Republic of the Philippines
SECURITIES AND EXCHANGE COMMISSION
SEC Building, EDSA, Greenhills, Mandaluyong City, Metro Manila

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SEC Opinion No. 06-19
Validity of provision restricting transferability of shares in close corporations

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Gentlemen:

This refers to your letter dated 02 February 2006, requesting opinion relative to the validity of a provision in the articles of incorporation of your client, Café Italianni's (Mall of Asia), Incorporated. The questioned provision is originally worded as follows:

> "*Encumbrance of Shares*. The shareholders may mortgage, pledge, or otherwise encumber all or part of their shares in the Corporation; provided that, the other parties shall give their written consent thereto; provided further that, written notice to the other parties shall be sufficient if the mortgagee or pledgee is a banking or financial institution."

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You mentioned that it was pointed out to you that part of the abovementioned provision requiring prior written consent of the other shareholders before any shareholder may encumber his shares is not valid, as it violates the doctrine of free transferability of shares. It was suggested that you remove the requirement of "prior written consent" and replace the same with "prior written notice."

It is your position that the abovementioned provision is valid for the following reasons:

1. Your client is a close corporation. As an exception to the general rule in Section 63 on the free transferability of shares of stock, Section 98 of the Corporation Code allows reasonable restrictions to be placed upon the right to transfer shares of a close corporation. Hence, if Section 98 allows restrictions to be placed upon the transfer of shares of a close corporation, with more reason can it be interpreted as permitting reasonable restrictions to be placed upon the lesser right to encumber the shares.

2. While shares of stock are personal property and shareholders have the right to exercise acts of ownership over the shares, which include the right to alienate and encumber the same, they are not precluded from waiving this right, such waiver not being contrary to any law or public policy. By previously signing a Joint Venture Agreement with the disputed provision, Café Italianni's (Mall of Asia), Inc.'s stockholders are presumed to have considered and appreciated the full consequences of said stipulation and voluntarily consented to be bound thereby. In doing so, it is your contention that they have effectively waived their right to encumber their shares without restriction.

3. The use of certain restrictions on the transfer or other disposition of shares in an agreement between stockholders, such as a joint venture agreement, and the inclusion of the same in the articles of incorporation or by-laws, are among the devices installed to safeguard the interest of the stockholders. They ensure succession of interest that is particularly relevant in close corporations such as Café Italianni's (Mall of Asia), Incorporated.

4. The disputed provision does not unduly restrict the right to encumber the shares considering that consent is required only if the proposed pledgee or mortgagee is not a bank or other financial institution. Mere notice is required in cases where the mortgagee or pledgee is a bank or other financial institution.

5. Café Italianni's (Mall of Asia), Inc. is merely complying with the requirement set forth in Section 98 which requires that restrictions on the right to transfer shares appear in the articles of incorporation and in the by-laws, as well as in the certificate of stock; otherwise, the same shall not be binding on any

purchaser thereof in good faith. Including the disputed provision in Café Italianni's (Mall of Asia), Inc.'s articles of incorporation is meant to protect not just the existing stockholders thereof, but unknowing third persons who may become transferees, pledgees or mortgagees of the stocks as well.

Firstly, before discussing the validity (or invalidity) of the questioned provision, it must be clearly presented by the applicant corporation that it is indeed a close corporation. The features or elements of a close corporation, as required by Section 96[1] of the Corporation Code, must be shown in the corporation's articles of incorporation.

An examination of Café Italianni's (Mall of Asia) Corporation's articles of incorporation confirms that subject corporation is a close corporation by virtue of the provisions governing the issuance and transfer of shares of the corporation embodied in the ninth section thereof.

Considering the special circumstances attending a close corporation, it is oftentimes justifiable, and at times imperative, for its stockholders to protect themselves from future conflicts by placing restrictions on the right of each one of them to transfer his share to an outsider. It is perhaps for this reason that the Corporation Code explicitly allows such restriction in, and in fact makes it an attribute of the close corporation.[2]

This is embodied in Section 98 of the Corporation Code, which provides as follows:

> "SECTION 98. Validity of restrictions on transfer of shares. — Restrictions on the right to transfer shares must appear in the articles of incorporation and in the by-laws as well as in the certificate of stock; otherwise, the same shall not be binding on any purchaser thereof in good faith. **Said restrictions shall not be more onerous than granting the existing stockholders or the corporation the option to purchase the shares of the transferring stockholder with such reasonable terms, conditions or period stated therein.** If upon the expiration of said period, the existing

[1] SECTION 96. Definition and applicability of Title. — A close corporation, within the meaning of this Code, is one whose articles of incorporation provide that: (1) All of the corporation's issued stock of all classes, exclusive of treasury shares, shall be held of record by not more than a specified number of persons, not exceeding twenty (20): (2) All of the issued stock of all classes shall be subject to one or more specified restrictions on transfer permitted by this Title; and (3) The corporation shall not list in any stock exchange or make any public offering of any of its stock of any class. Notwithstanding the foregoing, a corporation shall be deemed not a close corporation when at least two-thirds (2/3) of its voting stock or voting rights is owned or controlled by another corporation which is not a close corporation within the meaning of this Code.

[2] SEC letter to Atty. Victor Africa, 5 May 1986.

> stockholders or the corporation fails to exercise the option to purchase, the transferring stockholder may sell his shares to any third person." (*emphasis supplied*)

Accordingly, the Commission, as a matter of policy, allows restrictions on transfer of shares in the articles of incorporation if the same is necessary and convenient to the attainment of the objective for which the company was incorporated, unless palpably unreasonable under the circumstances. The underlying test as to whether the restriction is valid and enforceable is whether the restriction is sufficiently reasonable as to justify the restriction overriding the general policy against restraint on alienation of personal property.[3] It is for this reason that close corporations are allowed restriction clauses.

In addition, restrictions shall not be more onerous than granting the existing stockholders or the corporation the option to purchase the shares of the transferring stockholder with such reasonable terms, conditions or period stated therein. The Commission has held that the reasonable option period may range from 30 to 60 days or even more, depending on the circumstances surrounding the case.[4]

The disputed provision, as presented in your letter, does not provide for an option period for the existing stockholders/corporation and the transferring stockholder who desires to transfer/encumber his stocks. It only provides that the other parties shall give their written consent thereto before such encumbrance can be realized. The Commission had previously opined that a restriction clause is not valid and enforceable if it absolutely prohibits the sale or transfer of stock without the consent of the Board of Directors and/or stockholders, as this would violate the general law on free alienability of shares of stock as personal property.[5]

The above principle on restrictions on the transferability of shares applies in the case of transfer of shares of stock by way of pledge or mortgage, which transfers are recognized under Section 55 of the Corporation Code, quoted hereunder:

> "SECTION 55. *Right to vote of pledgors, mortgagors and administrators.* — In case of *pledged or mortgaged shares* in stock corporations, the pledgor or mortgagor shall have the right to attend and vote at meetings of stockholders, unless the pledgee or mortgagee is expressly given such right in writing which is

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[3] SEC letter to Attys. Bienvenido I. Somera, Jr. and Cynthia D. Nuval-Ambrosio, 4 July 1995, SEC letter to Atty. Merle P. Cunanan, 20 February 1995

[4] SEC letter to Atty. Helen C. De Leon-Manzano, 8 June 1995

[5] SEC letter to Sycip Salazar Hernandez and Gatmaitan, 28 August 1995

recorded on the appropriate corporate books by the pledgor or mortgagor. "(Emphasis supplied)."[6]

In view of the aforementioned discussion, we decline to confirm the validity of your position with respect to the questioned provision on encumbrance of shares in the articles of incorporation of your client, Café Italianni's (Mall of Asia), Incorporated. The provision, as it stands, does not provide for an option period to be exercised by the other stockholders or the corporation vis-à-vis the transferring stockholder. The result of the absence of such option period is to absolutely prohibit the mortgage, pledge or encumbrance of such stock without the written consent of the other stockholders. This violates the general law on free alienability of shares of stock as personal property.

Very truly yours,

VERNETTE G. UMALI-PACO
General Counsel

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[6] Ibid.