# SHIFTING PARADIGMS: THE NEED TO RECOGNIZE AGENCY PROBLEMS IN GOVERNMENT-OWNED-AND-CONTROLLED CORPORATIONS IN THE PHILIPPINES*

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## INTRODUCTION

State-owned enterprises play a critical role in the economy and politics of the Philippines. In fact, two-thirds of all government assets and one-third of its expenditures are managed by 157 state-owned enterprises called government-owned-and-controlled corporations ("GOCCs").[1] These GOCCs were created by the Philippine Government "to accomplish development objectives, particularly economic and social services, and infrastructure development."[2] Part of the appeal of using GOCCs to deliver government services is, among others, their feature of fiscal and managerial autonomy,

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* *Cite as* Leandro Angelo Aguirre, *Shifting Paradigms: The Need to Recognize Agency Problems in Government-Owned-and-Controlled Corporations in the Philippines*, 87 PHIL. L. J. 820, (page cited) (2013).

This paper was submitted as part of the requirements for the author's Master of Laws degree from Harvard Law School. This author would like to thank his LL.M. paper supervisor, Professor Jesse Fried, as well as Mark Dennis Joven, Jesusa Arellano-Aguda, and Melissa R. Encanto-Tagarda for all their help in developing the ideas for this paper.

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[1] Adm. Order No. 59, § 2(a) (1988). A government-owned and/or -controlled corporation is defined as "a corporation which is created by special law or organized under the Corporation Code in which the Government, directly or indirectly, has ownership of the majority of the capital or has voting control; . . . ."

*See also* Sponsorship Speech of Senator Franklin M. Drilon for the GOCC Governance Act of 2011, Senate Bill No. 2640, Jan. 26, 2011, Senate Journal No. 55 (*hereinafter* "Drilon Speech") 3, *available at* http://www.senate.gov.ph/lis/journal.aspx?congress=15&session=1R&q=55 (last visited Oct. 17, 2012).

[2] Drilon Speech, *id.* at 3.

which allows them to be run more efficiently, as well as their ability to generate higher revenues that ultimately redound to the benefit of the government.

This same feature, however, has lent itself to abuse by unscrupulous directors and officers of GOCCs. Being left to formulate their own corporate policies, including setting their own compensation, GOCC officers and directors have become some of the country's highest paid corporate officers despite the fact that they are public officials. Beyond the reach of government salary standardization laws and traditional anti-corruption monitoring, some GOCC officials have received up to 37 months of salary as Christmas bonuses, in addition to "calamity financial assistance" and countless other bonuses.[3] This excessive compensation, decried by Philippine President Benigno Aquino III in his first State of the Nation Address, sparked intense public outrage at a time when government coffers were being depleted by the global financial crisis and the alleged corruption of previous administrations was on the top of everyone's mind. This was the backdrop which led to the passage of Republic Act No. 10149 or the GOCC Governance Act of 2011 ("GOCC Act"), which constituted the Aquino administration's response to unconscionably excessive executive compensation in GOCCs.

The GOCC Act emphasized the character of directors and officers of GOCCs as public officers with a fiduciary duty to the government.[4] Significantly, the GOCC Act created a Governance Commission for GOCCs ("GCG"), an independent group of "super-directors" with broad powers to recommend director and officer appointments, evaluate compensation and performance, and even recommend the abolition of GOCCs. While a good concrete step, I believe this is not enough. In order to understand and consequently find solutions to the corporate governance problems of GOCCs, the nature of these corporations must first be understood.

This paper will first examine the history of GOCCs, the reason for their creation and subsequent proliferation, and how these affected their eventual structure. I will then discuss the corporate governance problems of GOCCs and show that these problems are rooted in their very history. The second part of this paper will discuss the key features of the GOCC Act and how it seeks to address the problems facing GOCCs. The third part of this paper will discuss the necessity of looking at GOCCs from a different perspective. I will show that the structure of GOCCs is different from the

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[3] *See, generally,* Drilon Speech, *supra* note 1.
[4] *See* Rep. Act No. 10149, § 2(e) and § 19 (2011).

typical Philippine corporation and, as such, corporate governance solutions developed for the private sector cannot simply be transplanted and applied to the GOCC context. I will further show that the structure of GOCCs results in a separation between ownership and control which is typical of widely held corporations in the United States ("US"). Thereafter, I will propose that GOCCs are plagued by the same agency problems inherent in widely held public corporations, where diffuse public shareholders find themselves unable to police managers with interests that diverge from theirs. The fourth part of this paper will then discuss the implications of this observation for the GOCCs, the GOCC Act, the governance mechanisms being developed by the GCG, and the GCG itself. Finally, I propose other steps that can be taken as well as studies that need to be done which can help improve the governance of GOCCs.

## A BRIEF HISTORY OF GOCCS

The role of GOCCs in the Philippines has not always been as extensive as it is now. Before World War II, GOCCs were only limited to the agricultural, transportation, and financial sectors.[5] Examples of GOCCs operating during this period are the Philippine National Bank, the Manila Railroad Co., the National Rice and Corn Corp., and the National Coconut Corp.[6]

Subsequently, the government's expansion of its participation into other sectors like public utilities and infrastructure saw the establishment of specialized government agencies such as the National Petroleum Corp., the National Iron Corp., and the Metropolitan Water District.[7] The government's increased participation in various areas of the economy, at a time when most commercial undertakings were under foreign ownership and control, necessitated the creation of the National Economic Council in 1936 and the reorganization of the National Development Corp.—both of which were mandated to encourage the growth of Philippine enterprises.[8]

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[5] Katsumi Nozawa, *Privatization Policy in the Philippines, in* INSTITUTE OF DEVELOPING ECONOMIES DEREGULATION AND ECONOMIC DEVELOPMENT IN THE PHILIPPINES 27 (Lim & Nozawa, eds., 1991), *available at* http://d-arch.ide.go.jp/idedp2/ASE/ASE001100_004.pdf (last visited Mar. 25, 2013).

[6] *Id.*

[7] *Id.* at 28.

[8] *Id.* at 27-28.

The period after the war saw a significant increase in the creation of GOCCs as the government tried to rehabilitate the economy. During this time, about 30 GOCCs were created in various areas such as public utilities and infrastructure, like the Metropolitan Water District and the National Power Corp.; in agriculture, like the National Tobacco Corp.; in finance, like the Government Service Insurance System; and, regulatory GOCCs such as the National Land Settlement Corp. and the Rural Progress Administration.[9] Due to the poor performance of these GOCCs and the substantial duplication of their functions, the government undertook divestment and reorganization efforts in the mid-50's and early 60's such that when President Ferdinand Marcos assumed power in 1965, there were only 37 GOCCs.[10]

The Martial Law years, with all political, legislative, and economic powers of government concentrated in President Marcos, saw the emergence of crony capitalism and a surge in the numbers of GOCCs as the President repeatedly sought to intervene in the country's economic activities.[11] By 1984, the number of GOCCs had risen to 303, consisting of 93 parent corporations, 153 subsidiaries, and 57 acquired assets.[12] GOCCs also suffered operational problems caused primarily by the government's intervention in their economic activities. As Katsumi Nozawa noted in a 1991 work he did for the Institute of Developing Economies in Tokyo,

> [t]he intervention affected several economic activities but the problems were more intensified by structural distortion brought about by the emergence of 'political nepotism' among the cronies. This is very evident in the following instances:
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> (1) *The overlapping of activities by the government agencies*. For instance, in the housing industry three agencies were simultaneously created, namely: the Human Settlements Development Corporation (HSDC), the National Housing Authority (NHA),

[9] *Id.* at 28.

[10] Presentation of Senator Franklin M. Drilon to the Asia Network on Corporate Governance of State-Owned Enterprises on the proposed GOCC Governance Act, May 17, 2011 (*hereinafter* "Drilon Presentation"), *available at* http://www.oecd.org/daf/ca/corporategovernanceofstate-ownedenterprises/48049338.pdf (last visited Sep. 25, 2013).

*See also,* Nozawa, *supra* note 5, at 28.

[11] Nozawa, *supra* note 5, at 29.

[12] *Id.*

> and the National Housing Corporation (NHC). It is a well-known fact that the housing projects of the Marcos Administration were handled by Mrs. Marcos . . . .
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> (2) *GOCCs acted as if they were [Government Financial Institutions]*. This led to corruption . . . . The most notorious case is that of the Philippine Coconut Authority (PCA) which collected levy from the farmers as if it were a revenue-collecting agency.
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> (3) *An increase of concurrent positions held by high government officials*. This became an additional cause to invite grafters. According to the 1984 Commission on Audit (COA) *Annual Report*, Geronimo Velasco of the Energy Ministry of the former administration occupied 43 directorships, including subsidiaries of the Philippine National Oil Company (PNOC).
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> (4) *Surprisingly enough, half of the GOCCs escaped COA's auditing*. According to COA's *Annual Report*, of the 303 GOCCs, 155 had refused to be audited by the COA . . . claiming that the subsidiaries established by the General Corporations Law are not subject to COA audit citing the Department of Justice Opinion No. 62 (1976) and No. 134 (1984).[13]

The result of all this is that the government suffered budget deficits due not only to the unprecedented number of GOCCs, their inefficiency, and the large amount of public resources they consumed, but also due to the burden brought about by their substantial domestic and external borrowings.[14] When the Marcos dictatorship was overthrown and Corazon Aquino assumed the presidency in 1986, Aquino issued Proclamation No. 50[15] authorizing the privatization of GOCCs to address and rationalize the problem concerning GOCCs.[16] As a result of the privatization policy implemented in 1986, the

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[13] *Id.* at 31-32.

[14] *See* Drilon Presentation, *supra* note 10. *See also id.*

[15] Municipality of San Juan v. Court of Appeals, G.R. No. 125183, Sep. 29, 1997. "After the so-called bloodless revolution of February 1986, President Corazon Aquino took the reigns of power under a revolutionary government. On March 24, 1986, she issued her historic Proclamation No. 3, promulgating the Provisional Constitution, or more popularly referred to as the Freedom Constitution. Under Article II, Section 1 of the Freedom Constitution, the President shall continue to exercise legislative power until a legislature is elected and convened under a new constitution."

[16] *See* Drilon Presentation, *supra* note 10.

number of GOCCs operating in the Philippines has since gone down to only 157.[17]

Bringing down the number of GOCCs, however, did not end the problem. Taking their cue from how GOCCs were run during the Marcos years, succeeding directors and officers operated GOCCs as if they were their own independent republics. Forgetting their duties as public officers charged with the management of "public enterprises designed to contribute to national progress,"[18] the directors and officers took advantage of the fiscal and managerial autonomy of GOCCs by setting policies that allowed them to give themselves not only high salaries and numerous bonuses, but also to extract whatever rents they could for their personal benefit, including holding extravagant meetings sometimes even in foreign countries.[19] They did all this despite the fact that a lot of GOCCs were underperforming and basically dependent on the government for subsidies. In fact, in 2008, it was reported that the actual subsidies to GOCCs amounted to over PhP 21.14 billion or about US$ 516 million.[20] Senator Franklin M. Drilon, in his sponsorship speech concerning what eventually became the GOCC Act, pointed out some of the abuses committed by directors and officers of GOCCs:

> The nation was outraged when we exposed, in the course of our inquiry, the staggering salaries, bonuses, and allowances of some GOCC officers and directors, and the hundreds of millions of pesos worth of stock option plans and profit share denominated as Directors' Fees in private corporations where pension funds were invested. We confirmed that members of the board of directors of certain GOCCs have allocated for their benefit obscene bonuses that went as high as the equivalent of 26 months of salary, despite the poor financial condition and staggering losses, P3.5 billion in the case of MWSS, of these corporations. We also discovered excessively generous and scandalous retirement schemes. For example, in the case of the Manila Economic and Cultural Office, (MECO), the directors can retire after only two years of service, with a retirement pay equivalent to P600,000 per year of service.

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[17] *Id.*

[18] Drilon Speech, *supra* note 1, at 1009.

[19] *See, generally, id.*

[20] Lee Chipongian, *Gov't subsidies to GOCCs total P5 billion in 5 months*, Manila Bulletin, Jul. 2, 2009, *available at* http://mb.com.ph/articles/208941/gov-t-subsidies-goccs-total-p5-billion-5-months#.UTKDDqXt5UQ (last visited April 10, 2013).

> They attend board meetings in a year in Taiwan, and after two years, they can retire and receive P1.2 million as retirement benefit.[21]

These governance problems of the government corporate sector become even more apparent when one considers the significant role GOCCs play in the Philippine economy:

> In 2009, total expenditures of GOCCs are equivalent to 28% of the total expenditures of the national government. GOCC assets, at 125 Billion US Dollars in 2009, also exceed national government assets at 65 Billion US Dollars. The 2009 Annual Financial Report of the Philippine Commission on Audit (COA) also indicates that out of the Ten Billion Five Hundred Million US Dollars Inter-Agency Receivables of the National Government, 91% are due from GOCCs.[22] (Emphasis omitted)

Based on the reports of the Commission on Audit, as of December 2010, the total assets of all GOCCs in the Philippines, with the exception of the *Bangko Sentral ng Pilipinas* ("BSP"), amounted to over US$ 116 billion.[23] However, the subsidies from the national government that allow for the continued operation of a substantial number of GOCCs have increased by 493%– from about US$ 1.46 billion in 2000 to US$ 13.65 billion in 2011.[24] All these factors contributed to the sense of urgency with which GOCC reforms had to be undertaken to ensure that they become an "effective vehicle in achieving social and economic progress."[25] After about seven months, the GOCC Act was signed into law.[26]

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[21] Drilon Speech, *supra* note 1.

[22] Drilon Presentation, *supra* note 10, at 4.

[23] GOVERNANCE COMMISSION FOR GOCCS, FIRST 200 DAYS REPORT (*hereinafter* "First 200 Days Report") 32 (2012), *available at* http://gcg.gov.ph/Annual%20Reports/The%20First%20200%20Days%20Report.pdf (last visited April 9, 2013).

[24] *Id.* at 36. At the exchange rate of US$ 1 = PhP 40.57.

[25] Drilon Presentation, *supra* note 10, at 3.

[26] Rep. Act No. 10149 (2011).

## THE GOCC GOVERNANCE ACT OF 2011

### Key Features

Meant to institute long-term reforms in the government corporate sector, the GOCC Act applies not just to GOCCs, but also to government instrumentalities with corporate powers, government corporate entities,[27] and government financial institutions,[28] except for the BSP.[29] The GOCC Act declares that:

> The State recognizes the potential of [GOCCs] as significant tools for economic development. It is thus the policy of the State to actively exercise its ownership rights in GOCCs and to promote growth by ensuring that operations are consistent with national development policies and programs:
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> Towards this end, the State shall ensure that:
>
> (a) The corporate form of organization through which government carries out activities is utilized judiciously;
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> (b) The operations of GOCCs are rationalized and monitored centrally in order that government assets and resources are used efficiently and the government exposure to all forms of liabilities including subsidies is warranted and incurred through prudent means;
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> (c) The governance of GOCCs is carried out in a transparent, responsible and accountable manner and with the utmost degree of professionalism and effectiveness;

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27 § 3(n). This provides: "Government Instrumentalities with Corporate Powers (GICP)/Government Corporate Entities (GCE) refer to instrumentalities or agencies of the government, which are neither corporations nor agencies integrated within the departmental framework, but vested by law with special functions or jurisdiction, endowed with some if not all corporate powers, administering special funds, and enjoying operational autonomy usually through a charter . . . ."

28 § 3(m). This provides: "financial institutions or corporations in which the government directly or indirectly owns majority of the capital stock and. which are either: (1) registered with or directly supervised by the [Philippine Central Bank]; or (2) collecting or transacting funds or contributions from the public and places them in financial instruments or assets such as deposits, loans, bonds and equity including, but not limited to, the Government Service Insurance System and the Social Security System."

29 § 4.

(d) A reporting and evaluation system, which will require the periodic disclosure and examination of the operations and management of the GOCCs, their assets and finances, revenues and expenditures, is enforced;

(e) The governing boards of *every* GOCC and its subsidiaries are competent to carry out its functions, fully accountable to the State as its fiduciary, and acts in the best interest of the State;

(f) Reasonable, justifiable and appropriate remuneration schemes are adopted for the directors/trustees, officers and employees of GOCCs and their subsidiaries to prevent or deter the granting of unconscionable and excessive remuneration packages; and

(g) There is a clear separation between the regulatory and proprietary activities of GOCCs, in order to achieve a level playing field with corporations in the private sector performing similar commercial activities for the public.[30]

Notably, the most significant feature of the GOCC Act is its creation of the GCG as the "central advisory, monitoring, and oversight body with authority to formulate, implement and coordinate policies" [31] in the government corporate sector.

According to the GCG in its *First 200 Days Report*, its creation was meant to address several fundamental problems confronting the government corporate such as: "(a) weak regulatory framework; (b) lack of a clear entity that exercises ownership functions; (c) poor oversight mechanism; (d) the need for institutional rationalization and fiscal discipline to stop the drain on government finances; and (e) the absence of a central monitoring and policy coordinating body."[32]

The GOCC Act grants the GCG broad powers and functions to carry out its mandate, including powers to:

(a) Evaluate the performance and determine the relevance of the GOCC, to ascertain whether such GOCC should be

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[30] § 2.
[31] § 5.
[32] First 200 Days Report, *supra* note 23, at 7.

> reorganized, merged, streamlined, abolished or privatized, in consultation with the department or agency to which a GOCC is attached . . . .
>
> (b) Classify GOCCs into: (1) Developmental/Social Corporations; (2) Proprietary Commercial Corporations; (3) Government Financial, Investment and Trust Institutions; (4) Corporations with Regulatory Functions; and (5) Others as may be classified by the GCG . . . The classification shall guide the GCG in exercising its powers and functions as provided herein;
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> . . .
>
> (e) In addition to the qualifications required under the individual charter of the GOCCs and in the bylaws of GOCCs. without original charters, the GCG shall identify necessary skills and qualifications required for Appointive Directors and recommend to the President a shortlist of suitable and qualified candidates for Appointive Directors;
>
> (f) Establish the performance evaluation systems including performance scorecards which shall apply to all GOCCs in general and to the various GOCC classifications;
>
> (g) Conduct periodic study, examination, evaluation and assessment of the performance of the GOCCs, receive, and in appropriate cases, require reports on the operations and management of the GOCCs including, but not limited to, the management of the assets and finances of the GOCCs;
>
> (h) Conduct compensation studies, develop and recommend to the President a competitive compensation and remuneration system which shall attract and retain talent, at the same time allowing the GOCC to be financially sound and sustainable;[33]

In addition to this, unlike before, when directors had fixed terms of as much as six years, the GOCC Act mandates a one-year term of office for appointive directors of GOCCs.[34] It also provides that the Chief Executive Officer ("CEO") shall be elected annually by the board of directors from among its members.[35] As noted by the GCG, "[t]his clarifies the role of the

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[33] Rep. Act No. 10149, § 5 (2011).

[34] § 17.

[35] § 18.

CEO as an agent of the Board elected to implement their decisions and directly accountable to the Board."[36]

Aside from this, while directors and officers of GOCCs have always been considered public officials and have corresponding fiduciary duties as such,[37] the GOCC Act expressly states that they are fiduciaries and trustees of the state and imposes on them the highest standard of extraordinary diligence in the conduct of their duties.[38]

To end the disparate treatment between GOCCs—where some were covered by the Salary Standardization Law while others were exempt from the same—the GOCC Act directs the GCG to develop a uniform position and classification system that shall apply to all officers and employees of all GOCCs, explicitly providing that "[a]ny law to the contrary notwithstanding, no GOCC shall be exempt from the coverage of the Compensation and Position Classification System developed by the GCG under this Act."[39]

As part of this Compensation and Position Classification System, the GCG is also mandated to "[e]stablish the performance evaluation systems, including performance scorecards which shall apply to all GOCCs in general and to the various GOCC classifications"[40]

## NECESSITATING A PARADIGM SHIFT

As explained by its principal author, Senator Drilon, the GOCC Act was intended to "rationalize the structure, existence and operations of the GOCCs. It is designed to reform the government corporate sector, improve corporate governance of GOCCs, and exact from them efficient and effective public service."[41]

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[36] First 200 Days Report, *supra* note 23, at 8.

[37] *See* Rep. Act No. 3019, § 2 (1960). This is known as the Anti-Graft and Corrupt Practices Act. *See also* Rep. Act No. 6713, § 3 (1989). This is known as the Code of Conduct and Ethical Standards for Public Officials and Employees.

[38] Rep. Act No. 10149, § 19 (2011).

[39] § 9.

[40] § 5(f).

[41] Drilon Speech, *supra* note 1.

The GOCC Act introduces features that are groundbreaking for Philippine corporate governance. The problem, however, is that these innovations only seem to be able to achieve the goals set out for the GOCC Act if they are considered from the perspective of the typical publicly held Philippine corporation. As will be shown later, because of the differences in their ownership structures, corporate governance strategies appropriate for corporations in the private sector may not necessarily be effective for GOCCs.

**Publicly Held Corporations in the Philippines**

In the Philippines, most, if not all, publicly traded corporations have concentrated shareholders controlling a majority of the shares of stock, as well as the board. Using the two biggest corporations in the Philippines as examples, it can be readily seen that the structure of corporations in the Philippines is very different from the dispersed ownership seen in US corporations. In the case of SM Investments Corp., arguably the biggest Philippine corporation in terms of market capitalization, the eight members of the Sy family, the family who founded the corporation, control a combined 53.65% of the total shares and four out of the eight seats on the board.[42] On the other hand, for the Philippine Long Distance Telephone Co., 65.63% of the shares are held by only about 13 corporations or individuals.[43]

In terms of public float, unlike in the US where many publicly traded corporations have widely dispersed shareholders,[44] based on disclosures submitted to the Philippine Stock Exchange, the five biggest corporations in the Philippines, based on market capitalization, only have an average public float of around 31.17%. In fact, one of them, San Miguel Brewery, Inc., a

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[42] March 2013 Information Statement submitted to the Philippine Securities and Exchange Commission (Copy with the author).

[43] 2012 General Information Sheet submitted to the Philippine Securities and Exchange Commission (Copy with the author).

[44] Arthur Pinto, *An Overview of United States Corporate Governance in Publicly Traded Corporations,* 58 AM. J. COMP. L. 257, 259 (2010), *citing* ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); *see also,* S&P 500 Equity Indices, which provides that a company must have a public float of at least 50% as one of the criteria for addition to the index, *available* at http://asia.spindices.com/documents/factsheets/fs-sp-500-ltr.pdf?force_download=true (last visited Sep. 25, 2013).

corporation with a market capitalization of about US$ 11 billion, has a public float of just below 1%.[45]

| Corporation | Market Capitalization in Philippine Pesos | Market Capitalization in US Dollars[46] | Public Float |
|---|---|---|---|
| SM Investments Corp.[47] | 660,968,771,340 | 16,292,057,464.63 | 39.22% |
| Philippine Long Distance Telephone Co.[48] | 619,647,962,700 | 15,273,550,966.23 | 53.89% |
| San Miguel Brewery, Inc.[49] | 451,527,033,528 | 11,129,579,332.71 | 0.61% |
| Ayala Land, Inc.[50] | 426,313,034,656 | 10,508,085,645.95 | 13.37% |
| Manila Electric Co.[51] | 351,429,550,515 | 8,662,300,974.00 | 48.78% |

The context of the typical publicly held Philippine corporation—concentrated shareholders having control of a majority of the shares and the board—is clearly not applicable to GOCCs. Despite this obvious difference, the corporate governance problems of GOCCs have, nevertheless, been approached from the same perspective as that of the typical publicly held Philippine corporation because that is the reality with which legislators and

[45] The Philippine Stock Exchange, Inc., *San Miguel Brewery, Inc. – Company Information*, *at* http://www.pse.com.ph/stockMarket/companyInfo.html?id=618&security=545&tab=0 (last visited March 27, 2013).

[46] At the exchange rate of US$1 = PhP 40.57.

[47] The Philippine Stock Exchange, Inc., *SM Investments Corporation – Company Information*, *at* http://www.pse.com.ph/stockMarket/companyInfo.html?id=599&security=520&tab=0 (last visited March 27, 2013).

[48] The Philippine Stock Exchange, Inc., *Philippine Long Distance Telephone Company – Company Information*, *at* http://www.pse.com.ph/stockMarket/companyInfo.html?id=6&security=134&tab=0 (last visited March 27, 2013).

[49] The Philippine Stock Exchange, Inc., *supra* note 46.

[50] The Philippine Stock Exchange, Inc., *Ayala Land, Inc. – Company Information*, *at* http://www.pse.com.ph/stockMarket/companyInfo.html?id=180&security=293&tab=0 (last visited March 27, 2013).

[51] The Philippine Stock Exchange, Inc., *Manila Water Company – Company Information*, *at* http://www.pse.com.ph/stockMarket/companyInfo.html?id=118&security=137&tab=0 (last visited March 27, 2013).

corporate practitioners are familiar.[52] The difficulty with this approach, however, is that it does not consider the problems that can arise in situations where ownership and control are separated—a situation that is irrelevant to the typical Philippine corporation, but is very much relevant to GOCCs. These problems are called *agency problems*.

**Agency Problems in GOCCs**

The GOCC Act explicitly provides that a GOCC and its board are "fully accountable to the State as its fiduciary" and should act "in the best interest of the State."[53] In addition, as "fiduciaries of the State," directors and officers of GOCCs are legally mandated to always act in the best interest of the GOCC and to conduct their dealings with utmost good faith.[54] Given all these, GOCCs, as instrumentalities of the government, and its directors and officers, as public officials, are bound by the principle enshrined in the Constitution that "[t]he prime duty of the Government is to serve and protect the people."[55]

The existence of GOCCs has been premised on their being an efficient mode of managing government assets and useful tools to accomplish development objectives, particularly economic and social services and infrastructure development.[56] If their continued existence is to be justified, the actions of GOCCs should be consistent not only with these purposes, but also with their duty to the people as instrumentalities of the government.

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[52] CESAR VILLANUEVA, THE LAW AND PRACTICE ON PHILIPPINE CORPORATE GOVERNANCE 369-403 (2011). This explains that the Model Code on Public Corporate Governance issued by the Office of the Government Corporate Counsel in 2008 "derived its inspiration from the Code of Corporate Governance issued by the Securities and Exchange Commission for private corporations." It used definitions of corporate governance and formulations of the fiduciary duties and other duties and functions of the board of directors of GOCCs that were based largely on those of the Securities and Exchange Commission ("SEC"). It also based its disclosure and transparency rules on that of the SEC, taking the same thrust as that for private corporations and, in certain instances, even tracked the same language used by the SEC in its own Code.

[53] Rep. Act No. 10149, § 2 (e) (2011).

[54] § 19.

[55] CONST., art. II, § 4.

[56] *See* Drilon Speech, *supra* note 1. *See also* Drilon Presentation, *supra* note 10, at 1.

If a corporation's primary goal is considered to be the maximization of shareholder value,[57] or even if the alternate view—described as the "pursuit of overall social efficiency"[58]—is considered, the only logical conclusion in the case of GOCCs is that they should exist for the benefit of the Filipino people—its shareholders and stakeholders.

In much the same way that the dispersed owners of publicly traded corporations in the US find themselves unable to monitor, police, and direct the actions of directors and managers because of such things as the collective action problem, the same situation is equally true for Filipinos in the case of GOCCs. GOCCs must be viewed not as owned by a single stakeholder—the Philippine government, represented by the President—but, as widely held by the Filipino people for whose benefit the GOCCs are supposed to work. In this regard, the Filipino people should be considered as the ultimate shareholder and principal of GOCCs and its directors and officers as their agents.

Viewed in this way, it is argued that GOCCs are structurally closer to US public corporations with dispersed ownership than they are to Philippine public corporations. With this separation of ownership and control comes a set of problems that have not really been examined in the Philippine context. As Justice Brandeis explained in his dissent in *Liggett v. Lee*,[59] the dispersed ownership of shareholders has resulted in problems arising from the separation of ownership and control:

> Ownership has been separated from control; and this separation has removed many of the checks which formerly operated to curb the

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[57] *See* Jeffrey Gordon, *The Rise of Independent Directors in the US, 1950-2005: Of Shareholder Value and Stock Prices*, 59 STAN. L. REV. 1465, 1529 (2007). This explains that: "The maximization of shareholder value as the core test of managerial performance had seeped into managerial culture . . . [In the 1997 statement of the Business Roundtable], we are given to understand that 'the paramount duty of management and of boards of directors is to the corporation's stockholders; the interests of other stakeholders are relevant as a derivative of the duty to stockholders."

[58] REINIER KRAAKMAN, ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 28 (2009). This explains: "The appropriate goal of a corporate law is to advance the aggregate welfare of all who are affected by a firm's activities, including the firm's shareholders, employees, suppliers, and customers, as well as third parties such as local communities and beneficiaries of the natural environment."

[59] 288 U.S. 517 (1933).

> misuse of wealth and power. And, as ownership of the shares is becoming continually more dispersed, the power which formerly accompanied ownership is becoming increasingly concentrated in the hands of a few.[60]

The main problem associated with the separation of ownership and control is what is known as the "agency problem." In general, this "arises whenever the welfare of one party, termed the 'principal', depends upon actions taken by another party, termed the 'agent'. The problem lies in motivating the agent to act in the principal's interest rather than simply in the agent's own interest."[61] Put in another way, agency problems arise when "[t]he principals (the shareholders) cannot directly ensure that the agents (the managers) will always act in the principals' best interests. As a result, the manager-agents, whose interests do not fully overlap those of the shareholder-principals, may deviate from the best course of action for shareholders."[62]

Professor Lucian Bebchuk explains that governance mechanisms, either through constraints or incentives, can be put in place to induce directors and management to "care about shareholder interests."[63] Otherwise, "[w]ithout adequate constraints and incentives, management might divert resources through excessive pay, self-dealing, or other means; reject beneficial acquisition offers to maintain its independence and private benefits of control; over-invest and engage in empire-building; and so forth."[64] In their book, *Pay without Performance*, Professors Bebchuk and Fried explained that the separation of ownership and control has given the directors and managers, as agents of the shareholder/owner, substantial discretion as to how the company should be run, allowing them to extract rents greater than they would normally be able to obtain under arms-length contracting.[65] They called this the "managerial power perspective."

Looking at GOCCs from this perspective, the very structure of GOCCs, by giving directors fixed tenures of several years and exempting a great majority of them from the Salary Standardization Law, has given

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[60] *Id.* (Brandeis, J., *dissenting*).

[61] KRAAKMAN ET AL., *supra* note 58, at 35.

[62] LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 16 (2004).

[63] Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 850 (2005).

[64] *Id.*

[65] *See, generally,* BEBCHUK & FRIED, *supra* note 62.

directors and officers of GOCCs tremendous power over their principals, allowing them to extract unconscionable amounts of rent from the GOCCs. Situations similar to the case of the Metropolitan Waterworks and Sewerage System, where its directors and officers gave themselves more than 37 months' worth of compensation, and other GOCCs, whose stock options were appropriated by the directors for their personal benefit,[66] have been ongoing for several years. What has allowed these abuses to continue undetected is the successful "camouflaging" of their existence from the public by GOCC officials, who obscured the total amount of their compensation through seemingly innocent bonuses, stock option plans, profit sharing plans, and retirement schemes.[67] After all, "[t]he more reasonable and defensible a package appears, the more rents managers can enjoy without facing significant outrage."[68]

The situation in GOCCs, unlike corporations in the US, was also made much worse by the fact that their directors and managers were practically free from any supervision and monitoring. In its *First 200 Days Report*, the GCG noted that the monitoring of GOCCs was very lax and even non-existent for some:

> Until June 2011, the monitoring of all GOCCs was the main responsibility of [the Department of Finance Corporate Affairs Group]; however, only fourteen (14) GOCCs (major non-financial government corporations) were closely monitored for their fiscal relevance as they account for a substantial portion of the country's consolidated public sector deficit (CPSD). Aside from [the] monitoring of the 14 GOCCs' contribution to CPSD, their liabilities and those of the three (3) Government Financial Institutions (GFIs) and 3 Social Security Institutions (SSIs) were also closely monitored because of its implications on the country's consolidated public sector debt.
>
> The [Department of Budget and Management], through its Budget and Management Bureau–F, also looked at the government corporate sector but this was limited to Chartered GOCCs and only to the extent of their Corporate Operating Budgets (COBs). That arrangement meant that GOCCs that were not relying on the national government for financial support were largely left on their

[66] Drilon Speech, *supra* note 1, at 1008.
[67] *Id.* at 1008-1009.
[68] BEBCHUK & FRIED, *supra* note 62, at 67.

> own, with their Boards and Management exercising practically full autonomy over their assets and operations.[69]

As such, these officials had little incentive to care about anyone other than themselves and ran the GOCCs like their own "independent republics."[70] The power they wielded, together with the absence of any institutional mechanism to monitor GOCCs, gave rise to a corresponding lack of constraints and incentives for GOCC directors and officers. All this has "resulted in GOCCs being used simply as milking cows of politicians and their recommended appointees to the Governing Boards of GOCCs, with little regard for the solemnity of the public offices involved and the preservation of resources and national interest."[71]

Aside from the absence of institutional mechanisms for monitoring, agency problems in GOCCs were also exacerbated by the collective action and free-rider problems faced by its shareholders, the Filipino people in general.[72] After all, if principals cannot organize themselves either to monitor their agent or decide on a particular course of action due to high coordination costs, then even the best governance strategy or mechanism will be rendered ineffective.[73] In the case of GOCCs, not only are there extremely high coordination costs, but there is also no direct and effective mechanism to enforce the fiduciary duties of GOCC directors and officers to the people. Before the GOCC Act, the only option available to Filipinos was to wait for the next elections and hope that the President appoints better GOCC officials. Oftentimes, however, the issue as to GOCCs is lost in the flood of other issues raised during elections, issues that seemingly affect the lives of Filipinos more directly than GOCCs.

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[69] First 200 Days Report, *supra* note 23, at 6.

[70] Drilon Speech, *supra* note 1, at 1008.

[71] First 200 Days Report, *supra* note 23, at 6.

[72] KRAAKMAN ET AL., *supra* note 58, at 36-37. This explains that: "Multiple principals will face *coordination costs*, which will inhibit their ability to engage in collective action. These in turn will interact with agency problems in two ways. First, the difficulties of coordinating between principals will lead them to delegate more of their decision-making to agents. Second, the more difficult it is for principals to coordinate on a single set of goals for the agent, the more obviously difficult it is to ensure that the agent does the 'right' thing. Coordination costs as between principals thereby exacerbate agency problems."

[73] *Id.* at 38.

**Implications of Agency Problems in GOCCs**

The Philippines' mindset in dealing with corporate governance problems, although significantly influenced by international best practices as shown above, has been largely shaped within the specific context of the typical Philippine corporation. As such, the idea of agency problems has never really entered the consciousness of Philippine corporate governance practitioners. Therefore, when the corporate governance problems facing GOCCs were examined, legislators, regulators, as well as their consultants, approached it in much the same way that they approached the same problems in private Philippine corporations—by imposing explicit fiduciary duties, clearly delineating the accountability of directors, officers, and other key people and increasing the number of required disclosures. Unlike private corporations in the Philippines, however, where the directors, being the majority owners or, at least, representatives of the majority owners, have the incentives to fulfill their fiduciary duties and require management to make the proper disclosures, as already discussed, GOCCs do not have the same incentives. Cesar Villanueva notes that the difference between private corporations and GOCCs is the "absence of direct proprietary interest" on the part of the latter.[74] As he put it, in the case of private corporations, "nobody can better protect a property other than the owner himself" while for GOCCs the reality is "[u]ltimately, nobody in authority is left to demand responsibility in the public sector."[75]

Admittedly, this failure to understand and address this difference in the incentives of GOCC officials has historically given rise to a host of problems, some of which we have already seen above. In the case of GOCCs, however, what should be important is not having someone in authority demanding responsibility, but enabling its ultimate owners—the people—to demand responsibility as they have been already shown to be capable of doing. After all, it was the people's "outrage"[76] at the excesses of GOCC

[74] VILLANUEVA, *supra* note 52, at 409.

[75] *Id.* at 410-411.

[76] BEBCHUK & FRIED, *supra* note 62, at 65. Outrage is described in this way: "Whether directors and managers will be deterred from adopting a given compensation arrangement depends on the extent to which it will be viewed by relevant outsiders as unjustified or even abusive or egregious. We will broadly refer to negative reactions by outsiders as 'outrage,' even though some of them may amount to criticisms not reaching the level of outrage, and to the costs that such reactions impose on managers and directors as 'outrage costs.' The more widespread and strong these negative reactions are – that is, the greater the outrage – the larger the costs to directors and managers. When the potential outrage costs are large enough, they will deter the adoption of arrangements the managers would otherwise favor.

compensation, which were brought to light in President Aquino's first State of the Nation Address in 2010, that spurred the process that ultimately resulted in the passage of the GOCC Act.

Within the context of the GOCC Act, while admittedly providing for better control mechanisms, it is argued that it still fails to address the problem of incentives with respect to GOCC directors and officers because it does not consider the existence of agency problems in GOCCs. Realizing that GOCCs have agency problems allows us not only to have a better understanding of the governance challenges that need to be overcome, but also to institute a governance framework that provides the proper incentives for GOCC officials to do the right thing, while instituting the mechanisms that can maximize the "outrage constraint."

## AGENCY PROBLEMS AND THE GOCC ACT

Under the GOCC Act, the power to set the compensation, per diems, and allowances of directors and officers has been withheld from the boards of GOCCs and given to the GCG:

> Sec. 23. *Limits to Compensation, Per Diems, Allowances and Incentives.* – The charters of each of the GOCCs to the contrary notwithstanding, the compensation, per diems, allowances and incentives of the members of the Board of Directors/Trustees of the GOCCs shall be determined by the GCG using as reference, among others, Executive Order No. 24 dated February 10, 2011; Provided, however, That Directors/Trustees shall not be entitled to retirement benefits as such director/trustees . . . .[77]

Essentially, the GOCC Act created the GCG as an independent group of "super-directors" to, among others, supervise, monitor, and set the compensation for all 157 GOCCs. The GCG is now in the process of developing a Compensation and Position Classification System and a Performance Evaluation System.

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We shall refer to arrangements that are deterred in this way as ones that violate the 'outrage constraint.'"

[77] Rep. Act No. 10149, § 23 (2011).

**Performance Evaluation System**

To go hand in hand with the Compensation and Position Classification System, the GCG is also mandated by the GOCC Act to establish a performance evaluation system that shall be applicable to all GOCCs, in general, while recognizing the differences inherent in the GOCC classifications to be developed by the GCG.[78]

A key aspect of the performance evaluation system is the annual performance agreement to be entered into and negotiated between the GOCC and the State, as represented by the GCG.[79] The performance agreement shall include, among others, the following: the GOCC's charter statement, strategy map, performance targets, performance scorecard, and whatever commitments and assistance the GOCC requests from the Philippine government.[80]

In developing their performance targets, GOCCs will formulate their strategic objectives for the year, focusing on outcomes or breakthrough results that are specific, measureable, achievable, realistic, and time-bound.[81] GOCCs are also directed to develop a strategy map that "visually illustrates the GOCC's strategy in achieving its mission/vision, providing the strategic themes, and the cause-and-effect linkages between the GOCC[']s strategic objectives."[82] Based on the strategy map, the GGC, together with the GOCC, will develop a performance scorecard that identifies measures to determine whether the GOCC has successfully executed its strategy for the year and met its performance targets.[83] Section 1.4 provides the following guidelines for setting performance targets:

> (a) The targets should be clearly defined, realistic and growth-oriented from the previous year. It should conform with the corporate operating budget adopted by the GOCC and submitted to the [Department of Budget and Management] in compliance with the annual Corporate Budget Call. The targets

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[78] § 5(f).

[79] Working Draft of the Performance Evaluation System for the GOCC Sector, GCG Memo. Circ. No. 2013-02 (*hereinafter* "PES Working Draft"), § 1 (on file with the Governance Commission for GOCCs; copy with author) .

[80] *Id.* § 1.

[81] *Id.* § 1.2(a).

[82] *Id.* § 1.2.

[83] *Id.* §§ 1.3, 1.4.

> shall also be consistent with the sectoral targets underlying the plans and programs of the GOCC's Supervising Agency . . . .
>
> (b) A reasonable range for the target should be defined based on experience or industry norm . . . .
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> . . .
>
> (d) GOCCs that receive subsidy, guarantees or other support that form part of the National Government's contingent liabilities shall include targets and/or strategic initiatives on reducing the same.[84]

While these are clearly important innovations and constitute substantial improvements over the current system governing GOCCs, it is argued that these systems can only be effective if the agency problems inherent in the structure of GOCCs and its corresponding effects on the incentives of directors and officers are taken into consideration.

### *i. Asymmetry of Information*

As discussed above, the performance evaluation system is primarily centered on the performance agreements to be negotiated between GOCCs and the GCG. In coming up with these agreements, the GOCC submits its performance targets and its strategy for meeting the same to the GCG for its approval. The arrangement does not seem to consider the potential problems resulting from the asymmetry of information existing between GOCCs and the GCG. In examining situations where there is asymmetry of information between supervisors and workers, Professor Stephen Bainbridge explains:

> Although firms have more information than workers about some aspects of production . . . scientific management has never succeeded in shifting the information asymmetry entirely in management's favor. Workers still have more information than their supervisors about many aspects of production. Management, for example, will rarely have satisfactory information about the ease with which workers could increase their personal productivity. Equipment may have unique properties that can become known only through use . . . .

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[84] *Id.* § 1.4.

> *Asymmetries of this sort are especially likely to persist when disclosure of such information would be adverse to the employees' interest*, by, for example, allowing the firm to utilize fewer workers or to demand greater employee effort. So long as it is in the workers' self-interest to conceal such information from managers, some information asymmetries will therefore persist no matter how efficient the firm's hierarchy is at transmitting information.[85] (Emphasis supplied)

Admittedly, this situation is commonplace in private corporations where management comes up with annual targets and strategies and presents it to the board for their approval. For these corporations, however, even though such asymmetry of information exists, the corporation's hierarchy keeps the problem in check by limiting the control a manager can exercise over the people he supervises and, consequently, the amount of information subject to his discretion.[86] As Professor Bainbridge explains:

> [B]ranching hierarchies put people into small groups, each member of which reports information to the same supervisor. That supervisor is likewise a member of a small group that reports to a superior and so on up to the top. Such an organizational system gets reliable information to the right decision maker more efficiently than any other organizational system.[87]

A corporation's hierarchy also makes it easier to measure the performance of its employees by limiting and focusing the work of individual managers, who usually only have to monitor smaller segments within the corporation.[88] The effect of this is not just to improve the flow of information

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[85] Stephen Bainbridge, *Privately Ordered Participatory Management: An Organizational Failures Analysis*, 23 DEL. J. CORP. L. 979, 1010-1011 (1998).

[86] *Id.* at 1006.

[87] *Id.*

[88] *Id.* at 1009. "Just as hierarchy emerged as an essential component of the information processing aspects of managing large organizations, it plays an equally essential role in the monitoring component of the managerial function. This is especially evident in the most important form of business organization, the M-form corporation. Such firms have two defining characteristics: many distinct operating units and management by a hierarchy of salaried executives. The board of directors delegates responsibility to senior management and monitors their performance. The senior managers in the firm's central office then delegate responsibility to managers of operating units. In turn, the managers of each operating unit are responsible for monitoring the productivity of their unit. The process continues down to the foreman on the shop floor. Creating such a branching hierarchy addresses the problems of uncertainty, bounded rationality, and shirking faced by monitors

within the corporation, but also to make governance mechanisms geared towards the detection and punishment of shirking more effective.[89]

This problem of information asymmetry is even less pronounced in Philippine corporations where the directors and officers of such corporations are themselves the owners of the corporation. Being the owners of the corporation, the value of their investment is inextricably linked to the corporation's performance. This pecuniary interest in the corporation gives them very strong incentives to understand the workings of the corporation and ensure that their managers are not shirking and under-setting the corporation's targets for the year.

On the other hand, a GOCC's directors and officers have no pecuniary interest in its performance. At the same time, its corporate hierarchy, in which its own board of directors is made subject to the GCG acting as a "super" board of directors, does not give rise to the same information processing and monitoring efficiencies as found in private corporations. In the case of the performance evaluation system, the asymmetry of information existing between the GCG and GOCC gives rise to several questions: What will be the GCG's basis for approving the GOCC's targets and strategy? Can GOCCs be expected to disclose everything to the GCG? Do the fiduciary duties of GOCC directors and officers provide sufficient incentive for them to make such disclosure? Uncertainties resulting from these questions make it difficult for the GCG to determine whether the targets and strategy submitted are "realistic and growth-oriented from the previous year."[90]

The GCG, pursuant to its mandate to rationalize the GOCC sector, has classified GOCCs according to sectors: (i) government financial institutions; (ii) social services and housing; (iii) land and water resources; (iv) power; (v) support services; (vi) commercial, trade, and tourism; and (vii) transportation, infrastructure, and communications.[91] Various aspects of the governance of GOCCs, such as compensation and performance scorecards,

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by breaking the firm team into discrete segments, each of which is more readily monitored than the whole. At each hierarchical level, the responsible monitor is responsible for supervising only a few individuals, which usefully limits and focuses his task."

[89] *Id.* at 1008-1009.

[90] PES Working Draft, *supra* note 79, § 1.4 (a).

[91] *See* First 200 Days Report, *supra* note 23.

will then be developed specifically for each sector to allow for better uniformity and comparability of GOCCs.[92]

While this will clearly help, nonetheless, part of the GCG's difficulty in properly monitoring and supervising GOCCs is its lack of time and expertise on the business of each GOCC it supervises. The GCG has to evaluate and approve the performance objectives and strategies of all GOCCs operating in sectors ranging from finance, commerce, and power to housing and agriculture.[93]

Professors Bebchuk and Fried's observations regarding the lack of time and expertise of independent directors in negotiating CEO compensation can also be applied to the GCG's task of negotiating and evaluating the performance targets and strategies of all the GOCCs spread out across various sectors:

> Even independent directors who for some reason wished to serve shareholders' interests in bargaining over CEO's pay have usually lacked the time and information to do so. Most independent directors have their own full-time careers. Independent directors have typically spent little time focusing on the performance of the corporations on whose boards they sit. Surveys of board practices prior to the wave of corporate scandals that began erupting in late 2001 indicated that independent directors devoted only about 100 hours a year to each board . . . .
>
> *In addition to facing time constraints, many directors do not have the knowledge and expertise needed to properly evaluate the compensation arrangements they are asked to approve* . . . .
>
> In reaching compensation decisions, *independent directors have generally had to rely on information and advice provided by the firm's human resources department and by compensation consultants* . . . .[94] (Emphasis supplied)

If the GCG were to devote the "inadequate" amount of 100 hours in a given year monitoring each GOCC under its supervision, it would need to spend about 654 days to do so. Clearly it cannot do this. Even assuming that

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[92] PES Working Draft, *supra* note 79, § 1.3(a).
[93] *See* First 200 Days Report, *supra* note 23.
[94] BEBCHUK & FRIED, *supra* note 62, at 36-37.

the GCG actually had sufficient time to devote to each GOCC, the existing information asymmetry and their lack of expertise in the business and operations of each GOCC will result in the GCG having to rely almost exclusively on the disclosures submitted by a GOCC in evaluating that GOCC's targets and strategies. This situation gives the GOCCs a practical monopoly on information about its operations and causes a distortion in incentives that raises questions on the reliability and accuracy of its disclosures. Realizing that the information contained in their disclosures will pretty much be the sole basis for evaluating the targets and strategies they submit, GOCCs do not seem to have any incentive to provide accurate disclosures.

It can be argued that since the GOCC Act and the GCG already provide guidelines on the nature and manner in which disclosures are to be made, the GCG should be able to properly rely on the same in making its decisions. Requiring disclosures is one thing; ensuring that the submitted disclosures are complete, accurate, and reliable is another thing altogether. In their book *Pay without Performance*, Professors Bebchuk and Fried observed that disclosures could be camouflaged by making them understandable only to a select group of people.[95] Some of the reasons for doing this are to avoid outrage costs, as well as to defeat the purpose for requiring the disclosures in the first place.[96] Following these observations and the discussion on the GOCC's incentives, it is reasonable to think that GOCCs can camouflage their disclosures to make them technically comply with the requirements. At the same time, GOCCs can control not only the manner in which the information in the disclosure is presented, but also the content of the disclosure itself, thus, making it unreliable.

More than disclosures, therefore, the GOCC Act and the GCG should focus on improving transparency and recognize the difference between the two.[97] In his article, *Improving Corporate Governance in SOEs: An Integrated Approach*, Simon Wong explained the importance of transparency for state-owned enterprises ("SOEs") such as GOCCs:

> Transparency is a cornerstone of any governance reform. Open access to information provides a basis for government accountability and raises the barriers against capricious, self-serving intervention. Without accurate and detailed information it is difficult

[95] *Id.* at 192-193.
[96] *Id.*
[97] *See id.* at 192-194.

> to assess company and board performance, set targets and allocate capital efficiently.
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> Although most SOEs are not listed on a stock exchange, they are public companies in the purest sense and should therefore be at least as transparent as listed companies. Information should be provided not only on performance but the objectives of each enterprise (especially non-commercial, social goals), the costs of pursuing non-commercial objectives and any subsidies granted by the government. Increased scrutiny by the public, press and non-governmental organisations raises accountability, both for SOE management and government overseers.
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> . . .
>
> Governments must also be more transparent. They should publicly disclose guidelines for the oversight of state enterprises, including when and how government will intervene. They should publish clear goals for SOEs and their management, along with periodic assessments of how well SOEs have achieved their objectives.[98]

Following this, the GCG should be mindful of the purpose of requiring particular kinds of disclosures and should institute mechanisms that will ensure that submitted disclosures not only advance such purpose, but also that the information it contains is understandable to more than just a small group of market professionals. After all, "[r]aw facts buried in a mountain of technical disclosure probably will not suffice. The salience of disclosure and degree of transparency are important."[99]

Implementing measures with emphasis on improving transparency rather than just increasing the amount and kinds of disclosures is an important step towards balancing the information asymmetry existing between GOCCs and the GCG. The *OECD Guidelines on Corporate Governance of State-Owned Entities*,[100] which provides recommendations for the improvement of

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[98] Simon Wong, *Improving Corporate Governance in SOEs: An Integrated Approach*, 7 CORP. GOVERNANCE INT'L 5, 14-15 (2004) *available at* http://papers.ssrn.com.ezp-prod1.hul.harvard.edu/sol3/papers.cfm?abstract_id=897121.

[99] BEBCHUK & FRIED, *supra* note 62, at 193.

[100] OECD GUIDELINES ON CORPORATE GOVERNANCE OF STATE-OWNED ENTITIES (2005), *available at* http://www.oecd.org/corporate/ca/corporategovernanceofstate-ownedenterprises/34803211.pdf (last visited April 8, 2013).

transparency and disclosure, can be a good starting point. The GCG can mandate the establishment of a GOCC internal audit office to be maintained under the control of the GCG.[101] Aside from this, in relation to the performance targets and strategy of GOCCs, the GCG can establish procedures for conducting a strategic audit of GOCCs.[102]

#### *ii. Director Reappointment*

The incentives of GOCC directors regarding their disclosures becomes more significant when considered with the provisions of the GOCC Act restricting the term of directors to one year and the manner in which they can be eligible for reappointment. The GOCC Act provides that the tenure of appointive directors shall be for one year and that only those appointive directors who have obtained a performance score of above average or its equivalent or higher, based on applicable performance criteria, can be nominated by the GCG for reappointment by the President of the Philippines.[103] It should be stressed that the performance scorecard mentioned in the law is based on the same performance targets and strategy map whose reliability and accuracy have been shown to be vulnerable to the perverse incentives that can result from agency problems.

In an effort to tie the continued tenure of directors to their performance, performance scorecards are to be used as one of the bases for reappointment. This may, however, give rise to consequences unforeseen by either the GOCC Act or the GCG. Considered in the context of agency problems, if directors and officers of GOCCs already lack the proper incentives to provide complete and accurate disclosures since these serve as the only basis to evaluate their performance, with more reason will they have less incentive to be candid with the GCG if it is their employment on the line.

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[101] *Id.,* V(b).

[102] *See* Gordon Donaldson, *A New Tool for Boards: The Strategic Audit, in* HARVARD BUSINESS REVIEW ON CORPORATE GOVERNANCE 53 (2000). Donaldson proposes that the independent directors establish a strategic audit committee that will "select the criteria for review of staregic performance, oversee the design of the database, and establish a review process." In designing the database, Donaldson understands that difficulty of reviewing a corporation's strategy when all information necessary to conduct such review "passes through the filter of a management perspective." To enable to strategic audit committee to perform its task effectively, the committee should get an outside consultant to design a database and gather the data necessary for the committee to do its job.

[103] Rep. Act No. 10149, § 17 (2011).

Although writing on a different matter, the explanation of Professors Bebchuk and Fried on why bonus plans do not necessarily reward good performance can help explain the distortion in the incentives of directors of GOCCs that can result from connecting their continued employment to their performance:

> Awarding the CEO for surpassing the preceding year's performance may not only fail to provide beneficial incentives; it may also distort manager's existing incentives. Such a scheme reduces the penalty for performing poorly: doing badly in any given year negatively affects that year's bonus but positively affects the next year's bonus. *The same scheme also lessens the rewards for performing well: improving performance in any given year, though perhaps increasing one's bonus next year, raises the bar and makes it harder to get a bonus the next year.*[104] (Emphasis supplied)

The working draft of the GCG's guidelines for the performance evaluation system requires that performance targets set by GOCCs be "clearly defined, realistic and growth-oriented from the previous year."[105] Following the explanation of Professors Bebchuk and Fried, it can be seen that it is in the directors' best interest to not only prepare their disclosures in the manner most favorable to them, but also to set performance targets that are easy to accomplish to ensure their reappointment.

Although the idea behind the performance evaluation system and the use of performance scores as one of the bases for director reappointment was to link the appointment of directors to their performance, instead of giving directors an incentive to do well, it may actually end up being counterproductive. It may seem counterintuitive, but it is argued that basing reappointment on performance scores does not incentivize directors to perform well.

It should be stressed that the annual targets set by the directors have to be "growth-oriented from the previous year." Given the previous discussion on asymmetry of information, to ensure that they get the necessary performance score that will allow them to be eligible for reappointment, directors actually have an incentive to be mediocre because it ensures that performance targets will be within easy reach year after year. Directors will

[104] BEBCHUK & FRIED, *supra* note 62, at 124-125.

[105] PES Working draft, *supra* note 79, § 1.4(a).

then intentionally set lower targets than what they reasonably believe can be achieved and temper the performance of the GOCC accordingly. This system ends up penalizing GOCCs that perform well since exceeding their targets by a large margin in any given year does not result in any benefit for them, but, instead, it raises the bar and makes it harder for them the following year. The fact that bonuses, which may be tied to the GOCCs performance, are no longer allowed only increases the incentive to aim for mediocrity.[106]

The result of all this is that, by underperforming, GOCCs not only fail to meet their objectives but also waste valuable government resources. Ultimately, the ones who suffer are the Filipino people.

**The Governance Commission for GOCCs: Who Guards the Guardians?**

As discussed above, the GCG is the "central advisory, monitoring, and oversight body with authority to formulate, implement and coordinate policies"[107] concerning GOCCs. The GCG has broad powers to, among others, recommend director and officer appointments, evaluate compensation and performance, coordinate operations, and recommend a GOCC's reorganization or abolition.[108] In effect, the GOCC Act constitutes the GCG as an independent board of "super-directors" for all GOCCs.

This then begs the question of whether the GCG is also subject to the same agency problems as GOCCs. At least structurally, it seems that the GOCC Act does not provide for any mechanisms to ensure that the GCG will always act according to the purpose for which it was created and not pursuant to its own self-interest.

In studying various mechanisms to improve corporate governance in US corporations, specifically in relation to executive compensation, Professors Bebchuk and Fried analyzed the option of having "super-directors" in this way:

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[106] GCG Memo. Circ. No. 2012-02, § 2.3 (2012). This concerns the Revised Interim Rules on *Per Diem* and Other Compensation Entitlements of Members of the Governing Boards of GOCCS Covered by Rep. Act No. 10149 (2011).

[107] Rep. Act No. 10149, § 5 (2011).

[108] *See id.*

> Should we, then, have another independent group of 'super-directors' set the compensation of the independent directors? And to make sure that the super-directors exercise their discretion in the interest of shareholders, should they be given an incentive scheme set by super-super directors, and so forth? The futility of such an infinite chain is quite apparent, and it illustrates the key problem with relying on director independence by itself: *Independence, even coupled with incentive schemes, cannot secure shareholder interests unless there is some mechanism at the end of the chain that makes the designers of incentive schemes designers* [sic] *accountable to shareholders.* This basic point highlights the importance of making directors dependent on shareholders.[109] (Emphasis supplied)

It may be true that the incentives of the GCG are different from those of GOCC officials in that the GCG gains no direct monetary benefit if it acts in a way that favors certain GOCCs. It should be considered, however, that there are factors outside of monetary gain that can cause members of the GCG to favor certain GOCCs, including friendship and loyalty to one or more of its directors or officers.[110] This idea of friendship and loyalty becomes more significant considering that positions in both the GCG and GOCCs are, at the end of the day, still political appointments. Especially in the Philippine context, it is not unlikely for the appointment of both a member of the GCG and a director or officer of a GOCC to have been supported by the same politician such that patronage politics comes into play.

Another factor to consider is that there is very little cost to a member of the GCG in favoring a particular GOCC.[111] If a GOCC performs poorly, the effect on a member of the GCG, as a Filipino citizen, is negligible compared to what he can potentially gain, in terms of political favors or otherwise, by favoring the GOCC. In addition, the risk of discovery is small considering that the problems the GCG may encounter in monitoring GOCCs, i.e., camouflage, information asymmetry and lack of time and expertise, are also problems that can arise in the GCG's submission of reports to Congress and the President.

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[109] BEBCHUK & FRIED, *supra* note 62, at 206.

[110] *Id.* at 31.

[111] *Id.* at 34-36. Professors Bebchuk and Fried note that the "potential cost to most directors of favoring executives are rather small. These costs can take two forms: (1) reduction in the value of any shares that the directors own in the corporation and (2) reputation costs to the directors."

Wong explains that one of the pillars of corporate governance for SOEs, such as GOCCs, is the establishment of clear objectives for them to follow.[112] In the case of GOCCs, the GCG plays a crucial role in the formulation of these objectives. For the GCG, the direction in which it must take these GOCCs is clear. The Philippine President, who spurred the ongoing drive towards better governance for GOCCs, has given the GCG a clear mandate to "ensure [the] financial viability and fiscal discipline [of GOCCs] through adherence to the highest standards of corporate governance" and hopefully "[transform] the GOCC Sector into a significant tool of the State in the attainment of inclusive growth and economic development."[113]

With President Aquino's strong anti-corruption and good governance drive paying off and resulting in strong economic gains for the country due in part to increased investor confidence,[114] the problem of political influence interfering with the GCG's mandate is remote. However, this might be true only while the current administration is in power and while the appointees of the President are the ones in charge of the GCG. The President's term ends in 2016. After such time, depending on who is in power, the GCG and, consequently, the GOCCs, might be steered towards a very different direction which would make them more susceptible to political interference.

Given this, if the GOCC Act and the GCG are to achieve their objectives, there is a very real need to insulate both the GCG and GOCCs from political interference. Studying the experience of other countries with SOEs, Wong explains the importance of insulating SOEs from politics:

> To ensure that a clear mandate is not subsequently muddled by inappropriate interference, SOEs must be insulated from political and bureaucratic pressures. Experience in New Zealand and elsewhere shows that sustaining the gains in performance from reforms over the long term depends, to a considerable extent, on the success in keeping civil servants and politicians at arm's length.

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[112] *See* Wong, *supra* note 98.

[113] First 200 Days Report, *supra* note 23, at 11.

[114] *See* Greg Rushford, *Asia's Next Tiger: President Aquino's Anti-Corruption Program is Just What the Philippines Economy Needs*, FOREIGN POLICY, Jun. 19, 2012 *available at* http://www.foreignpolicy.com/articles/2012/06/19/asias_next_tiger (last visited April 11, 2013); *see also,* Cris Larano & Natasha Brereton-Fukuji, *Fitch Promotes Philippines to Investment Grade*, WALL STREET JOURNAL Mar. 27, 2013 *available at* http://online.wsj.com/article/SB10001424127887324685104578386240156431334.html (last visited on April 11, 2013).

> Creating a real distance between government and the SOE makes it harder for civil servants and politicians to engage in self-interested conduct and, therefore, increases the likelihood that reforms will be durable.[115]

In the Philippines, however, insulating SOEs like GOCCs from political interference is easier said than done. As discussed previously, the GCG and key officials of GOCCs are all political appointees. To make matters worse, the members of the GCG, given the absence of any provision in the GOCC Act setting their tenure, all serve at the pleasure of the President pursuant to his appointment power.[116] This makes the GCG very vulnerable to political pressure and interference and raises uncertainty concerning the governance of GOCCs in the future. If the GCG and GOCCs are to be insulated from political inference, one of the first steps that have to be taken is to constitute the GCG as an independent body, as well as impose upon its members fixed terms of office. This will at least allow the GCG to fulfill its duty and exercise its discretion without having to worry about the popularity of an action it believes is correct.

## MOVING FORWARD

At the outset, it should be clarified that my aim in this paper is not to document all the problems concerning GOCCs and the GOCC Act or to propose a detailed set of solutions to improve corporate governance in GOCCs. My aim is simply to point out aspects of the governance problems plaguing GOCCs that, in my opinion, are presently not being considered, in the hope that this will result in a greater understanding of the nature of GOCCs and lead to the development of better solutions to its governance problems.

One aspect of GOCCs I believe worth examining, considering its long-term implications on the governance of GOCCs, is the dual roles it fulfills as both regulator and commercial entity.

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[115] Wong, *supra* note 98, at 11.

[116] Larin v. Executive Secretary, G.R. No. 112745, Oct. 16, 1997, *citing* CONST., art. VII, § 16. This held that a presidential appointee "comes under the direct disciplining authority of the President. This is in line with the well settled principle that the 'power to remove is inherent in the power to appoint' conferred to the President by Section 16, Article VII of the Constitution."

**Governmental vs. Proprietary Function of GOCCs**

A lot of GOCCs in the Philippines act as both regulator and commercial entity notwithstanding the obvious conflicts of interest this situation creates. One of the best examples of this is the Philippine Amusement and Gaming Corp., which, pursuant to its charter, has the power to not only establish and operate casinos throughout the Philippines, but also the "authority and power . . . to authorize, license and regulate games of chance, games of cards and games of numbers."[117]

The GOCC Act explicitly provides that there should be a "clear separation between the regulatory and proprietary activities of GOCCs, in order to achieve a level playing field with corporations in the private sector performing similar commercial activities for the public."[118]

In addition, the law expressly grants to the GCG the power to recommend to the President what it believes is the proper course of action to take in the event that it determines that a conflict exists between the regulatory and proprietary functions of a GOCC:

> Review the functions of each of the GOCC and, upon determination that there is a *conflict between the regulatory and commercial functions of a GOCC*, recommend to the President in consultation with the Government Agency to which such GOCC is attached, the *privatization of the GOCCs commercial operations, or the transfer of the regulatory functions to the appropriate government agency,* or such other plan of action to ensure that the commercial functions of the GOCC do not conflict with such regulatory functions.[119] (Emphasis supplied)

In my opinion, the importance of separating the regulatory and proprietary functions of GOCCs goes beyond the need for leveling the playing field with the private sector or resolving any conflict that might exist between the two functions. More importantly, the decision of whether to separate the

[117] Pres. Dec. No. 1869, § 10 (1983), as amended by Rep. Act No. 9487 (2007). This consolidated and amended Pres. Dec. Nos. 1067-A, 1067-B, 1067-C, 1399 and 1632, relative to the franchise and powers of the Philippine Amusement And Gaming Corporation.

[118] Rep. Act No. 10149, § 2(g) (2011).

[119] § 5(l).

regulatory and proprietary functions of GOCCs should involve a sort of existential examination of the reason why GOCCs have these two functions in the first place. Such an examination is important because its result will fundamentally affect how corporate governance of specific GOCCs should be approached.

As previously discussed, GOCCs were created "to accomplish development objectives, particularly economic and social services, and infrastructure development."[120] Historically, the value of GOCCs stemmed from their being able to efficiently manage government assets. While these reasons, assuming they are still true, can justify the continued existence of GOCCs that perform commercial functions, the same is not true for those performing only regulatory functions.

I believe the GCG should determine whether there is any justification for the GOCCs to continue performing regulatory functions. There seems to be no good reason why the regulatory functions of GOCCs cannot be performed by the government agency to which it is attached or even some other government agency for that matter. Allowing government agencies to perform these functions will not only simplify the governance of GOCCs by reducing possible conflicts as well as opportunities for rent-seeking, it will also result in a more efficient use of government resources.

After this, I believe the GCG should also undertake to study the continued desirability of having GOCCs at all, or whether privatization is the best course of action. In this regard, it should be stressed that GOCCs proliferated during the Marcos dictatorship and were largely the result of crony capitalism brought about by the desire to favor those close to the dictator.[121] It might be hard to imagine the Philippines without GOCCs since they seem to have become such an integral part of government, but this initial reluctance should not, however, result in an unshakeable belief that that is the way things should be.

If the GCG decides that there is no longer any justification for GOCCs to continue performing regulatory functions and proceeds to remove and transfer these to government agencies, is there still a need to have these GOCCs perform proprietary functions? Can the private sector perform these

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[120] Drilon Speech, *supra* note 1, at 3.
[121] *See* Nozawa, *supra* note 5.

proprietary functions of government better and more efficiently?[122] Could government resources be better used in ways that will result in greater benefit to the people?

I realize that this proposal will be met with a lot of resistance and goes into policy considerations that go beyond the optimal and efficient management of government resources. Given the amount of government assets currently in the hands of GOCCs and the amount of expenditures they are responsible for, I believe it is at least something worth studying, if only to better understand the situation concerning GOCCs.

## CONCLUSION

The idea that GOCCs are different from Philippine corporations in the private sector is not something new. People have always known this to be the case, but for most people understanding this difference ends with the fact that they are owned and controlled by the government and that some of them perform regulatory functions. It seemed that there was never any real need for a deeper understanding of GOCCs.

I have shown in this paper that GOCCs are fundamentally different from Philippine corporations in the private sector. As such, corporate governance solutions developed for the private sector cannot simply be transplanted and applied to the GOCC context and be expected to work just as well. Developing solutions to the problems of GOCCs necessitates a clearer understanding of the nature and structure of GOCCs and how these contribute to the incentives of GOCC directors and officers. Aside from such nature and structure, there is also value in understanding the purposes of the creation of GOCCs and the historical context that gave rise to the same. Doing so frees us from the mental trap that GOCCs are an indispensable part of the Philippine governance landscape and allows us to critically examine whether GOCCs are still relevant to the present day context of the Philippines.

One key difference between GOCCs and other Philippine corporations that I highlighted is the idea of separation of ownership and control and its implications for GOCCs, specifically agency problems and its corresponding effects on the incentives of GOCC directors and officers. Only

[122] *See* Rep. Act No. 10149, § 5(a) (2011).

by understanding these incentives and the factors that contribute to them can mechanisms be developed to address the governance problems of GOCCs. I realize, however, that agency problems constitute just one aspect of the governance problems of GOCCs, and that there may be other issues that can be gleaned from a better understanding of GOCCs. I hope this paper will contribute to this understanding and stimulate discussion in this regard. Hopefully, it will eventually pique the interest of legal scholars, legislators, and regulators enough to get them to think more critically about the nature of GOCCs, the problems concerning them, and how these problems relate to or are rooted in the very nature, structure, and even the history of GOCCs.

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