UPHOLDING EQUITY: AN ANALYSIS OF THE REQUISITES FOR THE INSTITUTION OF DERIVATIVE ACTIONS*

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The Board of Directors are tasked to exercise all the powers of the corporation and to conduct its business.[1] They owe the corporation the duty of obedience, diligence and loyalty[2] and occupy a position of trust for the benefit of all the stockholders, and not merely the controlling interest.[3] Thus, when corporate directors breach their fiduciary duties, the aggrieved minority may go to the courts to hold them accountable and for redress of a wrong done to the corporation.[4] This suit is called a derivative suit.

A derivative suit is a suit brought by the stockholders, for and on behalf of the corporation, for an injury done to it. It is a remedy established and recognized by the courts on equity considerations.[5] Ultimately, derivative suits become a battle between the majority and minority stockholders, with the latter asserting a right granted to the corporation, and by analogy, granted to them as stockholders so they could defend themselves against the abuses of the majority.

Since battle-lines are clearly drawn out in derivative suits, there should be a procedural rule that will give credence and stay true to the origins of the privilege to bring a derivative action, i.e., equity. This paper seeks to examine whether the rules on derivative suits as provided under Rule 8 of the Interim Rules of Procedure Governing Intra-Corporate Controversies[6] uphold the principle of equity, the very foundation of the

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[1] CORP. CODE, § 23.

[2] Strategic Alliance v. Radstock Securities, G.R. No. 178158, 607 SCRA 413, 459-60, Dec. 4, 2009.

[3] Angeles v. Santos, G.R. No. 43413, 64 Phil. 697, 706, Aug. 31, 1937.

[4] Chase v. Court of First Instance of Manila, G.R. No. 20457, 18 SCRA 602, Oct. 29, 1966.

[5] Western Institute of Technology v. Salas, G.R. No. 113032, 278 SCRA 216, 225, Aug. 21, 1997.

[6] A.M. No. 01-2-04 SC (hereinafter "INTERIM RULES") (2001).

origins of derivative actions. To do this, this paper looks at the previous cases involving derivative actions decided by the Supreme Court to trace the development of these rules.

The first part seeks to examine the origins of the concept in common law jurisdictions and its development in the Philippines. The next part of the article discusses each requisite, outlining the intent behind their inclusion. It concludes with an analysis of the effectiveness of these requisites in bringing ensuring redress principally, to the corporation, and incidentally, to the stockholders.

I. ORIGINS AND CONCEPT OF DERIVATIVE ACTIONS

Historical background: English and American development

The right of a stockholder to sue was recognized in England as early as 18th century, when joint stock corporations are the usual business organizational form resorted to in raising capital from many investors.[7] The law on partnership and trusts governed management conduct and policies, and directors were characterized as trustees of the corporation.[8] Due to the growth in size of these kinds of organizations and diverging interests of management and shareholders, problems on enforcing substantive law emerged.[9] The English courts recognized the inadequacy of the existing legal procedures to redress management abuses and supplied a remedy based on equity. [10] This led to the recognition of representative suits filed by shareholders against management or directors.[11]

The early representative suits were filed by shareholders on behalf of other members instead of the corporation, but the plaintiffs usually seek relief for the benefit of the corporation.[12] In*Preston v. The Grand Collier Dock Co.*, a shareholder sought judicial intervention to force the collection of the consideration of the subscribedshares that the directors of the corporation. While the plaintiff sued in behalf of all other shareholders, they argued that "it is merely a mode of expressing that he sues in the general right." This statement implies that there is a recognition that the plaintiff is suing for the benefit of the corporation itself, and not for the sole benefit of the

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Bert Prunty, Jr., *The Shareholders' Derivative Suit: Notes on its Derivation*, 32 NEW YORK UNIVERSITY LAW REVIEW 980, 982 (1957)

[8] *Id.*

[9] *Id.*

[10] *Id.* at 992

[11] *Id.* at 982

[12] *Id.*

suing stockholders. In another case[13], decided a year after *Preston,* the court entertained a suit filed by a group of shareholders, who, like the plaintiff in *Preston,* sued on behalf of themselves and all other shareholders, but did not ask for the recovery of the money misappropriated by the directors for themselves. Instead, they prayed for it to be restored in the company's treasury. This illustrates the growing recognition of the right of stockholders to sue for the benefit of the corporation, although denominated as representative suits during this time.

The equity court imposed the first limitation on the shareholders' right to sue in the case of *Foss v. Harbottle,*[14] involving a suit by two minority shareholders of the Victoria Park Company against the directors of the said corporation. The directors allegedly misappropriated the corporation's assets when they sold their own lands to the corporation at an excessive price. The court dismissed the suit, on the ground that the injury alleged is suffered by the corporation and thus, it is the corporation who has the standing to sue. This ruling in *Foss* was later termed as the "proper-plaintiff principle" [15]The court also established that they cannot intervene when the majority may ratify the matter raised in the action. Although *Foss* presented a limitation to the rights of minority stockholders, it did influence the development of derivative actions. Through an obiter, the court intimated that individual stockholders may sue in cases of injury to the corporation by some of its members, when no adequate remedy remained. This declaration later became the concept of a derivative suit.

In the United States, court intervention in intra-corporate disputes was originally predicated on equity, designed to protect minority shareholders from fraud, just like in England. In *Robinsons v. Smith,*[16] a bill was brought by several shareholders holding minority interest in the New York Coal Company, charging the directors of the corporation with fraud. They alleged that the directors were misappropriating the funds of the company by investing in the stocks of several banking corporations for private purposes, which is in violation of their duty. Similar to the early English courts, the Chancery Court of New York regarded the directors of the corporation as trustees of the corporate funds and held that "no injury the stockholders may sustain by a fraudulent breach of trust can, upon the general principles of equity, be suffered to pass without a remedy." The

[13] Hichens v. Congreve, 39 Eng. Rep. 58 (1828).

[14] 2 Hare 461 (1843).

[15] A.J. BOYLE, *Rule in Foss v. Harbottle (Ch. 1) in* MINORITY SHAREHOLDERS' REMEDIES (2002) *available at* http://assets.cambrige.org/97805217/91069/excerpt/9780521791069_excerpt.pdf (Date Last Visited: Apr. 1, 2012).

[16] 3 Paige Ch 222 (1832).

court, however, allowed the demurral on the ground that the corporation should have been either a complainant or one of the defendants.

It is interesting to note however, that the fact that the corporation was regarded as a necessary party in early shareholders' suits did not necessarily mean that the right of shareholders to sue was already conceived as derivative as it is understood now.[17] Subsequent cases held that the rationale behind the rule that the corporation is a necessary party is to prevent double recovery.[18] Thus, the early shareholders' suits were more regarded as individual or class action for the protection of their rights, with the corporation being mere recipient of whatever recovery sought by the plaintiffs.[19] The contemporary concept of derivative suits where the cause of action properly belongs to the corporation and the stockholders sue merely in a secondary capacity was concretized in the stream of cases involving third party defendants that are outsiders to the corporation.[20]

Forbes v. Whitlock[21] is the first illustrative case of such kind of litigation. The plaintiff-shareholders, in his individual capacity, sought to set aside a sale made to the third party defendant on the ground of fraud. It was however held that the rights being asserted refers to and belongs to the corporation as a separate entity, and it should have been asserted in the corporate name. Thus, the failure to implead the corporation as a party resulted in the inability to seek remedial measure from the courts.

In the landmark case of *Dodge v. Woolsey*,[22] a shareholder tried to enjoin the collection of a tax assessed by the State of Ohio on the Commercial Branch Bank of Cleveland for being unconstitutional. The tax collector, the directors of the bank and the bank itself were made defendants. The complainant brought the suit as a shareholder of the said bank, alleging that he had asked the directors of the bank to file such suit but they refused to do so. The court allowed the departure from the then general rule thata suit of such nature should be brought in the name of the corporation, saying that they did not see it necessary in view of the demand made by the plaintiff to the directors and the latter's refusal to heed to it.The court, in upholding their jurisdiction over the action, saw the refusal of the directors to sue as a disregard of duty than a mere error of judgment.

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[17] Prunty, Jr., *supra* note 7, at 989.
[18] *Id.* at 988.
[19] *Id.* at 989
[20] *Id.* at 990.
[21] 3 Ed Ch 446 (1841).
[22] 59 US 331 (1855).

In cases involving outsider defendant, the shareholders' right to sue based on breach of trust was not sufficient to justify judicial intervention since it is not just the trustee-directors that are being sued.[23] From the foregoing, there appeared to be two concepts affecting the shareholders right to sue:[24] first, that the corporation is a separate entity and its rights must be asserted in its name; and second, that the trust doctrine is paramount in corporate relations, and a breach thereof gives shareholders the rights to be protected from any misfeasance, malfeasance and nonfeasance of those to whom the trust was reposed.[25] Giving such suit a derivative nature made it possible to marry these two concepts.[26]

In 1882, the US Supreme Court noted the growth in corporate litigation since *Dodge v. Woolsey*, and reconsidered the *Dodge* ruling in *Hawes v. City of Oakland*.[27] They thus found it necessary to establish limitations on derivative suits. *Hawes* was a suit filed by a shareholder of a water company against the company, the directors and the City of Oakland. The plaintiff alleged that the company was furnishing water to the City beyond what is required by law, to the injury of the shareholders and the company. The case was dismissed by the Court on the ground that the plaintiff had no standing to sue. In arriving at this conclusion, the Court discussed that a stockholder has the power to bring a suit founded on the right of action belonging to the corporation under the following circumstances:

> Some action or threatened action of the managing board of directors or trustees of the corporation which is beyond the authority conferred on them by their charter or other source of organization;
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> Or such a fraudulent transaction completed or contemplated by the acting managers, in connection with some other party, or among themselves, or with other shareholders as will result in serious injury to the corporation, or to the interests of the other shareholders;
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> Or where the board of directors, or a majority of them, are acting for their own interest, in a manner destructive of the

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[23] Prunty, Jr., *supra* note 7, at 992.
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] 104 US 450 (1881).

> corporation itself, or of the rights of the other shareholders;
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> Or where the majority of shareholders themselves are oppressively and illegally pursuing a course in the name of the corporation which is in violation of the rights of other shareholders and which can only be restrained by the aid of a court of equity.[28]

The Court in *Hawes* added that to have standing to sue, the shareholder must show that he has exhausted all his remedies within the corporation (i.e. making a request to the directors or management, and consulting with the other shareholders) and should he fail to do so, he should identify the reasons why it was not done or the unreasonableness of doing so.[29] The facts which gave rise to the controversy and the steps taken by the plaintiff in protecting his rights must be alleged with particularity.[30] Moreover, an allegation of the plaintiff's status as a shareholder at the time of the transactions of which he complains of, or that his shares have devolved on him since by operation of law, should also be included in the complaint.[31] He must also allege that the suit is not a collusive one.[32]

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[28] *Id.* at 460.

[29] *Id.* at 461. In this case, the Court noted that a mere filing of a request, without more, to the President and Directors of the corporation is not enough to prove that the suing stockholder has exhausted all the remedies available before him.

[30] *Id.* The Court took note that there was no clear allegation of any wrong-doing being committed by the Directors of the Corporation in this case. Moreover, the plaintiff failed to allege with particularity the steps he has taken to protect his rights.

[31] *Id.* The Court made no substantive discussion on this point however, ruled that the other grounds alleged by the defendant justify a demurrer to the complaint.

[32] *Id.* This requirement is paramount in instituting actions before Federal Courts, since the jurisdiction of the latter may only be had upon a determination that the parties in the suit are of diverse citizenship. Thus, some scrupulous shareholders transfer their shares to another person who resides outside of the State of the defendant to make it appear that the suit involves a controversy between parties of diverse citizenship. This requirement also ensures that the suing plaintiff was a stockholder of the corporation at the time the transactions complained of took place, and prevents a situation where shares of stock of a corporation is transferred to another person for the sole purpose of instituting action to have a higher pecuniary benefit. This also forestalls nuisance suits. *See* discussion in Pascual v. Orozco, G.R. No. 5174, 19 Phil. 82, 95-96, Mar. 17, 1911.

The requirements laid down in *Hawes*[33] will eventually become the jurisprudential basis for the procedural requirements laid down by courts in instituting derivative actions.

Development in the Philippines

The landmark case which recognized the right of the stockholders to sue on a derivative action is *Pascual v. Orozco*[34] decided by the Court as early as 1911.This case was brought by plaintiff Candido Pascual, a stockholder of the banking corporation Banco-Español Filipino, in behalf of himself and for the benefit of the bank and other stockholders, against the directors of said bank who allegedly appropriated for themselves the profits of the bank in fraud of the other stockholders. The lower court sustained the demurrer of the defendants on the ground that the facts alleged do not constitute a cause of action. On appeal to the Supreme Court, the right of the plaintiffs to sue was recognized and upheld. Accordingly, "it is clear that the plaintiff, by reason of the fact that he is a stockholder in the bank (corporation) has a right to maintain a suit for and on behalf of the bank, but the extent of such a right must depend upon when, how, and for what purpose he acquired the shares which he now owns."

The Court in *Pascual* recognized that the Corporation Law and the Code of Civil Procedure then in force are silent on the right of shareholders' to sue for a cause of action that devolves to the corporation. The general rule is that the corporation can bring a suit through its Board of Directors. However, the Court in *Pascual* took cognizance of the suit on the ground of equity. Accordingly, stockholders are given standing to sue on behalf of the corporation when the people entrusted to manage the affairs of the corporation are themselves guilty of the mismanagement and it would be futile to seek redress from them. The Court thus relied on American precedents in affirming the validity of derivative suits in this jurisdiction and adopted the regulations on derivative suits already recognized by American jurisprudence.

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[33] The rules laid down in this case were eventually incorporated in the 94th Equity Rule adopted on Jan. 23, 1883 *as cited* in Pascual. *See also* FEDERAL RULES OF CIVIL PROCEDURE, Rule 23.1 (which adopted, with some minor modifications, these same rules).

[34] G.R. No. 5174, 19 Phil 82, Mar. 17, 1911.

In *San Miguel v. Kahn*,[35] the Court made a definitive summary on the requisites necessary to maintain a derivative suit based on established jurisprudence:

> 1. The party bringing suit should be a shareholder as of the time of the act or transaction complained of, the number of his shares not being material;
> 2. He has tried to exhaust intra corporate remedies, i.e., has made a demand on the board of directors for the appropriate relief but the latter has failed or refused to heed his plea; and;
> 3. The cause of action actually devolves on the corporation, the wrongdoing or harm having been, or being caused to the corporation and not to the particular stockholder bringing the suit.

From the foregoing, it is clear that the rules laid down by the Philippine Supreme Court followed the rules stated by the U.S. Supreme Court in *Hawes*.

These suits in equity were normally lodged in regular courts, but upon the effectivity of PD 902-A[36] on March 11, 1976, the jurisdiction over intra-corporate controversies was vested in the Securities and Exchange Commission. In *Philex Mining vs. Reyes*,[37] the Court explained the meaning of intra-corporate controversy as "one which arises between a stockholder and the corporation. There is no distinction, qualification, nor any exemption whatsoever. The provision is broad and covers all kinds of controversies between stockholders and corporations."

Thus, allegations of fraud and breach of the fiduciary duties of corporate officers and/or the majority shareholders in derivative actions are intra-corporate controversies falling within the exclusive jurisdiction of the SEC. The transfer of jurisdiction aims to expedite the resolution of the controversy and place the matter in the hands of experts.[38] Intra-corporate controversies filed before the courts were thus dismissible on the ground of lack of jurisdiction. However, Republic Act 8799 transferred this jurisdiction to Regional Trial Courts acting as commercial courts.[39]

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[35] G.R. No. 85339, 176 SCRA 447, 462-63, Aug. 11, 1989.

[36] This is the SEC Reorganization Act.

[37] G.R. No. 57707, 118 SCRA 602, 605, Nov. 19, 1982.

[38] Dionisio v. Court of First Instance of South Cotobato, G.R. No. 61048, 124 SCRA 222, 227, Aug. 17, 1983.

[39] § 5.2 (2000). This is The Securities Regulation Code.

Nature of a Derivative Action: The Corporation as the Real Party in Interest

A derivative suit must be distinguished from an individual suit:

> Suits based on breaches of the directors' fiduciary duties of care and loyalty under state law, such as suits based on grossly negligent mismanagement, waste of corporate assets, excessive compensation, usurpation of corporate opportunity, and on general self-dealing, are actionable only as derivate suits. On the other hand, suits for the deprivation of shareholders' voting rights, preemptive rights, or rights to inspect the corporation's books and records, suits to compel the declaration of dividends, and suits alleging that the directors/officers fraudulently induced the shareholder to sell stock, are generally treated as direct actions.[40]

Thus, a suit to inspect the corporate documents of the corporation is properly an individual suit,[41] while a stockholder suing for the mismanagement by the corporate officers resulting in an injury to the corporation is a derivative action.

The stockholders suing on a derivative cause of action is not bringing the suit for their benefit, but for the benefit of the corporation and any benefit recovered by the stockholder must redound to the benefit of the corporation since the cause of action actually belongs to it.[42] They may not thus bring an action to seek damages resulting from the mismanagement of the corporate officers for their own benefit.[43] The stockholders may not claim monetary awards granted, otherwise, this would result in a distribution of assets of the corporation even prior to its liquidation.[44]

Similar to *Hawes*, the Philippine Supreme Court also recognized the need to aver with sufficient particularity the acts complained of which resulted in or will result to an injury to the corporation occasioned by the negligence, mismanagement or fraud of its directors. Thus, in *Reyes vs. Tan*,[45] the Court held that the allegation that the officers of the corporation

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[40] Tim Oliver Brandi, *The Strike Suit: A Common Problem of the Derivative Suit and the Shareholder Class Action*, 98 Dick. L. Rev. 355, 360 (1994).

[41] Gokongwei v. Securities and Exchange Commission, G.R. No. 45911, 89 SCRA 336, Apr. 11, 1979.

[42] Chua v. Court of Appeals, G.R. No. 150793, 443 SCRA 259, Nov. 19, 2004.

[43] Evangelista v. Santos, G.R. No. 1721, 86 Phil. 387, 394, May 19, 1950.

[44] *Id.*

[45] G.R. No. 16982, 113 Phil. 191, 195-96, Sep. 30, 1961.

permitted the importation of textiles in violation of its Charter is a clear indication of fraud, which justified the derivative action filed by the stockholder-plaintiff. In *Republic Bank vs. Cuaderno*,[46] the Court reversed the order of dismissal by the lower court on the ground that the allegations in the complaint are sufficient to make out a cause of action for a derivative action. Accordingly, the plaintiff is not suing to vindicate his rights, but to seek redress for an injury caused to the corporation by the illegal disbursement of funds.

The requirement that the cause of action actually devolves on the corporation and not to the stockholder bringing the suit affirms the nature of a derivative suit. In a derivative suit, the corporation is the real party in interest and the stockholder filing the suit is merely a nominal party. Thus, a suit seeking for the annulment of the sale of shares of stock by the directors of the corporation on the ground that it violated their pre-emptive right is not a derivative action since the suing stockholders are alleging and vindicating their own individual interests, and not that of the corporation.[47] On a later case involving a prayer for the issuance of shares of stock to the rightful owners, nullification of shares of stock previously issued, reconveyance of property impressed with trust, accounting, removal of officers and directors and damages, the Court clarified that the existence of the personal injury suffered by the plaintiffs does not disqualify them from filing a derivative suit, instead, it merely gave rise to additional causes of action.[48]

Under Section 2, Rule 3 of the Rules on Civil Procedure, every action must be prosecuted or defended in the name of the real party in interest, unless otherwise authorized by law. In a derivative suit, the stockholder is suing on a cause of action belonging to the corporation. Consequently, the corporation is indispensable to the suit and it must be impleaded, either as a co-plaintiff or defendant.

In the earlier case of *Everett v. Asia Banking Corporation*,[49] the Court ruled that the failure of the plaintiffs to implead the corporation as a party to the suit was not fatal. This ruling was reiterated in *Pascual v. Santos*,[50] which was a suit instituted by the minority stockholders for, among others, the appointment of a receiver *pendente lite* and accounting of the books and accounts of the corporation. Accordingly, the general rule that a suit must

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[46] G.R. No. 22399, 19 SCRA 671, Mar. 30, 1967.

[47] Gamboa v Victoriano, G.R. No. 40620, 90 SCRA 40, May 5, 1979.

[48] Gochan v Young, G.R. No. 131889, 354 SCRA 207, Mar. 12, 2001.

[49] G.R. No. 25241, 49 Phil. 512, 527, 49 Phil. 512, 527, Nov. 3, 1926.

[50] G.R. No. 43413, 64 Phil. 697, 707-08, Aug. 31, 1937 (*citing* Everett, *supra* note 49).

be brought directly in the name of the corporation and in its behalf admits of exception, among which is the clear allegation of dissipation of assets being committed by the majority who holds control over the corporation.

In *Republic Bank,*[51] however, the Court ruled that the corporation should be made a party to the derivative suit to ensure that any judgment that may be had will be binding on the corporation and prevent future re-litigation of the issues. It is immaterial whether the corporation is joined as party-plaintiff or party-defendant,[52] since misjoinder of parties is not a ground for a dismissal of a case. What is important is that the corporation be made a party to the suit. This ruling was reiterated in *Asset Privatization Trust v. Court of Appeals*[53], where the Court held that the corporation is an indispensable party in a derivative action and joining the latter is a condition *sine qua non* in such a suit. The Court, moreover, emphasized that direct individual suits brought by the stockholders for their own benefit is proscribed for several reasons. First, it would conflict with the separate personality of the corporation and its stockholders. Second, it may result in the premature distribution of the assets of the corporation to the prejudice of its creditors. Third, it may interfere with the duty of the Board of Directors to institute suits for the protection of the corporation and its stockholders. Fourth, it would result in multiplicity of suits. Lastly, it would result in confusion regarding the amount of damages that may be recovered by the corporation.[54]

More recently in *Chua,*[55] the Court reiterated this ruling. *Chua* originated from a criminal case for falsification of documents filed against Chua. The Metropolitan Trial Court judge's order in excluding private complainant's private counsel prompted the private complainant to file a petition for certiorari with the Regional Trial Courts. In their petition, the private complainant alleged that she was suing as a stockholder, in behalf of Siena Realty Corporation, since the falsified documents pertain to projects of the corporation. The Court of Appeals held that the action was

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[51] G.R. No. 22399, 19 SCRA 671, Mar. 30, 1967.

[52] According to the Court, the English practice is to join the corporation as party defendant, while the American practice is to make it a party plaintiff. The Court took note however, joining the corporation as party defendant would bring it into the awkward position of resisting an action instituted for its benefit. Should it be made a party plaintiff however, the absence of a Board Resolution authorizing the suit may be invoked. *See* Lichauco v. Court of Appeals, G.R. No. 23842, Mar. 13, 1975 (where the corporation was impleaded as party defendant since no consent can be had regarding the institution of the suit).

[53] G.R. No. 121171, 300 SCRA 579, Dec. 29, 1998.

[54] *Id. citing* III AGBAYANI, COMMERCIAL LAW OF THE PHILIPPINES 565-66 *citing* Ballentine 366-67.

[55] G.R. 150793, 443 SCRA 259, Nov. 19, 2004.

a derivative suit. The Supreme Court found this CA ruling inaccurate and explained:

> Not every suit filed in behalf of the corporation is a derivative suit. For a derivative suit to prosper, it is required that the minority stockholder suing for and on behalf of the corporation must allege in his complaint that he is suing on a derivative cause of action on behalf of the corporation and all other stockholders similarly situated who may wish to join him in the suit. It is a condition sine qua non that the corporation be impleaded as a party because not only is the corporation an indispensable party, but it is also the present rule that it must be served with process. The judgment must be made binding upon the corporation in order that the corporation may get the benefit of the suit and may not bring subsequent suit against the same defendants for the same cause of action. In other words, **the corporation must be joined as party because it is its cause of action that is being litigated and because judgment must be a res adjudicata against it.**[56] (Emphasis supplied)

II. REQUISITES IN MAINTAINING A DERIVATIVE SUIT

The Interim Rules formally laid down the basic requirements that must be complied with in the institution of derivative suits. Rule 8, Section 1 of the Interim Rules provides:

> Section 1. *Derivative action.* — A stockholder or member may bring an action in the name of a corporation or association, as the case may be, provided, that:
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> (1) He was a stockholder or member at the time the acts or transactions subject of the action occurred and the time the action was filed;
> (2) He exerted all reasonable efforts, and alleges the same with particularity in the complaint, to exhaust all remedies

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[56] *Id.* at 268.

available under the articles of incorporation, by-laws, laws or rules governing the corporation or partnership to obtain the relief he desires;
(3) No appraisal rights are available for the acts or acts complained of; and
(4) The suits is not a nuisance or harassment suit.

In case of nuisance of harassment suit, the court shall forthwith dismiss the case.

Ownership of Stocks

That the complainant should be a shareholder of the company at the time of the act or transaction complained of in order for him to maintain a derivative suit has been enunciated by the Supreme Court in the case of *Pascual v. Orozco,* written by Justine Trent. In that case, the Court considered two causes of action. The first cause of action concerns the defendants' misappropriation of the corporate funds during 1903 to 1907; while the second one involves the defendants' failure to take action with regard tothe fraudulent misappropriation of corporate funds committed by the defendant's predecessors from 1899 to 1902. The complainant only became a stockholder on the 13th of November, 1903. The Court, relying mainly on American jurisprudence, ruled that the "a stockholder who was not such at the time of transactions complained of, or whose shares had not devolved upon him since by operation of law, cannot maintain suit of this character unless such transactions continue and are injurious to the stockholder, or affect him especially and specifically in some other way." The demurrer to the second action was sustained since the complainant was not a stockholder during the time in question in the second cause of action.

The Court in *Pascual* conceded the ruling in *Hawes v. City of Oakland,* with respect to the allegation in the bill that the plaintiff was a stockholder of the corporation at the time of the transaction complained of was a "mere rule of pleading". It took note that the regulations set in *Hawes* was motivated by the desire to prevent the practice of bringing fraudulent or collusive suits, saying:

> It is true that the court in writing the decision in the *Hawes* case, had in mind the prevalence of the practice of bringing suits in the Federal courts, by collusion between the parties, which should properly be tried in the State court. It is equally true that the court was desirous of preventing a

> continuance of these fraudulent practices, by establishing a test which should prevent them. The basis of the right to sue in the Federal courts being diversity of citizenship, the usual method employed to enable parties to suits of this kind to invoke the jurisdiction of these courts was to have a few shares of stock transferred to some person who was a citizen of a State other than that of which the proposed defendants were citizens. In a case of this kind the transfer of the stock would be, of necessity, merely nominal, and the plaintiff, under such circumstances, would not be a *bona fide* stockholder, and would not be entitled to maintain the suit. Of necessity, in cases of this kind, of genuine collusion to create a fictitious diversity of citizenship the nominal transfer of the stock is made at a date subsequent to that of the occurrence of the acts or omissions complained of.

Justice Trent added that "the mere fact that in some cases persons suing as stockholders for the redress of grievances anterior to the transfer of the stock held by the plaintiff are not acting in good faith would not justify or authorize a refusal to take jurisdiction in any case in which the plaintiff's stock was acquired after the occurrence of the facts supposed to constitute the cause of action, unless the court were of the opinion, as a matter of substantive law, that in no event would a stockholder so situated be entitled to maintain such an action." He averred that the existence of the fact of stock ownership during the transaction in order to give rise to the cause of action is a substantive rule and not merely a procedural requirement.

The Court went as far as declaring that even a transferee of a stock, who bought it without notice of the transferor's participation or silent acquiescence in a wrongful act or transaction, cannot maintain a derivative action. The Court reasoned:

> If the plaintiff himself had been injured by the acts of defendants' predecessors that is another matter. He ought to take things as he found them when he voluntarily acquired his ten shares. If he was defrauded in the purchase of these shares he should sue his vendor.

Ownership of shares of stock in the corporation at the time the acts complained of took place was also recognized by the Philippine Supreme Court as an important requisite to successfully bring a derivative action, as was unequivocally stated by the Court in *Pascual.* But the fact that the stockholder was such at the time of the transaction complained of is not sufficient in itself, should the latter thereafter lose his status as a stockholder of the corporation at the time the suit was filed. In a suit filed by a current stockholder and a previous stockholder for acts done while both were holding shares of the corporation, the Court dismissed the suit as to the previous stockholder, but allowed it as to the other current stockholder. Thus, the personality of one of the suing stockholders as a current stockholder is sufficient to invest her personality to maintain the suit.[57]

A mere trustee of shares of a corporation may vest him with personality to bring the action. Thus, in *San Miguel*,[58] the Court took cognizance of a suit filed by the PCGG-nominated director of San Miguel.[59]

However, in *Bitong vs. Court of Appeals*,[60] the Court refused to take cognizance of the derivative action filed by the plaintiff upon showing of evidence tending to prove that she was merely a trustee of another entity, JAKA Investment Corporation. The Court disregarded the fact that she was a holder of shares of the corporation, as evidenced by a stock certificate issued in her name, and the stock transfer books of the corporation. The ruling of the Court implies that the suit should have been instituted by the beneficial owner for the suit to prosper.

The amount of the stockholdings of the stockholder suing on a derivative cause of action, however, is not important, on the ground that the suit is for the benefit of suing stockholder but for the corporation.[61] In *San Miguel*, the PCGG-nominated Director owning 20 shares of stock of

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[57] Commart (Phils.), Inc. v. Securities and Exchange Commission, G.R. No. 85318, 198 SCRA 173, Jun. 3, 1991.

[58] G.R. No. 85339, 176 SCRA 447, Aug. 11, 1989.

[59] In allowing the suit filed by the PCGG-nominated director, the Court relied on Baseco v. PCGG recognizing the right of the PCGG to vote sequestered shares pending the outcome of the proceedings to determine their ownership.

[60] G.R. No. 123553, 292 SCRA 503, Jul. 13, 1998.

[61] Republic Bank v. Cuaderno, G.R. No. 22399, 19 SCRA 671, Mar. 30, 1967. Most American states also follow the same rule, except in cases where the law requires security for expenses, in which case the suing stockholders are required to post a bond for the payment of litigation expenses. *See* Seth Aronson et al., *Shareholder Derivative Actions: From Cradle to Grave*, *in* CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES 273 (2007).

San Miguel Corporation or a mere 0.0000164% owner of the total outstanding stock of the corporation instituted a derivative action impugning the resolution of the Board to assume the loan of its subsidiary. The Court ruled that the fact that the suing stockholder has a miniscule interest over the corporation is immaterial in determining his personality to sue on behalf of the corporation and "the *bona fide* ownership by a stockholder of stock in his own right suffices to invest him with standing to bring a derivative action for the benefit of the corporation."

Problems related to this requisite arise in instances where a corporation merge with another corporation and the stockholder loses his stockholdings in the constituent corporation. In *Crow vs. Context Industries*,[62] the Court disallowed the original stockholder of the absorbed constituent corporation to bring a suit on behalf of the absorbed corporation on the ground that he was no longer a stockholder of the subsidiary corporation at the time of the institution of the suit. Thus, a strict interpretation of the rule on contemporaneous ownership may deprive a stockholder the opportunity to vindicate his right as a shareholder of the absorbed corporation and to challenge the alleged illegal or invalid action.

Another matter associated with this requirement is the status of the plaintiff as stockholder during the pendency of the derivative suit. In most American States, it is required that the suing stockholder remain as such until the matter has been adjudged, otherwise, he will lose his standing to sue. Accordingly, this requirement ensures that a stranger to the transaction complained will not be allowed to prosecute a suit regarding an act which he is not involved in.[63]

In *Pascual* however, the Court recognized an exception to the rule on ownership, i.e., when the transaction or act complained of is a continuing one as to cause injury to the stockholder "or affect hum especially and specifically in some other way."[64] This is the so-called "continuing wrong doctrine," where the stockholder is allowed to bring a derivative suit even if the transaction complained of happened long before he purchased his shares in the corporation, if the wrong is still occurring at the time of his purchase.[65]

Exhaustion of Intra-Corporate Remedies

[62] 260 So. 2d 865 (Fla. Dist. Ct. App. 1972) *cited in* David Locascio, *The Dilemma of the Double Derivative Suit*, 83 NW. U. L. REV. 729, 739 (1989).

[63] Aronson et al., supra note 61, at 274-75.

[64] 19 Phil. at 101.

[65] Aronson et al., supra note 61, at 275-76.

The requirement of exhaustion of intra-corporate remedies has been long-standing in American jurisdictions. In *Hawes v. City of Oakland*, the plaintiff was held not to have standing to sue when he failed to show that he exhausted all means to have his grievances redressed within the corporation. The Court described the act necessary as "earnest, not a simulated, effort with the managing body of the corporation to induce remedial action on their part." If in case this was not done, it was held necessary to show with particularity the reason why it could not be accomplished or why it was unreasonable to do so. Although the rationale of that rule was not explained in *Hawes,* it was later established by other jurisprudence that the purpose of such requisite is to give the corporation a fair opportunity to act on the demand and to allow the directors a chance to conduct the corporation's affairs.[66] It also prevents the institution of frivolous or nuisance suits.[67]

In *Development Bank of the Philippines v. Judge Amir Pundogar*,[68] the Court clarified that before a stockholder may bring a suit, he must first exhaust the available remedies within the corporation, specifically, todemand the Board to sue the erring officers and/or third persons whose acts caused injury to the corporation. However, the demand may be dispensed with if it would be futile, as in *DBP* where the very constitution of the Board is in question or where the Board is under the complete control of the defendants.[69] This is the so-called futility exception and is:

> [a] very limited exception, to be applied only when the allegations or evidence clearly demonstrate, in a very particular manner, either that (1) a demand, or a delay in awaiting a response to a demand, would cause irreparable harm to the corporation, or (2) a majority of the directors are so personally and directly conflicted or committed to the decision in dispute that they cannot reasonably be expected to respond to a demand in good faith and within the ambit of the business judgment rule.[70]

Thus, the reasons for not complying with this particular requirement should be indubitable. The fact that the corporation is a family

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[66] 19 Am Jur 2d, §1963.

[67] Brandi, *supra* note 40, at 374. (However, Brandi posits that the stringency of the demand requirement also serves as deterrence to both meritorious and frivolous derivative actions "since the conditions for judicial review of the board or litigation committee's decision to reject the shareholder demand are not related to the merits of the underlying case").

[68] G.R. No. 96921, 218 SCRA 118, Jan. 29, 1993.

[69] Everett v. Asia Banking, G.R. No. 25241, 49 Phil. 512, Nov. 3, 1926.

[70] Danielewicz v. Arnold, 137 Md. App. 601, 630, 769 A. 2d 274, 291 (2001).

corporation is not as sufficient justification to do away with this requirement.[71]

It must be remembered that derivative suits were recognized by courts on considerations of equity. It would therefore, be error for the court to give credence to a repudiation made by the Board of Directors of a derivative suit filed by minority stockholders on the simple expedient of invoking the general rule that the power of the corporation to sue is lodged with its Board of Directors. The Board of Directors cannot be reasonably expected to institute a suit which would prejudice them[72] and "if a majority of shareholders is allowed to repudiate the derivative suit of the minority stockholders, no such action would ever prosper."[73] It would also "defeat the very nature and function of a derivative suit and render the right to institute the action illusory."[74]

What is important therefore is the existence of a *bona fide* effort on the part of the stockholder to make a demand on the Board of Directors to undertake the necessary actions to remedy the act complained of. But the Board may not, after such demand, move to dismiss a derivative action filed by minority stockholders on the simple pretext of invoking its power to conduct the business of the corporation.

Absence of Appraisal Right

In 2009, almost eight (8) years after the promulgation of the Interim Rules, the Court had the occasion to delve on the requirement of absence of appraisal right in the case of *Cua, Jr. vs. Tan.*[75] Appraisal right refers to the right of a stockholder who dissented and voted against a proposed corporate change to get out of the corporation by demanding the payment of the fair value of his shares. The Corporation Code provides that a stockholder may exercise its appraisal right: 1) in case of amendment to the articles of incorporation which has the effect of changing or restricting the rights of any stockholder or class of shares, or of authorizing preferences in any respect superior to those of outstanding shares of any class, or of extending or shortening the term of corporate existence;[76] 2) in case of sale, lease, exchange, transfer, mortgage, pledge or other disposition

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[71] Yu v. Yukayguan, G.R. No. 177549, 589 SCRA 588, 620, Jun. 18, 2009.

[72] Republic Bank v. Cuaderno, G.R. No. 22399, 19 SCRA 671, Mar. 30, 1967

[73] Marsman Investment Ltd. v. Phil. Abaca Development Company, G.R. No. 19160, 119 Phil. 95, Dec. 26, 1963.

[74] Commart (Phils.), Inc., 198 SCRA at 80.

[75] G.R. No. 181455-56, 607 SCRA 645, Dec. 4, 2009.

[76] *Compare with* CORP. CODE, § 37 (which provides that the in case of extension of corporate term, the dissenting stockholder may exercise his appraisal right).

of all or substantially all of the corporate property and assets as provided in this Code; and 3) in case of merger or consolidation.[77] This right is also granted in case of disagreement with a corporate resolution to invest in another corporation or business or for any purpose other than the primary purpose of the corporation.[78]

In *Cua, Jr.*, the controversy involved a clash between the minority stockholders and the controlling stockholders of Philippine Racing Club, Inc. (PRCI), a publicly listed company. The majority stockholders of PRCI are composed of a Malaysian company and the Cua family (Santiago Cua, Sr. and his three sons).[79] They also comprise majority of the board of directors.[80] PRCI was about to swap its huge race track at Makati with a zonal value of P3,817,242,000.00 (alleged to have a fair value of 12 billion pesos) for JTH Davies Holdings, Inc. stocks worth 397,908,894.50 only.[81] When the minority stockholders discovered this plan, they requested to be furnished with the documents pertaining to the transactions. Aside from this, they also publicly denounced the swap, alleging that they were "left in the dark" when the controlling group refused to furnish them the documents they requested and that the swap involves the most important asset of PRCI.[82]

The swap transaction was set to be submitted for stockholders' approval on their annual stockholders' meeting in 2007. However, days before the scheduled stockholders' meeting, two minority stockholders (Ocampo-Tan, et al.) and one director filed a derivative suit against PRCI directors. The complaint was based on the following causes of action:

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[77] § 81.

[78] § 42.

[79] Neal Cruz, *RP Stockholders may be cheated in P12-B deal,* Inquirer.net, August 8, 2007, *available at* http://newsinfo.inquirer.net/inquirerheadlines/regions/view/20070808-81223/RP_stockholders_may_be_cheated_in_P12-B_deal

[80] *Id.*

[81] Cua, Jr., 607 SCRA at 657.

[82] Neal Cruz, *Is PRCI Board trying to hide something,* INQUIRER.NET, Aug. 27, 2007, *available at* http://opinion.inquirer.net/inquireropinion/columns/view/20070827-84848/Is_PRCI_board_trying_to_hide_something%3F (date last visited: Mar. 31, 2012).

> (1) the approval by the majority directors of PRCI of the Board Resolutions dated 26 September 2006[83] and 11 May 2007[84] -- with undue haste and deliberate speed, despite the absence of any disclosure and information - was not only anomalous and fraudulent, but also extremely prejudicial and inimical to interest of PRCI, committed in violation of their fiduciary duty as directors of the said corporation;
>
> (2) respondent Solomon, as PRCI President, with the acquiescence of the majority directors of PRCI, maliciously refused and resisted the request of respondents Miguel, et al., for complete and adequate information relative to the disputed Board Resolutions, brazenly and unlawfully violating the rights of the minority stockholders to information and to inspect corporate books and records; and
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> (3) without being officially and formally nominated, the majority directors of PRCI illegally and unlawfully constituted themselves as members of the Board of Directors and/or Executive Officers of JTH, rendering all the actions they have taken as such null and void ab initio.[85]

The trial court granted a permanent injunction and restrained the discussion of the asset-for-shares swap on the scheduled stockholders' meeting until the case is resolved. The stockholders' meeting did not push thru because of lack of quorum. The directors filed a Petition for Certiorari with the Court of Appeals but it was dismissed for lack of merit, mootness, and prematurity. Failing to obtain a favorable order from the Court of Appeals, the directors raised their appeal to the Supreme Court. The Supreme Court issued a restraining order to enjoin the enforcement of the trial court's writ of permanent injunction. While the appeal was pending before the Supreme Court, the plan for the controversial asset-for-shares exchange was submitted to the stockholders for approval. In a meeting attended by stockholders representing 86.52% of the outstanding

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[83] The board of directors resolved to purchase 100% of the common stock of JTH Davies Holdings, Inc. and the plaintiff-director Brigido Dulay was the sole dissenter.

[84] The board of directors resolved to exchange PRCI's Makati Property with shares of JTH Davies Holdings, Inc. with plaintiff Brigido Dulay as the sole dissenter; Cua, Jr., 607 SCRA at 657-58.

[85] *Id.* at 659-60.

capital of the corporation, stockholders representing 75.23 % of the outstanding capital stock approved the transaction.[86]

Meanwhile, the Supreme Court resolved the issue in favour of the directors and dismissed the derivative suits, including another derivative suit filed by another set of minority stockholders during the pendency of the appeal. The decision, penned by Justice Chico-Nazario, was based on, among others, the availability of appraisal rights for the corporate act complained of. Accordingly, the sale of all or substantially all of the assets of the corporation accords to the dissenting stockholder an appraisal right, which he may exercise within the period prescribed under the Corporation Code.

The Court ruled that the availability of appraisal right is crucial in determining whether the derivative suit is a nuisance suit:

> The import of establishing the availability or unavailability of appraisal rights to the minority stockholder is further highlighted by the fact that it is one of the factors in determining whether or not a complaint involving an intra-corporate controversy is a nuisance and harassment suit... The availability or unavailability of appraisal rights should be objectively based on the subject matter of the complaint, *i.e.*, the specific act or acts performed by the board of directors, without regard to the subjective conclusion of the minority stockholder instituting the derivative suit that such act constituted mismanagement, misrepresentation, fraud, or bad faith.
>
> The *raison d'etre* for the grant of appraisal rights to minority stockholders has been explained thus:
>
>> [Appraisal right] means that a stockholder who dissented and voted against the proposed corporate action, may choose to get out of the corporation by demanding payment of the fair market value of his shares. When a person invests in the stocks of a corporation, he subjects his investment to all the risks of the business and cannot just pull out such investment should the business not come out as he expected. He will have to wait until the corporation is finally dissolved before he can get back his investment, and even then, only if sufficient

[86] *Id.* at 676.

> assets are left after paying all corporate creditors. His only way out before dissolution is to sell his shares should he find a willing buyer. If there is no buyer, then he has no recourse but to stay with the corporation. **However, in certain specified instances, the Code grants the stockholder the right to get out of the corporation even before its dissolution because there has been a major change in his contract of investment with which he does not agree and which the law presumes he did not foresee when he bought his shares. Since the will of two-thirds of the stocks will have to prevail over his objections, the law considers it only fair to allow him to get back his investment and withdraw from the corporation.**[87] (Emphasis supplied)

Moreover, the Court also explained that the allegations of misrepresentation and fraud do not excuse the plaintiff from the requirement that the appraisal right must not be available for the acts complained of. Accordingly, the allegations of fraud and misrepresentation does not render the right of appraisal unavailable, otherwise appraisal rights would be unavailable to every act subject of a derivative suit since every derivative suit is necessarily grounded on an alleged violation by the board of directors of its fiduciary duties, committed by mismanagement, misrepresentation, or fraud.

Not a Nuisance or Harassment Suit

While the courts recognize the necessity of derivative suits, it is "not favoured in the law"[88] since it clashes with the business judgments of the individuals tasked to manage the affairs of the corporation. Thus, there is a necessity to institute sufficient safeguards to ensure that suits of this nature are not used as a tool to suppress legitimate management decisions. Thus, jurisprudence has established that a derivative suit must not be a nuisance suit, otherwise called as harassment or strike suit.

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[87] *Id.* at 697-99.

[88] Bansbach v. Zinn, 1 N.Y. 3d 1 at 8, 801 N.E. 2d 395 at 401 (2003).

Thus, the courts have established that not all suits brought by minority stockholders are derivative actions. In derivative suits, it is important to allege that the plaintiff is suing on a derivative cause of action, otherwise, the court may not acquire jurisdiction over the complaint. Therefore, an appeal on the civil aspect of a criminal case instituted by the minority stockholders against the officers of the corporation may not be properly be recognized as a derivative action.[89]

In the Philippines, the Supreme Court has established several measures before a suit can be considered as a *bona fide* suit and not merely a nuisance suit. However, the Court has yet to delve into this matter into great lengths.

Section 1(b), Rule 1 of the Interim Rules provides:

> (b) *Prohibition against nuisance and harassment suits.* Nuisance and harassment suits are prohibited. In determining whether a suit is a nuisance or harassment suit, the court shall consider, among others, the following:
>
> (1) The extent of the shareholding or interest of the initiating stockholder or member;
>
> (2) Subject matter of the suit;
>
> (3) Legal and factual basis of the complaint;
>
> (4) Availability of appraisal rights for the act or acts complained of; and
>
> (5) Prejudice or damage to the corporation, partnership, or association in relation to the relief sought.
>
> In case of nuisance or harassment suits, the court may, *motu proprio* or upon motion, forthwith dismiss the case.

The first requirement seeks to prevent a situation where a dissenting stockholder with miniscule interest over the corporation can possibly subvert the legitimate management decisions of the corporation. In the United States, the extent of the interest of a suing stockholder is considered when the law requires security for expenses in favour of the corporate officers.[90]

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[89] Western Institute of Technology v. Salas, G.R. No. 113032, 278 SCRA 216, Aug. 21, 1997

[90] Aronson et al., *supra* note 61 at 273.

The subject matter of the suit is important to verify whether the suit is an individual, representative or a derivative action, while the factual and legal bases of the complaint seek to determine whether the allegations in the complaint are sufficient to establish a cause of action. The injury to the corporation is crucial in determining whether the suit is a derivative one for a cause of action of the corporation, and not for a cause personal to the stockholder. Lastly, the availability of appraisal right on the part of the suing stockholder seeks to prevent litigation and gives the dissenting stockholder instead, the opportunity to withdraw from the corporation.

Thus, not all suits brought by the stockholder may be taken cognizance of as a derivative action. In *Union Glass and Container Corporation v. SEC*,[91] the Court ruled that the buyer of a lot owned by the corporation cannot be made as a party in a derivative suit filed by the minority stockholder against the majority stockholder. Since Union Glass was not involved with the corporate controversy between the contending stockholders, the tribunal cannot have jurisdiction over it. Consequently, Union Glass should be dropped as defendant in the derivative action.

This suit in equity could not be used to circumvent the rules on forum shopping, as was illustrated in the case of *First Philippine International Bank v. Court of Appeals*.[92] In this case, the majority stockholders of the First Philippine International Bank filed a "derivative suit" with a prayer to declare any sale of the property owned by the Bank as unenforceable. Impleaded as defendants in this case were the Bank conservator and the purported buyers of the properties owned by the Bank. This case was filed during the pendency of a suit to enforce the alleged perfected contract of sale between Bank and the buyers of the lot (impleaded as co-defendant in the "derivative suit"). Due to the pendency of this case, the defendants in the derivative suit prayed for the dismissal of the case on the ground of *litis pendentia* and violation on the rule against forum shopping. In a turn-about, the majority stockholders averred that the suit is not a derivative suit since it was filed at the instance of the majority stockholders, who are also the members of the Board. It is the Bank itself that instituted the suit. The Court, in disposing of this argument, opined:

> [T]he corporate veil cannot be used to shield an otherwise blatant violation of the prohibition against forum-shopping. **Shareholders, whether suing as the majority in direct actions or as the minority in a derivative suit, cannot be allowed to trifle with court processes**, particularly where, as in this case, the corporation itself has not been remiss in

[91] G.R. No. 64013, 126 SCRA 31, Nov. 28, 1983.
[92] G.R. No. 115849, 252 SCRA 259, Jan. 24, 1996.

> vigorously prosecuting or defending corporate causes and in using and applying remedies available to it. To rule otherwise would be to encourage corporate litigants to use their shareholders as fronts to circumvent the stringent rules against forum shopping.[93] (Emphasis supplied)

Upholding Equity

A stockholders' derivative action is one that is grounded on equity. As can be seen in the discussion of the history of derivative suits, the courts of equity allowed derivative suits in order to give stockholders remedy from corporate insiders' abuse, malfeasance or misfeasance. The development of the concept of derivative suits shows that the courts of equity wanted to give protection to the stockholders while preserving the fundamental doctrine that the power and control of the corporation rests with the directors. The general rule is that when a corporation sustains an injury, a suit must be brought by its directors in the corporation's name. Exception to this rule was created based on equity in order to accommodate a situation where the directors are guilty of abuse and/or they refuse to institute a suit to the detriment of the corporation and its shareholders. The derivative suit became an instrument to make corporate directors accountable for fraud or any other form of abuse. In *Cohen v. Beneficial Industrial Loan Corporation,* it was explained:

> Equity came to the relief of the stockholder, who had not standing to bring civil action at law against faithless directors and managers. Equity, however, allowed him to step into the corporation's shoes and to seek in its right the restitution he could not demand in his own. It required him first to demand that the corporation vindicate its own rights but when, as was usual, those who perpetrated the wrongs also were able to obstruct any remedy, equity would hear and adjudge the corporation's cause through its stockholder with the corporation as defendant, albeit a rather nominal one. This remedy born of stockholder helplessness was long the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interest. It is argued,

[93] *Id.* at 288.

> and not without reason, that without it there would be little practical check on such abuses.[94]

However, as the stockholders' right to sue in behalf of the corporation became fundamentally recognized, the problem of nuisance or strike suits arose. The Court in *Cohen* went on to describe the problem of strike suits,

> Unfortunately, the remedy itself provided opportunity for abuse which was not neglected. Suits sometimes were brought not to redress real wrongs, but to realize upon their nuisance value. They were bought off by secret settlements in which any wrongs to the general body of share owners were compounded by the suing stockholder, who was mollified by payments from corporate assets. These litigations were aptly characterized in professional slang as 'strike suits.' And it was said that these suits were more commonly brought by small and irresponsible than by large stockholders, because the former put less to risk and a small interest was more often within the capacity and readiness of management to compromise than a large one.[95]

In *Hawes,* we see that the court noted the growth in corporate litigations, and so they imposed procedural hurdles in the institution of derivative suits. When problems of strike suit persisted, several states in the US enacted the security-for-expenses statutes in order to discourage frivolous suits.[96] Some commentators opined that the adoption of these statutes meant the death of derivative suits but the shareholder-plaintiffs managed to employ tactics to evade the applicability of these statutes to

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[94] 337 U.S. 541, 548 (1949).

[95] *Id.*

[96] Emmanuel Tipon, *Shareholders' Derivative Suits in the Philippines*, 43 PHIL. L. J. 486, 501-03 (1968). (Tipon stated that one of the conditions in maintaining a derivative suit is that the complainant must give security for expenses in certain cases (injunction and receivership). In his conclusion however, he said that adoption of security for expenses statutes is not necessary in the Philippines.).

their actions, and so the popularity of derivative suits was eventually revived.[97]

As early as 1911, the Philippine Supreme Court was already wary against harassment suits. In *Pascual,* it stated that "where stock is required for the purpose of bringing suit it has been held that the complaint is a mere interloper and entitled to no consideration."[98] More than 30 years later, the Supreme Court expressly prohibited nuisance or harassment suits in the Interim Rules. In doing so, they came up with a list of factors that can determine whether the suit is merely nuisance or is indeed meritorious. They also expressly required that derivative suits should not be a nuisance suit for it to prosper.

Procedural limitations were created in order to discourage, or eliminate, the practice of filing nuisance actions. However, procedural rules can also curtail meritorious claims just as much as it can prevent non-meritorious ones. In the regulation of derivative actions therefore, the legislators and the courts are faced with the problem of preventing nuisance or strike suits while keeping in mind the original purpose of a derivative suit, which is to protect the corporation and stockholders from directors' abuses.

A derivative suit is termed as such because a stockholder derives his cause of action from the corporation. Therefore, the corporation remains the real party in interest and any benefit that may be awarded in the suit shall devolve to the corporation. The stockholder thus remains a mere nominal party.

But it is inevitable that in suing on the cause of action of the corporation, the stockholder is also suing upon his own cause of action and is thus also a real party in interest. By suing on a derivative action, he takes on a dual role – as a representative of the corporation and as an individual stockholder, who stands to be benefitted or injured by the resolution of the controversy.[99] Derivative suits also serve as an instrument to expose management fraud and to demand accountability from the directors. It can function as a check on the vast discretion that the

[97] John Coffee, Jr. & Donald Schwartz, *The Survival of Derivative Suits: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REVIEW 261, 261 (1981).

[98] Tipon, *supra* note 96, at 529-30. (Tipon opined that although collusive and strike suits are not unlikely, there was no sufficient basis to believe that it will come up in the Philippines in the foreseeable future).

[99] Maximillian Koessler, *The Stockholder's Suit: A Comparative View*, 46 COLUM. L. REV. 238, 242-43 (1946).

directors have. By looking at a derivative action this way, the role of the stockholder is magnified and his interest becomes paramount, and not merely that of the corporation. Imposing stringent procedural rules in instituting derivative action may thus greatly curtail the ability of the stockholders to protect themselves and ultimately, the corporation.

In *Yu v. Yukayguan*,[100] the Court had the occasion to point out the effectivity of the new rules on filing derivative actions as provided under Rule 8 of the Interim Rules. No explanation however, was furnished by the Court in the inclusion of the other two requirements under the Interim Rules.

Almost six months after, the Court had another occasion to explain the rationale behind the expansion of the procedural rules on derivative actions in *Cua, Jr.* Similar to *Yu* however, the Court failed to explain the rationale behind the enactment of the requirements under Rule 8 of the Interim Rules. Instead of resolving the issue head on, the Court used the requirement on the badges of nuisance suit under Rule 1 of the Interim Rules to justify the requirement regarding the absence of appraisal right.[101]

In a seemingly smart move to skirt the issue, the Court took cover under the auspices of the requirement on nuisance suits under Section 1(b), Rule 1 of the Interim Rules. The Court then conveniently shifted the discussion on the importance of appraisal right, seemingly forgetting that the issue before them involved the importance of the appraisal right in relation to the institution of derivative suits. The most that could be gathered from the Court's discussion is that the change in the conditions in filing a derivative suit is to prevent a nuisance or harassment suit.

The requirement that a shareholder must not have appraisal rights on the matter is a dangerous procedural limitation as it can defeat the purpose of a derivative suit. In the Interim Rules, having appraisal right is a factor in determining whether a suit is a mere nuisance suit. The extent of ownership of the initiating shareholder is also considered a factor in considering whether the suit is merely for harassment. Although ownership of a small number of shares can be taken into account in identifying a strike suit, it does not necessarily mean that a stockholder's suit is merely for harassing the majority stockholders and the directors. In fact, jurisprudence is replete with the rule that ownership of just one shares of stock is not a hindrance in filing a derivative action. Just the same, there is no direct correlation between having appraisal rights and filing frivolous

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[100] G.R. No. 177549, 589 SCRA 588, Jun. 18, 2009.

[101] *See* Cua, Jr., 607 SCRA at 697-700.

claims. The cause of action in a derivative suit belongs to the corporation and the shareholder is merely representing it. **How can then an appraisal right belonging to the shareholder affect the merits of the corporation's cause of action?** The fact that the stockholder has an appraisal right does not affect the fact that an injury was done to the corporation.

To illustrate the danger of the additional requirement of absence of appraisal rights, if we assume that the directors-defendants in the case of *Cua, Jr.* was indeed guilty of fraud and motivated by bad faith in orchestrating the asset-for-shares swap, the minority shareholders would have no chance to demand accountability and restitution in behalf of the corporation before the court since the matter involves a transaction wherein appraisal right is available. The minority stockholders then would have no choice but to let go of their shares if they dissent with the directors' plan even if they knew it to be fraudulent and injurious to the corporation.

A cunning majority can easily subvert and trample the rights of the minority. It could easily create layer upon layer of transactions affording appraisal rights to cloak its wrongdoing with impunity, because a merger affords a dissenting stockholder an appraisal right. It renders nugatory the policy of protecting minority stockholders as implied in the Corporation Code. Should the requirements under the Interim Rules apply strictly, especially the requirement on the absence of appraisal right. This requisite is suspect since it does not uphold equity, the fundamental basis of derivative action.

Conclusion

The Constitution provides that the Supreme Court shall have the power to promulgate rules of procedure, provided that they do not diminish, impair substantive rights.[102] Procedural rules then, are meant to breathe life into the rights granted to the people and give them the means to enforce them.

The complexities of modern commercial transactions gave rise to multifarious issues that plague corporate management. Inevitably, in the process of conducting its business, stockholders disagree on the manner by which the enterprise is being managed. To remedy the controversies which arise between and among shareholders and the management, jurisprudence

[102] CONST. art. VIII, § 5(5).

has recognized the concept of derivative suits based on equity considerations. It is doubtful however, whether the Supreme Court was faithful in upholding its mandate in establishing the rules on derivative actions under Rule 8 of the Interim Rules with due regard to its origins in equity.

What is needed therefore is a re-evaluation of the rules on derivative suits as provided under Rule 8 of the Interim Rules. When measured against the immense powers of the majority, derivative actions become the sword that minority wields for their protection, and ultimately and more importantly, that of the corporation's. It is in light of this context that the importance of derivative actions cannot be over-emphasized.[103]

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[103] There are however, conflicting opinions on this matter. While others seek to expand the concept of derivative actions and espoused the recognition of double derivative actions, others have predicted their eventual demise and rely instead on market forces to address the matter. *See* Locascio, *supra* note 62.

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