THE FIDUCIARY DUTIES OF CORPORATE DIRECTORS UNDER PHILIPPINE LAW

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Introduction

The exigencies of economic expansion have made the corporation the most convenient vehicle for present day business operations. Its capacity to exist independently of individuals composing it, its efficiency and the ease with which it can draw upon the resources of many individuals has made the corporation an integral part in the complex of forces that constitute the economic world of the present time.[1]

But what has made the corporation step up with the fast tempo of modern economic activity? The answer to this query is complex and invariably leads us into the realm of management, strategy and business policy, revolving around that group of men called the "Board of Directors", which by legal mandate conducts and controls all the business as well as the property of the corporation.[2] Although the actual operation of corporate business is entrusted to executives and/or managers, yet it is this centralized corporate agency which provides the broad perspective and long-range view of company affairs. It is the locus of legal responsibility.[3] What this board does, how it performs its multifarious functions, and why, involves a study of the intricacies of business administration, but to determine just how far directors' activities can go, the limitations of their powers and prerogatives, in the contex of their relationships with the corporation, with the stockholders, and third persons, necessitates an inquiry into the field of corporate legal theory, particularly the principles relating to fiduciary duty and responsibility.

It is the purpose of this legal essay, to explore that particular aspect of commercial law, which relates to the duties and responsibilities of directors, in the light of statutes, judicial decisions and principles, that have evolved and enriched the Philippine legal system under the influences of Anglo-American common law and the Spanish Civil law. In a basically civil law system, with its characteristic codified rules, the absence of a definite provision or set of rules relating to directors' duties and respon-

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1 VAGTS, BASIC CORPORATION LAW, (Harvard Law School, 1970).

2 Act No. 1459 (1906), sec. 28:

"Unless otherwise provided in this Act, the corporate powers of all corporations formed under this Act shall be exercised, all business conducted and all property of such corporations controlled and held by a board of not less than five or more than eleven directors to be elected from the holders of stock, or where there is no stock, from the members of the corporation."

3 PALMER, DIRECTORS POWERS AND DUTIES 365 (1967).

sibilities necessitates resort to the case method practiced in common law jurisdictions. This peculiar development arises from the fact that the basic corporation law of the Philippines, Act No. 1459 of 1906, is a "codification of American Corporation Law"[4] superimposed upon an already existing set of commercial rules, principles and practices, embodied in the Code of Commerce of Spain and the Spanish Civil Code. Likewise, the rules governing the complex operations of corporate finance, the issuance, purchase and sale of stocks and securities are of American origin. The Philippine "Blue Sky Law", Act No. 2581 of 1916 was patterned after American Blue Sky laws existing in the different states, and primarily aimed at the issuance and sale of speculative securities.[5] Two decades after, securities regulations took a more complex form in Commonwealth Act No. 83, approved on October 26, 1936, otherwise known as the "Securities Act". This law was patterned after the Federal Securities Act of 1933 and the Federal Securities Exchange Act of 1934 and the provisions of the Uniform Sales of Securities Act drafted by the Conference of Commissioners of Uniform State Laws of the United States.[6]

The Philippines is a developing country. While the corporation and stocks and securities transactions may not have yet reached comparatively mature and sophisticated forms, recent trends show a gradual diffusion of stock ownership and desire to increase public participation in corporate investments as a prime factor in the growth of the corporation. To date, there are two operating stock exchanges[7] wherein one-hundred twenty-four (124) companies participate in securities trading. Of these listed enterprises, sixty-one (61) are issuers of mining and oil stocks, thirty-six (36) are commercial-industrial establishments, sixteen (16) belong to the banking-finance-insurance groups, five (5) are sugar companies and six (6) are of miscellaneous category.[8] With the special impetus for more expanded business, corporate enterprise will assume a more vital role in the development of the Philippines.

The importance of the role of the board of directors of a corporation cannot be underestimated, for it is the agency responsible for corporate policies. The power, prestige and advantage that inhere in a director's position leave much room for assumption of directorships with little regard for the fiduciary responsibility owed to the corporation, the stockholders and in-

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[4] Harden v. Benguet Consolidated Mining Co., 58 Phil. 141, 145-47. (1933).

[5] Act No. 2581 (1916) "An Act to Regulate the Sale of Certain Corporate Shares, Stocks, Bonds and Other Securities"; People v. Rosenthal, 68 Phil. 328 (1939).

[6] Com. Act No. 83 (1936) "An Act to Regulate the Sale of Securities, to Create a Securities and Exchange Commission to Enforce the Provisions of the Same, and To Appropriate Funds Therefore." Sibal, *Defects and Loopholes in the Securities Act*, 5 LAWYERS J. 487 (1937).

[7] The two existing stock exchanges are: Manila Stock Exchange and the Makati Stock Exchange.

[8] Gatica, *Manual of Philippine Securities—The Investors' Guide*, (1970 ed.) See Appendices attached.

vestors. These considerations give rise to the need for a re-examination of the ethical and legal norms that govern directors' conduct and that of managing executives. How these relationships are treated in our law is therefore a fitting subject of inquiry.[9]

Some Historical Perspectives

The corporate form as a juridical person, is not new in the Philippines. The Spanish Civil Code, which took effect as law in the Philippines in December, 1889 recognized juridical persons, with existence independent of the members thereof.[10] The Code of Commerce of Spain, extended to the Philippines on August 6, 1888, authorized several forms of commercial companies, associations and partnerships, such as the "sociedad en comandita" (limited partnership), the "sociedad regular colectiva" (general partnership),[11] the "sociedad cuentas en participacion" (joint account partnership).[12] There was also the "sociedad anonima" (anonymous society), which approaches most the concept of corporations as understood under the American system.[13] It is something like the English joint-stock company with features resembling both the partnership and the corporation. In matters concerning organization, distribution of dividends, and those that in equity intervene for the benefit of stockholders, the liability of management, this "sociedad anonima" was similar to the corporation. Likewise, the managers of the "sociedad" were considered its agents and were not subject to personal liability for obligations of the "sociedad" legally contracted by them.[14]

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[9] Rep. Act No. 5186 (1967); Rep. Act No. 6125 (1970). Cagampang, Tax Incentives for Industry in the Philippines, (Seminar Paper in Tax Reform in Developing Countries, Harvard Law School, 1971).

[10] SPANISH CIVIL CODE, art. 35—The following are juridical persons: (1) Corporations, associations and foundations of public interest recognized by law. Their legal existence begins from the very instant at which, in accordance with law, they are validly established. (2) Associations of private interest be the civil, commercial or industrial, to which the law may grant individual legal existence independent of that of each member thereof.

CIVIL CODE, art. 44: "The following are juridical persons:

(1) The State and its political subdivisions;

(2) Other corporations, institutions and entities for public interest or purposes, created by law; their personality begins as soon as they have been constituted according ot law;

(3) Corporations, partnerships and associations for private interest or purposes to which the law grants a juridical personality, separate and distinct from that of each shareholder, partner or member.

[11] CODE OF COMMERCE, arts. 116-150, 160-174.

[12] *Ibid*, arts. 239-243.

[13] *Ibid.*, arts. 151-159.

[14] *Ibid.*, art. 153: "The liability of the members of a corporation for the obligations and losses of the same shall be limited to the funds they contributed or bound themselves to contribute to the corporate capital.

Art. 154: "The corporate capital, composed of the stock and of the accrued profits shall be liable for the obligations contracted in its management and administration by a person legally authorized thereto and in the manner prescribed in the articles of incorporation, by-laws or regulations.

Art. 156: "The managers of a corporation are its agents, and during the time they observe the rules of the commission they shall not be subject to personal nor to joint liability on account of the business of the corporation, and if by reason

When the Philippines passed to the sovereignty of the United States, the Corporation Law, Act No. 1459 was enacted by the Philippine Commission in 1906. The purpose was to introduce the American corporation as the standard commercial entity and replace the "sociedad anonima" of the Spanish law. The Corporation Law of 1906 provided for the formation and organization of corporations, defining their powers and conditions for transaction business, thereby repealing certain articles of the Code of Commerce and other laws inconsistent thereto.[15] However, those "sociedades anonimas" existing in 1906, which chose to continue as such, continued to be regulated by the Code of Commerce in matters relating to their organization, method of transacting business and the rights of members among themselves. However, their relations to the public and public officials were governed by the Corporation Law of 1906.[16] After the expiration of their original term of existence, these "sociedades" could not extend such term,

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of infraction of the laws and statutes of the corporation, or if by acting in violation at general meetings, they should insur losses and there should be several persons responsible theretor, each one of the latter shall answer pro rata."

5 OPS. ATTY. GEN., 442 (1910). In this opinion, the *"Sociedad anonima"* was considered a corporation, having all rights and powers of a fullfledged corporation and therefore subject to obligations devolving upon corporations, such as the investigatory powers of the governor general. (citing Reyes v. Compania Maritima, 3 Phil. 519 (1904); Compania Maritima v. Munoz, 9 Phil. 326, 339 (1907)

Harden v. Benguet Consolidated Mining Co., *supra*, note 4 at 146. "For purposes of general descriptoin only, it may be stated that the *sociedad anonima* is something very much like the English joint stock company, with features resembling those of both the partnership and the corporation. Its affinity to the partnership is shown in the fact that the *sociedad* the genric component of its name in Spanish, is the same word that is used in that language to designate other forms of partnership, and in its organization it is constructed along the same general lines as the ordniary partnership. It is therefore not surprising that for purposes of loose translation the expression *sociedad anonima* has not infrequently been translated into English by the word partnership. On the other hand, the affinity of this entity to the American corporation has not escaped notice, and the expression *sociedad anonima* is now generally translated by the word corporation. But when the word corporation is used in the sense of *sociedad anonima* and close discrimination is necessary, it should be associated with the Spanish expression *sociedad anonima* either in a parenthesis or connected by the word or' ".

15 *Supra*, note 4 at 147. "As it was the intention of our lawmakers to stimulate the introduction of the American corporation into Philippine law in the place of the sociedad anonima, it was necessary to make certain adjustments resulting from the continued co-existence, for a time, of the two forms of commercial entities. Accordingly, in section 75 of the Corporation Law, a provision is found making the sociedad anonima subject to the provisions of the Corporation Law, 'so far as such provisions may be applicable', and giving to the sociedades anonimas' previously created in the Islands the option to continue business as such or to reform and organized under the provisions of the Corporation Law. Again, in section 191 of the Corporation Law, the Code of Commerce is repealed in so far as it relates to sociedades anonimas. The purpose of the commission in repealing this part of the Code of Commerce was to compel commercial entities thereafter organized to incorporate under the Corporation Law, unless they should prefer to adopt some form or other of the partnership. To this provision was added another to the effect that existing sociedades anonimas, which elected to continue their business as such, instead of reforming and reorganizing under the Corporation Law, should continue to be governed by the laws that were in force prior to the passage of this Act 'in relation to their organization and method of transacting business and to the rights of members thereof as between themselves, but their relations to the public and public officials shall be governed by the provisions of this Act.' ".

16 Act No. 1459 (1906), sec. 191, *supra*, note 4.

without undergoing basic organizational changes from a "sociedad anonima" to a corporation under Act No. 1459.[17]

For a period of about fifty years, from the enactment of the Corporation Law of 1906, both "sociedad anonima" and corporation, co-existed in the Philippine legal system. It is no wonder therefore, that the development of the principles and jurisprudence regarding internal management and fiduciary relations of directors, stockholders and the corporation should have something of both the civil law and common law. A preview of the interplay between the two legal systems is expressed in the language of the Philippine Supreme Court in the case of *Strong v. Repide*, 1906 decision, stating thus:

> "These American cases are instructive as showing light on the controversy over the duty of corporate managers to members, but the litigation before us must be controlled by the principles of our civil jurisprudence. While up to the recent date we have no private corporation so termed in our statutes, we have their likeness in anonymous societies or partnerships. The essential concept of a corporation is a legal entity endowed with succession of membership and a merging in itself the primary individual liability and right of the associates. Individual liabilities by ownership is completely extinguished; the membership is determined by ownership of stock and the managers are chosen by stockholders. x x x"

Subsequent developments in American law particularly in the field of securities transactions show the pervading influence of the case above-cited through the doctrine of "special circumstances" in stock trading. The basic principles on fraud and fiduciary duty embodied in both the common law and the civil law, may be said to merge in the case of *Strong v. Repide*.[18] Its pervading influence in the United States and the Philippines, particularly in the field of securities regulations and the duty of disclosure is therefore reasonable and explainable. The doctrine stated therein assumed statutory form in the United States in the Federal Securities Act of 1933 and the Federal Securities Exchange Act of 1934. In 1936, the Philippine National Assembly passed Commonwealth Act No. 83, known as the "Securities Act" patterned after the two American securities laws, likewise creating an administrative body called the Securities and Exchange Commission (SEC), to take charge of the registration of corporations, with powers to issue rules and regulations relating to stocks and securities transactions.[19] All these laws were aimed primarily to prevent exploitation

[17] *Ibid.*, at sec. 75. Benguet Consolidated Mining Co. v. Pineda, 98 Phil. 711 (1956). "A *sociedad anonima*, existing before the Corporation Law, that continues to do business as such for a reasonable time after its enactment, is deemed to have made its election. . . . under Section 75 of Act No. 1459. . . ."

[18] 6 Phil. 680 (1906), rev'd in 213 U.S. 419, 53 L. Ed. 853, 29 S. Ct. 521, 41 Phil. 947 (1909).

[19] Com. Act No. 83 (1936), sec. 2(q)—"The Commission hereby established shall have power, by rules and regulations, to define any technical, trade or accounting term used in this Act in so far as such definitions are not inconsistent with the provisions hereof."; Ch. II, secs. 3(a)-(c) and 31(a)-(e).

of the investors by the sale of unsound, fraudulent and worthless securities through misrepresentation and to place adequate information before the investor as well as to curb corporate "insiders" abuse of inside information.

The legal developments portrayed above and which will be discussed in this essay may illustrate that certain concept, that whether one system is made to prevail over the other, the basic principles of fairness, justice and equity so well enunciated in matters relating to trusts and fiduciary relations are basically the same, for the sense of natural justice and reason is borne and well etched in the conscience of man of all ages and in all places.

The Nature of the Corporate Directors' Office

The corporate form is essentially a sum of peculiar relations subsisting between members of the corporate group. It is a creature of the state, or otherwise approved with legal effect after spontaneous origin and maintenance by force of custom or contract.[20] The collective and contractual character of "sociedades" in Spanish law, together with the concept of a corporation as a creature of the state under American law, is what makes up the present day Philippine corporation.[21] Thus, a Philippine corporation can be formed only by not less than five nor more than fifteen persons. Such organization has corporated existence only by operation of law.[22]

[20] DAVIS, CORPORATIONS; A Study of the Origin and Development of Great Business Combination and Of the Relation to the Authority of the State, 5-35 (1905).

[21] Alyea, *Subsidiary Corporations Under the Civil and Common Law*, 66 HARV. L. REV. 1227 (1953. "The historical basis of the corporation is the Roman Law concepts that a corporation is and must continue to be a contract among several individuals. Thus it has been noted that Latin American corporation laws, that were derived for the most part directly or indirectly from the Spanish Law followed this contractual concept of the corporation."

In the Philippines, Act No. 1459 (1906), sec. 6 provides: "Five or more persons, not exceeding fifteen, a majority of whom are residents of the Prilippine Islands, may form a private corporation for any lawful purpose or purposes by filing with the Securities and Exchange Commission articles of incorporation duly executed and acknowledged before a notary public...."

Mead v. McCollough, 21 Phil. 96 (1911) reiterates the consensual character of corporation in the Philippnies: "This partnership or stock company (*sociedad anonima*) upon the execution of the public instrument in which its articles of agreement appear, and the contribution of funds and personal property, became a juridical—person..... The inscribing of its articles of agreement in the commercial register was not necessary to make it a juridical person—a corporation." (Note: this conforms to the Spanish concept).

1 DIES, LEYES MERCANTILES Y ECONOMICAS (Madrid, 1956) CODIGO DE COMMERCIO, 586. "The formation of the society is essentially consensual without executing the agreement in a public instrument ... all these (consent and intention) give life to another juridical person born by agreement, clear and indubitable."

The present day Philippine corporation is both contractual, as shown by Section 6 and a creature of the state as shown by Section 2. It exists by operation of law. Section 11 of the Corporation states: "The Securities and Exchange Commission on the filing of articles of incorporation provided by this Act to be filed, shall issue to the incorporators a certificate, under the seal of his office, setting forth that such articles of incorporation have been duly filed in his office in accordance with law; and thereupon the persons signing the articles of incorporation and their associates and successors shall constitute a body politic and corporate, under the name stated in the certificate....".

[22] The concept of the corporation as both a contract, consensual in nature is found in Section 6 of Act No. 1459 and as a creature of the state, is in Section

The corporation being an artificial person, can act only through human beings, now commonly known as Board of Directors, selected by members composing it. As such, these directors assume duties arising by virtue of their office, in relation to the corporation they represent, and the stockholders and/or members forming it. In determining what duties are imposed on directors and to whom these obligations are owed, the normal approach has been to compare their position to some legally accepted concept. Under the English common law, they have been referred to as "trustees". According to Gower, this is for historical reasons.[23]

> "Prior to 1844, most joint-stock companies were unincorporated and depended for their validity on a deed of settlement vesting the property of the company in trustees. Often the directors were themselves the trustees and even when a distinction was drawn between the passive trustees and the managing board of directors, the latter would quite clearly be regarded as trustees in the eyes of a court of equity in so far as they dealth with the trust property. xxx For one thing, the duties of the directors should obviously be the same whether the company was incorporated or not; for another, courts of equity always tend to apply the label "trustee" to anyone in a fiduciary position."

Historical reasons also explain the treatment of directors position under Philippine law. They have been considered as "agents" "mandatories" or "factors"—all of which terms connote the relation of agency. This arises from the fact that the civil law "sociedad" had legal personality. As such these had capacity to act and transmit powers to representatives, who manage and administer its affairs. On this premise, the company was the principal, while the directors was the agent. These "mandatories" were not mere employees for they performed important functions that require exercise of a trust not performed by ordinary workers.[24] Gower conforms to this idea when he says:

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2 of the same law, which states:

"Sec. 2. A Corporation is an artificial being created by operation of law, having the right of succession and powers, attributes, and properties expressly authorized by law or incident to its existence."

See also 4 OPS. ATTY. GEN. 661 (1908).

23 GOWER, MODERN COMPANY LAW 471.

24 DIEZ, *supra*, note 21 citing Sentencia de 4 de Junio de 1926: "Por asumir las companias anonimas una personalidad juridica propia inajena en absoluto a da de los associados, su representacion en juicio corresponde exclusivamente a los administradores mandatarios nombrados en sus estatutos conforme determinen los articulos 155-156 del Codigo de Commercio, ratificados por numero 2 del Articulo 35 del Codigo Civil (p. 598)" also citing Sentencia de 28 de Febrero de 1916: "Porque esos cargos son las de un empleado temico y a quien en al caso actual por la importancia de sus funciones se exigia la presentacion de una fianza lo que no hubiera podido hacerse de se tratase de un simple obreero."

In Reyes v. Compania Maritima, 3 Phil. 519 (1904), the Philippine Supreme Court declared that directors of *sociedades anonimas* stand in the same footing as commercial agents and act by virtue of a commercial agency. Citing Eixala, it stated: "The administrator of anonimous societies should be considered as factors as confirmed by the Supreme Court of Spain in Judgment of April 2, 1862, in which the Court declared that "managing directors of a manufacturing establishment can in law be regarded in no other light than as factors."

"In truth, directors are agents of the company rather than trustees of its property, but as agents they stand in a fiduciary relationship to the principal, the company." [25]

American cases also express the opinion that the liability of directors to the corporation for misconduct rests upon the common law rule which renders liable, every agent who violates his authority to the damage of the principal. But numerous views to the contrary have been expressed, asserting that the status of directors of corporations is a distinct legal relationship and reference to the concepts of trust and agency should be done only by analogy.[26]

The problem of characterization of a director's position is exemplified in *Mead v. McCollough,*[27] wherein the Philippine Supreme Court described a director as an officer or agent of the corporation who represents the interest of that abstract legal entity and owners of shares of stock. However, he is not such agent, inhibited from purchasing corporate property in Article 1459 of the Spanish Civil Code[28] because he is not only an agent but one with joint interest in the corporate property as well. This joint interest is true for all directors of corporations. Every director is required to own in his own name at least one share of the capital stock of the corporation.[29] On the whole however, directors have been considered as agents and/or trustees held responsible for corporate acts, contracts and funtions. Thus the case of *Mendezona v. Philippine Sugar Estates Development Company,*[30] stated that the corporation may be bound by the acts of

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[25] *Supra,* note 23.

[26] Uhlman, *The Legal Status of Corporate Directors,* 19 B.U.L. REV. 12 (1939); Note, *Liability of Directors for Negligent Mismanagement* 82 U. PA. L. REV. 364 (1934); Lynch, *Diligence of Directors in the Management of Corporations,* 3 CALIF. L. REV. 21 (1914); 3 FLETCHER, CYCLOPEDIA OF THE LAW OF CORPORATIONS, sec. 338 (1947), Hun v. Cary, 82 N.Y. 65, 37 Am. Rep. 546 (1880); Briggs v. Spaulding, 1941 U.S. 132, 11 S. Ct. 924, 35 L. Ed. 662 (1891).

[27] Mead v. McCollough, *supra,* note 21.

[28] Art. 1459 (OLD CIVIL CODE): (NEW CIVIL CODE, art. 1491). The following persons cannot acquire by purchase even at a public or judicial auction, whether in person or through the mediation of another:

(1) xxx

(2) Agents, the property whose administration or sale may have been entrusted to them, unless the consent of the principal has been given.

[29] Act No. 1459, sec. 30—"Every director must own in his own right at least one share of the of the capital stock of the stock corporation of which he is a director, which stock shall stand in his name on the books of the corporation. Any director who ceases to be the owner of at least one share of the capital stock of a stock corporation of which he is a director shall thereby cease to be a director. . . ."

Detective & Protective Bureau, Inc. v. Cloribel, G.R. No. 23428, November 29, 1968, 26 SCRA 255 (1968) applying the foregoing provision thus:

"There is in the record no showing that Jose de la Rosa owned a share of stock in the corporation. If he did not own any share of stock certainly he could not be a director pursuant to the mandatory provision of Section 30 of the corporation law, ..."

[30] 41 Phil. 475 (1921) citing 2 THOMPSON ON CORPORATIONS, pars. 1073 & 1408: "The general rule is that officers of corporations acting within the scope of their authority may bind the corporation in the same way and to the same extent as if they were agents of natural persons, unless the charter or by-laws otherwise provide. They cannot, in general bind the corporation by acts in excess of the authority with which they are clothed unless such acts are ratified. . . . ."

the directors acting within the scope of their authority, in the same way that "agents" of natural persons can bind their principal. And in the case of *Steinberg v. Velasco* [31] directors of corporations were held liable and accountable for corporate assets in the same way as other "trustees". In *Strong v. Repide,* 1906 decision of the Philippine Supreme Court, the accountability of directors as "mandataries" of the corporation was confined to corporate property with which they are charged, but not for the shares of the individual stockholders.[32]

The legal provisions of the Corporation Law, can provide the key to the problem of characterization of a director's position. By legal mandate,[33] whatever powers, attributes and properties a corporation may exercise and possess is derived from the sovereign state, which gave it corporate existence. The actual exercise of these powers are vested in a board of directors, which by law is part of the corporate machinery.[34] Thus, the powers of the board exercised for and in behalf of the corporation is a direct delegation from the state, not from the corporation. In this sense therefore, the board is not an agent of the corporation but of the state. The fiduciary responsibility of the board arises in favor of the corporation by reason of the fact, that it performs such powers and functions for the benefit of the corporate entity and as such they are responsible for any profit and losses that may accrue to it. The statement of the New York case of *Hoyt v. Thompson Executor*[35] finds some relevance to the legal framework above-described:

> "The board of directors of a corporation do not stand in the same relation to the corporate body which a private agent holds toward his principal. In the strict relation of principal and agent, all the authority of the latter is derived by delegation from the former and if the power of substitution is not conferred in the appointment, it cannot exist at all. But in corporate bodies, the power of the board of directors are in a very important sense, original and undelegated. The stockholders do not confer, nor do they revoke those powers. They are derivative only in the sense of

[31] 52 Phil. 953 (1929) citing 7 RULING CASE LAW 473, sec. 454. *"General duty to Exercise Reasonable Care*—The directors of a corporation are bound to care for its property and manage its affairs in good faith and for a violation of their duties resulting in waste of its assets and injury to its property, they are liable to account the same as any other trustee......"

[32] Strong v. Repide, *supra,* note 18. This ruling was later reversed by the United States Supreme Court, on the grounds of "special circumstances" amounting to fraud, as to establish director liability in favor of stock holders with respect to dealing with the latter's shares of stocks.

[33] Act No. 1459 (1906), sec. 2: "A corporation is an artificial being, created by operation of law, having the right of succession and the powers, attributes and properties authorized by law or incident to its existence.

[34] *Ibid.,* at sec. 28: "Unless otherwise provided in this Act, the corporate powers of all corporations formed under this Act shall be exercised all business conducted and all property of such corporations controlled and held by a board of not less than five nor more than eleven directors to be elected from among the holders of stocks, or where there is no stock from the members of the corporation."

[35] Hoyt v. Thompson, 19 N.Y. 207 (1859).

being received from the state in the act of incorporation. The directors convened as a board are the primary possession of all the powers which the charter confers and like private principals, the performance of any act which they themselves can perform."

It must be noted however, that corporate powers and functions are defined both in the law and in articles of incorporation filed with the Philippines Securities and Exchange Commission. This articles of incorporation form part of the corporate charter. It actually embodies the agreement of the incorporators and/or stockholders, who by law are empowered to amend it.[36] This same view is expressed in an Opinion of the Attorney General of the Philippines in 1906, thus:[37]

"In the Philippine Islands, both the Code of Commerce and the Corporation Act are laws of this (general laws permitting the organization of corporations) character. Whether a corporation is organized by special charter or by general law, the 'charter' is the source from which the institution derives the power to exercise its peculiar functions. xxx I am led to the conclusion that the 'charter' for a sociedad anonima organized under the Code of Commerce or a corporation formed under the Corporation Law is in reality made up of the provisions of the general law governing the organization of such companies and the articles of incorporation filed in pursuance of such law together with all general restrictions imposed by law on organizations of this character."

In this sense therefore, the powers of the board are derived both from the state and constituents of the corporation whose will is expressed in the articles of incorporation.[38] Thus, fiduciary relations extend both in favor of the corporation and the members thereof. In the ultimate analysis, one thing is certain—that directors are fiduciaries, *sui generis,* whether they be described as agents, trustees, or mandataries. As such they have fiduciary duties and liabilities.

The Corporate Directors and the Corporation

The director's fiduciary position in the legal scheme of corporations is well established. But what does it mean to be a fiduciary? What are the standards for proper compliance of these duties? What are the risks incurred by acceptance of the director's office? What is the legal status of transactions between a director and the corporation in which he holds such office? All these inquiries lead us into the general areas of fiduciary

[36] Act No. 1495, sec. 18: "Any corporation may for legitimate corporate purpose or purposes amend its articles of incorporation by a majority of its board of directors or trustees and the vote or written assent of the stockholders representing at least two thirds of the subscribed capital stock of the corporation. . . ."

[37] 3 OPS. ATT'Y GEN. 312, 313 (1906); 5 OPS. ATT'Y GEN. 468 (1910); 6 OPS. ATT'Y GEN. 154 (1911).

[38] Act No. 1459, sec. 7: "Articles of Incorporation of stock corporations unless otherwise provided, shall be sufficient if they comply substantially with the following form:

obligations, namely: (a) the director's fiduciary obligation of loyalty and good faith, and (b) the duties of business care and skill. These duties are imposed on the board of directors as a body, by reason of its functions, and on the individual directors by reason of their membership in said corporate body.[39]

That directors have an affirmative duty to manage the affairs of the corporation is conceded by express provision of law. But the standard with which to measure performance, and to which directors must adhere is still uncertain or at least defies proper verbal expression.[40] It is in this context that we proceed to examine these fiduciary relationships, with its four facets, namely: good faith, proper purpose, unfettered discretion and the more delicate issue of conflict of interest [41]—which are all summed up in the directors duties of diligence, good faith and loyalty.

The board of directors under Philippine law is charged with the conduct of all business and control of all property of the corporation, performing its functions properly as a body.[42] With the exception of certain corporate acts involving changes of a fundamental character, which needs the concurrence of the stockholders,[43] corporate powers as well as the business of the corporation has to be exercised by a board of directors acting as a collective body, according to proper procedures. The case of *Baretto v. La Previsora Filipina* [44] made definite pronouncements in this regard:

"... That we, a majority of whom are residents of the Philippines have this day voluntarily associated ourselves together for the purpose of forming a corporation under the laws of the Philippines ...."

Section 11 - "The Securities and Exchange Commissioner, on the filling of articles of incorporation provided by this Act to filed, shall issue to the incorporators a certificate under seal of his office, setting forth that such articles of incorporation have been duly filed in his office in accordance with law, and thereupon the persons signing the articles of incorporation and their associates and successors shall constitute a body politic and corporate under the name stated in the certificate on terms specified in the articles of incorporation, not exceeding 50 years unless sooner legally dissolved or unless otherwise provided in this Act." (As amended by Act No. 2728 (1918) and Com. Act No. 287 (1938).

[39] PALMER, DIRECTORS' POWERS AND DUTIES, 368-369 (1967).

[40] *Duties and Liabilities of Corporate Directors*, 22 BUS. LAW. 29, 31 (1966).

[41] *Supra*, note 23 at 474.

[42] Act No. 1459 (1906), sec. 28.

[43] *Ibid.*, sec. 17 - "(2/3 of the entire corporate capital stock subscribed must vote for the increase or deminishing of capital stock, or to incur, create or increase any bonded indebtedness.)

Sec. 12½-"2/3 of the voting power must approve the investment for corporate funds in any other corporation or business, or for any purpose other than the main purpose for which the corporators was organized.)

Sec. 25; "(for the election of directors and filling of vacancies.)

Sec. 28½ - "(2/3 of the voting power must authorize the sale, lease, exchange or disposal of all or substantially all of the property and assets, and goodwill of the corporation.)

Sec. 34 - (2/3 of the voting power may remove directors from office.)

Sec. 62 - "(2/3 of the entire capital stock outstanding must vote for the voluntary dissolution of a corporation.)"

[44] 57 Phil. 649, 655 (1932), citing 5 FLETCHER, *supra*, note 26, sec. 2097, (1967 ed.); 59 Phil. 212 (1933) citing FLETCHER, *supra*, note 26, sec. 2762 (1st ed.)

> "The law is settled that contracts between a corporation and third persons must be made by or under the authority of its board of directors and not by its stockholders, hence the action in such matters is only advisory and not in any wise binding on the corporation."

Neither can individual directors bind the corporation without the corresponding resolution or authority from the board.[45] There are cases however, where this duty to act as a board collectively was qualified. Thus, a corporation was constractually bound by certain conduct of its board of directors. The board of directors, like an individual can create liability by means other than by formal expression of its will, such as by customary conduct and usage,[46] ratification of unauthorized acts,[47] or where authority is assumed because the director or individual acting for the corporation practically runs the whole business of the corporation.[48] The seeming liberality of Philippine courts in imposing liability on corporations even for irregular conduct of board of directors may be motivated by the desire to afford greater protection to innocent third parties, who are most often in no position to be informed of the intricacies of corporate management and policies. This is on the whole, reasonable, considering that corporate outsiders more often have to rely on external appearances. It is in this context that directors must care for the corporate property and manage its affairs in the light of fiduciary duties towards the corporation and its stockholders, namely—the duty to exercise due care, good faith and loyalty.

The examination of standards of directors' conduct in the Philippines presents certain difficulties. For one thing, there are very few cases precisely on the point. Many of the cases begin and end up with the issue of whether or not plaintiff, most often a minority stockholder, had the right to bring the suit, and whether or not the complaint states a sufficient cause of action to justify a derivative suit. Besides, there are so many obs-

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[45] Theaters Supply Corp. v. Malolos, CA-GR No. 2830-R, February 28, 1950, 48 O.G. 1803 (May, 1952); Prudential Bank and Trust Co. v. Lanuza Bay Lumber Co., Inc., CA-GR No. 23988-R May 25, 1964, 5 C.A. Rep. 2d 931 (1964).

[46] Ramirez v. Orientalist Co., 38 Phil. 634 (1918); Araneta v. Herrero, CA-GR No. 26922-R February 26, 1963, 3 C.A. Rep. 2d 510 (1963).

[47] Board of Liquidators v. Kalaw, G.R. No. 18805, August 14, 1967, 20 SCRA 987 (1967); Pirovano v. De la Rama Steamship Co., G.R. No. 5377, December 29, 1954, 51 O.G. 755, (Feb., 1955), 96 Phil. 335 (1955); Francisco v. G.S.I.S., G.R. No. 18287, March 30, 1963, 7 SCRA 577 (1963); Central Cooperative Exchange, Inc. v. Tibe, Sr., G.R. No. 27972, June 30, 1970, 33 SCRA 593 (1970) (*contra*) That there was no laches or ratification on the part of the stockholder who did not take action for two years from the occurence of the unauthorized act complained of. He has the right to expect the directors to take remedial action within that period.

CIVIL CODE, art. 1393 - "Ratification may be effected expressly or tacitly. It is understood that there is a tacit ratification it, with knowledge of the reason which renders the contract voidable and such reason having ceased, the person who has a right to invoke it would execute an act which necessarily implies an intention to waive his right."

[48] Zamboanga Transportation Co. v. Bachrach Motor Co., 52 Phil. 244 (1928); Albert v. University Publishing Co., Inc., G.R. No. 19118, January 30, 1965, 13 SCRA 84 (1965).

tacles with minority or complaining stockholders have to hurdle, before relief from management, breach of trust and negligence of directors can be obtained from the courts.[49] This requirement is almost insurmountable particularly considering that characteristic Oriental disposition of a Philippine stockholder. An ordinary investor would usually hesitate to conduct an "embarassing campaign" to the finish. Absence of specific provisions for indemnification of costs and expenses may deter a dissatisfied stockholder, who will likely have to bear the burden of a protracted and expensive lawsuit.[50] Suits against erring directors often happen when there is change of ownership in the company, which is not too often, or on its dissolution. In the latter instance, the corporation will hardly have enough funds to finance a litigation. Besides, suits of this nature tend to be speculative, considering the tendency of courts to liberally construe the "business judgement rule" and the rule of "ratifications", to uphold the conduct of the board of directors. With these considerations in mind, we venture to explore the Philippine rules on corporate directors' duties and responsibilities to the corporation, the stockholders and third parties.

A. The Director's Duty of Due Care

The precise degree of care which directors must exercise is indefinite. Ultimately, the search for a standard leads to the law of torts, the application of which depends much upon the subjective evaluation of facts of the relevant circumstances in a specific situation.[51] A cursory view of the standards of care adopted in several jurisdictions show much similarity, but it is in the appreciation of the facts and circumstances wherein differences may occur.

1) Directors' liability for personal acts

"Ordinary" or "reasonable" is the measure of care which is required of directors in most jurisdictions. American cases and state statutes define this as the care that an ordinary prudent man gives to his own affairs, or that standard of ordinary skill and judgment, or such degree of care

[49] Salonga, *Stockholders Derivative Suit Under Philippine Law.* (Paper, Harvard Law School, 1948). Everett v. Asia Banking Corporation, 49 Phil. 512 (1926); Angeles v. Santos, 64 Phil. 697 (1937); Reyes v. Tan, G.R. No. 16982, 3 SCRA 198 (1961); Republic Bank v. Cuaderno, G.R. No. 22399, March 30, 1967, 19 SCRA 671 (1967); Pascual v. Del Saz Orozco, 19 Phil. 82 (1911); Central Cooperative Exchange, Inc. v. Tibe, Sr., *supra*, note 47. Note: To be able to bring a derivative suit, a stockholder must allege and establish that there is a corporate injury giving rise to a claim that has matured in favor of the corporation; that the corporation should have sought to redress but does not; and that he has unsuccessfully exerted all efforts to make the corporate representatives, whether director, trustee in dissolution, receiver or trustee in bankruptcy to take the necessary action. Or that, even if he did make application, that would have been useless because the majority of the board were wrongdoers or in collusion with the wrongdoers. Finally, he must also show that there is no other intra corporate remedy. (See Salonga).

[50] *Ibid.*

[51] Feuer, *Liabilities of Directors and Officers,* 5 N.Y.L.F. 133 (1959); Dyson, *The Directors' Liability for Negligence,* 40 IND. L.J. 341 (1964).

and diligence which an ordinary prudent director could reasonably be expected to exercise in like position under similar circumstances. Liability arises only when there is "gross negligence" or that "conduct or neglect has amounted to a betrayal of the trust".[52] The case of *Litwin v. Allen* [53] declares thus:

> "In the discharge of his duties, a director must of course act honestly and in good faith, but that is not enough. He must also exercise some degree of skill and prudence and diligence."

Application of these stated standards is difficult and may vary according to the circumstances. In this regard, leniency is said to characterize the English rule. English law does not apply the trustee analogy to the same degree, because the type of skill required of a cautious trustee is quite different from that which an enterprising director needs to display. This is in contrast to the heavy duties of loyalty and good faith.[54] Thus, it has been stated:[55]

> "There are . . . one or two general propositions that seem to be warranted by the reported cases: (1) A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. . . It is perhaps only another way of stating that same proposition to say that directors are not liable for more errors of judgment. (2) A director is not bound to give continuous attention to the affairs of the company. His duties are of an intermittent nature to be performed at periodic board meetings and at meetings of any committee of the board upon which he happens to be placed. He is not however bound to attend such meeting, though he ought to do so. (3) In respect of all duties that, having regard to the exigencies of business and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly."

Some civil law jurisdictions adopt substantially the same standard of "reasonable care". The Spanish law relating to "sociedades anonimas" gives statutory requirements. It refers to that degree of diligence required of an "ordinary merchant and a loyal representative". Liability arises only in cases of malice, abuse of authority and gross negligence.[56] This norm of

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[52] *Ibid.*, Nielsen, *Directors Duties Under Anglo-American Corporate* Law, 43 U. DET. L.J. 609 (1965-66); Hun v. Cary, *supra*, note 26; Kavanaugh v. Commonwealth Trust Co., 223 N.Y. 103, 119 N.E. 237 (1918); Briggs v. Spaulding, *supra*, note 26.

[53] Litwin v. Allen, 25 N.Y.S. 2d 667 (1940).

[54] *Supra*, note 23 at 497. Nielsen, *supra*, note 52.

[55] *Ibid.*, citing *In re City* Equitable Fire Insurance Co. (1925).

[56] 1 GARRIGUEZ, COMENTARIO A LA LEY DE SOCIEDADES ANONIMAS, 122-138 (Madrid, 1953).

"Art. 79 - La responsibilidad de los administradores - Los administradores desempenaran su cargo con diligencia de un ordenado comerciante y de un representante leal y reponderan frente a la sociedad, frente a los accoinistas y frente a los acreedores del dano causado por malicia, abuso de facultades o negligencia grave. En cualquier caso estaran exentos de responsibilidad los administradores que hayan slavado su voto en los acuerdos que hubiera causado dano.

conduct is said to be flexible because the operations of business has always been aleatory and prevents the application of rigid rules. Liability arises only upon proof of damage and the nexus between the damage and the act of the directors. The french law uses "diligence of a good father of the family" as a norm of conduct required of corporate directors.[57] The New Civil Code of the Philippines refers to this "good father of the family diligence" in regulating torts and quasi-delicts,[58] as well as the obligations of agents.[59] The absence of specific provisions on the standard of due care and diligence in the Corporation Law of the Philippines, necessitates resort to standards set in the Civil Code for general application, to supplement such deficiency.[60] This is justified under Article 18 of said Code:

> "Art. 18: In matters which are governed by the Code of Commerce and special laws, their deficiency shall be supplied by the provisions of this Code." (16a)

The basic rule which embodies the Philippine law on quasi-delicts is found in Article 1173 of the New Civil Code, which is derived from the Spanish Civil Code. It lays down the standard thus:

> "Art: 1173: The fault or negligence of the obligor consists in the omission of that diligence which is required by the nature of the obligation and corresponds with the circumstances of the persons, of the time and of the place. When the negligence shows bad faith, the provisions of Articles 1171 and 2201 par. 2 shall apply.
>
> If the law or contract does not state the diligence which is to be observed in the performance, that which is expected of a good father of the family shall be required." (Art. 1104, Spanish Civil Code)

The same standard is expressed in Article 1887 of the New Civil Code with respect to obligations of agents, which could be applied to corporate directors, who are likewise regarded as agents in various instances. Thus, it is stated:

> "Art. 1887: In the execution of the agency, the agent shall act in accordance with the instruction of the principal.
>
> In default thereof, he shall do all that a good father of a family would do, as required by the nature of the business."

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[57] *Ibid.*, known as "diligencia del buen padre de familia."

[58] CIVIL CODE, art. 1173 - "The fault or negligence of the obligor consists in the omission of that diligence which is required by the nature of the obligation and corresponds with the circumstances of the persons, of the time and of the place. When negligence shows bad faith, the provisions of articles 1171 and 2201, par. 2 shall apply.

If the law or contract does not state the diligence which is to be observed in the performance, that which is expected for a good father of the family shall be required."

[59] *Ibid.*, art 1887: "In the execution of the agency, the agent shall act in accordance with the instructions of the principal."

In default thereof, he shall do all that a good father of a family would do; as required by the nature of the business."

[60] *Ibid.*, art. 18: "In matters which are governed by the Code of Commerce and special laws, their deficiency shall be supplied by the provisions of this Code."

As applied in negligence cases, these provisions set forth a relative standard. Negligence is simply the absence of due care required by the nature of the obligation. It is in each case practically a question of fact whether the proper degree of care has been exercised, taking into consideration what a reasonable and prudent man would have done under the circumstances. The law adopts the standard supposed to be applied by the imaginary conduct of the discreet "pater familia" of the Roman Law.[61] It is relative or comparative, not an absolute term and its application depends upon the situation of the parties and the degree of care and vigilance which the circumstances reasonably require. Where the danger is great, a high degree of care is necessary and the failure to observe it is a want of ordinary care under the circumstances.[62] The diligence and care of a good father of a family in civil law concept is the counterpart of the "reasonable man" in American law. It denotes a person exercising those qualities of attention, knowledge, intelligence and judgment which society requires of its members for the protection of their own interest and the interest of others.[63] It takes into account the fallibility of human beings. Viewed in this light, it thereby appears that the nature and circumstances of a director's position requires that he must not only care but also use skill and sound judgment in pursuing the business and purposes of the corporation. This is required of the nature of the obligation he has assumed. A specific application of these standards is made in the case of *Steinberg v. Velasco*,[64] stating thus:

> "It has been said that directors are not liable for losses resulting to the corporation from want of knowledge on their part or mistake of judgments, provided they were honest and provided they are fairly within the scope of the powers and discretion confided to the managing body. But the acceptance of office of a director of a corporation implies a competent knowledge of the duties assumed and directors cannot excuse prudence on the ground of their ignorance or inexperience and if they commit an error of judgment by the mere recklessness and want of ordinary prudence or skill, they may be held liable for the consequences. Like a mandatary, to whom he has been likened, a director is bound not only to exercise proper care and diligence but ordinary skill and judgment. As he is bound to exercise ordinary skill and judgment he cannot set up that he did not possess them."

In the context of this ruling, skill and judgment is an indispensable part of the standard of care and diligence required of directors. As such, it is a higher standard of competence. As defined [65] skill connotes a special competence which is not part of the ordinary equipment of the reasonable man but which is a result of aptitude developed by special training and exper-

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[61] Picart v. Smith, 37 Phil. 809 (1918).

[62] U.S. v. Juanillo, 23 Phil. 212 (1912); U.S. v. Barias, 23 Phil. 434 (1912); U.S. v. Catangay, 28 Phil. 490 (1914); U.S. v. Reodique, 32 Phil. 458 (1915).

[63] RESTATEMENT, TORTS, sec. 283 (f); 36 WORDS AND PHRASE 556.

[64] *Supra*, note 31.

[65] *Supra*, note 63 at sec. 299; *supra*, note 63 at 477.

ience. Considering that directors are charged with the management of corporate business responsible for its property and policies, these tasks admittedly need such care and skill and sound judgment in the choice of alternatives which the nature and exigencies of corporate affairs may require. This rule is in consonance with the Civil Code provisions of Article 1173, above-stated, for the measure of diligence of an obligor is determined by the nature of the obligation, corresponding with the circumstances of persons, time and place.

Several American cases express the same idea declared in the *Steinberg* case. In *Hun v. Cary* [66] it was stated that a person who voluntarily takes the position of director and invites confidence, undertakes that he possesses at least ordinary knowledge and skill and that he will use them in the discharge of his duties. But it is not necessary that he should possess technical talent.[67] A fair summary of the decisions under American law regarding the standard of care required of directors would be — that an officer or director is liable for want of reasonable care, giving due consideration to the nature of corporate business, his own peculiar duties and the time, place and circumstances in which he is expected to perform them. Thus, the board of directors of a commercial corporation may take chances, the same kind of chances that a man would take in his own business. And where it exercised reasonable care, skill and judgment in pursuing such venture, the officers or directors cannot be held liable for mere mistake or errors of judgment.[68] The rationale for requiring such kind of competence and care is expressed in the case of *Kavanaugh v. Commonwealth Trust Co.*[69] stating thus:

> "(directors) x x x They should know of and give direction to the general affairs of the institution and its business policy and have a general knowledge of the manner in which the business is conducted, the character of the investment and the employment of resources. No custom or practice can make a directorship a mere position of honor devoid of responsibility or cause a name to become a substitute for care and attention. The personnel of a directorate may give confidence and attract custom; *it must also afford protection.*" (underscoring supplied)

In the last analysis however, whether or not a director has discharged his duty, whether or not he has been negligent depends upon the facts and circumstances of a particular case, the kind of corporation involved, its size and financial resources, the magnitude of the transaction, and the immediacy of the problem presented. A director is called upon to bestow the skill and care which the situation demands.[70]

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[66] *Supra*, note 26.

[67] Barnes v. Andrews, (D.C.N.Y.) 298 F. 614 (1924). For discussion on the subject see Nielsen, *supra*, note 52 at 610-613.

[68] 3 FLETCHER, *supra*, note 26, secs. 1039-1040.

[69] *Supra*, note 52.

[70] *Supra*, note 53.

2). Directors' liability for acts of other officers

The duty of care and diligence extends towards the conduct of other corporate personnel for which directors are held responsible. The basis for liability is the failure to perform properly the duty of careful selection and supervision. In common law, this is known as "vicarious" liability.[71] In Philippine law however, this is not strictly vicarious. Philippine law on torts and damages makes employers liable for employees' conduct on a "joint tortfeasor" basis. The employer is not entirely free from wrongful conduct. He is himself guilty of negligence, known as "culpa eligiendo" and "culpa vigilando".[72]

The board of directors is expected to delegate responsibility to officers and agents. They elect the officers and fix their salaries. These officers run the actual operations of the business but the board is responsible for the policies and guides company affairs in such manner as to achieve corporate objectives. In determining the degree of care in the selection and supervision to be exercised certain factors must be considered, such as, the nature of the business, its size, the extent, method and reasonableness of delegation of executive authority and the existence of zeal and honesty of purpose of the directors in the performance of their functions.[73]

This principle is best illustrated in the Philippine case of *Board of Liquidators v. Kalaw*[74] wherein it was the practice of the general manager of the corporation to enter into contracts even prior to the authorization of the board of directors, which usually ratified such contracts, both profitable and losing ones. The court upheld this practice, in a suit attacking the action of the board in ratifying the losing ventures entered into by the general manager. It was held that a corporate officer, entrusted with the general management and control of its business has implied authority to do acts necessary or appropriate to the conduct of the ordinary business of the corporation. The peculiar nature of copra trading known as "forward sales"[75]

[71] Dyson, *supra*, note 51.

[72] "Fault in selection" and "Fault in supervision"

[73] Graham v. Allis-Chalmers Mgf., Co., 41 Del. Ch. 78, 188 A. 2d 125 (1963), Board of Liquidators v. Kalaw, G.R. No. 18805, August 14, 1967, 20 SCRA 987 (1967).

[74] *Supra*, note 73.

[75] *Ibid.* The peculiar nature of copra trading lies in the fact that ordinary sales of copra is for future delivery. The movement of the market requires that sales agreements be entered into although the goods are not yet in the hands of the seller. This is known in business parlance as "forward sales." This is a conceded practice of the trade. A certain amount of speculation is inherent in the undertaking and the short-selling is inevitable at the time. In the light of other factors such as availability of vessels, the quantity required before being accepted for loading, the labor needed to prepare and sack the copra for market. Forward sales were a necessity for the company (NACOCO, National Coconut Corporation) here involved. Copra could not stay long in its hands, for it would lose eight and its value decreased. Copra conrtacts had to be executed at short notice at times within 24 hours. To be appreciated then is the difficulty of calling a formal meeting of the board. 20 SCRA 1001-2 (1967).

required the grant of wide discretion to the manager to cope up with the fast pace of the copra market. If the business were to be handled successfully, the usage and practice of the company that had evolved was reasonable, considering the difficulty and delay in requiring a formal board meeting for every transaction. The existence of authority was established by proof of the company's course of business, the usage and practices and by the knowledge of the board of directors regarding the transactions. These circumstances justified the manager's conduct. In the case of *Reyes v. Tan,*[76] the directors were charged with negligence, mismanagement, fraud and consent to fraud by allowing the wrong importation of goods which paralyzed the textile company. The directors permitted the fraudulent transactions to go unpunished, and nothing was done to remove the erring manager. The derivative suit was allowed, and a receiver was appointed in order to restore the faith and confidence of the Central Bank and grant the company another dollar allocation for the importation of raw materials. The liability of the directors may be considered both as vicarious and direct. It appears that the management acted directly under orders of the board of directors. Thus, mere change of management to forestall the appointment of the receiver was not acceptable. The case of *Pascual v. Del Saz Orozco* [77] is an illustration of directors' negligence. The Banco-Español-Filipino suffered heavy losses due to the fraudulent connivance between the depositor and employee of the bank. This could have been avoided if the president or directors were more vigilant in the administration of corporate affairs. Thus, minority stockholders were allowed to bring a derivative suit, to enforce the bank's rights against the negligent directors. In contrast to this is the American case of *Briggs v. Spaulding,*[78] where the president of the bank was allowed practically absolute control over its affairs without any supervision of the board of directors. In revealing the directors of liability, the court stated that directors of a corporation are not insurers of the fidelity of agents whom they have appointed. They cannot be held liable for loss caused by wrongful conduct of the agents of the company, unless the loss is a consequence of their own neglect of duty, either by failure to supervise the business with attention or in neglecting to use proper care in the appointment of agent. The distinction in these two cases lies actually in the fact that in the *Orozco* case, the loss was traceable to the negligence of the directors. Thus the case falls under the qualification of the *Briggs* ruling, justifying the imposition of liability. It must likwise be noted that the Philippine Supreme Court seemed to impose a stricter rule of integrity and moral responsibility on directors of building and loan associations, on account of the nature of this enterprise which is founded on strict mutuality

[76] G.R. No. 16982, September 30, 1961, 3 SCRA 198 (1961).
[77] *Supra,* note 49.
[78] 141 U.S. 132 (1890).

and equality of benefits and obligations among its members.[79] Thus imprudence is not excusable on account of ignorance or inexperience.[80] This is true also in the United States as expressed in same cases, where banking transaction was frequently subjected to close scrutiny and tested by a higher standard than that applied to ordinary commercial affairs. Thus, in *Litwin v. Allen,*[81] it was pointed out that for a bank director, honesty alone does not suffice. There must be more than honesty. There must be diligence. And that means care and prudence as well.

The provision of Article 2180 of the New Civil Code of the Philippines may help clarify the concepts that underlie a director's liability for employees' conduct in Philippine law. It provides:

> "The obligations imposed by Art. 2176 is demandable not only for one's own acts or omissions but also for those persons for whom he is responsible. x x x
>
> The owner and manager of an establishment or enterprise are likewise responsible for damages caused by their employees in the service of the branches in which the latter are employed or in the occasion of their functions. x x x
>
> The responsibility treated of in this article shall cease when the persons herein mentioned prove that they observe all the diligence of a good father of a family to prevent damage."

Two things are apparent in this article: that when an injury is caused by the negligence of a servant or employee, there instantly arises a presumption of law that there was negligence on the part of the master or employer, or in the supervision after the selection or both. That presumption is "juris tantum" and not "juris et de jure", and consequently, may be rebutted. If the employer shows to the satisfaction of the court that in selection and supervision he has exercised the care and diligence of a good father of a family, the presumption is overcome, and he is relieved from liability. This theory bases the responsibility of the master ultimately on his own negligence and not on that of the servant.[82] Applying this principle to directors of corporations, it therefore follows that where they are charged for negligence in the selection and supervision of other corporate officers and employees for whom they are responsible, there lies the presumption against them, and the burden of proof lies on the directors to show the diligence of a good father of the family to prevent the damage.

Basically, the liability of directors for negligence in the selection and supervision of corporate officers and employees under both Philippine and American law, is premised on the lack of due care in supervision. The dis-

[79] *Supra,* note 44 at 212; Legarda v. La Provisoria Filipina, G.R. No. 44451, December 16, 1938. 37 O.G. 816 (April 1939); Pascual v. del Saz Orozco, *supra,* note 49.

[80] Steinberg v. Velasco, *supra,* note 31.

[81] *Supra,* note 53.

[82] Cangco v. Manila Railroad Co., 38 Phil. 768 774 (1913).

tinction may lie in who bears the burden of proof to establish negligence or diligence to hold liable or exonerate the corporate director. It seems that under American law, the position of director, in and of itself, does not impose the liability for negligence and mismanagement of other executive officers. A complainant must establish either that the director participated in the act or suffered it to be permitted, knowing of such misconduct, or that knowledge is imputable to him, by reason of the failure to exercise ordinary prudence in ascertaining the facts.[83] On the other hand, by reason of the provision of Article 2180 of the Civil Code, above-cited, the presumption of negligence already lies against the director so charged. And the burden of proof lies on him to prove his defense of diligence of a good father of a family in the selection and supervision of persons for whom he is responsible.

3). The directors' liability for corporate crimes

The directors' duty of care and diligence, gives rise to liability for torts or quasi-delicts as well as crimes or delicts. The former makes him answerable for civil damages, the latter, for criminal fines and penalties.

Under Philippine Law, corporations are exempt from criminal liability arising from violations of the Revised Penal Code. The incapacity of corporations to commit crimes arises from the peculiar legal status and personal responsibility which still pervades large sections of the criminal law.[84] This principle is explained by the Philippine Supreme Court in the case of *West Coast Life Insurance Co. v. Hurd* in 1914:

> "The courts of the Philippine Islands, are creatures of statute and have only, as we have said, those powers conferred upon them by statute and those which are required to exercise that authority fully and adequately. The courts here have no common law jurisdiction or powers. If they have any powers not conferred by statute expressly or impliedly, they would naturally come from Spanish and not from common law sources. It is undoubted that under the Spanish criminal law and procedure, a corporation could not have been proceeded against criminally as such, if such entity as a corporation in fact existed under the Spanish law, and as such it could not have committed a crime in which a willful purpose or a malicious intent was required. Criminal actions would have been restricted or limited under that system to the officials of such corporation and never would have been directed against the corporation itself. This was the rule with relation to associations or combinations of persons approaching more or less the corporation as it is now understood and it would undoubtedly have been the rule with corporations. From this source then, the courts derive no authority to bring corporations before them in criminal actions, nor to issue processes for that purpose."

[83] 3 FLETCHER, *supra*, note 26, sec. 1087.
[84] 1 FRANCISCO, REV. PEN .CODE 75 (1958).

In this case, the corporation was criminally charged for libel. The absence of rules of procedure for the arrest and imprisonment of a corporation raised serious difficulties, since under the civil law system, as explained above, the courts cannot assume jurisdiction or improvise rules without express statutory grant of power.

The rationale behind the rule against corporate criminal liability under the Revised Penal Code conforms to the ancient theory that a corporation being an intagible entity could neither commit a crime nor be subject to punishment because any illegal act of a corporation agent was done without authority of the corporation, and is therefore "ultra vires" for which it is not answerable.[85] The rule enunciated in the *Hurd* case should however be limited to criminal liability arising from felonies as defined in the penal code, as distinguished from liability arising from special laws. The crimes included in the former invariably require the element of knowledge and criminal intent or "mens rea". Basis of liability therein is moral and personal responsibility. Under special laws however, criminal liability is prescribed by the mere doing of the proscribed act wholly unrelated to knowledge, actual and constructive. This distinction is justified under Article 10 of the Revised Penal Code itself.[86] This differentiation is important because the penal code has its own scheme of defining offenses. Felonies are committed either by "dolo" or "culpa" and are usually called "mala in se". On the other hand, offenses under special laws are "mala prohibita". They not inherently wrong, but made so by statute. The mere fact of commission of the prohibited act consummates the offense, regardless of the intent of the doer. This statutory prohibition is an expression of public policy, and the intention of the person who commits the crime under a special law is entirely immaterial.[87] And in these instances, a corporation could be held liable, and subjected to penalty in the form of fines or dissolution through quo warranto proceedings. This is true under the General Banking Act, the Corporation Law and the Revised Election Code,[88] which provides penalties for violations.

In contrast to the general proposition followed in the Philippines that corporations are not criminally liable, is the prevailing view in the United States, which holds otherwise. Thus corporations under American law may be held criminally for crimes which its agents are capable of committing in its behalf. However, it has been noted that the authorities are not so uniform as to whether a corporation is capable of manifesting a specific criminal intent or of committing crimes involving personal violence.[89] It

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[85] West Coast Life Insurance Co. v. Hurd, 27 Phil. 401 (1914).
[86] 1 AQUINO, REV. PEN. CODE 117 (1961).
[87] *Ibid*, at 48-49.
[88] Rep. Act No. 337 (1948), sec. 87; Act No. 1459 (1906), sec. 190(a); REV. ELECTION CODE, secs. 184-185.
[89] 10 FLETCHER, *supra*, note 26, sec. 4942.

would seem therefore, that the criminal liability of corporations should logically refer only to crimes which do not require a specific criminal knowledge and intent which is personal in nature. If such distinction is acceptable, then in effect, there would be no substantial difference between the rules followed in the Philippines and the United States as regards criminal liability of corporations.

The acceptance of the rule that corporations are exempt from criminal liability under Philippine penal law explains the phraseology of several penal provisions found in the penal code and special laws, when referring to liability of corporations. It is generally provided that where such violation is committed by a corporation, the president and each director and manager who knowingly permitted such breach is liable as principal. This is true under Article 186 of the Revised Penal Code, regarding monopolies and combinations in restraint of trade, the Usury Law, Act No. 2655, the Insurance Law, Act No. 2427, and the labor laws.[90] Imposing criminal responsibility on these officials and directors is justified by the theory that since corporations cannot act except through its officers or agents, the latter can be held liable for violation of a statute by the corporation. A director or other officer is criminally liable for acts though done in his official capacity if he participates in the unlawful acts either directly or as an aide, abettor and accessory.[91]

Although corporations may be exempt criminally under the penal code, these are not totally relieved of any responsibility, arising out of criminal acts of employees or agents in the discharge of their functions. By express provision of the Revised Penal Code, subsidiary liability is imposed upon corporations. But this liability is civil in nature, and arises in default of the persons criminally liable.[92] The fact of conviction is sufficient to establish this subsidiary civil liability against the corporation, for the acts of its employees or agents in the performance of their duties. Under this scheme in the penal code, a certain balance is achieved through the allocation of

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[90] Act No. 2655 (1916); Act No. 2427 (1914), sec. 203; Rep. Act No. 679 (1952), Rep. Act No. 1131 (1954).

[91] 3 FLETCHER, *supra*, note 26, sec. 1220; People v. Cartesiano, G.R. No. 1733-R-317, May 17, 1957, 53 O.G. 5276 (August 1957); People v. Montilla, G.R. No. 14863-R, April 4, 1956, 52 O.G. 4327 (Aug. 1956).

[92] REV. PEN. CODE, art. 102: "Subsidiary Civil Liability of inkeeper, tavern keepers and proprietors of establishments - in default of the persons originally liable, inkeepers, tavernkeepers and any other persons or corporations shall be civilly liable for crimes committed in their establishments, in all cases where a violation of municipal ordinance or some general or special police regulation shall have been committed by them or their employees.

> Article 103: Subsidiary liability of other persons—The subsidiary civil liability established in the next preceding article shall also apply to employers, teachers, persons and corporations engaged in any kind of industry for felonies committed by their servants, pupils, workmen, apprentices or employees in the discharge of their duties."

2 AQUINO, REV. PEN. CODE 721 (1961).

responsibilities between the corporation and the agents thereof, in the field of Philippine criminal law.

4). The business judgment rule

The standards of due care, diligence, skill and judgment which directors must exercise in management of the corporate business becomes almost academic when viewed in relation to the business judgment rule, for courts will refrain from substituting its own judgment for that of the board of directors, in matters of ordinary management of the business.[93] Judges display an understandable reluctance to interfere with directors' business judgment because of the unfairness in attempting to substitute their hindsight for the directors' foresight. Thus they are unwilling to condemn directors even though events have proved them wrong. Besides, they have generally less assurance among the complicated problems of economics and business administration.[94]

The trends of judicial decisions in the Philippines is to remove doubts in favor of validity of corporate acts. There is minimal court interference in corporate and internal affairs. Contracts are valid so long as these are not unconscionable as to amount to wanton destruction of the rights of the minority.[95] There is a presumption in favor of the board of directors that they have conformed to their duties of protecting the corporate interests with due regard for the stockholders and the minority. So long as done in good faith and for a just cause, corporate acts are binding on the minority. This principle is confirmed in Spanish jurisprudence, cited in *Mead v. McCollough*,[96] wherein Eixala states:

> "The resolution of the board passed by the majority vote are valid and authority for passing such resolution is unlimited provided that the original contract is not broken by them, the partnership fund is not devoted to foreign purposes or the partnership transferred and changes made which are against public policy or which infringe upon the rights of third persons."

It would seem that under said rule, the business judgment of the board has validity in the absence of breach of contract, (of association), not "ultra vires" and not unlawful. The business judgment rule in essence is geared toward the protection of directors and managing agents of the corporation who are expected to be enterprising businessmen, and as such will in most instances, have to take certain business risks. It also effectuates greater protection to third parties dealing with the corporation, who have little or

[93] *Supra*, note 52; *Lewis, The Business Judgment Rule and Corporate Directors Liability for Mismanagement*, 22 BAYLOR L. REV. 157-74 (1970).
[94] *Supra*, note 23 at 498.
[95] Ingersoll v. Malabon Sugar Co., 53 Phil. 745 (1927).
[96] *Supra*, note 21.

no information of the actual management and exigencies of corporate operations.

More recent Philippine cases give premuim to good faith, and honesty accompanying the business judgment, to uphold the directors' actions. Thus recent cases of *Montelibano v. Bacolod-Murcia Milling Co.*[97] and *Board of Liquidators v. Kalaw,*[98] relying heavily on American authorities, made definite pronouncements on the business judgment rule, thus:

> "They (directors) hold such office charged with the duty to act for the corporation according to their best judgment and in so doing they cannot be controlled in the reasonable exercise and performance of such duty. Whether the business of a corporation should be operated at a loss during a business depression or closed down at a smaller loss, is a purely business and economic problem to be determined by the directors of the corporation and not by the court. It is a well known rule of law that questions of policy of management are left solely to the honest decision of officers and directors of a corporation and the court is without authority to substitute its judgment for the judgment of the board of directors. The board is the business manager of the corporation and so long as it acts in good faith are not reviewable by the courts."

In the *Kalaw* case, "good faith clinched" the case for the directors and manager. The court considered the action of the Board in ratifying the losing contracts executed by the manager as called for by the "basic dictates of fairness". In both cases, the exercise of management powers has virtually become unlimited and unrestrained as long as good faith and honesty existed in making such decisions although they eventually turn out to be losing, unwise and inexpedient. Good faith and honesty is the protective mantle of directors errors and judgments. The concept of good faith is far from being simple. In defining it, resort has been made to what "bad faith" means. Thus, the court stated: [99]

> "Rightfully had it been said that bad faith does not simply cannot bad judgment or negligence, it imparts a dishonest purpose or some moral obliquity and conscious doing of wrong. It means breach of a known duty through some motive or interest or ill will; it partakes of the nature of fraud xxx bad faith contemplates with some motive of self-interest, or ill will or ulterior motive."

Under the foregoing rule, it would seem therefore that to be liable for lack of good faith on the part of directors, such conduct must amount to fraud. The good faith in the *Kalaw* case was based mainly on consideration that it was necessary to ratify the losing contracts as an "act of sim-

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[97] GR. .No. 15092, May 18, 1962, 5 SCRA 36 (1962) citing 2 FLETCHER, sec. 390.

[98] *Supra,* note 74.

[99] *Ibid,* citing Spiegel v. Beacon Participations, 297 Mass. 398 8 N.E. 2d 895 (1937), Air France v. Carrascoso, G.R. No. 214438, September 28, 1966, 18 SCRA 155 (1966).

ple justice and fairness to the general manager, and in the best interest of the corporation whose prestige would have been seriously impaired by the rejection of the contracts which proved disadvantageous, by the board of directors." The tendency of the Philippine Supreme Court to refrain from interfering with the corporate policies determined by the board seems to be self-imposed. Expressing itself in the case of *De La Rama v. Ma-ao Sugar Central*[100] it states that:

> "xxx the Court must admit its limitations and confess that it cannot pretend to know better than the board in matters where the board has not transgressed any positive statute or by-law, especially where as here, there is the circumstance that presumably, an impartial representative in the Board of Directors one from the Philippine National Bank, against whom apparently plaintiff have no quarrel, dces not appear to have made any protest against the same. The net result will be to hold that the culpable acts proved are not enough to secure a dissolution. The court will only order the correction of abuses proved xxx".

It would seem that the tenor of the cases above-cited, support the theory that in matters concerning the affairs and business of a corporation, the board of directors have such wide discretion to choose such course which they deem proper and profitable for the enterprise. The choice of policies and alternatives belong to them. So long as they do not violate a statute or by-law of the corporation, and they acted in good faith and honesty, the results would be immaterial, for they are the best judges of the needs and prospects of the corporate business. The courts cannot pretend to know any better than the directors as far as running the enterprise is concerned. Taken in this light, the requirements imposed by the directors' duty of diligence and due care, skill and judgment losses some of its forces and effectiveness in protecting the corporation and stockholders from losing ventures.[101] It seems unreasonable to relieve directors from liability by mere honesty and good faith. There is admittedly much more at stake in directors' decisions and formulation of business policies. Stockholders' investments in the corporation must be protected and wisely employed. Thus ventures must be justified only upon proof that the directors and the board had taken all reasonable steps to ascertain the profitability, and expediency of a corporate course of action. Where such action showed the failure ot exercise diligence, skill and sound judgment, liability should accrue against the directors, notwithstanding the presence of honesty and good faith. This is so because the assumption of office of director implies that the director represents himself as in possession of such reasonable skill and judgment necessary in discharging such office.

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[100] G.R. Nos. 17504-6, February 28, 1969, 27 SCRA 254 (1969).

[101] Montelibano v. Bacolod-Murcia Milling Co., *supra*, note 97; Board of Liquidators v. Kalaw, *supra*, note 74.

Acceptance of the business judgment rule in the extreme form may ultimately negate the significance of the director's duty to exercise due diligence, reasonable skill and sound judgment.[102] This is the reason why the rule in *Steinberg v. Velasco,*[103] is good law, for it imposes a positive duty of diligence, skill and judgment, and in the presence of which, directors cannot exercise imprudence on the ground of inexperience or ignorance. Errors of judgment, on account of want of ordinary prudence or skill, makes the directors liable for the consequence of such error. It would not be amiss perhaps, to restate the language of *Litwin v. Allen,* declaring that: [104]

> "Honesty alone does not suffice. The honesty of the director in this case is unquestioned. But there must be more than honesty—there must be diligence and that means care and prudence as well xxxx. There is more than the question of business judgment as to which men might well differ. The directors plainly failed in this instance to bestow the care which the situation demanded. Unless we are to do away entirely with the doctrine that directors of a bank are liable for negligence in administering its affairs, liability should be imposed in connection with the transaction."

Again, the application of the business judgment rule should be considered on a case to case basis, and the rulings of the cases above-cited should not be taken out of context to avoid the pitfalls that lie behind an indiscriminate and extreme application of the business judgment rule. This should be considered in the light of the requirements underlying the directors' duty of care, diligence, skill and sound judgment.

5). The unfettered discretion of corporate directors

The duty of care and diligence, and the business judgment rule presupposes that decisions and judgments are exercised by directors with freedom, unfettered by the interests of any particular group or clique. Any agreement whereby a director surrenders his freedom of action, or agrees to take orders from any particular person or group is against public policy, and therefore, void.[105] The case of *Palting v. San Jose Petroleum Inc.*[106] portrays the Philippine Supreme Court's attitude towards an organizational set up which is designed to perpetuate management control. In this case, the court enjoined the sale of voting trust certificates, issued under a voting trust agreement between the holding company and two trustees.[107] These trustees, under said agreement had the sole power, exercised personally or through proxies choses by them, to elect directors of the defendant corpora-

[102] *Lewis, supra,* note 93.
[103] *Supra,* note 31.
[104] *Supra,* note 53.
[105] *Supra,* note 23 at 471.
[106] G.R. No. 14441, December 17, 1966, 18 SCRA 933 (1966).
[107] The two trustees were: James Buckley and Austin Taylor.

tion. Thus ultimate control was vested in these trustees, and the management of the defendant Philippine corporation would actually be in the hands of a controlled board of directors, elected by these two trustees.

The court seemed to object to the fact that the voting trust agreement would be binding on all future holders of the voting trust certificates. As such it was possible to achieve continuity of control and management. It was possible to have a controlled board of directors because the trustees had power both to elect and remove and vote at any proposition for removal of the directors.[108] This was declared by the court, together with other features of the articles of incorporation as illegal because the arrangement "will work or tend to work a fraud on Philippine investors".

The implications of this ruling, at least on the point relating to voting trusts need some reexamination. The Philippine Corporation Law allows expressly the establishment of voting trusts for a period of five years.[109] This was introduced by Act No. 3518 of 1928. Even before the inclusion of Section 36 of the Corporation Law by Act No. 3518, voting trusts was a common law right having its sanctions from the principle of agency in civil law.[110] This is admittedly a device to achieve a unified control of the affairs of a corporation and consistency of policy. It also makes possible for a majority group of stockholders to dispose of the beneficial interest and still retain control. Except for the period provided in the voting trust agreement in question in the *Palting* case, (which was ten years), the terms thereof were in conformity with Section 36 of the Corporation Law. Said section 36 provides that the trustee may vote in person or by proxy. The trustee holds the legal ownership of the stocks, and is entitled

[108] The Voting Trust Agreement stated:

"(a) At all elections of directors, the trustess will designate a suitable proxy or proxies to vote for the election of directors designated by tre trustees in their own discretion, having in mind the best interest of the holders of the voting trust certificate, it being understood that any and all of the trustees shall be eligible for election as director.

"(b) On any proposition for removal of a director, the trustees shall designate a suitable proxy or proxies to vote for or against such proposition as the trustees in their own discretion may determine, having the best interest of the voting trust certificates.

(c) With respect to all other matters arising at any meeting the trustee will instruct the proxy or proxies attending such meeting to vote the shares of stock held by the trustee in accordance with instructions of each holder of voting trust certificates."

[109] Act No. 1459, sec. 36: "One or more stockholders of any corporation organized under this Act may, pursuant to an agreement in writing, transfer their shares to any person or persons, or to a corporation having authority to act as trustee, for the purpose of vesting in such person or persons, or corporation, as trustee or trustees, voting or other rights pertaining to such shares for a period not exceeding five years, . . . *Provided, however,* That no such agreement shall be entered into for the purpose of placing two or more corporations organized for the purpose of engaging in agriculture or in mining, which by reason of their corporate purposes cannot be organized as one corporation in accordance with this Act, under the control or management of the same trustee or trustees, or for the purpose of lessening competition or creating a monopoly of any line of commerce. x x x."

[110] Del Rosario, *Voting Trusts Under Sec. 36 of the Corporation Law,* 8 LAWYERS JOURNAL 206, (1940).

to exercise the rights of ownership subject to the terms of the trust agreement.[111] The stockholders holding the beneficial interest may transfer his certificate subject to the terms of said agreement. The law does not make any distinction as to present or future stockholders who would be bound by such agreement. Considering these provisions, it is not difficult to see why initially the defendant corporation was allowed to sell to the public the voting trust certificates covered by the questioned agreement. The objection seems to be that virtual perpetuation of control may be effected with the stockholders without recourse under the peculiar corporate structure of the company. The defendant San Jose Oil (Philippines), was a Philippine corporation. Ninety (90%) per cent of its stocks were owned by a Panamanian corporation, called San Jose Petroleum. The stocks of this latter (San Jose Petroleum) was held by another corporation, also Panamanian, known as Oil Investments. The stocks of the latter were held by two Venezuela corporations known as Pantepec Oil Company and the Pancoastal Petroleum Company. These two corporations issued stocks which are held by stockholders scattered in the forty-nine (49) states of the United States. This complex set up and so many other features of the agreements and articles of incorporation put at issue before the court in the case of *Palting,* has led the court to emphasize the necessity of affording greater protection to investors of the corporation, present or prospective. It likewise saw the need to maintain an unfettered board of directors which can exercise its functions free from the control of any particular group or vested interests.

B. The fiduciary duty of fidelity and loyalty

When a man accepts or seeks a position of trust as he does when he becomes a director or officer, he thereby undertakes to subordinate his personal interest to those of the corporation. But loyalty to one's self and one's own interests derives from an entirely human, perhaps instinctive need for self-preservation and desire for personal advancement.[112] The case of fiduciaries, like a corporate director, where conflicts of interests may arise, the search for a proper solution is of vital importance.

The fiduciary obligations and responsibilities bind directors to rules of conscientious fairness, morality and honesty. They are held in official action to the extreme measure of candor, unselfishness and good faith. These principles are rigid, essential and salutary.[113] Indeed, this fiduciary undertaking bespeaks a code of morality of a high order. The difficulty however arises upon their application because the demands of business may require some norm which are flexible and practical. According to Gower, com-

[111] Campos, *Commercial Law,* 42 PHIL. L.J., 99 (1967).
[112] Feuer, *Liabilities of Directors and Officers,* 5 N.Y.L.F. 139 (1959).
[113] Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 193 (1919); Litwin v. Allen, *supra,* note 52.

pliance with these ethical rules has been tested on common sense principles, the court asking itself, whether the directors have done what they honestly believed to be right. Courts have normally accepted that they have if satisfied that they have behaved as honest men of business might be expected to act.[114] Some attempts have been made to express the duty in statutory form, but these do not contribute much to the definition and understanding of the principles. Thus determination must have to be made on a case to case basis, èvaluating each case according to the facts and circumstances that surrounds the fiduciary's conduct.

1). The corporation and the director—on conflicts of interests

Anglo-American law allows directors a wide discretion in the management of the corporate business. Such freedom must, however, be accompanied by a high standard of loyalty to preclude the overriding of the corporation's interests by the personal interests of the directors. This duty of loyalty is enforced in English law in a stricter sense. Thus, contracts between a company and a director or his firm are voidable at the option of the company, notwithstanding that its terms were perfectly fair. So strictly is this principle adhered to that no question is allowed to be raised as to the fairness or unfairness of a transaction.[115] This is the starting point of American law on loyalty and good faith, but the doctrine has since then been subjected to several exceptions. Thus contracts were considered valid provided there was good faith and the transaction was fair to the company.[116] In contracts of this nature, it required that it must have been authorized by the board on which the interested directors neither voted nor was counted to constitute a quorum. Some statutory provisions recognized the validity of these contracts under certain conditions such as disclosure of the interlocking directorships held by a directors, or the financial interest involved. Such disclosure to the board must be noted in the minutes. The disinterested directors of the board must have approved or ratified the contract in good faith. Disclosure to the stockholders who approve or ratify the same in good faith by majority vote or written consent may also be required. Such contract must likewise be just and reasonable to the corporation.[117] The issue therefore revolves much around the fairness of the transaction and the good faith of the interested parties.

[114] *Supra*, note 23 at 474.
[115] *Supra*, note 23 at 478-479; Nielsen, *supra*, note 52 at 628.
[116] Nielsen, *ibid.*
[117] General Corporation Law of the State of Delaware:
Sec. 144. "Interested directors; quorum:
(a) No contract or transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which one or more of its directors or officers are directors or officers, or have a financial interest, shall be void or avoidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee thereof which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if:

The requirements under some civil law jurisdictions is substantially the same. Garriguez relates that the fundamental prohibition, against dealing with the society by directors charged with its administration, existed since the 17th and 18th century. Formerly, a logical and ethical limitation of the representatives' powers was that the director, by reason of conflict of interest with the society, ipso facto leaves his representative powers. This is so because there is an inherent incompatibility between the exercise of power and the end for which his powers were granted to him. These stringent rules however seemed impractical, and recent legislations have evolved a more benevolent rule for directors. Thus under the French law, a director could take or receive benefits provided he is authorized by the general assembly. Under the Italian Code, there is obligation to give notice to the other directors and the "colegio sindical". Furthermore, the interested director must refrain from participating in the deliberations relative to the question. There is no specific provision in the recent law on "sociedades anonima" in Spain, regarding this matter. But the commentators believe that the rules prohibiting the same in general closes the dangers involved in cases of conflicts of interest. Without legal rules, the directors are inherently morally obligated to communicate to the board the possibility of conflict of interest, and they must abstain from participating in the deliberations when the case directly or indirectly affects personal interests. And when a director competes with the general interests of the society, he will cease in his office. If he prefers his interest while still in office, he is guilty of disloyalty and is liable for damages by proper action against him.[118]

The Code of Commerce effective in the Philippines was definite about the acquisitions by directors of corporate property. Those charged with the administration of the property cannot acquire directly or indirectly the property with out the consent of the owner. This was to prevent fraud or abuse of confidence. Under the Spanish Civil Code also enforced in the Philippines, the agent cannot acquire, even at a public auction, or judicial

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(1) The material facts as to his interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or cmmittee in good faith authorizes the contract or transaction by a vote sufficient for such purpose without counting the vote of the interested director or directors; or

(2) The material facts as to his interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors; a committee thereof, or the shareholders.

(b) Interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction."

[118] 2 GARRIGUEZ, COMMENTARIO DE LA LEY DE SOCIEDADES ANONIMAS, 99-100 (1953).

sale, directly or indirectly the property subject of his administration. The incapacity under this code was unqualified—with or without the consent of the owner of the property. This prohibition against agents was based on morality. The law wanted to avoid the possibility of fraud or damage at all occasions arising from the possible conflict of interest. It fears that greed might get the better of the sentiments of loyalty and disinterest which should animate an administrator or agent. It does not trust human nature to resist temptation likely to rise out of antagonism between the interest of the seller (principal) and the buyer (agent).[119]

The directors of commercial entities under Spanish law were agents or mandataries, operating by virtue of a commercial agency. It was clear therefore, that directors were covered by the prohibition. While it is true that strictly speaking, directors are not agents in the real sense, yet, when the society is organized and they had been designated to administer a new relation between the director and the society is established and this is no other than that of agency. On this premise, Manresa, commenting on the Civil Code provision, concludes that directors are mandataries and are included in the incapacity under the law. This prohibition in the Civil Code and the Code of Commerce is so strict that, if the principal had acquiesed to the purchase by the agent, the heirs could still recover said property in the hands of the agent, subject to the rules of prescription. The incapacity created by law cannot otherwise be modified or converted into capacity by agreement by the parties.[120]

This view is confirmed in the decision of *Strong v. Repide,* (1906) of the Philippine Supreme Court, which declared that the prohibition against the purchase by corporate directors, refer only to property of the corporation under their administration.[121] However in the case of *Mead v. McCollough,*[122] decided in 1911, involving a director of a "sociedad anonima", organized under the Code of Commerce, the Philippine Supreme Court relying heavily on American authorities, introduced modifications to the rule laid down in Article 1459 of the Spanish Civil Code, and relaxed the absolute prohibition embodied therein.

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[119] CODIGO DE COMERCIO, Articulo 161 - "Los comisionistas no pueden hacer la adquicision por si ni por medio de otro persona de los efectos cuya enajenacion les haya sido confianza sin consentimeinto expreso del proprietario.

DE LA SERNA Y RUIZ, CODIGO DE COMERCIO, ANOTADO, 688 (1878).

El Codigo Civil, Articulo 1459 - "No podran adquirir por compra aunque sea en aubhasta publica o judicial por si no por persona alguna intermedia x x x los mandatarios, los bienes de cuya administracion o enajenacion esat viesen encargados.

8 MANRESA, EL CODIGO CIVIL, 180.

Gregorio Araneta Inc. v. Paterno, 91 Phil. 803 (1952).

[120] MANRESA, *supra,* at 108108. "La incapacidad de los mandatarios a que venimos hacienda referencia comprende pues a nuestro modo de ver, entre otros a los gerentes directors a administradores de los sociedades. Si atentamento se examen la relacion juridica que existe entre esos gerentes directores o administradores y persona juridica social veremos que la informer el principio de la representacion . . .

[121] Strong v. Repide, 6 Phil. 680 (1906).

[122] *Supra,* note 21.

The decision upholding the validity of the acquisition by the director of corporate assets was premised on the following considerations: that there was nothing in the articles of incorporation which expressly prohibited the sale or transfer of corporate property to one of the stockholders: that there was nothing in the Civil Code [123] dealing with the manner of dissolving a corporation, prohibiting the sale of corporate property to one of its members, who in this case happens to be also a director; neither is there anything in the Code of Commerce [124] which prohibited dissolution of a corporation by sale or transfer to one of the members; that the sale of corporate property to one of its members was a matter which a majority of the stockholders could very properly consider; that the resolution of the majority of stockholders when passed in good faith and for a just cause, deserved careful consideration and are generally binding on the minority; [125] that directors or officers have the power to dispose of all property in case of imperative necessity when the exigencies of all business require it; and that the majority of stockholders may dispose of all property where the corporation had become insolvent, or for a just cause as where continuation of the business becomes ruinous and against the interest of the stockholders.[126] In this case, it would seem that the sale of corporate property was more than an ordinary contract of purchase and sale, but it was to effectuate the dissolution and liquidation of the "sociedad anonima." The transaction was therefore considered as a concerted act of the stockholders. When regarded as such, it is reasonable to regard the transaction as one between independently interested parties, and that the director who happens to be the purchaser is not actually self-dealing with the corporation.

Even under the present Corporation Law, dissolution can be made by the affirmative vote of the stockholders representing two-thirds (⅔) of all shares issued and subscribed, at a meeting called for the purpose.[127] The ambiguity of the transaction in the *Mead v. McCollough* case, lies in the fact that the directors were the very same stockholders of the corporation. Thus it was hard to distinguish, at least in 1911, whether or not the director involved should be considered as agent or more stockholder of the corporation at that particular transaction in question. This is so considering the absence of specific provisions for dissolution of commercial entities.

In deciding on the validity of the contract between the corporation and the director, the court said: [128]

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[123] SPANISH CIVIL CODE (1889), arts. 1700-1708.
[124] CODE OF COMMERCE (1888), arts. 151-174.
[125] Mead v. McCollough, *supra,* note 21.
[126] *Ibid.* citing THOMPSON ON CORPORATIONS, secs. 2416-1418.
[127] Act No. 1459 (1906), sec. 62; REV. RULES OF COURT (1964), Rule 104.
[128] Mead v. McCollough, *supra,* note 21, citing Merrick v. Peru Coal Co., 61 Ill. 472 (1871); Harts v. Brown, 77 Ill. 226 (1875); Twin-Lick Oil Co. v. Marbury,

> "The authorities are not uniform in this question but on the general proposition whether a director or an officer may deal with the corporation, we think, the weight of authority is that he may. While a private corporation remains solvent, there is no reason why a director or officer by the authority of a majority of its the stockholders or board of a managers, may not deal with the corporation, loan it money or buy property from it in like a manner as a stranger... A director may in good faith and for an adequate consideration, purchase from a majority of the directors and stockholders the property even of an insolvent corporation and the sale thus made to him is valid and binding upon the minority."

Good faith, just consideration and fairness of the transaction are the dominant considerations for the validity of the contract. This conforms generally to the American practice, brought about by the Philippine Supreme Court's reliance on American authorities, in the case of *Mead v. McColluogh.*

In contrast to the opinion of Manresa, that directors are agents of the society, and as such, the prohibition in Article 1459 was applicable to directors, the court in the *Mead* case concluded otherwise. Thus, it considered directors as trustees and the stockholders as the *cestui que* trust, but both have a joint interest in all the property and effects of the corporation. As such a director is not an agent in the sense of Article 1459. Besides, there was a majority of the quorum of directors, who likewise constituted the majority of the stockholders, who approved the sale. Thus the director dealt with the corporation without being its agent or representative.

The rule enunciated in the *Mead* case was followed in a Court of Appeals case in 1939. In the case of *Abaya Lumber Co., Inc. v. Detrich.*[129] it was held that a loan made by the president and general manager cannot be held voidable nor void, where the transaction was not unfair to the corporation and the officer acted in good faith and for its benefit. It likewise declared valid the sale of lumber of thee defendant director's wife, where such sale was approved by resolution of the board of directors, made without the vote of the interested director. Likwise, there was no proof of bad faith or undue advantage gained by said director. On the other hand, a loan made by the corporation to a director was declared invalid in the case of *De La Rama v. Ma-ao Sugar Central, Inc.*[130] because it was apparent that there was a juggling of the books of accounts of the corporation. Besides, the by-laws of the corporation expressly prohibited directors from obtaining loans from the corporation. A similar situation occured in the case of *Camera Exchange Inc. v. Curameng,*[131] decided by the Court of

91 U.S. 587, 23 L Ed. 328 (1876); Whitwell v. Warner, 20 Vt. 425 (1848); Smith v. Lansing, 22 N.Y. 510 (1860); City of St. Louis v. Alexander, 23 Mo. 483 (1856); Beach v. Miller. 130 Ill. 162, 22 N.E. 464 (1889).

[129] Abaya Lumber Co., Inc. v. Detrich, 7 LAWYERS J. 678 (1939).

[130] *Supra,* note 100.

[131] Camera Exchange Inc. v. Curameng, G.R. No. 10093-R, December 9, 1953, 50 O.G. 2650 (June, 1954).

Appeals. Here, the defendant was guilty of appropriating the farm project and accounts of the corporation by transferring the same to his own personal account. He likewise awarded to himself compensation, in such amounts as to "saddle" the corporation even with his family and personal expenses. And all these transactions were done without the proper authorization or conformity of the board of directors. This is a good example, where personal benefit and advantage was the overriding motive in a directors dealing with the corporation, an out-right violation of the fiduciary obligations that law and morality requires of fiduciaries.

The evolution of the rules and principles governing situations involving conflicts of interests between the corporation and directors in Philippine law, portrays the transition from absolute prohibition to qualified validity, on account of reliance upon authorities from distinct legal systems. This development also shows, the willingness of Philippine courts to follow such norms and practices that can cope up with the changes of the times. Admittedly an absolute prohibition against directors dealing with the corporation in which he holds such position is both unrealistic and impractical under present day business needs. On the other hand, an unqualified allowance of such practices may lead to abuse and indiscriminate use of the power, influence and advantage that inhere in a director's position, for indeed, "no man can serve two masters." Thus the rules that have evolved in the cases, requiring good faith, honesty and fairness in the cases involving possible conflicts of interests, safeguarded by requirements of disclosure and abstention is both sound and commendable. Added to this, is the requirement that the burden of proof lies with the director so interested, that he acted with utmost candor and fair dealing for the interest of the corporation, and without "taint of selfish motives".[182] This, together with the vigilance of the courts to closely scrutinize transactions of this nature will afford protection to the corporation and the stockholders. But a clear statutory provision on the manner and procedure required in cases involving conflicting interests, both personal and corporate, particularly those of interlocking directorates, would afford more certainly and protection in so many other instances not within the knowledge and beyond the reach of the courts to rule upon.

2) Recent developments—the exclusionary clause

Since 1911, the case of *Mead v. McCollough,*[183] which stood for the proposition that a director of a corporation can make contracts with his corporation, purchase its property, make loans to it, provided that the contract was made in good faith, for a just corporate purpose, with a fair consideration, and duly approved by the majority of disinterested directors

[182] Mead v. McCollough, *supra,* note 21.
[183] *Supra,* note 21.

who constituted a quorum and/or approved or ratified by a majority of the stockholders, was considered an authority on the matter. The applicability of Article 1459 of the Civil Code was thus qualified as far as corporate directors were concerned. This ruling is strengthened by the provision of the New Civil Code, Article 1491 (2),[134] which was taken from Article 1459[135] of the Spanish Civil Code, in question in the *Mead* case. Under this new provision, the absolute provision inhibiting agents from purchasing the property under administration was qualified by the language, "unless the consent of the principal has been given." This conforms to the theory behind the *Mead* ruling as far as corporate directors are concerned, the principal being the corporation acting through a disinterested quorum of the board of directors, or the majority of stockholders.

In 1966 however, the case of *Palting v. San Jose Petroleum,*[136] raised serious doubts as to the doctrinal basis justifying directors' rights to deal with the corporation. Among the issues resolved in the case was whether the sale of voting trust certificates of the defendant company will operate as a fraud to Philippine directors. In resolving this issue, the court proceeded to examine the articles of incorporation of the San Jose Petroleum Company, which contained an exclusionary clause, stating thus:

> "That no contract or transaction between the corporation and other association or partnership, except in case of fraud by the fact that any of the directors or officers of such corporation is interested in or is a director or officer of such other association or partnership, and that no such contract and transaction of the corporation and any other person or persons, firm, associations or partnership shall be affected by the fact that any director or officer of the corporation is a party to or has an interest in such contract and transaction or has in any way connected with such other person or persons, firm, association or partnership, and finally, that all and any of all persons who may become directors or officer of the corporation shall be relieved of all responsibility for which they may otherwise be liable by reason of any contract entered into with the corporation, whether it be for his benefit or for the benefit of any other person, firm, association or partnership in which he may be interested."

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[134] NEW CIVIL CODE, art. 1491: "The following persons cannot acquire by purchase, even at a public or judicial auction, either in person or through the mediation of another:

1) xxx

2) Agents, the property whose administration or sale may have been intrusted to them, *unless the consent of the principal has been given.*" (underscoring supplied).

[135] Article 1459 (OLD CIVIL CODE)

"The following persons cannot acquire by purchase even at a public or judicial auction, whether in person or through the mediation of another:

1) xxx

2) Agents, the property whose administration or sale may have been entrusted to them."

8 MANRESA, EL CODIGO CIVIL 108.

[136] *Supra,* note 106.

The exclusionary clause is commonly adopted in English and American jurisdictions, either as part of the articles of incorporation or as a statutory provision.[137] The Philippine Supreme Court however, considered this exclusionary clause as a "unique and unusual provision", which "alone would outlaw any corporation locally organized or doing business in the Philippines." It was observed that the "impact of these provisions upon the traditional fiduciary relationship between the director and the stockholder is "too obvious" to escape notice by those who are called upon to protect the interest of the directors." The court feared that with this provision, the directors and officers of the company can do practically anything "short of actual fraud", with the affairs of the corporation even to benefit themselves directly or other persons or entities in which they are interested and with immunity because of advance condonation or relief from responsibility by reason of such act. This, together with the questionable voting trust agreement,[138] completely dissociated the stockholders from the government and management of the business in which they have invested.

The observation of the Court on this matter may be undoubtedly sound, but it lends itself to certain implications. It gives the implication that a director may not deal anymore with the corporation, as was allowed in the case of *Mead v. McCollough,* and under American jurisprudence, and state statutes.[139] An absolute prohibition has been found to be impractical, where such disqualification was simply for fear of possibility of dishonesty or unfairness, when perhaps, directors have the greatest interest in its welfare any may be willing to deal with the corporation upon reasonable terms. The policy of facility of business has prevailed over the policy of removal of temptation.[140] Even in English jurisdictions, with stringent rules regarding conflicts of interests, a waiver by the enterprise in the form of the exclusionary clause is allowed.[141] Justification for the exclusionary clause is the principle, that, just as the normal obligation of trustees can be waived or modified by express provision in the trust deed under which they were appointed, so can the normal fiduciary duties of directors be modified by express provision in the trust deed under which they were appointed, so can the normal fiduciary duties of directors be modified by express provision in the company's constitution. Such provisions have become common form in statutes and registered companies' articles of incorporation.[142] It is noted that failure to disclose the director's interest makes a contract cease to be covered by the exclusionary clause, hence it becomes voidable by the company. This is the rule under English

[137] Delaware General Corporation Law (1899) as amended.
[138] *Ibid.* at 32-34.
[139] *Supra.* note 111. Delaware, General Corporation Law, *supra,* note 137.
[140] GOWER, *supra,* note 23 at 480-84; Nielsen, *supra,* note 52 at 629-630.
[141] *Ibid.*
[142] *Ibid.*

law. In all cases however, the exclusionary clause does not relieve the director of the consequences of fraud, under the general principles of law. The exclusionary clause merely removes the prohibition on the contract in which the director is interested and thus render such a contract not a "breach of duty or a breach of trust", but it does not relieve directors of their duty to act bona fide in the interest of the company.[143]

The non-acceptance of the exclusionary clause in the Philippines as expressed in the *Palting* case is due to the implications it might have on the fiduciary relation of directors to the stockholders. This might be described as a negative or preventive attitude, notably present in Spanish civil law. Thus the court states that "the provision gives relief to future acts of directors which are short of Fraud". Fraud is often times difficult to prove, but there are certain acts which may approach it, and are equally if not more than reprehensible, hence should likewise be prevented. Article 1170 of the New Civil Code may explain the court's apprehension. It states:

> "Those who in the performance of their obligations are guilty of fraud, negligence or delay and those who in any manner contravene the tenor thereof are liable for damages."

And Article 1171 further enjoins:

> "Responsibility arising from fraud is demandable in all obligations. Any waiver of an action for future fraud is void."

It is perhaps with this in mind, that the court was afraid to approve such stipulation that give a premium to, or have the tendency to encourage, fraudulent practices. It is therefore doubtful whether such exclusion clauses will ever be admissible in view of the stringent standards of the New Civil Code.

Even in the absence of decisions such as *Mead v. McCollough,* and the *Palting* cases, the same results would have been possible in situations involving conflicts of interests, by reference to certain provisions of the New Civil Code on "Obligations and Contracts". Thus, Article 1330 states:

> "A contract where consent is given through mistake, violence, intimidation, undue influence or fraud is voidable."

Fraud is defined in Article 1338 as:

> "There is fraud when through insiduous words and machinations of one of the contracting parties, the other is induced to enter into a contract which without trem, he would not have agreed to."

That there is a duty to disclose on the part of directors with conflicting interests to that of the corporation is implied from the provisions of Article 1339 which states:

[143] *Ibid.*

"Failure to disclose facts, when there is a duty to reveal them, as when the parties are bound by confidential relations, constitutes, fraud."

The foregoing provisions state in brief form the essence of fiduciary relationships which establish the obligations of good faith, honesty and fairness. Thus, since a director is a fiduciary with duties towards the corporation and stockholders, he is under obligation to disclose whatever personal interests he may possess in conflict with that of the corporation. Failure to do so would constitute fraud. His concealment would be tantamount to "insiduous words or machinations" which induced his corporation to enter into a contract without full knowledge of all material facts which in fairness should have been made known by the interested director. This may even be evidence of undue influence, considering the position of the director as a "corporate insider" having access to all the information regarding the business of the corporation. Thus, a contract entered into between the corporation and the director under these circumstances is one trained with fraud or undue influence, which by law is declared as voidable. So that when such contract is attacked, the burden of proof lies upon the interested director to show: that there was disclosure of all material facts—all the circumstances which he duty bound to reveal, that he entered the said with good faith and honesty, and that the contract was an arm's length transaction, without any undue influence or concealment on his part. In sum, that the contract was fair to the corporation in which he is a director. This simple deduction from the rules does not, however, resolve more complex issues such as those relating to interlocking directorates, both as to directors and corporations so situated.

The usefulness of the exclusionary clause is perhaps most distinct in the case of interlocking directorates, for it defines the different transactions and parties which may possibly be involved and declares the validity thereof. On the other hand, there is indeed no better substitute for a specific provision in the Corporation Law which will define these relationships, as regards directors holding directorships in several corporations, which is a growing trends in the Philippines,[144] and as regards corporations which have common set of directors, or where some but not all of their directors interlock. The absence of standards and procedures for validity of transactions may present some serious dilemma, in view of the present state of the legal rules set by the Philippine cases so far decided, on the matter of conflicts of interest, and the exclusionary clause. To insist on an absolute standard as to debar a director or the corporation or firm in which he holds a directorship, from having any transaction with another corporation in which he holds such position may lead to anomalous situations. Such results may necessitate a prohibition against the holding of interlocking directorships altogether. On the other hand, it would be intolerable to

[144] CATICA, MANUAL OF PHILIPPINE SECURITIES (1970).

acquiese to certain business practices merely because they are customary in the business world. Where the complexities of corporate business grows from day to day, more certain standards of conduct and procedure are needed to afford protection not only to the corporation and stockholders, but also the interested director, who may stand to lose or gain depending on the path of legal theory the court at one time or another may follow in the absence of some definite legislative statutory pronouncements on the matter.

3). The directors' right to compensation

The duty of fidelity and loyalty comes to fore when directors have to determine the compensation they may receive for services to the corporation. It is in these instances where corporate and personal interests may run into conflict.

The common law rule which still prevails is that a director is not entitled to compensation for services rendered in the absence of express provision in the charter, by-laws or in a prior contract with the corporation. This rule extends ot directors who are also executive officers. They are not entitled to recover upon implied contract for what their services are worth, or "quantum meruit". The reason for this, is the custom that "fiduciary relationship repels any implication of contract that official services are to be paid for.[145] Directors are usually substantial shareholders hence will be willing to serve without pay. The return of their shares is sufficient motive for services without other compensation.[146]

Philippine decisions substantially follow the above-stated principle. Thus in the case of *Government of the Philippines v. El Hogar Filipino*,[147] the court held that the power to fix the compensation of a building and loan association pertains to the corporation to be determined in its by-laws and when the amount is thus fixed, the court will not concern itself with the question of propriety or wisdom of the measure of compensation adopted. This was clarified later in the case of *Baretto v. La Provisoria Filipina*,[148] to mean that the authority conferred upon corporations is that the compensation must be for future services of directors, officers and employees. Continuous compensation to a particular director after employment has terminated for past services rendered gratuitously is not allowed. To permit such transaction would be to create an obligation unknown to the law and to countenance a misapplication of the funds of the corporation, to the prejudice of substantial rights of its shareholders.[149] Even if the stockholders voted to grant compensation to the general manager and di-

[145] 5 FLETCHER, *supra*, note 26, secs. 2109-2110 (1967).
[146] *Ibid.*
[147] 50 Phil. 401 (1927).
[148] *Supra*, note 44.
[149] *Ibid.*

rector, for services rendered prior to the incorporation, such action was void.

The common law rule was likewise followed in the case of *Lingayen Gulf Electric Power Co. v. Baltazar.*[150] Where the by-laws of the company was silent as to the salary of the president, although it provided compensation for other officers, it was held that the president and board of directors were expected to serve without salary. On the other hand, in the case of *Central Cooperative Exchange Inc. v. Tibe,*[151] the by-laws of the corporation provided explicitly that the stockholders shall determine the compensation of the members of the board of directors. And where the stockholders had restricted such amounts only to cover actual expenses, it was held, that it is not within the power of the board of directors to enact a resolution providing for themselves, compensation for additional duties. Even without the express reservation of said power to the stockholders, the directors are not entitled to compensation, "for the law is well settled that directors of corporations, presumptively serve without compensation and in the absence of an express agreement or resolution in relation thereto, no claim can be asserted therefor."

Section 21 of the Philippine Corporation Law is definite on the point, that a corporation may provide in its by-laws the compensation of directors, officers, and employees. However, this authority is not absolute power to fix the amounts to be paid to corporate officers by way of basic salary, bonus or additional remuneration. Such compensation must be reasonable, to be measured by several factors, such as the amount and quality of the services performed in relation to the business, the character of the company's business, its net earnings, its locality, the employees' or officers qualification and contribution to the business and the general economic conditions. There is an obligation to pay such compensations in good faith, on the part of both the officer and corporation, and not for the purpose of evading payment of legitimate dues such as taxes.[152] And where a director of a corporation has practically "saddled" the corporation to pay even for his personal, family expenses, such act being grossly selfish amounts to a constructive fraud on the corporation, and cannot be ratified whatsoever.[153] The principle enunciated in the case of *Baretto* above-cited, was applied by the Court of Appeals in the case of *Araneta v. Herrero* [154] with reference to the award of bonuses. A continuing bonus to directors and officers, when objected to by the stockholders cannot be justified especially if such bonus or gift is granted by way of compensation for services al-

[150] 93 Phil. 405 (1953).

[151] Central Cooperative Exchange Inc. v. Tibe, *supra,* note 47.

[152] Kuenzle & Streiff v. Commissioner of Internal Revenue, G.R. No. 17648, October 31, 1964, 63 O.G. 11450 (Dec., 1967), 12 SCRA 30 (1964).

[153] Camara Exchange Inc. v. Curameng, *supra,* note 131.

[154] Araneta v. Herrero, C.A.-G.R. No. 26922-R, February 26, 1963, 59 O.G. 8397 (Dec., 1963), 3 C.A. Rep. 2d 510 (1963).

ready rendered for a prescribed compensation. Resolutions of the board of directors fixing salaries could have operation only for the future. There could not be any retroactive increase of salaries or voting of back pay. Otherwise this would be a misapplication of corporate funds.

The case of *Pirovano v. De La Rama Steamship* [155] however presents a unique situation, involving a remunerative donation in favor of the wife and children of the company's deceased past president," in consideration of services rendered, gratitude and a desire to compensate for such services". The late Pirovano was instrumental in the growth of the corporation. The Supreme Court upheld the validity of this donation both as an "intra vires" act and as a ratified, consummated "ultra vires" act of the corporation. Under said ruling, it would seem that even remunerative donations, although these are acts of liberality essentially, are valid corporate acts as long as some corporate purpose can be deduced therefrom, i.e. to enhance the image of the corporation as a fair and equitable business establishment, which gives it some advantage in the presence of less fair rivals. Indeed, in the *De La Rama* case, the court when a long way to justify this donation. For one thing, this involved a closed corporation, and the case turned out to be more a "family squabble" rather than a contest between strangers. Besides, the donation had already been consummated and partially performed. To invalidate it would have unsettled so many other transactions and disturbed vested rights.

On the whole however, the basic principle as regards directors' compensation in the Philippines is well settled. Directors are not entitled to compensation unless there is an express contract in advance of the services to be rendered. Past services cannot be compensated under some later contract or resolution. It is the by-laws or articles of incorporation which determines the entity in the corporation, which will determine such compensation, whether it be the body or stockholders or the board itself. And in the absence of such provisions, the members of the board of directors are presumed to serve in office without any compensation.

4). The directors' duty of obedience

The duty of obedience is what Gower calls the "second facet of a director's duty". This is the duty to exercise powers for a particular purpose, and not for some extraneous purpose, even though they honestly believe that to be in the best interest of the company.[156] This is the basis of the "ultra vires" doctrine, which inhibits a corporation from usurping powers which are not granted by law, nor defined in its articles of incorporation or by-laws. The liability of directors responsible for violation of this duty of obedience, would largely depend upon good faith and honesty.

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155 *Supra*, note 47.
156 GOWER, *supra*, note 23 at 474.

The validity of such acts will depend on whether or not these are inherently illegal, hence void ab initio, or merely ultra vires, which can be ratified by the stockholders of the corporation.

In the Philippines, the "ultra vires" doctrine is adopted from American jurisprudence. One of the earliest discussions on the subject may be found in an Opinion of the Attorney General of September 21, 1911, involving the Hongkong and Shanghai Bank's power to engage in the business of executing fidelity and guaranty bonds and other insurance contracts. It was opined that if these acts were done, not in connection with negotiable instruments or other business growing out of legitimate banking operations, these were "ultra vires". However, if such corporation, acting through its duly authorized officers, has entered into such guaranty and surety contracts which are beyond its powers with the knowledge and acquiescense of the Board of Directors and stockholders, and has enjoyed the benefits of such contracts, the corporation cannot set up as a defense the fact that the act was "ultra vires".[157] In the case of *Coleman v. Hotel France,*[158] the Supreme Court ruled that "ultra vires" cannot be interposed as a defense by the corporation to avoid an obligation otherwise legal and and equitable, where it defeats the ends of justice or work a legal wrong.

The "ultra vires" issue is closely linked with the problem of "ratification". Where the defense of "ultra vires" is made, the usual approach of the court to resolve the issue is to look into the particular position and relation of the officers or directors, the conduct of the board, the nature of the interest, as well as the attitude of the stockholders and the corporation itself. The general policy is to declare as valid such acts, which are proved to be ratified or acquiesced to by the corporation or stockholders, as long as these are not illegal per se. This is on the ground of estoppel. Thus in the case of *Pirovano v. De La Rama Steamship Co.,*[159] where all the stockholders were the very same directors, who performed the "ultra vires" act, the corporation was held in estoppel to allege "ultra vires".

The *De La Rama Steamship Co.* case is an important precedent on the "ultra vires" doctrine in Philippine law. It involved a remunerative donation of a considerable amount of money in favor of the wife and children of the deceased company president, responsible for the success of the enterprise. The court passed upon on the validity of said donation, relying on the American authorities, stating thus:

> "Granting arguedo that it is "ultra vires" the same cannot be invalidated for that reason alone, it appearing that the donation represents not only the act of the board of directors but of the stockholders themselves as shown by the fact that the same had been expressly ratified in the re-

[157] Opinion dated September 21, 1911, 6 OPS. ATT'Y GEN. 159 (1929).
[158] 29 Phil. 323 (1914).
[159] *Supra,* note 47.

solution duly approved by the latter. By this ratification, the infirmity of the corporate act if any has been obliterated thereby making the act perfectly valid and enforceable. This is particularly so if the donation is not merely executory but executed and consummated and no creditor is prejudiced or if there are creditors affected, the latter have expressly given their conformity xxx.

Distinction would be made between corporate acts or contracts which are illegal and those which are merely ultra vires, not illegal and void ab initio, but not within the scope of the articles of incorporation, are merely voidable and may become binding and enforceable when ratified by stockholders, x x x" (citing 7 Fletcher, Cyc. Corp. 563-564).

Ratification is a crucial issue in cases involving acts which are not illegal or declared by law as contrary to public policy. In determining this issue, reference must be made to the facts, circumstances and actuations of the corporation, the board of directors and stockholders in relation to the act in question. This is so because ratification can be done expressly or tacitly. It is tacit ratification that may give rise to problems of evaluation of facts. The Civil Code states thus:

"Art. 1393: Ratification may be effected expressly or tacitly. It is understood that there is a tacit ratification if, with knowledge of the reason which renders the contract voidable and such reason having ceased the person who has the right to invoke it should execute an act which necessarily implies an intention to waive his right."

Under Philippine law, the defense or allegation of "ultra vires" can be overcome by the rules of "estoppel" and ratification" as declared in the *De La Rama Steamship Co.* case and the New Civil Code.

A more recent case involves an interpretation of Section 17½ of the Corporation Law. In the case of *De La Rama v. Ma-ao Sugar Central Co. Inc.*,[160] the investment of corporate funds and delivery thereof to an affiliated company, without the approval of the Ma-ao Board of Directors was attacked as "ultra vires" and illegal. In resolving the issue, the Supreme Court made certain distinctions as to the applicability of Section 17½[161] of the Corporation Law. Said provision required the affirmative vote of ⅔ of the voting power of the corporation, for the investment of company funds in any other corporation or business or any purpose other than

[160] *Supra,* note 100.

[161] Act No. 1459 (1906), as inserted by Com. Act No. 437 (1939).

Sec. 17 1/2: "No corporation organized under this Act shall invest its funds in any other corporation or business, or for any purpose other than the main purpose for which it was organized, unless its board of directors has been so authorized in a resolution by the affirmative vote of stockholders holding shares in the corporation entitling them to exercise at least two-thirds of the voting power on such a proposal at a stockholders' meeting called for that purpose: Provided, That for the purpose of this section, the business described in the prospectus issued by the corporation upon its organization and duly filed in the Securities and Exchange Commission shall prevail over the purpose clause of its articles of incorporation xxx".

the main purpose for which the corporation was organized. It held that if the funds or property were disposed pursuant to a corporate purpose, expressed in the articles of incorporation, stockholders approval is not necessary. But when use of funds is solely for investment and not to accomplish a stated corporate purpose, then Section 17½ requisite of stockholder vote is necessary. In this case, there was some corporate purpose sought to be accomplished, hence the "ultra vires" allegation failed. The rule seems to be that as long as an act is for some stated corporate purpose it cannot be considered "ultra vires", hence valid and enforceable.

The duty of obedience also requires that directors act only with and in accordance with the authority vested upon them. But what is the liability of a director who acts without or contrary to his authority?

The protection of innocent third parties seems to be the prime concern of the Supreme Court, as can be seen from the cases. The burden of proof is placed upon the corporation to establish that such authority did not in fact exist in favor of the officer or director purporting to act for the corporation. And on the part of the officer claiming authority, the burden lies upon him to show that he was in fact authorized or that his acts were ratified by the whole board. Failing this, he becomes personally liable for all consequences of the controverted transaction.[162] This is reasonable, considering that the public is bound to rely to a large extent upon outward appearances, particularly so when the directors permit the officer or agent to exercise the authority and thereby held him out as a person competent to bind the corporation. The public is not supposed nor required to know the transactions which happen around the table where the corporation's board of directors and/or stockholders formulate policies. Whether a particular officer actually possess the authority which he assumes to exercise is frequently known to a very few. Besides, proof of such authority is usually not readily accessible to the stranger who deals with the corporation on the faith of the ostensible authority exercised by the corporate officer.[163]

Usage of the company and acquiescence of the board is such proof of apparent authority and protects the third party who has acted in good faith in dealing with the corporation. However, there must likewise be evidence that such reliance was justified, otherwise the party claiming against the corporation will have to assume the risk of the consequences of lack of authority. Thus in a case where the claimant contracted merely with the manager of a provincial branch, who was neither a director, officer or stockholder of the corporation, which facts were known to the plaintiff, the latter was said to have assumed the risk of the unauthorized transaction.[164] On

[162] Prudential Bank and Trust Co. v. Lanuza Bay Lumber Co., Inc., CA-G.R. No. 23988-R, May 25, 1964, 5 C.A. Rep. 2d 931 (1964); Theaters Supply Corp. v. Malolos, CA-GR, 2830-R, February 28, 1950, 48 O.G. 1803 (May, 1952).

[163] Ramirez v. Orientalist Co., 38 Phil. 634 (1918).

[164] Deen v. Pacific Commercial Co., 41 Phil. 732 (1922).

the other hand, reliance was justified where the officer was in reality its owner, holding nearly all of its stocks and was permitted to manage the business of the corporation by the other directors who were interested only nominally.[165] Acceptance of benefits by the corporation is ratification of the allegedly unauthorized contract, hence said corporation cannot repudiate it.[166] However, a corporation cannot legally enter into contract of partnership with another corporation. Such contract, being illegal, is void and cannot be ratified.[167]

The foregoing case law establishes the manner and the reasons behind corporate and director's liability for unauthorized acts in relation to third parties dealing with the corporation. One question however, still remains unanswered. What is the liability of the director acting without, beyond or contrary to his authority towards the corporation? The answer to this query would depend much again upon thee good faith of the director. As held in the case of *Prudential Bank and Trust Company v. Lanuza Bay Lumber Co.*, decided by the Court of Appeals, a director or officer is personally liable and the burden of proof lies on him to show that he had authority.[168] If having failed to do so, and the corporation suffers damage by reason of his conduct, it is but just that the director should be answerable. Such damage may be actual damages. And where the violation of the authority was willful, with deliberate intent or in bad faith, he may liable for moral and exemplary damages, under the Civil Code provisions.[169] However, where the corporation has expressly or tacitly ratified or approved the director's unauthorized conduct, with full knowledge of such facts, or has enjoined the benefits thereof, there seems to be no reason to hold the officer or director for any liability. In the first place, there would be nothing with which to measure actual damages suffered. Secondly, in these instances, particularly where the corporation has benefited from the transaction, and for more practical reasons, it is unlikely that a corporation will hold an officer or director liable for conduct which have proved beneficial to its interests. This is perhaps the reason why, at least in the Philippines, no case involving this issue has yet arisen.

[165] Zamboanga Trans. Co. v. Bachrach Motor Co., Inc., 52 Phil. 244 (1928); Board of Liquidators v. Kalaw, *supra,* note 73.

[166] NEW CIVIL CODE, art. 2220:
361 (1963).

[167] J.M. Tuazon and Co., Inc. v. Bolanos. 95 Phil. 106 (1954).

[168] *Supra,* note 162.

[169] NEW CIVIL CODE, art. 2220·

"Willful injury to property may be a legal ground for awarding moral damages if the court should find that, under the circumstances, such damages are justly due. The same rlue applies to breaches of contract where the defendant acted fraudulently or in bad faith."

"Art. 2229. Exemplary or corrective damages are imposed, by way of example or correction for the public good, in additoin to the moral, temperate, liquidated or compensatory damages."

On the whole, it will be good faith that will decide the fate of an erring director. Failure to come up to some objective standard set up on the conferral of powers, does not per se mean a violation of this duty. Where the director has endeavored to interpret the purpose of his powers correctly and honestly believed that the action will fulfill that purpose and is in the best interest of the company, he is free from liability. However, gross error may mean that the duties of care and skill was violated but not the fiduciary duty to act in good faith for the best interest and within the purposes of the corporation.[170]

It might be expected that like the duty of care and skill, this duty of obedience will also gain a more liberal treatment in favor of directors, in view of the liberal trend now followed as regards the business judgment rule, and increasing reliance on the rule of estoppel and ratification for the validity of corporate contracts and transactions. And where there is ambiguity in the grant of powers, the presumption of good faith and honest purpose, will operate in favor of validity of the director's conduct. This is both sound and expedient, otherwise, the job of a director will become extremely hazardous and too onerous as to warrant serious consideration by those qualified and able to run the corporate business but cannot guarantee the correctness of their judgments at all times.

The corporate director and the stockholder

The fiduciary relation of the director to the corporation and to the stockholders as a whole body is well recognized. Thus his position of trust prevents him from making personal gains at the expense of the company or the whole body of stockholders. He cannot use powers for personal advantage, no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. He is at all times subject to the equitable limitation that powers may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion and detriment of the cestuis.[171] However, serious difficulties arise in working out the principles of law governing the relations between the individual stockholders and the director. It is this personal relation between the stockholder and the director and managing officer of a corporation which gives rise to troublesome situations, on account of the advantage taken by corporate insiders of the knowledge and information gained through his official position and access to many opportunities for profit, at the expense of the stockholder.[172]

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[170] GOWER, *supra,* note 23 at 477.

[171] Thompson, *The Trust Relations Between Corporation Officers and Stockholders Buying of or Selling Their Stocks to Them,* 67 CENT. L. J. 45 (1908); Berle, *Corporate Powers as Powers in Trust,* 44 HARV. L. REV. 1049 (1931); Nielsen, *supra,* note 52 at 609 (1965-66).

[172] Bigelow, *The Relation of Directors of a Corporatoin to Individual Stockholders,* 81 CENT. L. REV. 256 (1915).

The problem seems to proceed from the position of shares of stock in the scheme of corporate organization. It is evidence of interest in the property of the corporation under the control of the directors. As described in the case of *Stockholders of F. Guanzon & Sons, Inc. v. Register of Deeds of Manila,*[173] it was stated:

> "A corporation is a juridical person distinct from the members composing it. Properties registered in the name of the corporation are owned by it as an entity distinct and separate from its members. While shares of stock constitute personal property they do not represent property of the corporation. The corporation has property of its own which consists chiefly of real estate. A share of stock only typifies an aliquot part of the corporate property or the right to share in its proceeds to that extent when distributed according to law and equity but its holder is not the owner of any part of the capital of the corporation. Nor is he entitled to the possession of any definite portion of its property or assets. The stockholder is not a co-partner or tenant in common of the corporate property."

Since shares of stock represent an interest in corporate property, if these are transferred, these shares transmit undivided and substantial interest to the purchaser. And if acquired by a director, it means an acquisition of rights and interest to the property under his control and administration as agent for the corporation.

Directors and managing officers conduct of the corporate business produces significant effects on the shares of stock. It is common knowledged that the market value of shares rise and fall not only because of an increase or decrease of tangible property, but by reason of real or contemplated action on the part of the managing officers, such as declaring dividends, making profitable or losing contracts and good or bad management as a whole. It is also the common understanding of those forming the corporation that the securing of profit is the prime corporate purpose.[174] Under this operational set up, it is but reasonable to expect that some fiduciary relations exist between the director and the individual stockholder with respect to such shares in the latter's possession. It is on these considerations that in several instances, directors have been placed under a duty to disclose personal interest and facts of material importance with respect to his dealings with the stocks in the hands of a stockholder. The situations involved however, are far from being simple. That is why divergent theories have been expounded to govern this relation between a director and a stockholder with respect to the acquisition of shares of stocks by the latter.

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[173] G.R. No. 18216, October 30, 1962.

[174] Thompson *supra*, note 171.

A. The director's duty of disclosure

The duty of disclosure relates to the question whether a director who obtains favorable information regarding the corporate business which will shortly put up the prices of shares in the market may deal or buy shares from other stockholders without giving any hint of unusual developments and thereby reap tremendous profits. The theories aimed at resolving this issue swing from one extreme to the other and are expounded with equal force to condemn or justify directors' dealing with corporate shares, with or without disclosure of material facts.

In English common law jurisdictions, the director normally owes no duty to individual stockholders. Thus *Percival v. Wright*,[175] holds that directors cannot be liable to members whose shares they bought without disclosing a take-over bid at a higher price. On the other hand, there are in the United States distinct theories of director's fiduciary duty of disclosure to shareholders. Thus the orthodox majority holds that directors owe a fiduciary duty to the corporation as an entity, and sustain a relation of trustee to stockholders, collectively. However, as to the individual stockholders, no such fiduciary relation exists. And even with respect to the stockholders as a whole, such trust relation is limited to acts in connection with the property of the corporation itself and the management of the business. Aside from that, there is no application of the trust doctrine to the separate individual stockholder. Since, individual dealings are not corporate business, as long as there is no active misrepresentation by word or act, the director does not commit any wrong and may therefore trade like strangers at arms length. He need not disclose to the stockholder such information, at least in the absence of inquiry.[176] The difficulty however lies in cases where there is stock manipulation by the director to secure profit, but no positive misrepresentation or malfeasance can be established. The tendency to encourage unscrupulous directors to take advantage of their position and official knowledge to the prejudice of shareholders, made this rule morally questionable.[177] The result was a movement to the other extreme which required the director to disclose any official knowledge which materially affects the value of the shares and puts the shareholder at an unfair advantage. Under this "minority or fiduciary rule" the director has the burden of proof to show that he had dealt the stockholder fairly, disclosing all pertinent information in his possession when bargaining for the

[175] GOWER, *supra*, note 23 at 493; Percival v. Wright, 2 Ch. 421 (1902).

[176] Smith v. Hurd, 12 Met. C. 371, 46 Am. Dec. 690 (1847); Von Aua v Magenheimer, 110 N.Y.S. 629, 639 (1908); Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659, 661 (1933); Bigelow, *supra*, note 172.

[177] Loss, *Fiduciary Concept as Applied to Trading By Corporate Insiders In The United States*, 33 MOD. L. REV. 34 (1970). It was noted that the Jenkins Committee of Canada recommended the overruling of Percival v. Wright, *supra*, note 175.

shares, even without inquiry from the stockholder.[178] In effect, it required the director to volunteer all information, and proclaim his reason, which sometimes amounted to absurdity.[179] Manifestly, the object of the minority rule was to balance the powers of the stockholder and the director for otherwise the superior knowledge of the director would enable him to take advantage of the stockholder's ignorance. Full disclosure gives the stockholder an indispensable bargaining weapon to secure a fair trade.

The harshness of the majority rule and the inflexible rigidity of the minority rule, the first tending to unduly favor directors in dealing with the shareholder, and the second, tending to make a director's position extremely hazardous, have induced a good number of courts to adopt a middle ground. Under the so-called "special facts" doctrine, while a director does not stand in fiduciary relation to the stockholder, he is under legal obligation to make fair and full disclosure of pertinent official information where special circumstances exist giving rise to the obligation to disclose.

The "special facts" rule has its origin in the Philippines in the case of *Strong v. Repide*.[180] This case developed under a setting predominantly of Spanish influence involving a "sociedad anonima" organized under the Spanish Code of Commerce, but decided on the persuasion of both Spanish and American jurisprudence.

1). *Strong v. Repide* and the "Special Facts" doctrine

The juridical entity involved in the case of *Strong v. Repide* [181] was a "sociedad anonima" organized in 1900 in accordance with the provisions of the Code of Commerce of Spain. Defendant Repide was the director, managing agent and the majority stockholder of the society. Plaintiff, Mrs. Strong, was a minority shareholder, owning bearer certificates of stocks which she entrusted to her agent, named Jones. The defendant procured the purchase of plaintiff's stocks under special circumstances, so well contrived, that it merited a distinct treatment by the various courts passing on the issues of the case.[182] Thus, in the Court of First Instance, recovery was

[178] Hotchkiss v. Fisher, 136 Kan. 530, 16 P. 2d 531 (1932); Walker, *The Duty of Disclosure by a Director Purchasing Stocks From His Stockholders*, 32 YALE L. REV. 637 (1923).

[179] *Supra*, note 26.

[180] *Supra*, note 18.

[181] *Supra*, note 18.

[182] 6 Phil. 680 (1906); Rev'd. in 213 U.S. 419 (1909), 53 L. Ed. 853, 29 S. Ct. 521, 41 Phil. 947 (1909).

The special facts are:

Defendant was a director, owing ¾ of the shares of stocks of the corporation; he was at the same time administrator general of the company, with large powers and engaged in the negotiations which finally led to the sale of the company's only asset—land, to the government, a price which the very greatly enhanced the value of the stock. He was the chief negotiator for the sale of his land and he alone knew the nature and progress of the negotiation. By reason of such ownership and agency for the shareholders, no one knew as well as he the exact condition of the negotiations,

allowed on two premises: lack of authority on the part of plaintiff's agent to sell said shares, notwithstanding the fact that they were bearer certificates, hence negotiable under certain circumstances; and that there was fraud in the acquisition of said shares by the defendant. Authority to sell was necessary because transfer by delivery of bearer certificates is sufficient to convey ownership only when done on a commercial exchange or through a licensed commercial broker.[183] On appeal to the Philippine Supreme Court, the first ground of authority of the agent was upheld, but not the ground of fraud. Non-disclosure of facts which will likely increase the value of the stocks was not considered fraudulent because, there was no duty to disclose on the part of the director. Besides, neither plaintiff nor her nor her agent inquired or applied to the defendant for information or communication with him in any way. Nor was the defendant shown to have put forth statements whether in public or private for the purpose of influencing the sale. This line of reasoning clearly follows the "majority rule" in American law discussed above.

The court further considered the accountability of corporate directors as limited to the property of the corporation subject to administration and does not include the shares in the hands of stockholders. Being so, the prohibition against acquiring property by agents under Article 1459 of the Spanish Civil Code,[184] did not apply. Hence directors may deal with such shares like any other property of strangers. While these shares may in fact be evidence of property rights on corporate property yet members have no title pertaining to such property. A dissenting opinion was made by Justice Johnson, pointing out the circumstances of fraud and the clandestine manner of acquisition of shares at a very low price equal to one-tenth of the value thereof, based upon the price which defendant had already been offered. This and other facts was a violation of fiduciary relations which existed between him as general manager and director towards the individual stockholder. This fiduciary duty to the stockholder individually and col-

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and the probability of sale, and the probable price that might be obtained on such sale. The lands were the only valuable asset of company.

The purchase of the plaintiff's shares was done as follows: Before negotiation for sale was completed, the defendant employed an agent to purchase the stocks, and concealed from the plaintiff's agent his own identity and his knowledge of the state of the negotiations and their probably results, with which he was familiar as chief negotiator for the company and the shareholders. He kept up this concealment by giving a check to pay said shares issued in another's name. Defendant used two intermediaries for the purchase although his office was just next door ot the office of plaintiff's agent who was in possession of the shares.

183 CODE OF COMMERCE, art. 545(3).

184 OLD CIVIL CODE: (Spanish)

"Art. 1459: The following cannot acquire by purchase even at a public auction or judicial sale, whether in person nor by an agent:

1) xxx

2) Mandararies, the property with the administration of which or alienation of which they have been charged.

See 10 MANRESA, CODIGO CIVIL 100; See text, pp. 38-41a.

lectively does not allow such director to deal with property of the cestuis to reap individual benefits at the expense of the individual shareholder. Justice Johnson's dissent however assumed that such fiduciary relation exists, which is precisely the point negated by the majority opinion and the "majority rule".

The decision of the Philippine Supreme Court above-described, was reversed by the United States Supreme Court, in 1909.[185] This decision hinged mainly on the issue of fraud through "insidious machinations" under Article 1269 of the Spanish Civil Code—the very issue which the Philippine Supreme Court practically passed sub-silentio, on the premise that there was no fiduciary relation between the director and stockholder with respect to shares on the hands of shareholders.

The Spanish Civil Code declares void,[186] the contracts procured through fraud or deceit by words or insidious machinations to induce one of the contracting parties to execute a contract which without them, he would not have made. "Insidious machinations" was thus defined to include both active and passive fraud." [187]

> "The meaning of the words "insidious machinations" may be said to be a deceitful scheme or plot with an evil design or in other words, with a fraudulent purpose. Thus, the deceit which avoids the contract need not be by means of misrepresentation in words. It exists where the party who obtains the consent does so by means of concealing or omitting to state material facts with intent to deceive by reason of which omission or concealment the other party was induced to give consent which he would not otherwise have given. xxx This is the rule of common law also; but in both cases it is based upon the recognition that under all the circumstances of the case it was the duty of the party who obtained consent, acting in good faith to have disclosed the facts which he concealed. xxx This was the Spanish law before the adoption of the Code. xxx In such case concealment is equivalent to misrepresentation."

This definition contains all the elements of fraud. Common law deceit as noted above consists of false representation of material facts, which defendant knows to be false, but nonetheless he makes the statement for the purpose of including the plaintiff to rely on it. There must be reliance on the part of the party induced, who thereby suffers damage as a consequence thereof. Note however, that no common law liability arises from complete non-disclosure, as distinguished from a half-truth. No liability arises from complete concealment, unless the other party is prevented from acquiring material information, or one party is under duty to the other to exercise reasonable care to disclose the matter in question because a fiduciary or other similar relation of trust and confidence exists between the parties to the transac-

[185] *Supra*, note 18.
[186] SPANISH CIVIL CODE, arts. 1261, 1266, 1268 and 1269.
[187] Strong v. Repide, *supra*, note 18.

tion.[188] These circumstances give rise to active fraud which is alone actionable under common law. Passive fraud or mere non-disclosure as such is not actionable.

The decision of *Strong v. Repide* in its interpretation of Article 1269 on "insidious machinations" makes both positive misrepresentation and passive concealment or non-disclosure fall within the purview of the term. And it is the existence of "special facts" that established the fiduciary duty to disclose material facts to the shareholder. Thus fraudulent conduct under the common law concept was to a certain extent expanded. The court stated:

> "If it were conceded for the purposes of the argument that the ordinary relations between directors and shareholders in a business corporation are not of such a fiduciary nature as to make it the duty of a director to disclose to a shareholder the general knowledge which he may possess regarding the value of the shares of the company before the purchases any from a shareholder, yet there are cases where by reason of the special facts, such duty exists."

The duty of disclosure here becomes part of the good faith to justify dealing with corporate property and shareholders' stocks. The defendant was made liable not alone and simply in his character as a director but because in consideration of all the existing circumstances above-detailed, it became the duty of the defendant acting in good faith to state facts before making the purchase. The special facts took out the director-stockholder relation of the general (majority) rule, so that the former cannot purchase shares from the stockholder without informing the latter of the facts that affect the value of shares.

The materiality of the facts concealed is essential in finding fraud in the transaction. Thus the state of negotiation of the sale of land and their probable result were the most material facts affecting the value of the shares of stock of the company. The stockholder's agent would not have sold them at the price he did, had he known of the actual state of negotiation as to the lands. Concealment of identity was considered a strong evidence of fraud on the part of the defendant. Its purpose was apparently to more easily avoid questions relative to the state of negotiations and the value of the shares. Besides, the price would have been greatly affected if he were known to the seller. By concealing his identity, the defendant avoided the possibility of having to make actual positive misrepresentation - which act constituted active fraud, and clearly actionable. As a matter of fact the scheme met some success in the Philippine Supreme Court. The opinion of Justices Mapa and Arellano stated that "lack of some positive

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188 Loss, Securities Regulations 1430-31.

act of misrepresentation did not make the directors' conduct fall within the definition of fraud "though insidious machinations" which requires positive conduct. It was asserted that some positive act is necessary, which may not necessarily amount to "estafa" under the Penal Code.

The United States Supreme Court decision defining "insidious machinations" makes the distinction between passive and positive concealment unnecessary. Both kinds are actionable fraud.

The case of *Strong v. Repide,* exemplifies both facets of fraud. There was plain concealment and non-disclosure. Yet, it cannot be said that defendant did not take steps to bring about the situation wherein he avoided making positive representations. Concealment of identity was positive fraudulent conduct, actionable under common law. Non-disclosure took the form of concealment of material facts on the state of negotiations and value of shares. In the presence of "special facts" this gave rise to a duty to disclose, failing which, amounted to fraud.

That complete non-disclosure is fraudulent conduct, finds support also in the *"Siete Partidas" Partida 7, Titulo 16, Ley 1,*[189] the old Spanish law, and precedent of Article 1269 of the Spanish Civil Code in question in the case of *Strong v. Repide.* Thus it is stated:

> "Partida 5, Titulo V, Ley 57-A. Land estate or house, or vineyard, or everything else of somebody, where he does not know how much they are worth, nor has he even seen them, and *without wanting to sell them, but somebody else induced him through false reasons to sell* so that a sale was made, we say, that such bargain can be retracted and is not binding, where such sale was entered for a price less than its value, or for a price that is not less. But if the owner of the thing *wants to sell,* and the purchaser deceives him, hiding some of the things which belong to the estate, or to the thing sold, or craftily makes the owner believe that some of the things which belong to the estate are in the possession of somebody else, or that they were difficult to cashed, or that they were lost, then we say that the bargain is binding, because the seller had the willingness to sell."
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> "Partida 7, Titulo XVI, Ley 1-'Dolus' in Latin means 'fraud' and fraud is that some person do against another with words false or deceiving or biased which they say with the intention to deceive, and to carry a lie. This fraud is in Latin called 'dolus malus' which means 'bad fraud' and although the deceivings can be done in many ways, the principal ones are two: the first one is when they do it with lying or crafty words; the second one is when somebody is asked about something and he remains silent with intention to fraud, not willing to answer, or if he answers, says misleading 'hidden' words, so that through them the one who asks cannot protect himself from the fraud."

The court also referred to American cases, to support its theory. The pattern of the court's analysis shows the shift from the "majority rule" to

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[189] La sexta y setena partida, Tomo 3, Codigo de Las Siete Partidas, *in* LOS CODIGOS ESPAÑOLES 402 (2d. ed., 1872); 20 SCAEVOLA, CODIGO CIVIL 616 (1904).

the "minority rule" until it reached a middle ground of "special facts" to warrant the existence of a fiduciary duty of the corporate insider to disclose material facts.

The existing jurisprudence as of 1909 showed the following rationale for negating or supporting the existence of a fiduciary duty between the director and individual stockholder (1) some misrepresentation of a material fact was made by the officer directly to the selling shareholder, in which case, fiduciary relation is immaterial to establish liability; (2) false reports whether by false statements of facts or partial or incomplete statements intentionally made to the corporation or the public upon which the injured party relied, in that case, fiduciary relation is likewise immaterial; (3) false statements of facts designed to induce action were made but were not relied upon or where the party relied on his own independent investigation, or had equal knowledge, opportunity or the representation did not relate to a material fact; (4) full disclosure of all the material facts then known to the officer affecting or likely to affect the value of the shares at the time of the purchase was made, hence no liability exists whether or not trust relation exists; (5) where the purchasing officer has made a special agent of the shareholder to sell the share in which case the special agency created a fiduciary relationship; (6) where there was fraudulent misrepresentation in order to depress the value of the shares for the purpose of purchasing them at less than their value in which case, the right of action properly pertains to the corporation; (7) where there was concealment, either active, by misrepresentation through misleading reports or statements, or passive by mere silence, e.g. as to existing conditions or future prospects of the company, as to pending profitable sales of all property; as to the existence of conflicting interests and as to identity of the purchasing officer.[190] This is exemplified by *Strong v. Repide.*

From this review, it is evident that there is liability for actual fraud, for the abuse of confidence of a special agent, for fraudulent acts affecting the value of the shares concealing this for the purpose of purchasing at the depressed value or for active or intentional concealment but *not* for mere silence or passive concealment. And there is no presumption of fraud

[190] Wilgus, *Directors Purchase of Shareholders Shares,* 8 MICH. L. REV. 267 (1910) Cases cited are Smith v. Hurd, 12 Met 371; 47 Am. Dec. 690 (1847); Carpenter v. Danforth, 52 Barb (NY) 581 (1868); Board of Tippecannoe Country v. Reynolds, 44 Ind. 509 (1873); Deaderick v. Wilson, 8 Baxt. 108, 67 Tenn. 108 (1877); Gillette v. Bowen, 23 F. 625 (1885); Crowell v. Jackson, 53 N.J.L. 656, 23 A. 426 (1891);Krumbhaar v. Griffiths, 151 Pa. 223; 25 A. 64 (1802); Percival v. Wright, 2 Ch. 421; Wahsh v. Goulden, 130 Mich. 531, 90 N.W. 406 (1902); O'Niele v. Ternes, 32 Wash. 528, 73 P. 692 (1903); Hooker v. Midland Steel Co., 215 Ill. 444, 74 N.E. 445 (1905); Walsham v. Stainton, 66 Eng. Ch. 517, (1863); Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903); Stewart v. Harris, 69 Kan. 498, 77 P. 277 (1904); Von Au v. Maganheimer, 126 App. Div. (NY) 257, 110 N.Y.S. 629 (1908); Steinfield v. Nielsen, 12 Ariz. 24, 100 1094 (1909); Perry v. Pearson, 135 Ill. 218, 25 N.E. 636 (1890).

or existing duty to disclose arising out of the relation alone. The case of *Strong v. Repide,* was therefore the first case of its kind where passive concealment was actionable fraud on account of the "special facts".

2). The "special facts" doctrine and insider trading

The "special facts" doctrine assumed considerable importance in the United States, where we witness the flowering of the corporate form as the main vehicle of business. It was indeed a welcome innovation to the "majority rule" unacceptable to many on account of some moral scruples. Thus *Strong v. Repide,* became a leading case on the relation of directors to non-official shareholders in the purchase of the latter's shares of stock. It was an answer to the need for some moral yet flexible scheme to assure the ultimate success of the corporation as a safe place for investments. Subsequent cases show that courts have been willing to find some "special facts" to bring the case out of the "majority rule".[191] This is particularly so in the case of "closed" corporations where the buyer and seller of the shares are the only shareholders. In these cases courts have invariably held that a fiduciary relation existed between them and have held transfers of stock under such circumstances to the same standard of good faith as transactions between partners.[192]

This is a desirable trend, particularly if applied to the Philippines. A considerable number of corporations that are organized are mostly closed corporations formed by members of the same family or relatively few individuals. The diffusion of stock ownership has not yet reached such high proportions that majority control is readily traceable to one or few individuals, who actually run the affairs of the corporation. These are the persons who know the business, and therefore have an obvious, natural superiority over the mere shareholders. It is in these instances therefore where a duty to disclose need to exist as a rule rather than as an exception.

Prior to the passage of federal securities laws and regulations, the "special circumstances" rule played a vital role. The definition of fraudulent conduct aided in determining issues of manipulation, fraudulent concealment, in criminal prosecutions for fraudulent use of interstate mails.[193] The concept of passive fraud as an actionable conduct gained ground. Thus where a director, general manager and vice-president of the company enforced an option contract, this was denied on the ground that he had con-

[191] Smith, *Purchases of Share of a Corporation by a Director From a Shareholder,* 19 MICH. L. REV. 698 (1921).

Cases reviewed after Strong v. Repide: George v. Ford, 36 App. D. C. 315 (1911); Black v. Simpson, 94 S.C. 312, 77 S.E. 1023 (1913); Jacquith v. Mason, 99 Neb. 509, 56 N.W. 1041 (1916); Dawson v. National Life Ins., Co., 176 Iowa 362, 157 N.W. 929 (1916); Poole v. Camden, 79 W.V. 310, 92 S.E. 454 (1917); Bollstrom v. Duplex Power Car Co., 208 Mich. 15, 175 N.W. 492 (1919).

[192] *Ibid.*, at 714-717.

[193] Coplin v. U.S., CCA Wash, 88 F. 2d 652 (1937); U.S. v. Buckner, CCANY 108 F. 2d 921 (1940).

cealed the fact that there was already arrangement for the sale thereof to another at a higher price. His position and the circumstances of the sale, placed him in fiduciary relation with special duty to disclose material facts.[194] Suppression of material facts was an actionable fraud.

In some cases however, the rule was not applied either because, the defendant acted in good faith in giving such information he believed to be sufficient to apprise the seller of the true condition of the company,[195] or where the evidence did not show that the defendant had any more knowledge of the business or value of the stocks than the plaintiff,[196] or where the plaintiff could have obtained such information by examining the books of the corporation to which he had access or he relied on other information obtained from other sources.[197] In many cases, failure of recovery or rescision of contract of sale was denied for lack of sufficient proof establishing the elements of fraud, particularly-materiality and causation. Clear and convincing evidence is necessary and mere allegation of fraud, without specifying what information was concealed or in what respect defendant failed to make full disclosure was not a proper pleading.[198]

In the Philippine scene, no case similar to *Strong v. Repide* has arisen. It is noted however that if the case of *Strong v. Repide* were to be decided under the New Civil Code of 1950, perhaps, there would have been less divergence of opinion among the members of the Philippine Court, on what constitutes "insiduous machinations" and whether or not concealment is actionable fraud. Following Article 1338, which is a restatement of Article 1249 the Spanish Civil Code on "fraud", Article 1339, stating thus:

> "Failure to disclose facts when there is a duty to reveal them as when the parties are bound by confidential relation constitutes fraud."

This provision settles the issue of passive fraud or concealment, however, more vital issue of existence of fiduciary relation which is the basis of the duty to disclose, remains to be controverted. While this clarifies what constitutes fraudulent conduct, a clear statement of the nature of director-stockholder relations is wanting. *Strong v. Repide,* does not decide the issue with precision. It merely acknowledges the fiduciary relation because of "special facts" which brought the case outside of the "majority rule". As such this calls for determination on a case to case basis.

This observation is supported by the statement of the court:

> "It is here sought to make defendant responsible for his action not alone and simply in his character as a director but because in consideration of

[194] American Trust Co. v. California Western State Life Insurance Co., 98 P. 2d 497 (1940); Dunnett V. Am. CCA Okl. 71 F. 2d 912 (1934).
[195] Ryder v. Bamberger, Cal. 158 P. 753 (1916).
[196] Ruckker v. Sanders, 182 N.C. 607, 109 S.E. 853 (1916).
[197] Buckley v. Buckley, 230 Mich. 504, 202 N.W. 955 (1925).
[198] Blakeslee v. Wallace, CCA Mich. 45 F. 2d 347 (1930).

> all the existing circumstances above-detailed it became the duty of the defendant acting in good faith, to state the facts before making the purchase. That the defendant was a director of the corporation is but one of the facts upon which the liability is asserted, the existence of all the others in addition, making such a combination as rendered it the plain duty of the defendant to speak."

Considered in this light such provision resolves the issues only halfway. There is still a need to determine the fiduciary relation case by case. In this aspect of law, uncertainty remains to be price of flexibility.

No doubt, the doctrine of "special facts" has done a lot of good, particular in the field of securities trading. It is here where the duty to disclosure is a declared statutory policy. However, the facts giving rise to the duty need to be appraised with the rule in mind.

B. The duty of disclosure and securities regulations

Disclosure is the essential mechanism regulating securities transactions both in the United States and the Philippine. The common law definition of fraud and the concept of fraud enunciated in the case of *Strong v. Repide,* may be said to be the starting point in the application of anti-fraud provisions of securities statutes. Thus recurrent problems invariably dwell on the same elements of common law fraud-materiality, scienter, reliance and damage.[199]

The United States Securities Act of 1933, used disclosure as a means of reforming practices which had characterized the public distribution of new stocks of the great crash.[200] The Securities Exchange Act of 1934, sought to free the securities market from artificial influences that affect stock trading, and also curb corporate "insider" abuse of information, which affect stock value.[201] Securities regulations in the Philippines first took the form of a "Blue Sky Law" in Act No. 2581 of 1961. It dealt primarily with the issuance and sale of speculative stocks to protect the public interest against speculative schemes which have no more basis than so many feet of blue sky, and the sale of stock in fly-by-night concerns, visionary oil wells, distant gold mines, and other like fraudulent exploitations. In 1936, the Securities Act, Commonwealth Act No. 83, was passed, to regulate both issuance, public distribution and trading of stocks and securities, thereby creating a Securities and Exchange Commission to implement the provisions thereof. Patterned after the two federal statutes, disclosure was likewise the means used to prevent or curtail fraudulent practices in securities transactions.

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[199] Loss, *supra*, note 188 at 1452.

[200] Wheat, *"Truth in Securities"*, 13 How. L. J. 100 (1967).

[201] Rubin and Feldman, *Statutory Inhibition Upon Unfair Use of Corporate Information by Insiders*, 94 U. PA. L. REV. 468 (1914); Lowenfels, *Codification and Rule 10(b)-5*, 23 VAND. L. REV. 591 (1970).

Disclosure, as described and defined under these statutes arise no longer as part of fiduciary duty as such but, as well a defined public policy to prevent fraud. It is made a duty by statutory definition. Disclosure is a continous process under these laws, from initial registration,[202] to the filing of periodic reports,[203] preparation of financial statements,[204] proxy rules,[205] and such provisions applied especially to corporate "insiders" [206] and the more comprehensive fraud provisions [207] prohibiting false or misleading statements with respect to any material fact. Through these measures, insiders and dealers are bound to exercise reasonable and due diligence not only in ascertaining what is material as of the time of transaction but in disclosing fully those material facts about which the outsider is presumably uninformed and which would in reasonable anticipation affect his judgment.

This particularly refers to Rule 10(b)-5[208] of the United States Securities Regulations, which is said to have become the weapon for those victims of unfair deals by both corporate insiders and other dealers. Strange perhaps, but this rule has its counterpart in the Philippine Securities and Exchange Commission's Rule C-1 and Section 20 of the Securities Act, Commonwealth Act 83 of 1936. It appears thus:

> "Sec. 20a—(4) If a dealer or broker or other person selling or offering for sale purchasing or offering to purchase the security, to make, regarding any such security for the purpose of inducing the purchase or sale thereof, any statement which was at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, and which he knew or had reasonable ground to believe was so false or misleading."

No case law has developed on this provision, in the Philippines, in contrast to the numerous instances wherein Rule 10(b)-5 is applied in the United

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[202] Com. Act No. 83 (1936), secs. 4 & 7.
[203] *Ibid.*, sec. 11; U.S. Securities and Exchange Act, sec. 13.
[204] *Ibid.*, sec. 7(11), (Phils.); *Ibid.*, U.S. sec. 14.
[205] *Ibid.*, sec. 24, (Phil.); *Ibid.*, U.S. Rule 14-a-3.
[206] *Ibid.*, sec. 26, (Phil.); *Ibid.*, U.S. sec. 16.
[207] *Ibid.*, sec. 20(4); Phil. Securities and Exchange Rules, Rule C-1; *Ibid.*, U.S. Securities and Exchange Rules, Rule 10(b)-5, 17 C.F.R., sec. 240.
[208] *Ibid.*

Sec. 20 (a)(4) "It shall be unlawful for any person, directly or indirectly: If a dealer or broker or other person selling or offering for sale or purchasing or offering to purchase the Security, to make, regarding any such security, for the purpose of inducing the purchase or sale thereof, any statement which was at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact and which he knew or had reasonable ground to believe was so false or misleading."

Ibid., Rule 10 (b)-5, SEC Rules U.S.

"It shall be unlawful for any person directly or indirectly by the use of any person or instrumentality of interstate commerce or of any facility of any national securities exchange: (1) To employ any device; scheme or artifice to defraud (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made in the light of the circumstances under which they were made, not misleading, or (3) To engage in any act, practice or course of business which operates or could operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

States, making such provision of vital importance. Future application in the Philippines will necessitate reference to the well developed jurisprudence on the subject in the United States.

Materially of fact concealed or misrepresented remains to be the issue in determining the presence of fraud. Reference to the concepts of fraud in common law and civil law and the rationale behind the ruling of *Strong v. Repide,* and subsequent cases decided on its authority will be helpful. This is justified because the securities acts and regulations aim essentially at fraud achieved through "untrue statements of material facts" or omission to state "material facts" which in the "light of circumstances under which they are made are misleading". Indeed, a view has been expressed that securities regulations has practically codified the "special facts" reasoning of the *Strong v. Repide* case.[209]

Materiality of facts is viewed, considering the time, publicity, importance of the information, good faith and intention or motive as discernible from the insiders' conduct.[210] And on this particular matter the doctrine embodied in *Strong v. Repide,* and the analysis of facts will greatly help in determining what facts assume materiality in the light of circumstances which raise the presumption of fraud and constitute a violation of fiduciary duty.

The duty to disclose rests on particular grounds, namely: the existence of relationship giving access directly or indirectly to information intended for a corporate purpose and not for the personal benefit of anyone, and the inherent unfairness involved where a party takes advantage of such information knowing that it is unavailable to those with whom he is dealing. A fact is material if it is of reasonable importance, which if omitted or disclosed, will affect the choice of action in the transaction. This concept is likwise embodied in the definition of "insidious machinations" in the Civil Code and *Strong v. Repide.*

The duty to disclose must also be considered in the light of fair and honest business practices under the circumstances existing at the time of transaction. It should likewise be related to the motive or intent in concealing a particular fact. Intent to defraud can be inferred from the conduct and attitude of the defendant, such as his method of acquisition, or an urgent desire to acquire stocks. The query of the court in the case of *Strong v. Repide,* will illustrate how intent is inferred:

> "Under these circumstances x x x why would he (defendant) desire to purchase more shares which if no sale went through were in his opinion

[209] Ginsberg, *"Insiders" and Materiality of Information Disclosed,* 18 AM. U. L. REV. 427-440 (1969); Ruder, *Corporate Securities Law,* 61 NEV. L. REV. 872; Cohen, *The Development of Rule 10-b-5,* 23 BUS. LAW. 593 (1968); Cohen, *Toward Coordination of 1933-34 Acts Disclosure Requirements;* 22 BUS. LAW. 811 (1967).

[210] Securities & Exchange Commission v. Texas Gulf Sulphur Co., 401 F. 2d 833 (1968).

worthless because of the failure of the government to properly protect the lands in the hands of their then owners?"

The same question should also be asked of directors or "insiders" who race to acquire more stocks upon knowing of a valuable report, no matter how insubstantiated such report may be at the time. Certain reports may initially be speculative, but why should a stockholder whose stock is sought to be purchased, not be entitled to know such facts at the time, and judge for himself the value, truth and certainty of favorable prospects, the same way as the corporate "insider"?

The case of *Texas Gulf Sulfur Co.*[211] exemplifies a situation where timing was the pivotal point in determining materiality of a fact. In these instances, there is the problem of balancing the need to disclose in order to act fairly toward the stockholder, and the obligation not to disclose in order to act fairly toward the corporation, whose interests might be jeopardized by premature disclosures. It would seem however, that the stockholder should also be informed of the facts motivating the desire to purchase on the part of the "insider", with the caution that such facts are "unofficial" or unsubstantiated. For both purchaser and seller, there then operates the principle of "caveat emptor" an assumption of risk on final results and developments. It is but fair that facts which inspire the purchaser to acquire more stocks should also be available to the seller for fair evaluation and decision.

The "caveat emptor" proposition may however raise difficult problems like: What should be disclosed? When should disclosure be made? How should it be made? Who should make the disclosure? — the insider or the corporation? To whom should disclosure be made — to the individual stockholder or to the public at large? The answers to these inquiries should be determined on the particular facts and circumstances of each case, for no hard and fast rule can be formulated.

The basic policy behind securities regulations is to afford fair and equitable opportunity to the investing public to be informed of the actual state of corporate affairs, in order to make sound investment decisions. This is the rationale of the duty to disclose. The operations of this policy is extremely difficult, in the presence of Rule 10(b)-5 of the United States SEC regulations, and possibly also the Philippine counterpart, above-cited. Violation of Rule 19(b)-5 is possible through negligence or intent to defraud, for it is the fact of making any untrue or misleading statement or omission to state a material fact that constitutes violation under subsection (2) thereof. Thus where premature, unsubstantiated reports are made, to the public, either by the insider or the corporation, there is extreme danger of liability for false or misleading disclosure. On the other hand, certain in-

211 *Ibid.*

formation though unverified and unsubstantiated may spur a high degree of stock trading activity among those who are duly informed. The problem is, should such information be disclosed, otherwise liability may arise for non-disclosure of a material fact. Here lies the dilemma that confronts a corporation and an insider, as may be seen in the *Texas Gulf Sulfur Co.* case.[212]

Section 20 a-4 of the Securities Act of the Philippines may possibly have a different interpretation as far as the matter of negligence or intent as a manner of violating said provision is concerned. The provision adds the phrase "and which he new or had reasonable ground to believe was so false or misleading". This implies knowledge and intent, to mislead or defraud. So that the mere fact of making untrue statement does not of itself create liability. Knowledge of its falsity must likewise be established. With this observation, it seems that it would be more difficult to impose liability upon an individual under Section 20 a-4, than under the American Rule 10 b-5, considering that knowledge and intent are essentially subjective and probable in most cases mainly by circumstantial evidence only. It is in these instances where the analytical process in *Strong v. Repide* and the "special facts" doctrine, its appreciation of facts and circumstances constituting fraud may assume vital importance.

The concern for the investor against possible "insider" abuse is further manifested in expanded definition of what is an "insider",[213] and in specific provisions on short-swing profits, under Section 16(a) and (b) of the United States Securities Exchange Act.[214] Again, this provision has its counterpart in the Philippine Securities Act, under Section 26(b) which provides:

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[212] *Ibid.*

[213] Schoenbaum v. Firstbrook, 268 F. Supp. 385 (1967); 405 F. 2d 215 (1968) "*Schoenbaum v. Firtsbrook: The New Fraud, Expands Federal Corporation Law*", 55 VA. L. REV. 1103-1127 (1969).

3 Loss, *supra*, note 188 at 1452. "Insiders" include the controlling stockholder, directors and officers, members of their immediate family, friend or acquaintance or "tippees', any person who picks up private information in the course of business negotiation with the corporation, brokers who purchase on behalf of an insider and who has knowledge of inside information under obligation to disclose as the insider who purchases directly and the issuer.

[214] Com .Act No. 83 (1936), section 26: (b) Any profit realized by a beneficial owner, director, or officer through the unfair use of information received as such, from any purchase and sale, or any sale and purchase, of any security of such issuer (other tran an exempted security), within any period of less than six months of the issue thereof, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer.

(US) Securities and Exchange Act

Section 16 (b) for the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director or officer by reason of his relationsrip to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted shall inure to and be recoverable by the issuer, *irrespective of any intention* on the part of such beneficial owner, director, or officer in entering into such transaction of holding such security purchased or of not repurchasing the security sold for a period exceeding six months. xxx." (Underscoring supplied. Note: This phrase is absent in the Philippine version).

"Section 26(b): Any profit realized by a beneficial owner, director, or officer through the unfair use of information received as such, from any purchase and sale, or any sale and purchase, of any security of such issuer (other than an exempted security) within any period of less than six months of the issue thereof, unless such security was acquired in good faith in connection with a debt previously contracted shall inure to and be recoverable by the issuer."

This provision is supplemented by Rule C-1 of the SEC of the Philippines. The beneficial owner thus defined, refers to the owners of more than ten percent of any class of security. The United States Section 16(b) is more specific in stating that intention is immaterial. The Philippine version seems to require proof of unfair use of information. This will include determination of issues of intent and good faith. No explanation is available for the distinction. Section 26(b) may perhaps be a paraphrased version of the long provision of the American counterpart. However, when we note the distinction between Rule 10b-5 and the Philippine Section 20a-4, relating mainly to the requirement of knowledge and intent, the reference of these elements under Section 26(b) reveals a consistency in the Philippine legislative policy that is to hold persons liable under said provisions only upon proof of knowledge and intention to defraud or mislead or to profit through unfair means.

One will also observe from Section 20a-4, that "omissions to state a material fact" is not covered therein, unlike Rule 10b-5. Considering however the ruling of *Strong v. Repide* and the Civil Code provisions on "insidious machinations" which includes non-disclosure, the same result may follow. The well-developed jurisprudence of Rule 10b-5 of the United States may still have strong persuasive force.

Remedies to enforce coroporate directors' duties

The fiduciary relations established between the director and the corporation and stockholders, give rise to certain actionable rights, the enforcement of which leads us to explore the field of procedural law. In the Philippines, remedial law may be found in the Revised Rules of Court of 1964. With reference to corporations, specific rules may be found in the Corporation Law and the Securities Act. The rules on derivatives suits arise mainly through case law.

A. General considerations

When a director violates his duties, he may be removed from office in accordance with the provisions of Section 34 of the Corporation Law. The procedure outlined in said section may present serious difficulties.[215] For one thing, a vote of two-thirds of the members entitled to vote, or in stock

[215] Act No. 1459 (1906), sec. 34.

corporations, a vote of stockholders holding two-thirds of the subscribed capital stock entitled to vote, is required to effect a removal. Then there is the inherent difficulty of calling a meeting, particularly when the officer charged to do so, refuses to call a meeting for the purpose.

The right of the corporation to sue and enforce a cause of action accruing to it is granted by law. Thus, as a juridical person, it may be a party in a civil action,[216] however its legal existence as an organized association of persons with capacity to sue must be averred in the pleadings,[217] where director or officer has committed acts against the interests of the corporation, it is undoubted that the corporation has a cause of action against them. The problem however arises when the corporation fails to take such action for redress. This is so when the board of directors refrains or refuses to take action against its own colleagues, or where several members of said board have in one way or another participated in such misconduct although in varying degrees of culpability. The helplessness of the corporation and the stockholders is here recognized. It is here where a derivative suit by the stockholder is necessary and justified.

The right to bring a derivative suit in thee Philippines has developed by case study. The difficulty of these approach gives rise to a need for some be explained by the persuasiveness of American Law and jurisprudence which runs throughout the development of Philippine corporate law. Thus, the prerequisites to justify a derivative suit can be gathered only by a case by case study. The difficulty of these approach gives rise to a need for some specific procedural rules on the matter.

It is now well settled in the Philippines that where a corporate director is guilty of a breach of trust and intra-corporate remedy is futile, the minority stockholder may resort to the courts for appropriate relief.[218] An individual stockholder is permitted to institute a derivative or representative suit in behalf of the corporation wherein he holds stocks, in order to protect and vindicate corporate rights whenever the officers of the corporation refuse to sue or are the ones to sued or hold the control of the corporation. In such action, the suing stockholder is regarded as a nominal party, with the corporation as the real party in interest.[219] The stockholder must however establish that there is a corporate injury giving rise to a claim that has matured

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[216] *Ibid.*, sec. 13. "Every corporation has the power:
(2) To sue and be sued in any court.
RULES OF COURTS, Rule 3, Section 1 -Who may be parties - Only natural or juridical persons or eentities authorized by law may be parties in a civil action."

[217] *Ibid.*, Rule 8, Section 4 - Facts showing the capacity of a party to sue or be sued x x x or the legal existence of an organized association of persons that is made a party, must be averred. . ."

[218] Angeles v. Santos, *supra*, note 49; Chase v. Court of First Instance, G.R. No. 20457, October 29, 1966, 18 SCRA 602 (1966)

[219] Republic Bank v Cuaderno, *supra*, note 49; Pascual v. del Saz Orozco, *supra*, note 49; Everett v. Asia Banking Corporation, *supra*, note 49.

in favor of the corporation; that the corporation should have sought to redress but does not; and that he has unsuccessfully exerted all efforts to make the corporate representatives, whether director, trustee in dissolution, receiver or trustee in bankruptcy to take the necessary action. He must also show that even if he had made such efforts that would have been useless because the majority of the board were wrong doers or in collusion with the wrongdoers. Finally he must show that there is no other intra-corporate remedy available.[220]

Considering that the corporation is the real party in interest, it should be made a party to the action. The problem however arises as to how it should be included. This is a matter of procedure which the Philippine Supreme Court discussed in the case of *Republic Bank v. Cuaderno.*[221] Thus it was stated:

> "The English practice is to make the corporation a party plaintiff, while the United States, the usage leans in favor of its being joined as party defendant. Objections can be raised against either method. Absence of corporate authority would seem to militate against making the corporation a party plaintiff, while joining it as defendant places the entity in ackward position of resisting an action instituted for its benefit. What is important is that the corporation should be made a party, in order to make the court's judgment binding upon it and thus bar future litigation of the issues. On what side the corporation appears loses importance when it is considered that it lay within the power of the trial court to direct the making of such amendment of the pleadings, by adding or dropping parties, as may be required in the interest of justice. Misjoinder of parties is not a ground to dismiss an action."

It would seem however, that it would be more logical to join an unwilling corporation as a defendant, as may be implied from Section 10, Rule 3, of the Rules of Court which states:

> "Sec. 10— *Unwilling co-plaintiff* - If the consent of any party who should be joined as plaintiff can not be obtained, he may be made a defendant and the reason therefor shall be stated in the complaint."

In suits instituted against erring directors of a corporation, the usual remedy sought, pending the determination of the case is the appointment of a receiver. In such case however, receivership is addressed to the sound discretion of the court. Such discretion must however be exercised with great caution.[222] Thus minority stockholders cannot have a receiver appointed where the only ground involved is their diffrence as to the internal management of the corporation and the acts complained of are neither "ultra vires" or fraudulent. But when it was established that the breach of trust and mismanagement was committed by the directors of a corporation, and

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220 Salonga, *supra*, note 49.
221 *Supra*, note 49.
222 Angeles v. Santos, *supra*, note 49.

intra-corporate remedy was futile, appointment of receiver was proper. This was so when it was necessary to restore the credit of the corporation.[223]

It will be noted that there are relatively few derivative suits decided in the Philippines. This may be due to the inherent difficulty of complying with the above-stated prerequisites, and the expenses that are involved in protracted litigations. Absence of specific provision for indemnity to the complaining stockholder is also a deterring factor. Moreover, many grievances may have been settled out of court in view of the policy of the law requiring exhaustion of intra-corporate remedies. And even where a lawsuit had actually been instituted, the Rules of Court provide a mandatory "pre-trial" proceeding wherein the parties are given the opportunity to consider the possibility of an amicable settlement, or of a submission to arbitration.[224] Protection against possible shady deals or compromises by an interested stockholder in a derivative suit is afforded under the Rules of Court. A derivative suit may be of the nature of a "class suit", defined under Rule 3, Section 12. As such it cannot be dismissed or compromised without the approval of the court, by express mandate of Rule 17, Section 1 of the Rules of Court.

There may be cases, where directors' abuses and mismanagement has reached such magnitude as to necessitate the dissolution of the corporation. This may be done according to the procedure laid down in Rule 104 of the Rules of Court. However, it is required that two-thirds of the outstanding stock must be voted approving said disolution.[225] A corporation dissolved will continue in existence as a juridical entity for a period of three years after the declaration of its dissolution, to wind up its affairs and protect its interests during the period of litigation.[226] At any time during said three years, said corporation is authorized and empowered to convey all of its property to trustees for the benefits of members, stockholders, or creditors and others interested.[227] It is usually during these years where accounting of corporate assets and liabilities is made, and anomalies discovered. This is where suits against the directors are often instituted. Thus, aside from derivative suits instituted by stockholders against erring directors, we have also trustees or boards of liquidators, who have the right to enforce corporate rights of action.

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[223] Reyes v. Tan, G.R. No. 16982, September 30, 1961, 3 SCRA 198 (1961).

[224] RULES OF COURT, Rule 20, sec. 1(a).

"Section 1. *Pre-trial mandatory*:- In any action, after the last pleading has been filed, the court shall direct the parties and their attorneys to appear before it for a conference to consider."

(a) The possibility of an amicable settlement or of a submission to arbitration;"

[225] Act No. 1459 (1906), sec. 62.

[226] *Ibid.*, secs. 77 & 78; National Abaca & Daguhoy Enterprises, Inc. v. Ponce, 96 Phil. 15 (1954).

[227] Act No. 1459, (1906) sec. 78; National Abaca & Other Fibers Corp. v. Pore, G.R. No. 16779 August 16, 1961, 2 SCRA 989; Board of Liquidators v. Kalaw, *supra*, note 74.

B. Remedies under the securities laws and regulations

In the field of securities transactions, the party usually with the right of action against the issuer, company or corporate-insider, is the stockholder or investor. To them belongs a personal not a derivative cause of action. Prior to the Securities Laws, the cause of action arose out of general rules of contracts and obligations, particularly in sales transactions. Under Securities Laws, remedies are specified therein, and the enforcement of causes of action arising from the violation thereof is in the hands of the Securities and Exchange Commission and the stockholder or investor affected.

The Securities and Exchange Commission in the Philippines, is the administrative body, charged with the implementation of the Securities Act and the Corporation Law. Thus, it is the central body for the registration of corporations and its articles of incorporation, issues the charter which gives the corporation, its juridical existence.[228] It is likewise the administrative body charged with the registration of acts relating to securities transactions, with powers to issue rules and regulation, to investigate and bring such proper action to enjoin violation or command compliance with the Securities Laws and Regulations.[229] It is therefore a proper party in cases involving securities transactions. Its investigatory powers are extensive. It can subpoena witnesses, compel attendance, take evidence and require the production of any book, papers and documents, which it may deem relevant or material to its inquiry. And if disobeyed, it can cite any person for contempt of court upon application with the Court of First Instance, where the person resides. In its exercise of powers against any person, it is bound by the elementary rules of due process - it must give due notice and opportunity for hearing, before action is undertaken.[230]

The extensive powers of the Securities and Exchange Commission of the Philippines, includes the authority to permit or deny the public sale and distribution of securities. Its orders are however subject to review by the Supreme Court in the manner provided in Rule 43 of the Rules of Court,[231] on the ground that the body rendering the ruling, order or decision appealed from, has decided a question of substance not therefore determined by the Supreme Court, or has decided it in a way not in accordance with

[228] Act No. 1459 (1906); secs. 6-11.

[229] Com. Act No. 83 (1936); section 31.

[230] *Ibid.*, sec. 31 & 32.

[231] *Ibid.*, sec. 35: *Court review of orders.*—(a) *Any persons aggrieved* by an order issued by the Commission in a proceeding under this Act to which such person is a party or who may be affected thereby may obtain a review in such order in the Supreme Court of the Philippines by filing in such court, within sixty days after the entry of such order, a written petition praying that the order of the Commission be modified or set aside . . ." (Underscoring supplied)

RULES OF COURT, Rule 43, sec. 1. *How appeal taken*: - *Any party may appeal* from final order, ruling or decision of the Securities and Exchange Commission, x x x by filing with said bodies a notice of appeal and with the Supreme Court x x x, petition for certiorari or review of such order, ruling or decision, as the corresponding statute may provide. x x x" (Underscoring supplied)

law or the applicable decisions of the Supreme Court.[232] It would seem obvious that the proper party to contest an SEC order is the person or corporation granted or denied the authority to issue securities for public distribution. The issue of "who" is the proper party to seek a review of an SEC order arose in the case of *Palting v. San Jose Petroleum, Inc.*,[233] wherein the right of a "prospective investor" to bring suit was questioned.

The Supreme Court noted the changes in phraseology of the different provisions of law, and reexamined the policy behind the Securities Act, to justify the action for review. Since the Rules of Court of 1964 merely required that "*any party* may appeal from a final order, ruling or decision" of the Securities and Exchange Commission, as distinguished from the Section 35(a) of the Securities Act, which provides that "*any person aggrieved* by an order", such distinction meant that a proper party need not be directly aggrieved, to be allowed to seek a review. A "prospective investor" may enjoin the sale of stocks by a corporation, for policy reasons. As stated:

> "(A prospective investor) xxx may oppose the registration and licensing of the share of stocks of a corporation engaged in oil exploration. The statement in the notice published by the SEC that "any person" opposed to the petition for registration and licensing of securities may file his written opposition, is in consonance with the generally accepted principle that Blue Sky Laws are enacted to protect investors and prospective purchasers and to prevent fraud and preclude the sale of securities which are in fact worthless or worth substantially less than the asking price."

On the other hand, the Securities Act gives the purchaser of securities who relied on a false and misleading statement the right to invalidate and avoid the contract of sale. The director, officer or agent who personally participated or aided in making the sale is jointly and severally liable, to the purchaser upon tender of the securities sold, or of the contract made for the full amount paid by such purchaser with interest. This right is subject to the statute of limitations of two years from the date of such sale.[234] It would seem that it is necessary that the purchaser must be in a position to

[232] RULES OF COURT, Rule 43, sec. 3.

[233] *Supra*, note 106.

[234] Com. Act No. 83 (1936), sec. 30:

(a) Every sale made in violation of any of the provisions of this Act or wherein the purchaser shall have relied upon any statement which was at the time and in the light of the circumstances under which it was made false and misleading with respect to any material fact contained in any application, report, or document filed pursuant to this Act or any rule or regulation thereunder, shall be avoidable at the election of the purchaser; and the person making such sale and every director, officer or agent or for such seller, if such director, officer or agent shall have personally participated or aided in any way in making such sale, shall be jointly and severally liable to such purchaser in an action in any court of competent jurisdiction upon tender of the securities sold or of the contract made for the full amount paid by such purchaser, with interest, together with all taxable court costs and reasonable attorney's fees: Provied, That no action shall be brought for the recovery of the purchase price after two years from the date of such sale: And provided, further, That no purchaser otherwise entitled shall claim or have the benefit of this section who shall have refused or failed within thirty days from the date thereof to accept

return the securities sold or the contract, otherwise recovery will be barred. Thus, where a purchaser has subsequently disposed the securities, he loses a right of action. This view is strengthened by the proviso in said Section 30, stating that a purchaser forfeits his right to recover or avoid the contract if he refused or failed to accept an offer in writing by the seller to take back the security in question or to refund the full amount paid by the purchaser. This action falls under the jurisdiction of civil courts.

The system of administration and implementation of the Securities laws and regulations follows a relatively simple pattern, in view of the national set up of the government machinery. In matters which are administrative in nature, the Securities and Exchange Commission has primary jurisdiction but its orders are subject to review by appeal directly to the Philippines Supreme Court. This is exemplified in the case of *Palting*. The SEC may also take action enjoining and prosecuting violations of the Act, through the Court of First Instance, a civil court of general juridiction. This is provided under Section 31 of the Act. The remedies given to private parties under Section 30, is based on fraud and contract, hence action is with civil courts.

Conclusion

The present day trends of business enterprise and government policy in the Philippines, seek to encourage more investments in many areas of the economy. These spell a movement toward the adoption of a widely owned corporation with an increased number of stockholders and investors. The rising need to venture into new or "pioneer" industries which are capital intensive, raises problems of more capital investments. Increased public participation in corporate investments is expected. With this will eventually rise grave problems of internal management and its relation to the stockholders. This will therefore need a set of rules, containing a more precise definition of rights duties and responsibilities, and the total relationship of all the constitutive elements of the corporation. The complexities envisioned arise from the eventual diffusion of stock ownership and the growth of the corporation.

The success of the corporation as a vehicle for business must to a large degree depend upon the confidence which people in general have on the form of organization. While much depends upon the integrity of the officers and directors chosen to run the corporate enterprise, the law must through a sound, clear and definite legislation seek to safeguard interests to assure that capital invested will not be entirely at the mercy of unscrupulous opportunists who reap profits at the expense of the silent, impotent

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an offer in writing of the seller to take back the security in question and to refund the full amount for the period from the date of payment by such purchaser down to the date of repayment, such interest to be computed: x x x."

minority. It standards of diligence, care and good faith and loyalty are as nebulous and vague as they come, it is unlikely that the corporate form will long survive as a means of inviting capital participation among a great number of people. Its ability to invite services of able men to directorships, as well as harness great financial resources will be greatly curtailed.

The judicial process cannot sufficiently provide the answer to many questions affecting internal corporate affairs and relations. This is particularly true in the Philippines, where suits of this nature are as yet too few to afford an extensive development of certain fixed and settled rules and precedents. Thus it is only by legislation, either amending or adding to the present Corporation Law, where basic issues, can be resolved without resort to protracted and tedious litigations. This refers particularly to such matters as: the standard of due care, and diligence expected and required of directors and its procedural aspects to establish the absence thereof; the propriety, effects and validity of directors dealing with the corporation in which he is a member of the board; the propriety, effects and validity of transaction between corporations with total or partial interlocking directorates and the procedural problems connected with matters of this nature. There is also the matter of indemnification for the prosecution and/or defense of litigations for an in behalf of the corporation. There is also a need for rules outlining the procedure for derivatives suits, the nature and extent of directors' liability for breach of fiduciary duty both to the corporation and the stockholders. On the whole, a re-examination of the Philippine Corporation Law is advocated, with the view of updating and making it respond to the changing developments of the times.

It may be noted, that the corporation law is increasingly becoming a statute law. Thus, it may be that statutes afford greater certainly and thus forstall many complex or unsettling litigations. In a basically civil law country, such advantages need no further exposition.

Taking note of recent judicial trends in the Philippines, fair warning may be made as to the dangers of the espousal of the business judgment rule in an extreme form. While business expediency may require a grant of liberal powers and wide discretion to directors, yet certain ethical considerations must not be overlooked in upholding business judgments. It is the corporate investors' money and property invested in the corporation, that is entrusted to him, to pursue some legitimate enterprise with proper caution and judgment. Notwithstanding the corporate fiction, the director holds a position of trust to the stockholder investing his hard-earned funds on the faith that the directors of the corporate enterprise should use such funds with care, fidelity and loyalty, with the interests of the corporations and the stockholders in mind. This is the essence of the directors' offce. It is a fiduciary relation of trust, in the fulfillment of which lies the success and feasibility of the corporation as a means of progress.

APPENDIX "A"

MINING AND OIL STOCKS

Abra Mining & Industrial Corporation
Acoje Mining Company, Inc.
Acoje Oil Exploration & Drilling Co.
American Asiatic Oil Corporation
Anglo-Philippine Oil & Mineral Corporation
Astro Mineral & Oil Corporation
Atlas Consolidated Mining & Development Corp.
Atok-Big Wedge Mining Company, Inc.
Baguio Gold Mining Company, Inc.
Batong-Buhay Gold Mines, Inc.
Benguet Consolidated, Inc.
Benguet Exploration, Inc.
Black Mountain, Inc.
Carmen Mindanao Mining Consolidated, Inc.
Coco Grove, Inc.
Consolidated Mines, Inc.
Copper Belt Mining Corporation
Fil-Am Resources, Inc.
Filipinas Mineral Corporation
Frontino, Inc.
General Base Metals, Inc.
Golden River Mining Corporation
Hercules Minerals & Oils, Inc.
Hixbar Mining Company, Inc.
Inco Mining Corporation
Infanta Mineral & Industrial Corporation
Island Mining & Industrial Corporation
Itogon-Suyoc Mines, Inc.
JEL Mining & Development Corporation
Lepanto Consolidated Mining Co., Inc.
Leyte Base Metal Company, Inc.
Liberty Mines, Inc.
Manila Mining Corporation
Maremco Mineral Corporation
Marinduque Mining & Industrail Corporation
Mineral Integrated Development Services Corp.
Minerva Mines, Inc.
Montevista Minerals, Inc.
Omico Mining & Industrial Corporation
Pacifica, Incorporated
Palawan Consolidated Mining Co., Inc.
Palawan Quicksilver Mines, Inc.
Paracale-Gumaus Consolidated Mining Co., Inc.
Philex Mining Corporation
Philippine Iron Mines, Inc.
Philippine Oil Development Co., Inc.
Philippine Overseas Drilling & Oil Development Corp.
Pioner Natural Resources Exploration Co., Inc.
Republic Resources & Development Corporation

Sabena Mining Corporation
Samar Mining Company, Inc.
San Jose Oil Company, Inc.
San Mauricio Mining Company, Inc.
Sta. Ines Mining & Steel Corporation
South-Eastern Sierra Madre Resources, Inc.
South Seas Oil & Mineral Exploration Development Co.
Surigao Consolidated Mining Co., Inc.
Trans-Asia Oil & Mineral Development Corporation
United Paracale Mining Co., Inc.
White Eagle Overseas Oil Co., Inc.
Zambales Base Metals, Inc.

COMMERCIAL-INDUSTRIAL STOCKS

Alatco Transporation, Inc.
Atlas Fertilizer Corporation
Bacnotan Consolidated Industrials, Inc.
Elizalde Iron & Steal Corporation
Filipinas Cement Corporation
B.F. Goodrich Philippines, Inc.
Industrial Textiles Mfg. Co. of the Philippines
Maharlika Corporation
Manila Broadcasting Co., Inc.
Manila Jockey Club, Inc.
The Manila Wine Merchants, Inc.
Marsman & Company, Inc.
Pacific Cement Company, Inc.
Philippine Air Lines, Inc.
Philippine Breweries Corporation
Philippine Long Distance Telephone Co., Inc.
Philippine Racing Club, Inc.
Philippine Tobacco Flue-Curing & Redrying Corporation
Ramie Textiles, Inc.
Republic Cement Corporation
Republic Glass Corporation
Riverside Mills Corporation
Del Rosario Bros. Marketing Corporation
The San Miguel Corporation
Universal Cement Company, Inc.
Universal Textile Mills, Inc.

BANK-FINANCE-INSURANCE STOCKS

The Bank of the Philippine Islands
China Banking Corporation
The Consolidated Bank & Trust Corporation
Filipinas Investment Corporation
Filipinas Mutual Finance, Inc.
House of Investments, Inc.
Industrial Finance Corporation
Manphil Investment & Financing Corporation

Meralco Securities Corporation
Monterrey Investment & Land Development Corp.
Pacific Investments Company, Inc.
Private Development Corp. of the Philippines
Beneficial Life Insurance Co., Inc.
Insular Life Assurance Co., Ltd.
Metropolitan Insurance Company, Inc.
Philippine Guaranty Company, Inc.

SUGAR STOCKS

Bago-Medellin Milling Co., Inc.
Central Azucarera de Bais, Inc.
Central Azucarera de La Carlota, Inc.
Central Azucarera de Pilar, Inc.
Central Azucarera de Tarlac, Inc.

MISCELLANEOUS STOCKS

Batan Pulp & Paper Mills, Inc.
Filoil Refinery Corporation
Firestone Tire & Rubber Co. of the Philippines
Hawaiian-Philippine Company, Inc.
Salt Industry of the Philippines, Inc.
Victorias Milling Company, Inc.

Source: Manual of Philippine Securities (1970 Ed.) R. Gatica