CONFLICT OF INTERESTS IN CORPORATE MANAGEMENT *

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It is a fundamental rule in the law governing private corporations in this country that the board of directors shall exercise all corporate powers, except only those which the law expressly reserves to the stockholders.[1] All corporate policies are thus framed by said board and it exercises all powers of management, to the exclusion of the stockholders. Practically the only rights left to the stockholders besides the right to share in the profits, are the right to elect the directors and to make fundamental changes in the corporate set-up.

The directors are of course elected by the stockholders, but once elected, are as a body vested with wide discretion in the exercise of corporate powers. In granting them these broad powers, the law has in effect made them fiduciaries of the corporation, and as such, they are expected to serve the corporation not only with reasonable diligence and skill, but also with utmost loyalty to its interests.

In the majority of Philippine corporations, directors usually hold relatively large blocks of stock or are intimately connected by family or other ties with large stockholders, so that self-interest of such directors is in most cases identical with self-interest of the stockholders. In other words, in this country, close corporations still predominate over those whose stocks are widely held, so that questions of conflict of interest have not been very common, since ownership and control would usually lie in the same people.

In recent years, however, there has been a slow but steady increase in the number of large corporations where ownership and control are in different hands—that is, where directors may own less than a majority of the stocks, yet exercise effective control because the rest of the stocks are held by a great many stockholders who are either indifferent to management or lack the unity necessary to exert substantial influence in the running of corporate af-

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[1] See Sec. 28, Corporation Law.

fairs. This situation is specially true in corporations whose stocks are traded on the exchange. In these cases then, the position of the owner *vis-a-vis* control is necessarily weakened. Although corporations of this nature are still very much in the minority, public attention is naturally more drawn to them because they affect more people in the community. This is not to say however that conflict of interest problems do not arise in close corporations, because they do. In fact, the faith placed by the stockholders in the directors of close corporations may even be greater because frequently a personal relationship exists among them. The situation in a widely-held corporation however lends itself more easily to conflict of interest problems. And considering the present governmental policy of encouraging large corporations to go public, problems of this nature are bound to crop up with more frequency in the future.

A director of a corporation holds a position of trust and is oftentimes referred to as a fiduciary of the corporation. Although many authorities still hold that under ordinary circumstances directors are not fiduciaries of the stockholders, it is well-settled that they owe a duty of loyalty to the corporation they serve. At the present time, the doctrine of fiduciary obligation generally enunciated with respect to the management of the corporation can be characterized as favorable to the recognition and enforcement of fiduciary duties. Directors cannot put their own personal interests over and above that of the corporation without incurring liability. As corporate managers, they are committed to seek the maximum amount of profits for the corporation. But where the directors have a limited stake in the corporation, it is not difficult to imagine the temptation there is to seek personal gain at the expense of the corporation, specially where the risk of detection and punishment is small.

Aside from the provisions governing agents in general, there is hardly any existing provision in our law expressly covering conflict of interests between directors and the corporations they serve. The Corporation Law itself is silent on the matter. Some of its provisions do give allowance for measures to prevent or minimize abuse as a result of such conflict, but these are certainly far from adequate guidelines for the proper conduct of directors. The Proposed Corporation Code seeks to fill this gap and contains some general provisions on the matter. Whether these will serve the purpose, if the Code is ever approved, only time will tell. In solving conflict of interest cases however, one must keep in mind that a good balance must be kept between protecting the interests of the corporation and the body of stockholders on the one hand, and on the other, not to discourage experienced and talented men from accepting a position in the directorate of a corporation which needs their services.

The fiduciary duty of a corporate director has many ramifications. It is impossible to describe all the situations which may constitute a conflict of interest on the part of a director, for the possibilities are almost limitless. Each possibility may raise different factual and practical problems. Cases range from those where there can be no doubt that a breach of trust has been committed to those where there is obviously no disloyalty. Between these two extremes lies a wide range of situations where there may be some doubt whether the fiduciary obligation has been violated. Thus, where a director or officer converts to his own use funds or property belonging to the corporation, no court will allow him to keep the benefits he derives from his wrongdoing. And he cannot defend on the ground that he has repaid the corporation and that it has therefore lost nothing.[2]

Similarly, a court would have on trouble deciding that the acceptance by an officer of profits or commisisons as consideration for exercising his power of management in favor of those seeking to do business with the corporation constitutes a violation of his duty of loyalty to the corporation.[3]

In many other situations, however, the line of demarcation between the fiduciary relationship and a director's personal rights is not easy to define. No hard and fast rule can be formulated and there is no fixed scale which measures the standard of loyalty. And we can find little help from the decisions of our Supreme Court since very few cases have come up before it involving directly the issue of conflict of interest. But since our law governing corporations was borrowed from common law jurisdiction, and our own Supreme Court has itself relied heavily on American decisions, it is to these jurisdictions that we must turn, nationalistic considerations notwithstanding, for the rules of conduct which should guide corporate directors and officers.

Since the subject matter is very broad, this discussion will limit itself to the more common situations involving conflict of interests. For this purpose, we shall categorize these into four headings: (1) the use of inside information; (2) the self-dealing directors; (3) the seizure of corporate opportunity or, as others prefer to call it—

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[2] See Bromschwig v. Carthage Marble & Lime Co., 334 Mo. 319, 66 S.W. 2d 889 (1933).

[3] See Ellgren v. Wooley, 65 Utah 183, 228 P. 906 (1924); Comm. Title Ins. & Trust Co. v. Seltzer, 227 P. 410, 76 A. 77 (1910).

competing with the corporation; and (4) the interlocking director. At the outset, it should be emphasized that there is no clear dividing line separating these categories and that many conflict of interests cases many involve more than one, and sometimes all four categories, so that it would ordinarily not be practical to compartmentalize them. The categorization is made here merely for the purposes of clarity and convenience in the discussion.

I. USE OF INSIDE INFORMATION

As insiders, directors and officers are in a position to use confidential information for their personal advantage, oftentimes to the prejudice of the corporation. It is precisely for this reason that attempts have been made in one of our large corporations to disqualify for the position of director, stockholders who have substantial interests in a competitor corporation. The corporation probably fears, justifiably or unjustifiably, that once elected, these directors may place the interests of its competitor over and above those of the corporation. Once elected to the board, however, directors assume a fiduciary position which prohibits them from using any confidential information they may obtain as such to benefit the competitor corporation in which they have a more substantial interest. And this would be true though the corporation to which board they have just been elected suffers no injury.[4]

A director may misuse inside information where he buys stocks from another stockholder without revealing matters which may affect the latter's decision to sell. Although authorities differ in their opinions as to whether a director owes a fiduciary duty to individual stockholders, many of them admit that the special circumstances of a case may give rise to such a duty. Some of you, I am sure, are familiar with the leading case of *Strong v. Repide*[5] decided as early as 1909. The defendant Repide was a director of the Philippine Sugar Estates Development Co. and was the owner of about 3/4 of its shares. The financial condition of the company was not too good and the value of its shares was wholly dependent on making an advantageous sale of its real property to the Government. The stockholders had delegated to the defendant director full authority to decide when and whether to sell. He bought the plaintiff's stocks in the corporation through a hired broker, taking all pains to conceal his identity as the buyer. At the time of the sale, dividends had not been declared for some time and negotiations for the sale of the corporate property was dragging. Only the defendant knew that

[4] See Louisiana Mortgage Corporation, Inc. v. Pickens, 167 S. 914 (1936), 182 S. 385 (1938).
[5] 41 Phil. 947 (1909).

the sale of the corporation's property was imminent. Shortly after defendant purchased the plaintiff's stocks, the sale of the corporate property pushed through and the value of the shares rose by about 10 times. Sustaining the defendant's arguments, our Supreme Court dismissed the stockholder's complaint for rescission of the sale of her stocks, on the theory that a director, although a fiduciary of the corporation and the body of stockholders, is not a fiduciary of the individual stockholder and is under no duty to reveal to him material information before purchasing his stocks. On appeal however, the United States Supreme Court reversed the decision and upheld the plaintiff's right to rescind the sale, on the ground that under the special circumstances of the case, the director should have at least revealed that he was the buyer. Had he done so, the plaintiff would probably not have sold or would at least have sold her stocks for a higher price. This so-called "special facts" doctrine was followed by various American courts in subsequent cases.[6] Special facts which have been held sufficient to give rise to a fiduciary duty include not only peculiar knowledge like that involved in the *Strong v. Repide* case, but also prospective merger or sales, and impending declaration of unusual dividends.

One wonders however how this "special facts" doctrine can effectively apply to a situation where the transaction is made by a director through the stock exchange. In a Massachusetts case,[7] the defendant directors of a mining corporation bought the plaintiff's stocks through the exchange, after they had heard a geologist's theory of the possible existence of copper deposits under geological conditions similar to those affecting the mining corporation's property. Whether the theory was sound or fallacious, no one knew. The evidence did not disclose any element of fraud or misdoing by the directors. On the other hand, the plaintiff stockholders was no no vice and was in fact a member of the Boston Stock Exchange and had kept track of the trading of the corporation's stocks on the exchange. Under these circumstances, the Massachusetts Supreme Court held that the defendant directors could not be held liable to the selling stockholder either by way of accounting or for redelivery of the shares. Evincing a pragmatic approach to the issue, it stated:

> ...Purchases and sales of stock dealt in one the stock exchange are commonly impersonal affairs. An honest director would be in a difficult situation if he could neither buy nor sell on the stock ex-

6 See Hotchkiss v. Fisher, 136 Kan. 530, 16 P. 2d 531 (1934); Fox v. Cosgniff, 66 Idaho 371, 159 P. 2d 224 (1945); Agatucci v. Corradi, 327 Ill. App. 153, 65 N.E. 2d 630 (1945); Nichol v. Senseubrenner, 220 Wis. 165, 263 N.W. 650 (1935); and Taylor v. Wright, 69 Cal. App. 2d 371, 159 P. 2d 980 (1945).

7 Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933).

change shares of stock in his own corporation without first seeking out the other actual ultimate party to the transaction and disclosing to him everything which a court or jury might later find that he then knew affecting the real or speculative value of such shares. Business of that nature is a matter to be governed by practical rules. Fiduciary obligations of directors ought not to be made so onerous that men of experience and ability will be deterred from accepting such office. Law in its sanctions is not coextensive with morality. It cannot undertake to put all parties to every contract on an equality as to knowledge, experience, skill and shrewdness. It cannot undertake to relieve against hard bargains made between competent parties without fraud. On the other hand, directors cannot rightly be allowed to indulge with impunity in practices which do violence to prevailing standards of upright business men. Therefore, where a director personally seeks a stockholder for the purpose of buying his shares without making disclosure of material facts within his peculiar knowledge and not within reach of the stockholder, the transaction will be closely scrutinized and relief may be granted in appropriate instances.

On the question of whether the director who uses inside information in speculating in the corporation's stock should account to the corporation for his profits was answered in the negative by some early American cases,[8] on the theory that speculation in its own stock is not a corporate function. It would seem however that this rule is not logical since inside information is in effect a corporate asset and when the director uses it to speculate for his own profit, he violates his fiduciary duty to the corporation. This rationale was recognized by the New York Supreme Court in the case of *Oreamuno*[9] decided in 1969. Defendants in that case were chairman and president of the corporation. As a result of a sudden increase in expenses, its net monthly earnings decreased by about 75% in a period of one month. This information was not made public until two months later. Before the public announcement, defendants, armed with the inside information, had sold through the stock exchange more than 56,000 shares of the corporation at $28 per share. Upon release of the information to the public, the per share price plummetted down to $11. Plaintiff stockholder brought a derivative suit against the defendant to compel an accounting of profits to the corporation. A unanimous court held the defendants liable to the corporation on the ground that corporate officers and directors who trade on undisclosed inside information violate their fiduciary duty to the corporation and may be held accountable to it for their

8 Keely v. Black, 91 N.J. Eq. 520, 111 A. 22 (1920); Bisbee v. Midland Linseed Products Co., 19 F. 2d 24 (1927); Steven v. Hale-Haos Corp., 249 Wis. 205, 23 N.W. 2d 620 (1946).

9 24 N.Y. 2d 494, 248 N.E. 2d 910, 301 N.Y. 2d 78, (1969). See also Security and Exchange Commission v. Texas Gulf Sulphur Co., 401 F. 2d 833 (1968), where the directors were held liable to the corporation under SEC Rule promulgated under the Federal Securities Act.

personal gains, notwithstanding the fact that the corporation has suffered no damage by their act. The same rationale seems to be behind our Securities Act. Section 26(b) provides:

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> (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 a 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, inure to and be recoverable by the issuer.

Recovery under the provision is in favor of the corporation, is not made a requisite, it would be entitled to the insider's profits as long as there has been an unfair use of inside information. Although this provision applies only to purchase and sale transactions during the six month period after the issue of the securities, it is believed that the court can still hold the director or officer liable for the same acts committed after said period, using as basis for such liability his fiduciary duty to the corporation.

It would seem therefore that when the transaction is made through the stock exchange, although it would be difficult to hold the director liable to the selling or buying stockholder for the profits the former may have obtained by the unfair use of inside information, he may nevertheless be made accountable to the corporation for such profits due to his breach of his fiduciary duty in using a corporate asset (*i.e.*, the inside information) to his own personal advantage. Although this rule does not directly compensate the injured party, it does create a deterrent by taking away the illegal profits of the insider.

The Proposed Corporation Code contains no provision covering particularly the use of inside information, but the general provision found in Section 39 thereof can possibly apply to a director who uses this unfairly:

> SEC. 39. *Liability of directors or trustees.* Directors or trustees who vote for or assent to patently unlawful acts of the corporation, or who are guilty of gross negligence or bad faith in directing the affairs of the corporation,... shall be liable jointly and severally for all damages resulting therefrom suffered by the corporation, its stockholders and other persons....

However, it is possible under the proposal to relieve the erring director from liability by unanimous vote of the stockholders, as long as the conduct of such director does not amount to an illegal act.

II. THE SELF-DEALING DIRECTOR

Aside from the misuse of inside information, another situation in which a director may gain an undue advantage over his corporation is when he enters into a contract with such corporation. In this situation, he is referred to as a "self-dealing" director. Perhaps one of the most typical situations of self-dealing is the fixing of directors' compensation. Compensation may take various forms —per diems, salaries, and profit-sharing arrangements like bonuses, stock option plans, pension plans, and the like. As a general principle, directors as such are not entitled to compensation for performing services ordinarily attached to their office, unless the articles of incorporation or the by-laws expressly so provide or a contract is expressly made in advance.[10] They are presumed to serve without pay.[11] Assuming however that compensation is intended, who may fix it? It is well-settled that only the stockholders may do so and not the directors themselves, unless they have been authorized to do so by the stockholders.[12] When they do fix their own compensation in pursuance of authority granted by the stockholders, a conflict of interest between the directors and the corporation will arise. In some cases, the compensation so fixed is substantial rather than merely nominal. This is not to say that this should not be the case. Directors in assuming the role of framers of corporate policies take upon themselves a heavy burden of responsibility. It is only fair therefore that they be recompensed for their services if the corporation can afford to do so. Normally, the stockholders would not raise serious objections as long as the compensation fixed is reasonably proportional to the profitability of the corporate enterprise. It is the fixing of compensation for executive officers when they are also directors which presents a more fertile ground for abuse. Ordinarily, it is within the powers of the directors to fix the compensation of the officers and executives appointed by them. They have a wide discretion in the matter and the courts will usually not interfere, leaving it to the business judgment of the directors. But where the executive officers are chosen from among the directors, conflict of interest is apparent since the directors would be contracting with their own corporation. The need for fiduciary restrictions is therefore obvious. Under the prevailing view, a director-officer's presence cannot be counted toward a quorum and his vote cannot be included toward the majority vote necessary to fix his compensation as officer. Otherwise, the board resolution fixing such

[10] See Central Cooperative Exchange, Inc. v. Tibe, Sr., G.R. No. L-27972, June 30, 1970, 33 SCRA 593 (1970); Lingayen Gulf Electric Power Co. v. Baltazar, 93 Phil. 404 (1953).

[11] *Ibid.*

[12] *Ibid.*

compensation would be voidable at the option of the corporation although the amount thereof may be reasonable.[13] However, such resolution may be ratified by the stockholders, including the interested director, as long as the amount of the compensation is reasonable.[14] And the burden of proof is upon the director to show that it is reasonable.[15]

One of the most famous compensation cases which came before the United States Supreme Court is one which involved the emoluments of the President and executives of the American Tobacco Company.[16] In addition to their already large fixed salaries, they were given huge bonuses and participated in some very profitable stock option plans. The president's total compensation in cash and stock came to over $2 million. One of the two suits brought by a minority stockholder involved the bonus payments which had been approved by the majority stockholders. In reversing the appellate court and holding against the validity of the bonus, the United States Supreme Court said in part:

> Much weight is to be given to the action of the stockholders, and the by-law is supported by the presumption of regularity and continuity. But the rule prescribed by it cannot, against the protest of a shareholder, be used to justify payments of sums as salaries so large as in substance and effect to amount to spoliation or waste of corporate property. The dissenting opinion of Judge Swan indicated the applicable rule: 'If a bonus payment has no relation to value of services for which it is given, it is in reality a gift in part, and the majority stockholders have no power to give away corporate property against the protest of the minority.'

In *Elward v. Peabody Coal Co.*,[17] five out of seven directors attended the meeting and voted stock options as incentive compensation to two of them at a price $2 below par. The recipients contracted to remain in the company's employ. The company sought and obtained ratification by 66 percent of the stockholders. Considering the compensation unreasonable, the Court held the transaction void despite stockholder ratification, and concluded: "It is manifest, however, that the shareholders cannot approve the action of the board of directors of a corporation agreeing to sell $5 par value stock at $3."

In most cases, however, the reasonableness of the compensation is an issue which is difficult of determination. Courts faced

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[13] See Kerbs v. California Eastern Airways, 33 Del. Ch. 69, 90 A. 2d 652 (1952).

[14] *Ibid.*

[15] Hill v. Erwin Mills, Inc., 239 N.C. 437, 80 S.E. 2d 358 (1954).

[16] Rogers v. Hill, 289 U.S. 582, 53 S.Ct. 737, 88 A.L.R. 744, 77 L.Ed. 1385 (1932).

[17] 9 Ill. App. 2d 234, 132 N.E. 2d 549 (1956).

with such an issue may feel inadequately equipped to grapple with the problem and would in all probabilities not find it easy to seek a valid ground for disapproving what the majority of the stockholders have approved.[18]

On this matter of compensation, the Proposed Corporation Code incorporates the rule that directors as such are not entitled to compensation unless it is fixed in the by-laws or by a stockholders' resolution. And the vote of at least two thirds of the outstanding capital stock is necessary to grant them compensation other than per diems. In no case however can the total amount of all such compensation exceed 10% of the net profit of the corporation in any one year, after payment of taxes.[19] Under the proposal, therefore, the directors can never fix their own compensation, per diems or otherwise. On the other hand, the proposed Code is silent as to compensation of officers; which means that the matter will be, as it is at present, left to the discretion of directors. If this attitude of the Code is not ideal, it is at least realistic.

The validity of other contracts of self-dealing directors is tested by the same standards used in the compensation cases. The traditional view, followed by a majority of the courts, is rather strict and holds that a contract or other transaction between a corporation and one or more of its directors is voidable without regard to the fairness of its terms, if the director's presence in the meeting at which the resolution authorizing the contract is adopted is necessary to constitute a quorum, or if his vote is necessary to approve the resolution.[20] However, such a contract may be ratified by the stockholders, including the interested director, provided there has been full disclosure of the director's adverse interest and the contract is fair and reasonable.[21]

One of the earliest Philippine cases on this point was *Mead v. McCullough*[22] decided by the Supreme Court in 1911. The corporation in that case was engaged in engineering and construction work. Its business proved to be unprofitable and at the time of the transaction complained of, the corporation was in the brink of insolvency,

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[18] See for example Government v. El Hogar Filipino, 50 Phil. 399 (1927); Keller v. Boylan, 29 N.Y.S. 2d 653 (1941).

[19] Section 38 of the Proposed Corporation Code of the Philippines.

[20] See Parson v. Tacoma Smelting & Refining Co., 25 Wash. 492, 65 P. 765 (1901); Paxton v. Heron, 41 Colo. 147, 92 P. 15 (1907); Hotaling v. Hotaling, 193 Cal. 368, 224 P. 455 (1924).

[21] See North-West Trans. Co. Ltd. v. Beatty, 12 App. Cas. 589, Privy Council (1887); Gamble v. Queens County Water Co., 123 N.Y. 91, 23 N.E. 201 (1890); Atlas Coal Co. v. Hose, 245 Iowa 506, 61 N.W. 2d 663 (1953). See also Cal. Corp. Code, sec. 820; Michigan, sec. 450.13; Rhode Island Gen. Laws (1938), sec. 21; Vermont Pub. Laws (1933), sec. 5827, now Sec. 5800, Gen. Corporation Law.

[22] 21 Phil. 95 (1911).

In order to prevent more loses, it sold its most valuable asset—the wrecking contract with the naval authorities—to McCullough, one of its four incumbent directors. The sale was unanimously approved by all four directors, including McCullough. The plaintiff, the only other stockholder of the corporation, questioned the validity of the assignment. The Supreme Court, citing American authorities, followed the prevailing view and held that a director or officer may under certain circumstances deal with his corporation. It found that the corporation was represented by a quorum of three directors when the sale was approved and that McCullough's presence and vote were not necessary. Furthermore, it found that McCullough had acted with utmost candor and fair dealing, and without taint of selfish motives. It therefore upheld the validity of the contract.

Where however the transaction is clearly unfair to the corporation, it will not be respected although the interested director inhibited himself from voting. The theory apparently is to prevent any undue influence which the director may exert on the other directors. In the case of *Steinberg v. Velasco,*[23] the corporation's business was beginning to fail and three of the directors wanted to get back their investment. The board allowed them to resign as directors so that they would not have to participate in the approval of the sale of their stocks to the corporation. The purchase of the shares was approved by the board although the corporation had no surplus out of which payment could be made. The Supreme Court's reaction served as a stern warning to those who had similar intentions as the defendant directors. It treated the resigned director as self-dealing directors, inspite of their resignation, and rescinded the sale. The resigned directors were ordered to return to the corporation the consideration they had received for their shares, and the other directors were held secondarily liable should the resigned directors fail to do so.

Some of the recent American cases have veered away from the strict traditional view and have tested the validity of self-dealing directors' contracts solely on the issue of fairness. The position of this so-called "enlightened minority" is that although the interested director participated in the approval of the contract between him and his corporation, the latter cannot avoid it unless it is unfair.[24] The burden of proving fairness however lies with the director, the contract being presumed unfair until proven other-

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[23] Steinberg v. Velasco, 52 Phil. 953 (1929).

[24] See Wyman v. Bowman, 127 F. 257 (1904); Nicholson v. Kingery, 37 Wo. 299, 261 P. 122 (1927); Binz v. St. Louis Hide and Tallow Co., 378 S.W. 2d 228 (1964); Ruetz v. Topping, 453 S.W. 2d 624 (1970).

wise.[25] One good reason for favoring the "fairness" doctrine over the prevailing traditional rule is that the latter can be used to the detriment of the corporation. A disgruntled minority stockholder could threaten to sue the corporation to annul its contract with an interested director, although the contract serves the best interests of the corporation. For example, why should a loan made by a director to a corporation under financial stress be held voidable simply because said director's presence was necessary to constitute a quorum of the board in the meeting approving said loan? On the other hand, the numerous details of business relations and the frequency of secret understandings between directors and other business interests open to doubt the accuracy of a judicial finding of fairness, and tends to show the wisdom of the stricter traditional view.

Many American corporations finding it practicable and even necessary to avoid judicial inquiry into corporate transactions with interested directors, have inserted provisions in their articles of incorporation, permitting such directors, in the absence of fraud, to be counted towards a quorum and to vote. Some courts have upheld the validity of such provisions.[26] Our own Supreme Court however disapproves of this kind of a provision as evidenced by the following statement in *Palting v. San Petroleum, Inc.*:[27]

> The impact of these provisions upon the traditional fiduciary relationship between the directors and the stockholders of a corporation is too obvious to escape notice by those who are called upon to protect the interest of investors. The directors and officers of the company can do 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 impunity because of the advance condonation or relief from responsibility by reason of such acts. This and the other provision which authorizes the election of non-stockholders as directors, completely disassociate the stockholders from the government and management of the business in which they have invested.

On the other hand, our Supreme Court has upheld a provision in the by-laws of a building and loan association disqualifying a director from receiving loans from the corporation, on the ground that it is designed to prevent the possibility of looting the corporation by unscrupulous directors. According to the Court, "a more

[25] Hill v. Ermin Mills, Inc., 239 N.C. 437, 80 S.E. 2d 358 (1954); Noe v. Roussel, 310 S. 2d 806 (1975).

[26] See Piccard v. Speery Corporation, 48 F. Suppy. 465 (1943); Martin Foundation v. North American Rayon Co., 31 Del. Ch. 195, 68 A. 2d 313 (1949); Whalen v. Hudson Hotel Co., 183 App. Div. 316, 170 N.Y.S. 855 (1918).

[27] G.R. No. L-14441, December 1, 1966, 18 SCRA 92 943 (1966).

discreet provision to insert in the by-laws of a building and loan association would be hard to imagine."[28]

Considering the attitude of the Supreme Court toward self-dealing directors, the better side of caution must have prompted the proposal in the Corporation Code to follow the stricter rule that a *participating* interested director's contract with his corporation is voidable, regardless of its fairness.[29] But the proposal allows ratification of such a contract by a two-thirds vote of the stockholders, provided the contract is fair and reasonable, and a full disclosure of the director's adverse interest is made.

Perhaps the only existing provision of law which relates directly to a self-dealing director is Section 83 of the General Banking Act which prohibits a director or officer of a banking institution from borrowing, directly or indirectly, from his own bank, except with the written approval of the majority of the directors excluding the director concerned. Criminal liability consisting of both fine and imprisonment is imposed on an erring director or officer. And if he owns more than 2% of the subscribed capital stock, his loan cannot exceed the amount of his outstanding deposits in the bank and the book value of his paid-in capital contribution. Considering the nature of the banking business as one greatly affected with a public interest, it is easy to see why the self-dealing banking director has been singled out by the law. But even here, the prohibition is not absolute, since the director or officer can procure a loan within the limits allowed, as long as his vote is not necessary in approving it.

THE CORPORATE OPPORTUNITY THEORY

A significant aspect of a director's fiduciary obligation is his duty to refrain from usurping a business opportunity rightly be-

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[28] Government v. El Hogar Filipino, 50 Phil. 399 (1927).

[29] Sec. 40, Proposed Corporation Code of the Philippines provides:

Sec. 40. Dealings of director with corporation. —A contract of the corporation with one or more of its directors or trustees is voidable at the option of such corporation unless all the following conditions are present:

(1) That the presence of such director or trustee in the board meeting in which the contract was approved was not necessary to constitute a quorum of such Board;

(2) That the vote of such director or trustee was not necessary for the approval of the contract; and

(3) That the contract is fair and reasonable under the circumstances.

Where any of the first two conditions set forth in the preceding paragraph is absent, such contract may be validated by a ratification of two-thirds of the members or of the stockholders representing at least two-thirds of the outstanding capital stock in a meeting called for the purpose; *Provided*, That full disclosure of the adverse interest of the director or trustee involved is made at such meeting; *Provided further*, That the contract is fair and reasonable under the circumstances.

longing to the corporation. If the transaction, considering all the circumstances surrounding it, is one which the corporation has the right to appropriate, it is the specific duty of a director not to seize it for himself, otherwise he would in effect be competing with the corporation, and should account for all the profits he obtains. Conversely, if the business opportunity is one which does not properly belong to the corporation, then the director may enter upon his profits. The problem lies in the determination of what are the opportunities that belong to the corporation.

From a layman's point of view, "corporate opportunity" might mean anything the corporation is interested in doing and could do. Legally, however, the term is not quite so broad in scope. Although so far our Supreme Court has not had any opportunity to rule directly on this question, there have been many cases decided by the various American courts on this issue. A study of these cases shows that for the most part, the issue is determined by the facts of each case. Perhaps the most obvious situation where disloyalty is found is where an officer who, being entrusted with the duty of negotiating or developing a venture on behalf of the corporation, takes it for himself.[30] Other situations are not as clear. In the leading case of *Legarde v. Anniston Lime & Stone Co.*,[31] the corporation owned a one third interest in a certain quarry, leased a second one-third interest and was negotiating for the purchase of the portion so leased as well as for the last one-third interest. The acquisition of the whole quarry would have been highly beneficial to the corporation. A director, knowing all this but who was not the one assigned to buy the property for the corporation, bought the two-thirds interest for his own account, with the intention to quarry and sell lime in competition with the corporation. The Court held that the purchase of the one-third which the company held under lease was a breach of the director's fiduciary duty to the corporation, since it had the expectancy of renewal. As to the other one-third interest, the court held that the director was within his rights in buying. Although it would have been valuable to the corporation, its acquisition was not necessary to the corporate business. The court stated in part:

> ...the legal restrictions which rest upon such officers in their acquisition are generally limited to property wherein the corporation has an interest already existing or in which it has an expectancy growing out of an existing right, or to cases where the officers'

[30] The Trenton Banking Co. v. McKelway, 8 N.J. Eq. 84 (1849); Blake v. Buffalo Creek R., 56 N.Y. 485 (1871); Michigan Crown Fender Co. v. Welch, 211 Mich. 148, 178 N.W. 684 (1920).

[31] 126 Ala. 496, 28 S. 199 (1900).

> interference will in some degree balk the corporation in effecting the purposes of its creation.

The so-called "present interest or expectancy" test laid down in the foregoing case has been followed by many courts, but has been criticized as unduly lax in favor of the director. In the words of Ballantine:[32]

> ...the true basis of the doctrine should not be found in any expectancy or property interest concept, but in the unfairness of the particular facts of a fiduciary taking advantage of an opportunity when the interest of the corporation justly calls for protection. This calls for the application of ethical standards of what is fair and equitable to particular sets of facts.

An increasing number of courts have followed Ballantine's approach and have adopted the test of "fairness".

Whichever test is followed, the factors which have been considered by the courts in the determination of whether the opportunity belongs to the corporation or not are the following: good faith, although its presence will not necessarily result in fairness; similarity of the business opportunity to the corporation's existing line of business; its importance to the corporation; the manner in which the matter came to the attention of the director; disclosure of the opportunity to the corporation; financial ability of the corporation to have accepted and exploited the opportunity; and the use of corporate resources. These factors are among those which must be weighed and balanced, and various sets of facts will produce variable results.

Many jurisdictions recognize the right of corporate directors and officers, acting in good faith, to engage in a competing business when it does not injure the corporation.[33] In the case of *Carter v. Frost Oil Co.*,[34] the corporation was organized for the purpose of purchasing, developing and operating oil lands in Louisiana. A director was sent there to act as general manager. While there, he purchased some oil leases for himself and for his own personal benefit. These lands were not developed at the time of the purchase, and their value was not certain. The evidence did not show that the corporation itself could have purchased the same land at a reasonable price. It was offered to the defendant personally at a reduced price. Had the transaction not occurred, it was not certain that the

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[32] BALLANTINE, CORPORATION 204 (1946).

[33] Red Top Cab Co. v. Hanchett, 48 F. 2d 236 (1931); Barr v. Pittsburgh Plate Glass Co., 51 F. 33 (1892); Detroit Fidelity & Surety Co. v. First National Bank of Wichita, 66 S.W. 2d 406 (1933); N.Y. Automobile Co. v. Franklin, 49 Misc. 8, 97 N.Y.S. 781 (1905).

[34] 72 Colo. 345, 211 P. 370 (1922).

corporation would have purchased the property. Furthermore, he was not sent to Louisiana for the specific purpose of finding oil lands and purchasing the same for the corporation. He was sent as general manager, and was not empowered as such to buy property. Under these circumstances, the court held that there was no obligation on defendant's part to purchase the property for his corporation or to offer the same to such company and he had the right to purchase it for himself. The court therefore absolved him from the complaint stating:

> When acting in good faith, a director or officer is not precluded from engaging in distinct enterprises of the same general class of business as the corporation is engaged in.

In another case,[35] the Supreme Court of New York held that the directors were not accountable to the corporation for the profits they had obtained from a transaction which, though in line with the corporate business, it did not want to risk and which it would not have accepted. Similarly, a corporation which, acting independently, has previously cast aside an opportunity or has completely abandoned previous efforts to consummate the transaction, will not be permitted to assume an inconsistent position by decrying the director's conduct in subsequently taking it personally, specially where he spends his own funds in doing so.[36]

Although insolvency of the corporation will often save a director from liability for seizing a corporation opportunity, financial inability is not always a valid defense. In *Irving Trust Co. v. Deutsch*[37] the U.S. Circuit Court of Appeals refused to accept the justification of the directors that the corporation had rejected the business deal in question because it was financially unable to undertake the venture. The evidence showed that the corporation had some receivables which were still uncollected and that there was a possibility of obtaining banking accommodations. The Court believed that should the justification be acepted, then there would be a temptation on the part of interested directors to refrain from exerting their strongest efforts to obtain financing on behalf of the corporation, but after making feeble attempts, would stand by and later reap the opportunities for themselves.

A number of cases have held that if a third party refuses to sell property to the corporation, the directors may purchase that property themselves, provided that they did not cause the refusal

[35] Litwin v. Allen, 25 N.Y.S. 2d 667 (1940).
[36] See Sandy River RR. v. Stubbs, 77 Me. 86, 2 A. 9 (1885); Lancaster Loose-Leaf Tobacco Co. v. Robinson, 199 Ky. 313, 250 S.W. 997 (1923).
[37] 73 F. 2d 121 (1934).

of the third party to sell to the company.[38] In a leading English case decided in 1972,[39] the court refused to apply this theory and preferred to align itself with those American courts which exact a high degree of loyalty from a director. The defendant officer in that case raised two defenses: first, that the third party contacted him in his personal capacity and not in his capacity as officer of the company. He argued therefore that the information and the opportunity were not those of the company, but his own. Second, that this was an opportunity which the company could not have obtained because the third party's policy was not to contract with companies like the plaintiff. In rejecting both contentions, the court held, first, that the only capacity in which a director receives information concerning the company's business is his capacity as a director. It is his duty therefore, to pass all such information on to the company. Second, a director's duty of loyalty requires the non-exploitation of the opportunity by him, even though the company cannot itself exploit the opportunity. The question, said the Court, is not whether, had there been disclosure, the company would have succeeded in obtaining the contract, but whether because of the non-disclosure the director had succeeded in obtaining profits which, had he disclosed, he would not have received. The case seems to imply that had the director disclosed to his corporation the opportunity offered him, the result could have been different. Whatever the implication may be, notice to the corporation that a director is entering into business enterprises similar to those engaged in by the corporation, is a very important factor in determining whether a business opportunity belongs to the corporation.[40] To be effective however, the disclosure must bring home to the corporation and the stockholders full and complete knowledge of the director's potential or actual conflicting interest, and its impact upon the corporation.[41] In this connection, it has been suggested that the only safe approach is to definitely place the corporation on notice by insisting upon an express agreement from the corporation, as a condition, precedent to the director's acceptance of the directorship, that the director shall be permitted to engage in business which is in competition with the business of the corporation.[42] This kind of special dispensation, however, should only be granted by the corporation where

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38 See Pioneer Oil & Gas Co. v. Anderson, 168 Miss. 334, 151 S. 161 (1934); Crittenden v. Cowler Co. v. Cowler, 72 N.Y.S. 701 (1901).

39 Industrial Development Consultants Lts. v. Cooley, 1 W.L.R. 443 (Birmingham Assize) (1972).

40 Young v. Columbia Oil Co., 110 W.Va. 365, 158 S.E. 678 (1931).

41 Blum v. Fleischhacker, 21 F. Supp. 527; mod. 109 F. 2d 543; cert. denied 311 U.S. 665 (1940); Durfee v. Durfee & Canning Inc., 323 Mass. 187, 80 N.E. 2d 222 (1948).

42 Hopper, *Doctrine of Corporate Opportunity Applied to Interlocking Directorates,* 10 WYO. L.J. 148 (1956).

absolutely necessary, as where a director's or officer's services as expert are needed by the corporation. Under such special circumstances, courts have upheld the validity of such agreements.[43] As an extra precaution, the agreement should recite the circumstances and necessity for obtaining the services.

One factor the presence of which will always result in the director's liability, regardless of other circumstances, is the director's use of corporate funds and facilities in exploiting a business opportunity.[44] If there have been profits, the director must account to the corporation for them all, regardless of how disproportionate they may be to the amount of corporate funds used.[45] An interesting case involving massive use of corporate facilities is *Guth v. Loft, Inc.*[46] The plaintiff corporation owned a chain of soda fountains. It had become dissatisfied with its business arrangements with the manufacturers of Coca Cola. Its president then acquired for his personal benefit the rights to the Pepsi Cola formula held by an insolvent company. The opportunity came to him as a result of his connection with the corporation, and the acquisition was made mainly with corporate funds. In developing his own cola enterprise, he used corporate funds, assets and personnel, and never risked his own property. The Supreme Court of Delaware held the President liable on a two-fold basis: first, because the venture was almost completely financed by the corporation; and second, because the business he acquired was so closely related to the corporate business as to constitute a corporate opportunity.

A unique situation somewhat different from the usual corporate opportunity cases was that involved in *Dravosburg Land Co. v. Scott.*[47] A director of the plaintiff corporation owned a one-acre lot adjoining a 65-acre tract of land owned by his corporation. A purchaser offered $75,000 for both lots, but the director refused to sell his lot for less than $40,000. Rather than lose the $35,000, the directors and the stockholders unanimously agreed to the deal. In a suit for unjust enrichment, the court refused to hold the defendant liable, stating:

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[43] Anderson v. Dunagan, 217 Ia. 672, 250 N.W. 115 (1933); Wallach v. Billings, 277 Ill. 218, 115 N.E. 382; cert. denied, 244 U.S. 659 (1917).

[44] Backus v. Findlestein, 23 F. 2d 357 (1927); Weismann v. Snyder, 338 Mass. 502, 156 N.E. 2d 21, (1959); Sparks v. McGraw, 112 S.C. 519, 100 S.E. 161 (1919); Battle Creek Food Co. v. Kirkland, 298 Mich. 515, 299 N.W. 167 (1941).

[45] Backus v. Findlestein, 23 F. 2d 351 (1927); Bronschwig v. Carthage Marble & White Lime Co., *supra*, note 2.

[46] 23 Del. Ch. 255, 5 A. 2d 503 (1939).

[47] 340 P. 280, 16 A. 2d 415 (1940).

> No law, outside of eminent domain, compels a person to part with his property for what other persons or a court may regard as sufficient compensation.
>
> No duty to his company restricted his right to refuse to sell his land, or if he sold it at all, to do so only at a price satisfactory to himself.

To relieve directors from liability for seizing corporate opportunities, some corporations have incorporated in their by-laws provisions expressly exculpating them. This has been met with conflicting reactions. Most courts have considered this as a gift of a corporate asset and therefore invalid.[48] Others have expressed the opinion that ratification by stockholders would allow seizure of a corporate opportunity.[49] Considering the attitude of our Supreme Court in the few conflict of interest cases that have come before it, it is very doubtful whether a similiar provision would be upheld in this jurisdiction.

Although the cases have usually applied the same standards of loyalty to both directors and officers, some authorities believe that this should not be so. An officer is usually a fulltime corporate agent and is usually paid a salary for his services. A director on the other hand, unless he is also an officer, spends only a part of his business time and efforts for the corporation, for which he either is not paid at all, or if he is, only for every meeting attended. It is therefore implied that such director can devote his time and efforts to his own business affairs. Furthermore, as a general rule, a director who is not an officer or a dominating force in the management of the company, has relatively less opportunity or authority in making business decisions on the operational level. His interest might therefore not fall within the same limitations as that of an officer. Thus, although the principles governing the fiduciary duties of directors and of officers may be similar, the inherent differences in their relations to the corporation should be considered in the determination of fairness and the existence of disloyalty sufficient to give rise to liability.[50]

In determining the liability of directors and officers in corporate opportunity cases, one must keep in mind that the doctrine is intended to safeguard the corporation and not the fiduciaries. And if the "fairness" test seems to be too nebulous, it is precisely its flexibility and uncertainty which should deter overreaching by fiduciaries. The broad language of the proposed Corporation Code

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[48] See Gottlieb v. McKee, 34 Del. Ch. 537, 107 A. 2d 240 (1954).

[49] See Sutherland v. Dahlen, 357 P. 143, 53 A. 2d 1143 (1947).

[50] See Carrington and McElroy, *The Doctrine of Corporate Opportunity as Applied to Officers, Directors and Stockholders of Corporation,* 14 BUS. LAW. 957 (1959).

allows for a similar flexibility and gives the court wide discretion in determining the liability of a disloyal director:

> SEC. 42. *Disloyalty of a director.*—When a director by virtue of his office acquires for himself a business opportunity which should belong to the corporation thereby obtaining profits to the exclusion of such corporation, he must account to the latter for all such profits unless his act has been ratified by the unanimous vote of the stockholders. This provision shall be applicable notwithtsanding the fact that the director risked his own funds in the venture.

With such a general provision, our courts would have plenty of room to consider the factors mentioned earlier in deciding whether or not a defendant director has in law usurped a corporate opportunity.

THE INTERLOCKING DIRECTOR

In this day of complex business relationships, it is not unusual to witness a situation where one person sits on the board of directors of more than one corporation. Many times, these corporations of which he is concurrently a director may have some business ties, such as that of supplier and customer, or manufacturer and distributor. Or the corporations may be competitors.

Although we have no existing provision of law governing interlocking directors in general, the nature of the business of some corporations has prompted our law-making power to impose restrictions in some sensitive areas. The Investment House Act[51] for example, prohibits a director or officer of an investment house to be concurrently an officer or director of a bank without authority from the Monetary Board. In no event however, can a person be concurrently an officer of an investment house and of a bank.[52] Although restrictions with respect to banks deal with ownership of stocks,[53] these could in some instances have the effect of limiting interlocking bank directors. No express provision however prohibits or restricts their presence. The broad provisions of the law punishing acts resulting in monopolies and unlawful combinations in restraint of trade could possibly cover interlocking directors of competing corporations.[54] But many of the interlocks do not involve competing corporations, and as to them, our law is completely silent.

The issue that usually comes up relating to interlocking directors is whether the presence of an interlocking director or direc-

[51] Pres. Decree No. 129.
[52] Section 6, *Ibid.*
[53] See Secs. 12-B and 12-D, General Banking Act (Rep. Act No. 337 [1948] as amended by Pres. Decree No. 71 [1972].
[54] See Sec. 186 of the REV. PEN. CODE.

tors affects the validity of contracts between the corporations concerned. As in the case of seizure of corporate opportunity, no case directly involving the issue has come before our Supreme Court. In the face of this gap in our statutes and applicable decisions, we turn again to American decisions for guidance.

The original attitude of the American courts to corporations with common directors was one of prohibition. They were concerned mainly with protecting shareholders from overreaching directors. Justice Brandeis voiced his criticism of the practice in the following words:

> The practice of interlocking directorates is the root of many evils. It offends laws human and divine. Applied to rival corporations, it tends to the suppression of competition and to violation of the Sherman law. Applied to corporations which deal with each other, it tends to disloyalty and to violation of the fundamental law that no man can serve two masters. In either event it tends to inefficiency; for it removes incentives and destroys soundness of judgment. It is undemocratic; for it rejects the platform: 'A fair field and no favors', —substituting the pull of privilege for the push of manhood.[55]

With the tremendous growth of the corporate enterprise in the early part of this century and the greater familiarity of the courts with the corporation, came an increasing realization that interlocking relationships often presented very definite advantages to the corporation. This realization has produced a gradual change of judicial attitude which today is no longer one of prohibition but at least one of tolerance.

Where the interlocking directors are in the minority of both boards and a disinterested majority of the directors approve the arm's length transaction, no problems usually arise. Where, however, a majority of the directors are common to the contracting corporations, although some courts still consider the contract voidable without regard to fairness,[56] most courts, finding this rule to be impractical and unworkable, have applied a more elastic one which allows the scrutiny of the circumstances of each case to determine whether the contract attacked is fair and reasonable. Under this rule, which is the majority view, the contract would be voidable only if found to be unfair or unreasonable.[57] Without such a

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[55] Cathedral Estates v. Taft Realty Corp., 228 F. 2d 85 (1955); Colorado Management Corp. v. American Founders Life Ins. Co., 145 Colo. 413 (1961); Alabama Co. v. Dubberly, 198 Ala. 545, 73 S. 911 (1917).

[56] See Evansville Public Hall Co. v. Bank of Commerce, 144 Ind. 34, 42 N.E. 1097 (1896); United Towing Co. v. Phillips, 242 F. 2d 627 (1957); United Hotels Co. v. Mealey, 147 F. 2d (1945).

[57] See Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 41 S.Ct. 209, 65 L.Ed. 425 (1921); Corsicana National Bank v. Johnson, 251 U.S. 68, 40 S. Ct. 82 (1919); Shelensky v. South Parkway Building Corp., 19 Ill. 2d.

rule, few dealings would be possible between a parent company and its subsidiaries, since oftentimes interlocking directors constitute a majority of the boards of both parent and subsidiary. Even under this view however, the burden of proving fairness is on the corporation which seeks to uphold the contract.[58] Some courts have gone all the way and have held the contract *prima facie* valid until proven unfair by the party attacking it.[59] The problem is, as in the other conflict of interests situations, in determining whether the transaction involved is "fair" or "unfair". Again here, no fixed rule has been devised, and the circumstances of each case will have to be considered.

Whatever view as to the voidability of the contract may be, it is generally held that the defect may be cured by stockholder ratification, either express or implied from a failure to object over a long period of time, although there was knowledge of all the facts. And in such ratification, the common director's vote may be included.[60]

In *Chelrob Inc. v. Barrett*,[61] a contract was entered into between subsidiaries of the Long Island Lighting Company, whereby one was to supply the other with gas at a price lower than the average over-all production cost. The price was supposed to represent only the direct cost involved in producing the extra amount of gas to be sold under the contract. The subsidiaries had a number of common directors who had participated in the approval of the deal. In a derivative suit at the instance of a minority stockholder of the selling corporation, the court held that inspite of the good faith of the common directors, the contract must be subject to the closest scrutiny to determine its fairness and that the contract in question could not bear such scrutiny, and was therefore voidable.

Even where the common directors does not participate in the approval of a contract between two corporations, if he exercises a dominating influence over the selling corporation and the contract is unfair and oppressive, the contract would still be voidable. In the case of *Globe Woolen Co. v. Utica Gas & Electric Co.*,[62] the plaintiff corporation sued to compel specific performance of a contract

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268, 166 N.E. 2d 793 (1960); United Towing Co. v. Phillips, 242 F. 2d 627 (1957).

[58] Crowell & Thurlow SS Co. v. Crowell, 280 Mass. 343, 182 N.E. 569 (1932); Wentz v. Scott, 10 F. 2d 426, (1926).

[59] See Notes, *The Validity of Contracts Between Corporations with Common Directors*, 51 HARV. L. REV. 327 (1937).

[60] 293 N.Y. 442, 57 N.E. 2d 825 (1944).

[61] 224 N.Y. 483, 121 N.E. 378 (1918).

[62] The preceding section deals with the self-dealing director, Sec. 40, *supra*, note 29.

by the defendant corporation to supply electric current to plaintiff's mills. The main defense was that the contract was unfair and was obtained due to the influence of a common director. The plaintiff's chief stockholder and president was also a director of the defendant electric company and chairman of its executive committee, holding only one share to qualify him as director. He presided over the meeting of the defendant's executive committee at which the contract was approved, but did not vote. His influence however dominated the other two members of the committee, who looked up to him as a superior. Under the contract, the defendant company would supply electricity to the plaintiff for ten years at a fixed price, which could not be adjusted despite any increase in the price of labor or fuel, or despite any extensions of the plaintiff's plant. The common director gave no word of warning, although he knew of the plaintiff corporation's plans of expansion, which quickly followed the approval of the contract. The court refused to compel performance of the contract stating:

> A beneficiary about to plunge into a ruinous course of dealing, may be betrayed by silence as well as by the spoken word... The refusal to vote does not nullify as of course an influence and predominance exerted without a vote. We hold that the constant duty rests on a trustee to seek no harsh advantage to the detriment of his trust, but rather to protect and renounce if through the blindness of those who treat with him he gains what is unfair.

In an attempt to avoid being brought before the courts to prove fairness of such transactions, some corporations insert in their articles of incorporation or by-laws a provision that no contract would be invalid by reason merely of interlocking directors. Whether such a provision be considered valid or not, it definitely does not deprive the court of the power to scrutinize the situation to determine the fairness of the contract and to hold it void, despite said provision, if found unfair.

The Proposed Corporation Code, in seeking to fill the gaps in our existing law, incorporates the prevailing view on the effect of contracts between corporations with interlocking directors. Section 41 reads as follows:

> SEC. 41. *Contracts between corporations with interlocking directors.*—Except in cases of fraud, and provided the contract is fair and reasonable under the circumstances, a contract between two or more corporations having interlocking directors shall not be invalidated on that ground alone; *Provided however,* That if the interest of the interlocking director in one corporation is substantial and his interest in the other corporation or corporations is merely nominal,

he shall be subject to the provisions of the preceding section insofar as the later corporation or corporations are concerned.[63]

Section 116 furthermore provides:

> SEC. 116. *Interlocking directors. No person shall be at the* same time a director in any two or more corporations which by the elimination of competition by agreement between them would create an illegal monopoly or a combination of trade.

Although Section 41 just quoted adopts the majority view upholding the validity of a fair and reasonable contract between corporations with common directors, it does not state what side has the burden of proof. In the absence of such a provision, our courts may adopt the prevailing view that the contract is presumed unfair and the burden to prove fairness is on the party who seeks to maintain the challenged transaction. This seems to be a logical rule since those who would sustain the transactions generally possess greater knowledge of the salient facts, and placing the burden on them compensates the stockholders for the absence of the arm's-length bargaining in transactions approved by a majority of interlocking directors.

CONCLUSION

After having listened to this brief discussion, I would not be entirely surprised if some of you may feel more confused now than you were when you stepped into this room. The rule of law as to conflict of interest is clear in its general definition—in all the categories discussed, the essential test is fairness of the transaction. However, we have seen how extraordinarily vague the rule is in its application to the borderline case. While a rule of thumb would be advantageous to the director in guiding his conduct in the management of corporate affairs, no such formula has been or will probably be found. It can only be suggested that when a director is faced with what seems to be a borderline case, that he resolve it in favor of the corporation. Otherwise, he must be ready to bear the risk of litigation and the possibility of the court's finding that what he thought was not improper was, in law and in fact, a breach of the duty of loyalty he owes to his corporation. Although this lack of a clearly defined border may be burdensome to the director or officer, the laying down of hard and fast rules would not only be impractical but may prove prejudicial to all parties concerned, including the corporation. It is this absence of certainty which allows the courts more freedom in their efforts to keep the standards of

[63] U.P. LAW CENTER, DIVISION OF RESEARCH AND LAW REFORM, PROPOSED CORPORATION CODE OF THE PHILIPPINES (1973).

loyalty at a respectable and acceptable level, and at the same time respecting, in proper instances, contracts involving conflict of interest when to do so would prove beneficial to the corporation. The only other alternative would seem to be the gradual evolution of a code of ethics, fostered by the business community itself. This, of course will take time to fully materialize.

In the meantime, it may be a good idea for a corporation which believes that it may be faced with the problem of conflict of interests to study the feasibility of taking measures to protect its directors and officers, because in so doing, it will ultimately be protecting the corporation and stockholders as well. The measures taken should be both educational and preventive, and if possible should cover not only conflict of interest situations but also other situations which may give rise to the liability of directors and officers. They should be made aware of the possible legal liabilities to which they are exposed, and protective measures could at the same time be designed so as to minimize the risks that liability should actually occur.

To this end, many large corporations in the United States have issued general policy statements directed at their directors, officers and employees concerning conflict of interests. Perhaps some of our corporations should consider doing the same. In the formulation of such a policy, house counsel would naturally play an important role, and after its adoption, his opinion will be sought when cases arise under such policy. Although house counsel would of course have to concern himself with legal rules, he has to consider other non-legal factors, including his company's relationship with its officers, employees, customers, suppliers, its stockholders and even the public at large. Thus, he must not forget that the success of a large corporate organization depends to a great extent on the mutual confidence and respect among the men responsible for running its affairs. When the corporation pries into their private affairs by the issuance of a policy statement regarding conflict of interests, they may be deeply offended by an action which to them questions their loyalty after long years of dedicated and efficient service.

On the other hand, house counsel would not be serving the interests of the corporation by advocating a "soft" policy. If "kickbacks" and "payola" should be condoned in even just one instance, the company's relationship with its suppliers and customers could be adversely affected.

The corporation's public image must also be kept in mind. Exposure of dishonest conduct in any large corporation will necessarily tarnish its image, reputation, good will and continued public acceptance, not to mention the marketability of its stock.

Finally, and more significantly, dishonesty in large corporations, just like dishonesty in public office, may have the effect of setting a standard of morality in all other matters. Even as the world is shocked by the revelations of Lockheed and Watergate, would it be totally unexpected to hear the man on the street say: "If that big business tycoon can do it, why can't I?"

If only for these reasons, it should be a big challenge to house counsel to do his best to insure that his corporation's conscience is clear.

Conflict of interests is likely to become a growing field of law, and public attention will increasingly be directed to it. It is very probable that, at one time or another in the future, each of us as lawyers will be called upon to give advice with respect to various aspects of the problem, because of its increasing importance in our nation's economic life. We cannot therefore underestimate the lawyer's role in influencing the businessman's conduct. We must necessarily share the responsibility for the ethical standards which will evolve on this matter. And should these standards reach the status of a professional code of ethics, let us hope we can all keep our heads high in the knowledge that we have served not only the interests of our clients but those of the whole nation as well.