferred to the applicant. It was held that one to whom a certificate of membership had been duly transferred but who had not made application for membership, was not a member of the corporation. The association, it was held, had an undoubted right to adopt this by-law, and, as it prescribed the mode, and the only mode, in which membership in the corporation could be acquired, no one could justly claim to be a member, who had not been admitted in the mode thus prescribed.<sup>12</sup>

A court of equity has no power to compel a corporation to admit a person to membership against the will of those whose consent is, according to the charter, or an authorized by-law, essential to the eligibility of the applicant.<sup>13</sup> This is also true with non-stock corporations, as well as with stock corporations. But in the latter case, membership may be acquired by purchasing shares from one who owns them, in which case there is a

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<sup>11</sup> *Coppage vs. Hutton* (24 N. E. 112).

<sup>12</sup> *American Live Stock Commission Co. vs. Chicago Live Stock Exch.* (32 N. E. 274).

<sup>13</sup> *Id.*

novation of contract of membership. The transferee is substituted by the implied or express consent of the corporation to all the rights and privileges of the transferrer, and generally assumes his liabilities.<sup>14</sup>

### PART III

#### MAIN CONSIDERATIONS

*Right of Stockholders to Transfer Shares.*—By the charters of private corporations, the shares of stock are often expressly declared to be transferable by the holders, but express provision is not at all necessary to give the right to transfer. It exists at common law. In the absence of express statutory restrictions, it is always implied that shares of stock are transferable. Subject to the limitations hereafter shown it is well settled that a stockholder has an absolute right incident to his ownership, to make an actual and bona fide sale and transfer of his shares to any person who is capable in law of taking and holding them, and of assuming liability as a stockholder. And, in the absence of express restrictions in the charter or in some statute, or by contract, the right is not in any way dependent upon the consent of the directors or of the other stockholders. Unless the power to do so is expressly conferred by the Legislature creating the corporation, or by an authorized amendment of its charter, neither the directors nor a majority of the stockholders can, directly or indirectly, prohibit or refuse to recognize bona fide transfers.<sup>15</sup>

The jus disponendi, being an incident of the ownership of property, the general rule is that owners of corporate shares have the same uncontrollable right to alienate them which attaches to the ownership of any other species of property. A shareholder is under no obligation to refrain from selling his shares, at the sacrifice of his personal interest, in order to secure the welfare of the corporation, or to enable another shareholder to make gains and profits.<sup>16</sup>

The correlative right to purchase corporate shares rests upon similar grounds; the right to become the possessor, by lawful means, of this species of property is as clear a right as the right to become the possessor of any other species of prop-

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<sup>14</sup> Id.

<sup>15</sup> Clark on Corporations and authorities cited, page 514.

<sup>16</sup> 10 Cyc. 577, Sec. 1.

erty; nor can the motive influencing the party who makes such a purchase become the subject of a judicial inquiry, where the motive is not in itself unlawful. Accordingly it has been held that parties who are interested in opposition to a corporation have the right to purchase its stock in order to defeat a contract which it is about to make; and in general it is competent for one person to obtain a controlling interest in a corporation by buying all or a majority of its shares.<sup>17</sup> The mere fact that the purchaser of shares is a business rival of the corporation, and hostile to it, does not affect his rights as transferee, and is no ground for refusal of a court of equity to compel the corporation to register the transfer.<sup>18</sup> While inquiry into the motive of the transferee is ordinarily regarded as immaterial in the eye of the law, it has nevertheless been held that registration was properly refused by the corporation where the avowed purpose of the transferee was to wreck the corporation if possible.<sup>19</sup>

The right of shareholders to transfer shares on the books of the corporation is established by the Philippine Corporation Law (sec. 35), which provides that shares of stock "may be transferred by delivery of the certificate endorsed by the owner or his attorney \* \* \*"; but that the transfer shall not be valid, except as between the parties—"until the transfer is entered and noted upon the books of the corporation so as to show the names of the parties to the transaction, the date of the transfer, the number of the certificate, and the number of shares transferred".

The right to transfer shares is one of the most important incidents of property in them. Unless the corporation is justified in declining to make the transfer because of the existence of a lien or claim in its favor upon the shares to be transferred it has simply a plain ministerial duty to perform in making the transfer on its books.<sup>20</sup>

*Power of a Corporation to Prohibit the Transfer of Shares.*  
—The directors or managing officers of a corporation have no power to prohibit the transfer of shares. Nor is it within the power of the stockholders, unless expressly authorized by the

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<sup>17</sup> 10 Cyc. 577, Sec. 1.

<sup>18</sup> Rice vs. Rockefeller (31 N. E. 907).

<sup>19</sup> Senn vs. Union Premium Mercantile Co. (92 S. W. 507); State vs. McIver (2 S. C. 25).

<sup>20</sup> 136 A. S. R. 1029; Fisher, page 147.

charter, to enact a by-law prohibiting the transfer of shares without the consent of the president or board of directors. Where a by-law provided that no valid transfer could be made without the consent of the board of directors, the court said: "Its enforcement would operate as an infringement upon the property rights of others which the law will not permit. It would, besides, operate as a restraint upon the disposition of property in the stock of the corporation, in the nature of restraint of trade, which courts will not tolerate."<sup>21</sup> However, if the charter of a banking corporation authorizes its board of directors to make rules regulating the transfer of its shares, a by-law adopted by them forbidding the transfer of stock so long as the owner is indebted to the bank is valid, although inconsistent with the general law of the state governing the transfer of property.<sup>22</sup> But it has been held that a by-law which prohibited the transfer of stock by a holder without the consent of all the stockholders was against public policy and void. In this connection the court said: "Its sale, full and complete, may thus be prevented by the will and at the option of another who has no interest in it. The claim is against all reason and justice. When the law makes stock personal property it clothes it with all the incidents of personal property, and the owner has full dominion over it and may dispose of it at will. That such a by-law as that under consideration is void as against public policy nearly all of the authorities seem to hold."<sup>23</sup>

*Power of a Corporation to Restrain Transfer of Shares.—*

On this question the authorities are divided. Some authorities answer the question in the affirmative, while others answer in the negative. We shall first show what the affirmative say and their reasons for so holding.

**Affirmative:** The grant to a corporation of the power to "regulate" transfers of its shares has been generally held sufficient to authorize a by-law restraining such transfers until the payment of any indebtedness due by the shareholder to the corporation.<sup>24</sup>

The stock of a corporation is personal property and may be transferred at will. The corporation, when all conditions have been complied with, cannot prevent a transfer. Trans-

<sup>21</sup> Elliott, pages 570-571.

<sup>22</sup> 10 Cyc. 360.

<sup>23</sup> In re Klaus (29 N. W. 582); cases cited therein.

<sup>24</sup> 10 Cyc. 582

fers may, however, be restricted, \* \* \* (b) By its by-laws, \* \* \*. In order that a restriction upon the right of transfer be valid, it is necessary that such restriction be stated upon the face of the stock certificate.<sup>25</sup>

The several limitations which, through diverse means, have been imposed upon the unqualified right of a corporate shareholder to dispose of his stock, find a practical justification in their economic background. They are designed to effectuate a variety of purposes prominent among which are the protection of prospective purchasers against possible injurious changes in the control and management of the corporation, and the retention of the power to select one's associates, and advantage possessed by partnerships but usually not available to corporations. In a few instances, they are intended to secure to a limited number of individuals the benefit of participating in the enterprise without permitting others to obtain the same privilege; or, as in the case of banking organizations, an attempt is made to retain a lien as security for any indebtedness due the corporation. The extent to which these restrictions will receive judicial sanction depends for the most part upon the form in which they have been made articulate.<sup>1</sup> By-laws restraining the sale of shares without the assent of the directors, while the stockholder is indebted to the bank, may be made by National banks.<sup>2</sup>

Negative: Shares of stock in a corporation are personal property, and the right to sell or otherwise dispose of personal property is a necessary incident to its ownership; it follows that a by-law which absolutely restricts the right of a shareholder to transfer his stock would be void as against common right, as being opposed to the law of the land, and also as being in restraint of trade. It is obvious proposition, supported by authorities, that the power to regulate by by-laws the transfer of stock, does not carry with it the power to restrain transfers, or to make such transfers conditioned on the approval of the board of directors, or subject to the assent of any officers of the corporation.<sup>3</sup> So a by-law restricting the rights of stockholders to

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<sup>25</sup> Marquette Law Review, April, 1930, page 115.

<sup>1</sup> Harvard Law Review, Vol. 42, pages 555-559.

<sup>2</sup> Young vs. Vough (23 N. J. Eq. 325); Lockwood vs. Mechanics' Nat. Bank (11 Am. 253).

<sup>3</sup> Farmers' Bank vs. Wasson (30 Am. 398); Ireland vs. Globe Mill. Co. (41 Atl. 258).

convey their stock to any one until the directors had refused to purchase it or while indebted to the corporation, was held to be without warrant or authority of law, and not binding either on the stockholders or those purchasing from them.<sup>4</sup>

A by-law cannot take away or abridge the substantial rights of a stockholder.<sup>5</sup> The corporation, in the absence of such a power, cannot ordinarily inquire into or pass upon the legality of the transaction by which its stock passes from one person to another, nor can it question the consideration upon which a sale is based.<sup>6</sup> Under a statute authorizing by-laws for the transfer of stock, a corporation can do no more than prescribe a general mode of transfer on the corporate books and cannot justify an unreasonable restriction upon the right of sale.<sup>7</sup> Restrictions upon the traffic in stock must have their source in legislative enactment, as the corporation itself cannot create such impediments.<sup>8</sup>

*Power of the Corporation to Regulate Transfer of Shares.*—By-laws providing for the transfer of stock on the books of the corporation, are intended for the protection of the corporation, in order that the board of directors may know who are entitled to vote, who are entitled to receive dividends, etc. Their purpose is not to give the directors power to approve or disapprove the registry of transfers. They are not regarded as restrictions on the right of the holder to transfer his stock, but mere regulations for the convenience and advantage of the corporation.<sup>9</sup>

The corporation has the inherent or implied power to regulate by by-laws the transfer of stock. But the power or authority to regulate must not be exercised so as either to restrict or infringe the inherent right of the holder of the shares to transfer them.<sup>10</sup> Authority to make by-laws for the transfer of stock gives power only to prescribe the officers by whom the stock shall be transferred and the mode of its transfer; but

<sup>4</sup> Brinkerhoff-Farris Trust Co. vs. Home Lumber Co. (24 S. W. 129).

<sup>5</sup> People vs. Home Sav. Bank (38 Pac. 452).

<sup>6</sup> Mundt vs. Comm. Nat. Bank (99 Pac. 454).

<sup>7</sup> Kinnan vs. Sullivan Co. Club (50 N. Y. S. 95).

<sup>8</sup> Bank vs. Durfee (118 Mo. 431).

<sup>9</sup> Johnson vs. Laflin (103 U. S. 800); Chouteau Spring Co. vs. Harris (20 Mo. 382); Feckheimer vs. National Bank (79 Va. 80).

<sup>10</sup> Miller vs. Farmers' Milling Co. (110 N. W. 995).

this does not give power to impose any penalty preventing the unconditional right of transfer, nor to refuse the owner of the stock permission to vote thereon.<sup>11</sup>

#### PART IV

##### THE HEART OF THE DISCUSSION

###### *Right of the Corporation to Purchase its Own Shares.—*

This is another subject in corporation law in which the authorities are also conflicting and divided. The writer finds it indispensable in the treatment of the subject under consideration to bring out to light what is the status of the decisions on this point, because were the corporation absolutely denied the right to purchase its own shares, it would no longer be necessary to go any further in the discussion of this thesis, for any by-law that contravenes this prohibition would be of no effect.

Again we shall try to discover the weight of the authorities on this point by following the order we pursued in discussing the authorities concerning the power of the corporation to restrain the transfer of its shares.

Affirmative: The rule established by the undoubted weight of authority is that corporations, without express authority, and when not prohibited by their own charter or by statute, may buy and sell their own shares, provided they do so in good faith without intending to injure, and without in fact injuring, their creditors.<sup>12</sup> A Federal court said that there is no reason why the stock should not be purchased, at least with the profits derived from the business of the corporation, where all the stockholders assent thereto.<sup>13</sup> Perhaps the reason for courts conceding this power lies in the fact that a purchase of its own stock by the corporation is beneficial to the stockholders. To the extent of the purchase it enriches the shares of every stockholder, as it is obvious that whether the purchased shares be retired or sold at a profit, to be distributed pro rata among the stockholders, the chance for an increase of dividends or shares enhances the value of each existing share. This reason, at least, has been

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<sup>11</sup> Kinnan vs. Sullivan Co. Club (26 App. Div. [N. Y.] 218).

<sup>12</sup> Cooper vs. Frederick (1 Ala. 738); Dacovich vs. Canizas (152 Ala. 287); Copper Belle Min. Co. vs. Costello (95 Pac. 94); Robinson vs. Beall (26 Ga. 17); Clapp vs. Peterson (104 Ill. 26).

<sup>13</sup> Lowe vs. Pioneer Threshing Co. (70 Fed. 646); State vs. Minnesota Mfg. Co. (90 N. W. 87).

assigned as against complaints by stockholders.<sup>14</sup> The word "property" was held sufficiently broad to cover this form of purchase where there was no pretense of fraud or bad faith in the transaction and the rights of creditors were not injuriously affected.<sup>15</sup> So, statutes which declare shares of stock in a corporation to be personal property as its purposes might require, were held sufficient to authorize a purchase by a corporation of its own stock.<sup>16</sup> A corporation authorized by statute to retire shares of its preferred stock was held to have power to purchase and hold its own shares.<sup>17</sup> It has been held however, that corporations are not given power to purchase their own shares of stock by a statute merely giving them the power to hold, purchase and convey such real and personal estate as the purposes of the corporation shall require; nor by a memorandum of association empowering the corporation to do all things which it may deem conducive to the attainment of the objects for which it was established; nor by a statute conferring the power to acquire and convey at pleasure all such real and personal estate as may be necessary and convenient to carry into effect the objects of its incorporation.<sup>18</sup> Along this line it has been held that a corporation could not purchase its own stock in the face of a statute which forbade it to employ its stock, means, assets or other property, directly or indirectly, for any other purpose whatever than to accomplish the legitimate objects of its creation.<sup>19</sup>

In most jurisdictions, the doctrine that a corporation cannot purchase and hold its own stock, unless expressly authorized to do so, is not recognized. On the contrary, most of the courts in which the question has arisen have held that it may do so without express authority, in the absence of express restrictions, provided it acts in good faith and without prejudice to the rights of creditors.<sup>20</sup> It is held that there is no reason why the stock should not be purchased, at least with the profits

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<sup>14</sup> *Hartridge vs. Rockwell* (Chart. [Ga.] 260); *Coleman vs. Columbia Oil Co.* (51 Pr. St. 74).

<sup>15</sup> *Iowa Lumber Co. vs. Foster* (31 Am. 140).

<sup>16</sup> *Chapman vs. Iron Clad \* \* \* Co.* (41 Atl. 690).

<sup>17</sup> *Berger vs. United States Steel Corp.* (53 Atl. 68).

<sup>18</sup> *Barton vs. Port Jackson Rd. Co.* (17 [Barb.] N. Y. 397); *In re Dranfield Coal Co.* (17 Ch. D. 76).

<sup>19</sup> *German Sav. Bank vs. Wulfekuhler* (19 Kan. 60).

<sup>20</sup> *Johnson County vs. Thayer* (94 U. S. 631); *Burnes vs. Burnes* (137 Fed. 781); *Clapp vs. Peterson* (104 Ill. 26).

derived from the business of the corporation, where all the stockholders assent thereto.<sup>21</sup>

*Limitations to this power.*—The power of a corporation to purchase its own shares is generally said to be limited by the requirement that such purchase must be made in good faith and out of corporate surplus. Where the rights of creditors are not involved, however, some courts have held that the corporation could not assert the absence of a "surplus" either for the purpose of resisting the claim of the vendor for the payment or of recovering payments already made. It is well settled that creditors existing at the time of the making of the purchase agreement may, on the ground of lack of "surplus", resist the claim of the vendor or recover payments already made to him.<sup>22</sup> Private corporations may purchase their stock in exchange for money or other property, and hold, reissue or retire the same, provided such act is had in entire good faith, is an exchange of equal value, and is free from all fraud, actual or constructive, this implying that the corporation is neither insolvent nor in process of dissolution, and provided the right of creditors are not affected.<sup>23</sup> It has been held that whether or not the corporation is solvent, it cannot buy back its own stock from one or more of its stockholders in such amount as to reduce the outstanding capital stock of the corporation to an amount below the minimum capital stock stated in the charter.<sup>24</sup> And in Arkansas, where the statute provides that in no event shall the paid-up capital stock of certain classes of corporations be less than a certain sum, such a company has no power to purchase shares of its own stock.<sup>25</sup>

Negative: In England, though it is held that a corporation may deal in the shares of other corporations, it is held that it cannot purchase shares of its own stock, unless it is expressly authorized to do so, whether its purpose be to reissue them or to retire them.<sup>1</sup> "There is great difference", it is said, "between dealing in the shares of other companies and in its own. The former is ordinary business, attended only with the usual risks of ordinary transactions, but the latter tends inevitably to

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<sup>21</sup> Lowe vs. Pioneer Threshing Co. (70 Fed. 446).

<sup>22</sup> Yale Law Review, Vol. 19 page 902, and cases cited therein.

<sup>23</sup> Clapp vs. Peterson (104 Ill. 26).

<sup>24</sup> Dalton Grocery Co. vs. Blanton (70 S. E. 183).

<sup>25</sup> Lefker vs. Harner (186 S. W. 75).

<sup>1</sup> Trevor vs. Witworth (12 App. Cas. 407).

breaches of their duty on the part of the corporation itself. Consequently, a corporation, to possess such a power, must have it conferred by the plainest and most explicit language.<sup>2</sup>

In the United States, some courts have held, as in England, that a corporation cannot purchase its own shares of stock, either to retire them or to reissue them, unless such power is expressly conferred by its charter or some other statute.<sup>3</sup> This is the rule in Kansas, Maryland, New Hampshire, Ohio, Tennessee, and Washington, which is the minority rule in the United States. This view is based, not only upon the ground that a corporation cannot increase or diminish the amount of the capital stock as fixed by the legislature, and on the ground that such a transaction is a fraud upon the stockholders and creditors, but also, and chiefly, on the ground that it is foreign to the purposes for which the corporation was created, and therefore a violation of its charter, and a diversion of its funds to an unauthorized purpose.<sup>4</sup>

The Philippine Corporation Law has no provision directly in point. However, a corporation in the Philippines may purchase at auction shares of stock of its own stockholders for unpaid subscriptions, if no bidder offers to purchase them.<sup>5</sup>

*Right of Corporation by its Charter to Reserve to Itself Option to Purchase the Shares of its Stockholders.*—It has been shown that the charter of a corporation may place certain restrictions upon the sale of stock. This amounts to an agreement among the stockholders themselves, and being in the charter is notice to all persons dealing with the stock. So a charter provision against transfers, until the capital stock is all paid in, is binding.<sup>6</sup> According to English authorities the charter may expressly confer upon the directors the right to refuse to transfer stock; and where such right is given a reason for the refusal cannot be required where there is no bad faith.<sup>7</sup>

Although shares of stock constitute no exception to the general rule that restraints on alienation of property are strict-

<sup>2</sup> Trevor vs. Whitworth (12 App. Cas. 409).

<sup>3</sup> Crandall vs. Lincoln (52 Am. Rep. 560); St. Louis Rawhide Co. vs. Hill (72 Mo. App. 142).

<sup>4</sup> Maryland Trust Co. vs. Nat. Mech. Bank (17 N. E. 558); Crandall vs. Lincoln (supra).

<sup>5</sup> Phil. Corp. Law (Act 1459), sec. 14.

<sup>6</sup> Williams vs. Montgomery (148 N. Y. 519); Barnes vs. Brown (80 N. Y. 527); Hodge vs. Sloan (107 N. Y. 244); Merrill vs. Call (15 Me. 428).

<sup>7</sup> Shortridge vs. Bosanquet (16 Beav. 84).

ly construed, it is well settled that a charter provision reserving the right to the corporation to have the first opportunity to purchase its stock is valid. The Delaware courts rationalized their decision on the basis of a contractual relationship, on the theory that each person who became a holder of the stock bound himself to afford the corporation the first opportunity to purchase his stock. Other theories advanced by the courts to sustain these restrictions are, the giving of equitable relief for interference with contractual relations, and the enforcement of a constructive trust. It has been suggested that in effect the courts have recognized the equitable servitude of a chattel. Provided that the restraint is set out in the charter, a logical basis for its being upheld is that the corporation comes into existence with this preemptive right. The objection to this reasoning has been that it would work too much hardship on bona fide purchasers without notice. But it is suggested that if a corporation issues stock certificates that are not freely transferable without disclosing the restrictions, the corporation should be estopped from setting up its preemptive right against bona fide purchasers. While stock certificates are not negotiable, because of the commercial demand that these shares be readily transferable, the courts of the United States have given these certificates the attributes of quasi-negotiability. This doctrine, which has been applied to protect purchasers from undisclosed rights of previous holders should also be used to protect them from the claims of the corporation itself.<sup>8</sup> Such restrictions are valid and binding so long as they are reasonable. This view is based on two grounds. As regards the corporation, the business being strictly private, it has a right to choose its stockholders. As the New York court has said: "A single share of the stock of any one of the corporations passing into hostile possession places in the hands of the possessor unlimited opportunity to harm and harrass the management. The business is strictly private, and carried on in competition with other similar establishments. The inviolability of its business privacy and commercial secrets should be no longer safe from its aggressive rivals if the stock might be transferred in disregard of the prohibition mentioned".<sup>9</sup> As regards the stockholders and subsequent purchasers of stock the former are not prejudiced for they became stockholders with knowledge of such

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<sup>8</sup> Pennsylvania Law Review, Vol. 78, page 422.

<sup>9</sup> Bloomingdale vs. Bloomingdale (107 N. Y. Mics. 646).

a restriction; and the latter are also charged with notice of such a restriction for, where the restriction is on the certificate themselves, it forms a part of the contract. It follows from this that if there is a charter authorization or an express agreement in the articles of incorporation (and there is no statutory prohibition) a corporation can provide in its by-laws that before the stock can be sold to outsiders it should be offered first to its stockholders.<sup>10</sup> This restriction is not against public policy as it does not absolutely prohibit the transfer of stock but simply limits and regulates it, and there is nothing unreasonable and oppressive in this regulation.

*Right of Corporation by Its Articles of Incorporation to Reserve to Itself Option to Purchase the Shares of Its Stockholders.*—The rule is well settled that a provision in the articles of incorporation that no stockholder shall sell and transfer his stock either, without the consent of all other stockholders, or that he will first offer it to the stockholders or to the corporation before selling to other persons, is binding on persons who become owners of the stock.<sup>11</sup> These provisions, which really amount to agreements between the stockholders themselves, are not invalid as against public policy nor do they amount to an improper restraint of the power of alienation.<sup>12</sup> There seems to be no objection to a corporation reserving to existing members the right to choose their associates.<sup>13</sup> Indeed the same reasons mentioned for the right of the corporation by its charter to reserve to itself the option to purchase the shares of its stockholders may also be assigned in support of this right in favor of the corporation.

*Right of Corporation by Agreement Between Its Stockholders to Reserve to Itself the Option to Purchase the Shares of Stockholders.*—According to the weight of authority, an agreement between a stockholder and the corporation, or among stockholders themselves, giving the corporation an option to purchase the shares of the stockholders before offering them to others is valid as between the parties and as against transferees with notice.<sup>14</sup> A provision in a certificate issued to an employee as a

<sup>10</sup> *Hosel vs. Rhole* (214 N. Y. App. Div. 654); *Id.*

<sup>11</sup> *Chandler vs. Northern Cross R. Co.* (18 Ill. 190).

<sup>12</sup> *Scruggs vs. Cobterill* (73 N. Y. S. 822).

<sup>13</sup> *Barrett vs. King* (181 Mass. 476).

<sup>14</sup> *Barrett vs. King* (181 Mass. 476); *Rosenfield vs. Abbott* (46 N. J. L. 479).

gratuity to the effect that if his employment shall cease the president of the company shall be privileged to purchase the shares at a specified price is valid, and since this condition appears on the face of the certificate a transferee has notice of and is bound by it.<sup>16</sup> And the same is true of an agreement requiring a stockholder wishing to sell his stock to offer it first to the other stockholders, or to offer it first to the corporation and then to their stockholders, before selling it elsewhere.<sup>16</sup> A provision that the shares shall not be transferable except in pursuance of a vote of two-thirds of all the outstanding shares, that this majority may either consent to the transfer or themselves purchase the shares at par, and that if they do neither the holder is at liberty to sell and transfer the shares as usual, contained in the contract of subscription, the articles of incorporation, and the by-laws, and appearing on the face of the stock certificates, is valid.<sup>17</sup> A shareholder may agree to be bound by by-laws which impose restrictions on his power of alienation of his shares and which might apart from such agreement be held null and void.<sup>18</sup> Our courts hold the same view.<sup>19</sup>

*Right of Corporation by Its By-laws to Reserve to itself the Option to Purchase the Shares of Its Stockholders.*—The foregoing discussions have brought us face to face with the main issue in this work: They are preliminary landmarks that will guide us to our destination in following the path of this exposition. And again there is in this question a parting of the ways among the authorities, so that the foregoing revelations will aid us in choosing proper doctrine that we should adopt in this jurisdiction in questions like the present one. In examining the opposite views we shall hear the affirmative opinion first, and then that of the negative, before we draw our unbiased and just conclusions.

**Affirmative:** It may be said generally that a corporation has no power to prevent its stockholders from alienating their stock.<sup>20</sup> The reason seems to be that such restrictions generally, are in restraint of trade and against public policy, and there-

<sup>16</sup> Douglas vs. Aurora Daily News Co. (160 Ill. App. 506).

<sup>17</sup> Garrett vs. Pa. Lawn Mower Co. (39 Pa. Sup. 78).

<sup>18</sup> Farmers' Mercantile & Supply Co. vs. Laun (146 Wis. 252).

<sup>19</sup> New England Trust Co. vs. Abbott (38 N. E. 432).

<sup>20</sup> Lambert vs. Fox (26 Phil. Rep. 588).

<sup>21</sup> Strattons Ind. vs. Dines (135 Fed. 449).

fore void.<sup>21</sup> More specifically, varying views have been expressed in regard to by-laws restricting the alienation or transfer of its stock without legislative enactment authorizing the same. The line of authority expressed by such viewpoint takes the position that the authority granted a corporation to regulate transfers of its stock extends only to the adoption of regulations as to formalities and procedure, and does not empower it to restrict the right of a stockholder to transfer his shares.<sup>22</sup> But a different rule has been followed in the majority of jurisdictions in regard to corporate by-laws which prohibit the sale or transfer of the corporate stock to an outsider without first giving the other stockholders an option and opportunity to purchase the same. Such by-laws have been upheld often, upon one of two grounds, either first, that the by-laws are valid; or second, and more often, that the by-laws may be sustained as an agreement between the parties.<sup>23</sup> And in the case of *Lawson vs. Household Finance Corporation* (147 Atlantic Reports 312), it was held that "even where the charter is silent upon the question and the subject is undertaken to be dealt with in by-laws, cases are to be found which hold that the restraint is nevertheless a valid one. These cases, though they may be in dissent with others, are in accord with the decided weight of authority to the effect that so far as public policy is concerned a reasonable restraint upon alienation of stock which is designated to give the issuing company the first call upon its purchase is unobjectionable".<sup>24</sup> A shareholder may agree to be bound by by-laws which impose restrictions on his power of alienation of his shares and which might apart from such agreement be held null and void. For instance, a person who subscribes for shares, with knowledge of a by-law providing that any shareholder desirous of selling his shares, or the executor of any deceased shareholder, shall sell the shares to the company at a valuation to be placed thereon by the directors and who accepts a share-certificate upon which that by-law is indorsed, is taken to agree to be bound thereby; and consequently, whether or not the by-law would *proprio vigore* be operative, an executor of a deceased shareholder may be compelled by a court of equity to assign his shares to the company at the valuation placed thereon by the direc-

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<sup>21</sup> *Bloede vs. Bloede* (84 Md. 129).

<sup>22</sup> *In Re Klaus* (29 N. W. 582).

<sup>23</sup> *Iowa Law Review*, Vol. 16 (April 1, 1931).

<sup>24</sup> *Virginia Law Review*, Vol. 16, page 289.

tors.<sup>25</sup> Again, where the defendant acquired stock under the provisions of a by-law, referred to in the certificates of stock, that if a member desired to dispose of his stock offer thereof must first be made to the association at a specified price; that if the offer was not accepted by the association a similar offer must then be made to the stockholders; and that if the stockholders should fail to purchase, the stock might be sold to any body at any price, the court said: "Under these circumstances common justice forbids that she should be permitted to retain the stock and enjoy the benefits incident to its ownership without incurring the burdens she agreed to assume by such ownership. If the contract is valid so far as it conferred benefits upon her, it is equally valid so far as it imposed obligations upon her".<sup>1</sup> It has been held by a number of courts that a void by-law on this subject may become a valid contract.<sup>2</sup> One who was a stockholder at the time of the adoption of such a by-law is estopped to deny its validity as a contract.<sup>3</sup> Thus where a person purchased certificates of stock which provided that they were transferable only to the company, and at the appraisal to be made by the directors, as provided in the by-laws printed on the back of the certificates, and signed a receipt therefor, "subject to the conditions and restrictions therein referred to and to the by-laws of the company to which I agree to conform, he was bound by the provisions of the certificate, although mere by-laws containing such provisions would have been void.<sup>4</sup> It is to be noted that such provisions do not assume to take away absolutely the right of a stockholder to alienate his stock. A way is provided for him to sell his stock and take out of the corporation his investment therein. The only restraint imposed is that a particular person, viz., the corporation, shall first have the opportunity to buy the stock and next that the price if not mutually agreed upon, shall be determined by an appraisal made in a designated manner. There is thus no attempt to inhibit the stockholder from ever disposing of his stock. There

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<sup>25</sup> *New England Trust Co. vs. Abbott* (38 N. E. 432); *Blue Mt. Forest Assn. vs. Borrowe* (51 Atl. 670); *Beswell vs. Buhl* (63 Atl. 56); *Lindsay's Estate* (59 Atl. 1074); *Bonggs vs. Boggs* (66 Atl. 105).

<sup>1</sup> *Blue Mt. Forest Assn. v. Borrowe* (supra).

<sup>2</sup> *New England Trust Co. vs. Abbott* (162 Mass. 148); *Weiland vs. Hogan* (177 Mich. 626).

<sup>3</sup> *Weiland vs. Hogan* (supra).

<sup>4</sup> *New England Trust Co. vs. Abbott* (supra).

is an attempt made to compel the stockholder to deal first with only one of the possible purchasers—the corporation itself. If that purchaser refuses the stock, then it is liberated from all restraint. The partial restraint upon alienation which the charter or by-law imposes is decidedly in the best interests of the corporation and well calculated to promote the welfare of its stockholders. Where reasonable restraints founded in considerations which favor the corporate welfare are imposed in favor of the acquisition of a corporation's stock by the corporation itself, the authorities hold that such restraints are not offensive to the general policy of the law which favors the freedom of alienation.<sup>5</sup>

Negative: A corporation cannot without charter or statutory authority enact a by-law compelling a stockholder, who desires to dispose of his stock, first to offer such stock to the corporation or to the remaining stockholders.<sup>6</sup> The power to regulate by by-law transfer of stock does not include authority to control its transferability by prescribing to whom the owner may sell and to whom not, or upon what terms.<sup>7</sup> And a by-law giving the corporation the first right to purchase stock for sale by any member, was held invalid under a statute specifying several subjects upon which by-laws might be enacted, but making no reference to the question of stock transfers.<sup>8</sup> And a void by-law prohibiting the transfer of stock, except to the corporation imposes no legal obligation on the corporation to buy the stock of a retiring member, the company is under no obligation to do so, though it has uniformly done so with other retiring members.<sup>9</sup> A by-law, providing that stockholders must first give the corporation an opportunity to buy their shares before selling them to others cannot be legally sustained. But, if originally such is the agreement between the stockholders and the corporation, or if such conditions are printed on the certificate they are generally held to be binding.<sup>10</sup>

<sup>5</sup> Virginia Law Review, Vol. 16, page 289.

<sup>6</sup> Bloede vs. Bloede (34 Atl. 1127) Brinkerhoff-Farris Trust Co. vs. Home Lumber Co. (24 S. W. 129).

<sup>7</sup> Bloede vs. Bloede (supra).

<sup>8</sup> Ireland vs. Globe Mil. Co. (32 Atl. 921).

<sup>9</sup> Herring vs. Ruskin Coop. Assn. (52 S. W. 327).

<sup>10</sup> Jennings vs. Bank of Cal. (79 Cal. 323; Weiland vs. Hogan (177 Mich. 626).

## PART V

## RECAPITULATION AND CONCLUSION

By making a brief survey of what has already been treated so far in the foregoing discussion of the subject of this thesis, we shall discover that by-laws of a private corporation, in order to be valid and enforceable for or against the stockholders or the corporation itself, must fulfill the following essential requirements, viz.:

- (1) They must not be contrary to law;
- (2) They must not be contrary to the articles of association;
- (3) They must not be in excess of corporate powers;
- (4) They must be reasonable;
- (5) They must operate equally;
- (6) They must not disturb vested rights;
- (7) They must not be in restraint of trade;
- (8) They must not release stockholders from the payment of stock subscriptions;
- (9) They must be in consonance with the corporate charter;
- (10) They must be consistent with the nature, purposes and objects of the corporation;
- (11) They must not restrict the right to sue;
- (12) They must not compel stockholders to submit to arbitration;
- (13) They must be consonant with public policy;
- (14) They must not operate retrospectively.

When by-laws comply with all these requirements they also acquire the force and effect not only of a contract between the stockholders of the corporation, or between them and the corporation itself, but also the force and effect of law, binding and enforceable upon the stockholders and the corporation. The stockholders can not escape liability arising from the by-laws on a plea of ignorance thereof. Valid by-laws are binding on them, whether they have signed them or not, and they are charged with notice of their existence, even though they have been adopted before they had become stockholders. That it is one of the most important powers of the stockholders in their constituent capacity to enact by-laws, accounts for the legal and contractual effect of by-laws binding on stockholders and the corporation itself. This principle is further confirmed by the fact that membership in a corporation is contractual.

A person cannot be a stockholder of a corporation without his consent, nor can he acquire membership without the consent of the corporation, either through original or subsequent subscription to the shares of stock of the corporation.

Shares of stock are personal property, hence they are transferable. However, the certificates of shares that represent them are not negotiable papers. They are given a conventional term of quasi-negotiability as their charter partakes of the nature of the overlapping qualities of a negotiable and a non-negotiable paper.

We notice that in the absence of any express valid restriction in the charter, statute or contract, the stockholder has an absolute right to alienate and transfer his shares to whomsoever he chooses to transfer the same. This right is incident to the right of ownership and possession of personal property. The corporation cannot impose absolute prohibition upon this right. However, the corporation may regulate such right, which carries with it the power to impose reasonable restraints, according to a decided weight of authority. The reasons for the existence and necessity of such restraining power are:

(1) For the protection of the prospective purchasers against possible injurious changes in the control and management of the corporation;

(2) The retention of the power to select one's associates;

(3) To secure to a limited number of individuals the benefit of participating in the enterprise without permitting others to obtain the same privilege;

(4) To protect the business and good name of the corporation.

The undoubted weight of authority holds that a corporation, when not prohibited by its charter or by statute, may purchase its own shares. As a consequence it is now held by a preponderant weight of authority that under the same conditions the corporation may, by its by-laws, reserve to itself the first opportunity to purchase the shares of its stockholders who wish to retire as such or any of them who may desire to sell his shares, in the same manner that it can reserve to itself, by its charter, articles of incorporation, or by agreement among the stockholders, the same right of first option to purchase the shares of its stockholders. The by-law providing for such reservation is conclusively regarded as a valid and reasonable agreement between the corporation and its

stockholders, a contract that is binding and enforceable as any other valid contract. Stockholders are charged with notice of the existence of such provisions in the same way that they cannot plead ignorance of the existence of any other provisions of the same by-laws. It is upheld for the protection of stockholders remaining and of the corporation itself, as intimated above. Such is not considered against public policy nor in restraint of trade, for as discussed elsewhere above, it is not a true restriction after all in the real sense of the term. At most it is only a partial restraint, a restraint that shall protect the corporation and promote the welfare of its stockholders.

However, it must not be forgotten that this power of reservation by the corporation is subject to limitations before it can be validly exercised. Such limitations are:

(1) It is not prohibited by the charter of the corporation or statute;

(2) The reservation appears in the by-laws of the corporation;

(3) It must appear on the stock certificate, or some other notice must be given, in order to affect subsequent stockholders;

(4) The purchase must be in good faith and free from fraud;

(5) The purchase money must come out of the corporate surplus;

(6) The purchase price must be equal in value of the shares or that agreed upon between the corporation and stockholder selling his shares;

(7) The purchase must not injure or prejudice the rights of the creditors of the corporation.

Unless and until all these requisites or limitations are complied with, the reservation in the by-laws is without effect and cannot be enforced, neither by the corporation nor by the stockholder. This right is therefore a relative right, the exercise of which, depends entirely upon the fulfilment of all these requisites. There is therefore, an implied contract that in case any of these requirements could not at any time be complied with, the stockholder may sell his shares to whomsoever he pleases, the corporation waiving its right to choose its stockholders and protection without the fault of the stockholder, and the corporation may refuse to purchase the same on the same ground. Thus either the corporation, the stockholder, or any creditor to be

prejudiced by such transaction, may prevent its consummation, invoking such failure of compliance with the restrictions by any of the parties thereto. The books of the corporation will furnish all the date to support such an objection.

## PART VI

### THE DOCTRINE OF THE CASE OF FLEISCHER VS. BOTICA NOLASCO Co. (47 PHIL. REP. 783)

#### Resume of the Case—

This action was commenced in the Court First Instance of Oriental Negros, on August 14, 1923, against the board of directors of the Botica Nolasco Co., a corporation duly organized and existing under the laws of the Philippine Islands, the complaint alleging that the plaintiff became the owner by purchase of five shares of stock of said corporation which refused to register said shares in his name in the books of the corporation, in spite of repeated demands to that effect, which refusal caused him ₱500 damages which he demanded payment.

As a special defense, the defendant corporation alleged that pursuant to article 12 of its by-laws, it had preferential right to buy from the plaintiff said five shares at the par value of ₱100 a share, plus ₱90 as dividends corresponding to the year 1922, and that said offer was refused by the plaintiff.

Said article 12 provides as follows:

“ART. 12—Las acciones de la Corporacion pueden ser transferidas a otra personas, pero para que estas transferencias tengan validez legal, deben constar en los registros de la Corporacion con el debido endoso del accionista a cuyo nombre se ha expedido la accion o acciones que se transfieran, o un documento de transferencia. Entendiendose que, ningun accionista transferirá acción alguna a otra persona sin participar antes por escrito al Secretario-Tesorero. EN IGUALDAD DE CONDICIONES, LA SOCIEDAD TENDRÁ EL DERECHO DE ADQUIRIR PARA SI LA ACCION O ACCIONES QUE SE TRATEN DE TRANSFERIR.”

According to our Supreme Court, the latter part of said article “creates in favor of the Botica Nolasco Co., a preferential right to buy, under the same conditions, the share or shares of stock of a retiring shareholder.” It therefore, asked the question: “Has said corporation any power, under the Corporation Law, to adopt such by-law?”

In affirming the decision of the lower court, our Supreme Court, after citing Anglo-American authorities (also cited elsewhere in this work), came to the following conclusion and held:

"The foregoing authorities go farther than the stand we are taking on this question. They held that the power of a corporation to enact by-laws restraining the sale and transfer of shares, should not only be in harmony with the law or charter of the corporation, but such power should be expressly granted in said law or charter."<sup>11</sup>

"The only restraint imposed by the Corporation Law upon transfer of shares is found in section 35 of Act No. 1459, quoted above, as follows: "No transfer, however, shall be valid, except as between the parties, until the transfer is entered and noted upon the books of the corporation so as to show the names of the parties to the transaction, the date of the transfer, the number of the certificate, and the number of shares transferred". This restriction is necessary in order that the officers of the corporation may know who are the stockholders, which is essential in conducting elections of officers in calling meetings of stockholders, and for other purposes. But any restriction of the nature of that imposed in the by-law now in question, is *ultra vires*, violative of the property rights of shareholders, and in restraint of trade.

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

*Observations.*—This case is simple, and typical of those cases decided both in England and the United States dealing the very point in issue here. In view of the authorities cited by our Supreme Court<sup>11</sup> in support of its decision in this case, the conclusion arrived at and the decision are correct. But we shall notice that said authorities relied upon in the decision are those cited in this work as holding the minority opinion. Whereas we found that the majority opinion maintains the contrary rule, upholding the validity of such a by-law, as being reasonable, not in restraint of trade, and not against public policy. The same is held in the recent case of *Lawson vs. Household Finance Cor-*

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<sup>11</sup> *Supreme Commendery of Knights of Golden Rule vs. Ainsworth* (71 Ala. 436); *People's Home Savings Bank vs. Superior Court* (104 Cal. 649); *Ireland vs. Globe Milling Co.* (21 R. I. 9); *Brinkerhoff-Farris Trust & Sav. Co. vs. Lumber Co.* (118 Mo. 447); *Farmers' & Merchants' Bank vs. Wasson* (48 Iowa 338); *Hager vs. Bryan* (19 Phil. 138).

poration (147 Atl. 312), a case decided in December, 1930. So that we can readily conclude that both the majority and the modern decision maintain the validity of such a by-law.

However, in the long run, the decision of our Supreme Court is correct, in view of the fact that the appellee in this case had no knowledge of the existence of such a provision of the defendant's by-laws, and he cannot be charged with notice of such provision, he being a third party to the enactment of the same. The case would have been different had the question arose between the defendant corporation and the original owner of such shares, Manuel Gonzales. Apparently the provision in the by-law referred to was not printed on the certificates of stock transferred to the appellee, otherwise he should have known it. We can, therefore, at once see that one of the requirements mentioned in the previous discussion was not fulfilled by the corporation in this case, the printing of the by-law on the certificates of stock, or the giving of some other notice of the existence of such by-law.

It may be argued, granting that our Supreme Court upheld the validity of such a by-law, that the second part of the decision would create an avenue of escape in favor of a shareholder who is motivated with malice and bad faith, to evade the by-law provision, and at the same time protecting a third person, the transferee, instead of the corporation. But it is well settled that as between two parties who must suffer from the fraud or bad faith of a third person, he who has given the opportunity for the commission of such fraud must be the one to suffer the consequence. In this case the defendant corporation, by failing to give notice of the existence of the by-law by printing the same on the certificates of shares, furnished the avenue by which fraud was committed, and must therefore suffer the injury. This failure of the corporation amounts to a waiver of its right as against the transferee herein. In order, therefore, to avoid such unceremonious transfer of the shares by their original owner and to avoid the defense of the transferee in case such is sought to be avoided, the corporation should have been reasonably prudent in guarding its own right.

Turning back to the first part of the decision, the Supreme Court said that the authorities require the power to enact such by-law should not only be in harmony with the law or charter of the corporation, but should be expressly granted in said law or charter. Nothing further is said about this requirement in

the decision. However, we have seen in the discussion and in the above cited case, that such grant is not essential nor necessary for the enactment of such by-law.

Again the Supreme Court said that "any restriction of the NATURE of that imposed in the by-law now in question, is ultra vires, violative of the property rights of shareholders, and in restraint of trade. It is therefore unquestionable, that this by-law is in restraint of trade whether expressly granted or not in the charter or statute, for it is the nature of the provisions that determine its validity. But again we have noticed that this kind of by-law is not such a restraint of trade as herein alleged, because the only restraint imposed is that a particular person, viz., the corporation, shall first have the opportunity to buy the stock and next that the price if not mutually agreed upon, shall be determined by an appraisalment. There is thus no attempt to inhibit the stockholder from ever disposing of his stock. There is an attempt made to compel the stockholder to deal first with only one of the possible purchasers—the corporation itself. If that purchaser refuses to purchase the stock, then it is liberated from all restraint. The partial restraint upon alienation which the by-law imposes is decidedly in the best interests of the corporation and well calculated to promote the welfare of its stockholders. Where reasonable restraints founded in considerations which favor the corporate welfare are imposed in favor of the acquisition of a corporation's stock by the corporation itself, the authorities hold that such restraints are not offensive to the general policy of the law which favors the freedom of alienation, and therefore not in restraint of trade nor violative of the property rights of shareholders. If the corporation has no corporate surplus, or if the purchase would prejudice or injure the rights of its creditors, the corporation could not make the purchase, and the shareholder is absolutely free to alienate and transfer his shares to anyone whom he chooses. Indeed this is not an absolute restraint on the power or right of alienation.

## PART VII

### RECOMMENDATION

Although the majority of the Courts in the United States uphold and maintain the validity of the enactment of a by-law reserving to the corporation the first right to purchase the shares of its retiring stockholder or any of its stockholders desiring to dispose of his shares, and holding that the exercise of such power

and right is a valid protection of the corporation and promotive of the welfare of its stockholders, yet many of the states still hold the contrary view as is held by our Supreme Court. In view of this conflict of decisions and opinions on the matter, the necessity of harmony gave rise to the enactment of the UNIFORM STOCK TRANSFER ACT.

In 1931 there were already twenty states in the American Union that have adopted this act.

Article 6 of the Act provides: "There shall be no lien in favor of a corporation upon the shares represented by a certificate issued by such corporation and there shall be no restriction upon the transfer of shares so represented by virtue of any by-law of such corporation, or otherwise, unless the right of the corporation to such lien or the restriction is stated upon the certificate." This provision is clearly a compromise between the opposing authorities. So unless such restriction appears on the certificate of shares, any shareholder may sell his shares in total disregard of by the by-law and with impunity, and the transferee is protected, as it is obvious that he has notice of such by-law provision. In this manner the conflict will be avoided on the very point discussed in this work. The writer feels that this enactment is wise and sound, and he therefore recommends the adoption of a similar provision as an amendment to our Corporation Law. In addition to this requirement, it should be provided that the purchase money must come from the surplus funds of the corporation not otherwise available for any other purpose provided for by the Corporation Law, the same to be exercised without injury or prejudice to the rights of the creditors of the corporation.