THE RIGHT OF INCORPORATION UNDER THE PHILIPPINE INCORPORATION LAW

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On January 2, 1958, the Securities & Exchange Commissioner issued an order in connection with the application of the COMPOSTELA MINING CO., INC. for registration of its articles of incorporation, which reads as follows:

"ORDER

"The COMPOSTELA MINING COMPANY, INC. (registrant) presented to this Commission its articles of incorporation for registration. According to said articles, the capital stock of registrant is ₱500,000.00 divided into 4,000 shares of the par value of ₱100.00 each and 10,000 shares of the par value of ₱10.00 each, of which ₱28,000 represented by 2,800 shares of the par value of ₱10.00 each, has been subscribed and the sum of ₱7,000.00 paid on account thereof. The total subscriptions of ₱28,000.00 is less than 20% of the entire capital stock of ₱500,000.00, although the total number of subscribed shares of 2,800 is exactly 20% of the entire number of authorized shares of 14,000. This happened because the subscriptions were made exclusively on the shares with the par value of ₱10.00 each, altogether losing sight of the fact that there are other shares with a par value of ₱100.00 each.

"It is the view of the Commission that where the capital stock of a proposed corporation is divided into shares with different par values, the 20% subscription requirement should be based on the entire amount of capital stock and not literally on the entire number of authorized shares without considering the different par values into which said shares have been divided. Otherwise, situations could be created which are not contemplated under the law. Thus, by the expediency of classifying shares with different par values and getting subscriptions only for the shares having the least par value, it would be posible to form a corporation with an authorized capital stock of ₱1,000,000.00 with only ₱0.50 as the paid-up capital stock, as can be seen from the following:

"Authorized capital stock of ₱1,000,000.00, divided into 1,000 shares, to wit:

499 shares at ₱2,000 par value	.....	₱ 998,000.00
1 share at ₱1,995 par value	.....	1,995.00
500 shares at ₱0.01 par value	.....	5.00
Total 1,000 shares	Total par value	₱1,000,000.00

"Twenty per centum of 1,000 shares which is the authorized number of shares is 200 shares. If the subscription is taken from

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the ₱0.01 par value shares, the subscribed capital stock will be ₱2.00 and the paid-up capital stock will be 25% of ₱2.00 or ₱0.50. This is clearly absurd.

"The statute prior to the 1928 amendments requires the affidavit of the treasurer to state that at least twenty per centum of the authorized capital stock has been subscribed. Section 9 of the law as amended in 1928 now requires the treasurer to certify in an affidavit that at least twenty per centum of the entire number of authorized shares has been subscribed.

"It is believed that the change made in Section 9 was not meant to do away with the requirement of having a minimum subscribed capital stock before incorporation. In the United States, the corporation laws of some States do not require a minimum subscription on the authorized capital stock, other state corporation laws require a certain percentage or all the authorized capital stock to be subscribed before commencing the transaction of business, and other state laws require a certain percentage to be subscribed before incorporation. The Philippine Commission when it enacted our Corporation Law in 1906 followed the corporation law in those states which requires a certain percentage of the authorized capital stock to be subscribed before incorporating by providing that at least twenty per centum of the authorized capital stock must be subscribed before incorporation.

"The weight of authority in the United States supports the view that the purpose of the legislature in requiring a certain percentage of the authorized capital stock to be subscribed before incorporation is to give assurance to the public that may deal with the new corporation that it is actually able to operate and undertake to do business and to meet obligations as they arise from the start of its operation. In a leading case in the Supreme Court of the United States (*Burke vs. Smith*, 16 Wall. [U.S.]) it was held that the purpose of such a requisition is, that the state may be assured of the successful prosecution of the work, and that creditors of the company may have, to the extent, at least, of the required subscription, the means of obtaining satisfaction for their claims.

"The amendment introduced in Section 9 by the 1928 amendments did not discard altogether the requirement of having a certain percentage of the authorized capital stock to be subscribed before incorporation for the purposes stated in the above-cited case for the statute as amended still requires a minimum subscription before incorporation. If it is not necessary that a corporation being formed must have a capital at the time of incorporation for the purposes stated in the aforementioned case, the requirement of having certain percentage of subscription whether on the basis of the authorized capital stock or on the authorized number of shares is an idle gesture.

"That the requirement is still at least twenty per centum of the authorized capital stock as before the amendment may be deduced from Secs. 6 and 7 of the Corporation Law. It is explicit in paragraph (8) of said sections that in the articles of incorporation regarding subscriptions to the authorized capital stock what must be set forth therein in case of subscriptions to par value shares is the *amount* of capital stock subscribed. It is only where subscriptions

are for no par value shares when only the number of shares must be set forth in the articles of incorporation.

"Now it may be asked, what was the reason for making the change in Section 9 of the Corporation Law? The change can easily be explained. The 1928 amendments to our Corporation Law authorized for the first time Philippine Corporations to issue no par value shares. The authorized capital stock of corporations with no par value shares cannot be stated in amount of Philippine currency. Only the number of no par value need be stated in the articles of incorporation as the authorized capital stock. Since subscriptions to no par value shares are for number of shares and not for the amount of capital stock as in par value shares, the words "authorized capital stock" in Section 9 was changed to "authorized number of shares" so as to cover cases where the authorized capital stock is of no par value shares. It is unfortunate that the Legislature did not employ precise words in Section 9 so as to cover both par and no par value shares as it did in Sections 6 and 7, but the intention of the Legislature may be gleaned by interpreting Section 9 in the light of the requirements of Sections 6 and 7. It may be shown further that the Legislature never intended to alter the requirement in changing the phraseology in Section 9 by referring to a later enactment of that body. Section 6(j) of the Securities Act in referring to the minimum requirement of pre-incorporation subscriptions speaks of authorized capital stock and not of authorized number of shares.

"FOR THE FOREGOING CONSIDERATION, the registrant COMPOSTELA MINING COMPANY, INC. is hereby required to increase the subscriptions to its capital stock to at least ₱100,000.00, and to make the corresponding corrections in its articles of incorporation.

"SO ORDERED.

"Manila, Philippines, January 2, 1958.

(Sgd.) MARIANO G. PINEDA
Commissioner"

The writer of the present article respectfully disagrees with the above ruling.

It must be remembered that the original provision of said Section 9 of the Corporation Law, before it was amended, reads as follows:

"SEC. 9. The Director of the Bureau of Commerce and Industry shall not file the articles of incorporation of any stock corporation unless accompanied by a sworn statement of a treasurer elected by the subscribers showing that at least twenty per centum of the entire capital stock has been subscribed and that at least twenty-five per centum of the subscription has been either paid to him in actual cash for the benefit and to the credit of the corporation, or that there has been transferred to him in trust and received by him for the benefit and to the credit of the corporation property the fair valuation of which is equal to twenty-five per centum of the subscrip-

tion: * * *" (*Sec. 9, Act No. 1459, as amended by Act 1834, Sec. 2, and Act No. 2792, Sec. 1.*)

In 1928, by virtue of the so-called 1928 amendments, the said Section 9 was amended by Act No. 3518, such that, as impliedly amended also by Commonwealth Act No. 287, it now reads as follows.

> "SEC. 9. The Securities & Exchange Commissioner shall not file the articles of incorporation of any stock corporation unless accompanied by a sworn statement of a treasurer elected by the subscribers showing that at least twenty per centum of the entire number of auhorized shares of capital stock has been subscribed, and that at least twenty-five per centum of the subscription has been either paid to him in actual cash for the benefit and to the credit of the corporation, or that there has been transferred to him in trust and received by him for the benefit and to the credit of the corporation property the fair valuation of which is equal to twenty-five per centum of the subscription: * * *."

The Securities & Exchange Commissioner believes "that the change made in Section 9 kas not meant to do away with the requirement of having a *minimum subscribed capital* before incorporation." This is true. But, certainly, it *changed the basis* upon which such minimum subscribed capital should be computed. For, instead of the entire capital stock (*in terms of money*) as the basis, it is now the entire *number of authorized shares.* In other words, it is true that the amendment did not do away with the requirement of having a minimum subscribed capital before incorporation, but the amendment certainly changed the basis upon which the amount subscribed and paid shall be computed. This conclusion, based on the amended provision, is not "literal" nor "absurd" but finds support in the corporation laws of other jurisdictions of which the Securities & Exchange Commissioner is also cognizant, when he says—

> "In the United States, the corporation laws of some states *do not require a minimum subscription on the authorized capital stock*, other state corporation laws require a certain percentage or all the authorized capital stock to be subscribed before commencing the transaction of business, and other state laws require a certain percentage to be subscribed before incorporation." (*Italics supplied*).

It may be added, that other states require only a certain percentage of the entire *number* of authorized shares to be subscribed. Of course, it may be said that "the entire number of authorized shares" is equivalent to "the entire capital stock," inasmuch as the entire capital stock may be made to appear in the articles of incorporation *either in terms of money in Philippine currency* (where the capital stock is divided into par value shares), *or in terms of the number of shares* (where the capital stock is divided into non-par value shares.) But, where it appears that the shares are of different par values, it does not necessarily follow that "*twenty per centum*

of the entire number of authorized shares" is the same as *"twenty per centum* of the entire capital stock" in terms of money. There is certainly a distinction between "capital stock" and "capital". If a stock corporation has an authorized capital stock of ₱75,000, divided into 1,000 shares, fifty per centum (50%) of which are of the par value of ₱100 a share and the other 50% of which are of the par value of only ₱50 a share, the authorized capital stock of this corporation may either mean ₱75,000 in terms of capital, or 1,000 shares in terms of capital stock or number of authorized shares. Is there any doubt that the present law, in the above case, refers to 1,000 *shares* and not the ₱75,000?

But the Securities & Exchange Commissioner opines that—

> "It is the view of the Commission that where the capital stock of a proposed corporation is divided into shares with *different par values*, the 20% subscription requirement should be based on the entire amount of capital stock [1] and not literally on the entire number of authorized shares without considering the different par values into which said shares have been divided."

And the reason of the Commission for this opinion is that—

> "Otherwise, situations could be created which are not contemplated under the law. Thus, by the expediency of classifying shares with different par values and getting subscriptions only for the shares having the least par value, it would be possible to form a corporation with an authorized capital stock of ₱1,000,000 with only ₱.50 as the paid-up capital stock, as can be seen from the following:
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> "Authorized capital stock of ₱1,000,000, divided into 1,000 shares, to wit:

499 shares at ₱2,000 par value	₱	998,000.00
1 share at ₱1,995 par value		1,995.00
500 shares at ₱0.01 par value		5.00
Total 1,000 shares Total par value	₱	1,000,000.00

> "Twenty per centum of 1,000 shares which is the authorized number of shares is 200 shares. If the subscription is taken from the ₱0.01 par value shares, the subscribed capital stock will be ₱2.00 and the paid-up capital stock will be 25% of ₱2.00 or ₱0.50. This is clearly absurd."

If the classification of the above shares has been made by the incorporators with the intent of organizing the corporation for the mere purpose of "floating" it, so as to abstract money from the innocent investing public, then, certainly, the Securities & Exchange Commissioner has the power to deny the incorporation of said corporation on the *ground* that its *purpose* is "unlawful". Under the law, corporations may be organized only for *lawful purpose or purposes*, and the Securities & Exchange Commissioner may determine the lawfulness of the purpose of a corporation beyond the mere statement of a lawful purpose in its articles of incorporation. But, where it appears that the organization of a corporation is being made in

[1] Evidently meaning in terms of money.

good faith, that the classification of shares with different par values is not done for purposes of fraud, that the subscribers voluntarily and indiscriminately subscribed to only one kind or class of shares, and that this subscription constitutes "twenty per centum of the *entire number* of authorized shares" and 25% of the subscription has been paid in, and that the articles of incorporation are in accordance with the prescribed form, then the incorporators have already complied with the requisites for incorporation and the certificate of incorporation must issue. To require the incorporators to do more than what the law prescribes is no longer "interpretation" but "legislation".

The *right of incorporation* must not be confused with the *ability of operation*. Our law, as amended, is not concerned with how much *capital* a business corporation should have in its possession before it could lawfully operate, except in certain kinds of private corporation like banks and insurance companies. In other words, except in corporations which directly affect public interest, our law merely resuires that 20% "of the entire number" of the authorized shares must be subscribed and 25% of the subscription paid. This legal requirement is merely formal or nominal. It may happen to be only ₱500 in some cases, or ₱1,000 in other cases, or may mean ₱1 million in some others. But certainly, the law could not require beforehand *how much capital* a private corporation should have for its business, because this problem properly belongs to the business judgment of those in charge of the management. As previously stated and admitted by the Securities & Exchange Commissioner, there are some corporation laws which require *no subscription* at all prior to incorporation, as the primary purpose of incorporation is for the incorporators to acquire a separate juridical personality. The *right of incorporation* is quite distinct from the *ability of operation*. The Securities & Exchange Commission has no right under the general incorporation law to pre-determine whether ₱700 or ₱7,000 or ₱7,000,000 is necessary for a private corporation to operate. Under the general incorporation law, whatever may be the result of 25% of the entire number of authorized shares subscribed, whether it be ₱5,000 or ₱0.50, *the right of incorporation exists although the ability of operation may not.* Thus, a corporation, by having complied with the requisites for incorporation may be permitted to incorporate, but it may not be able to operate for lack of sufficient capital. The Commission should concern itself with the capacity for incorporation but not the capacity for operation. Anyway, the Corporation Law (Section 19) expressly provides that *if an incorporated corporation fails to organize itself and commence the operation of its business within two years from the date of incorporation, then its corporate powers shall cease.* It is evident therefore that the law is not particular about the minimum amount of *capital* which every incorporated corporation must have for purposes of operation. It merely fixes the minimum number of authorized *shares* to be subscribed and paid, for purposes of incorporation. That the general incorporation law does not intend to fix the minimum amount of capital for operational purposes is quite understandable, because this problem belongs exclusively to the business judgment of the incorporators and the direc-

tors. Of course, as has been stated previously, if the incorporators are organizing a corporation for purposes of *fraud,* then certainly, the incorporation may be denied on the ground of fraud, but not on the ground of too little capital. *In the absence of fraud* in the incorporation, the Securities & Exchange Commission has no power under the general incorporation law to deny incorporation of a private corporation if the requisites for incorporation prescribed by the said law have already been complied with.

And requiring subscriptions to *all classes of shares* of different par values (where the capital stock is divided into shares with different par values) is not one of the requisites required by law.

The case of *Burke vs. Smith,*[2] cited by the Commissioner in his Order on the COMPOSTELA case is not in point. It does not involve a provision similar to our own. This case refers to the incorporation of a railroad under the laws of Indiana. Under the Indiana law, all railroad companies are required to have a subscription to their capital stock of *not less than $1,000 for every mile of their proposed roads before they may exercise corporate powers.* It must be noted that this Indiana law differs from our own law in two respects: (1) It specifies a definite amount to be subscribed *in terms of money;* (2) and this requirement is essential for the *exercise of corporate powers,* and not merely for purposes of incorporation. It is very clear that under the Indiana law the existence of a definite amount of *capital* is a condition precedent to engaging in the railroad business. For this reason, the U.S. Supreme Court held:

> "This requirement is intended as a protection to the public and to the creditors of the companies. The stock subscribed is the capital of the company, its means for performing its duty to the commonwealth, and to those who deal with it."

And the Court further states:

> "When a company is incorporated under general laws, as the new Albany & Sandusky City Junction RR. Co. was, and the law provides that a certain amount of stock shall be subscribed before corporate powers shall be exercised, if subscriptions, obtained before the organization was effected, may be subsequently rendered unavailable by creditors attached to them, the substantial requirements are defeated. The purpose of such requisition is, that the state may be assured of the successful prosecution of the work and that creditor of the company may have, to the extent of at least of the required subscription, the means of obtaining satisfaction of their claims. The grant of the franchise is, therefore, made dependent upon securing a specified amount of *capital.*"

There is nothing in this Indiana case that supports the view that "number of *shares*" must be interpreted to mean "amount of *capital.*" In Indiana, as well as in some other jurisdictions, the requirement as to the minimum amount of capital to be subscribed is

[2] 16 Wall. (U.S.) 390, 21 L. Ed. 361 (1873).

definite and clear; in the Philippines, that used to be the rule or corporate practice. After the 1928 amendments, it is enough that a *definite number of shares*, regardless of the par value thereof, and consequently, regardless of the amount resulting from the required subscription, has been subscribed and paid.

It is not absurd for a private corporation *to incorporate* itself with only a small amount of capital. But it is absurd for it *to operate* with only ₱0.50 capital. A corporation may lawfully be incorporated but it may not be able to operate. Where a corporation has been incorporated with insufficient funds for actual operation, after having complied with the formal requisites for incorporation, the following remedies are available to it under the law:

(1) To issue calls for unpaid subscriptions and to sell delinquent stock at public auction pursuant to law; or,

(2) To file suits against the delinquent subscribers.

If, notwithstanding these remedies, no additional capital is raised, then certainly the corporation that has been incorporated may not be able to operate, and if its inactivity continues for two years, it shall be deemed dissolved by operation of law.[3]

In the COMPOSTELA case, it appears that out of ₱28,000 subscriptions, the sum of ₱7,000 had been paid in. The sum of ₱7,000 cannot be deemed an "absurdity." Besides, it is admitted that this amount of ₱7,000 represents 25% of the 20% subscription prescribed by law. And even if, in another case, only the sum of ₱0.50 had been paid in, but this amount represents 25% of the paid subscription, the *right of incorporation* under the general incorporation law exists, although the *ability of operation* may not be possible. In which latter case, the remedies provided for by law regarding calls and assessments and sale of delinquent stock, or the remedy by judicial suit, may be resorted to by the incorporated corporation. Hence, it is submitted, that under the Philippine general incorporation law, the following are the requisites for incorporation:

(1) That there must be at least five but not more than fifteen incorporators, a majority of whom are residents of the Philippines;

(2) That these incorporators must file articles of incorporation in accordance with the prescribed form, duly acknowledged before a notary public;

(3) That the articles of incorporation must be accompanied by an affidavit of the treasurer of the corporation, certifying to the fact that "at least 20% of the entire number of authorized shares" has been subscribed and that at least 25% of the subscription has been paid in.

If the above conditions are in order, and there is *no question as to the lawfulness of the purpose of the corporation*, the certificate of incorporation should issue.

There is nothing in sections 6 and 7 of the Corporation Law nor in Section 6(j) of the Securities Act which will militate against the

[3] Section 19, General Incorporation Law (Act No. 1459).

clear provision of Section 9, as amended, of the Corporation Law that "at least 20% of the entire number of authorized shares has been subscribed, and that at least 25% of the subscription has been x x paid x x x".

It is, and should be, the policy of the law not to unduly restrict the incorporation of business corporations. As long as the purpose is lawful, the right to engage in legitimate business should not be unduly restrained. It is not within the contemplation of the general incorporation law to discourage incorporation of business corporations with small capital. Fraud is not necessarily associated with small capital. On the contrary, it is in big, moneyed corporations where fraud could easily be committed through the adoption of various corporate devices. In the absence of fraud in the incorporation of a corporation, every legitimate business enterprise should be allowed to flourish to promote the economic salvation of the country. Unless the law clearly and unequivocably provides otherwise, and unless public policy clearly dictates to the contrary, incorporation should be the rule rather than the exception. And, even when public policy dictates that in cases of public utilities, 60% of their capital must be owned by citizens of the Philippines, the Supreme Court upheld the right of incorporation even where it appears that less than 60% of the capital is owned by Filipino citizens, on the ground that this condition is required only for *purposes of operation* and not for *purposes of incorporation.*[4] This clearly illustrates the principle that the right of incorporation must not be unduly restricted.

It is reiterated that, if a group of incorporators, in good faith, would like to organize a private corporation with a little capital, and such little capital represents 25% of the subscription of the 20% of the *entire number of authorized shares* of capital stock, and the other formal requirements of the law have been complied with, the *right of incorporation* exists, unless after due investigation it appears that the corporation is being incorporated for an *unlawful purpose.*

[4] People vs. Quasha, 49 Off. Gaz. 2826 (1953).