CORPORATE WATCH–DOGS

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Being an artificial person, a corporation can act only through natural persons. However, in contrast to a partnership, in a corporation the management is not vested in the owners, i.e., the stockholders, but is centralized in a board of directors. Practically the entire management of the corporation is delegated to the board of directors. As such, the directors hold a fiduciary position. It is the purpose of this article to discuss the relations of directors with the corporation, stockholders and third parties.

I. ELECTION, QUALIFICATIONS AND RESTRICTIONS

A. ELECTION

Section 23 of the Corporation Code reads in part:

> "Unless otherwise provided in this Code, the corporate powers of all corporations formed under this Code shall be exercised, all business conducted and all property of such corporations controlled and held by the board of directors or trustees to be elected from among the holders of stocks, or where there is no stock, from among the members of the corporation, who shall hold office for one (1) year and until their successors are elected and qualified."

Since the law requires directors to be elected annually, the articles of incorporation or the by-laws cannot provide for a longer term.[1] In the case of ordinary corporations, the term of office of the directors cannot be staggered.[2] Whenever the term of office of the directors may be staggered, there is a legal provision expressly following it, as in the case of the trustees of non-stock and educational corporations.[3] The director must be elected by a majority of the stockholders present at a meeting. Thus, they cannot be elected by region with the stockholders within each region electing a director.[4]

Since the directors must be elected, the by-laws cannot create the position of an *ex-officio* director.[5] An alternate director cannot be elected to replace an absent director, because directors cannot delegate their powers.[6] If more directors are elected than what is provided for in the

articles of incorporation, the election of the entire board is voidable.[7]

Section 24 of the Corporation Code provides in part:

> "In stock corporations, every stockholder entitled to vote shall have the right to vote in person or by proxy the number of shares of stock standing at the time fixed in the by-laws, in his own name on the stock books of the corporation, or where the by-laws are silent, at the time of the election; and said stockholder may vote such number of shares for as many persons as there are directors to be elected or he may cumulate said shares and give one candidate as many votes as the number of directors to be elected multiplied by the number of his shares shall equal, or he may distribute them on the same principle among as many candidates as he shall see fit; Provided, That the total number of votes cast by him shall not exceed the number of votes owned by him as shown in the books of the corporation multiplied by the whole number of directors to be elected: Provided, however, That no delinquent stock shall be voted."

Since cumulative voting is a right granted by law, the exercise of this right cannot be prohibited by a resolution of the stockholders or by a provision in the by-laws.[8] Likewise, since the right to vote by proxy is granted by law, the by-laws cannot prohibit voting by proxy.[9] The number of proxies which an individual may hold cannot be limited.[10] Otherwise, this will restrict the right of stockholders to choose their proxies if they do not wish to be represented by anyone except that person. The by-laws cannot provide that each stockholder will have one vote only irrespective of the number of shares he owns, because the law provides that the number of votes shall be based on the number of shares of stock.[11]

Section 24 of the Corporation Code requires: "The election must be by ballot if requested by any voting stockholder or member."

The election may be conducted ***viva voce*** or by a show of hands if no stockholder present objects.[12]

B. QUALIFICATIONS

Only natural persons can be directors. A corporation cannot be director, because being an artificial person, it has to act through a representative.[13]

The qualifications which a director must possess are either statutory or conventional, i.e., required by law or the by-laws.

Section 23 of the Corporation Code provides in part:

> "Every director must own at least one (1) share of the capital stock of the corporation of which he is a director, which share shall stand in his name on the books of the corporation. Any director who ceases to be the owner of at least one (1) share of the capital stock of the corporation of which he is a director shall cease to be a director. Trustees of non-stock corporations must be members thereof. A majority of the directors or trustees of all corporations organized under this Code must be residents of the Philippines."

For a person to be qualified to be a director, he must own at least one share of stock.[14] It is sufficient that it appears in the books of the corporation that the director has legal title to the share of stock, even if beneficial ownership is vested in somebody else. Thus, a trustee is qualified to be a director.[15]

Where the shares are registered in the name of the heirs of the deceased, the heirs are eligible to the board.[16]

A director who ceases to be a stockholder automatically ceases to be a director.[17] Even if he reacquires a share of stock, he will not be restored to the position.[18]

In the United States, the majority of the decisions hold that to be eligible a director need not be a stockholder at the time of the election. It is sufficient that he becomes a stockholder before actually assuming office.[19] The minority view believes that a director must be a stockholder at the time of his election.[20]

The minority view seems to be what is applicable in the Philippines because of the peculiar wording of Section 23 of the Corporation Code, which requires that directors be elected from among the stockholders.[21] This was the same wording of the law in the case of *Rozecrans Mining Co. v. Morey*, 43 P 585, 586. This is also the opinion of the Securities and Exchange Commission.[22]

A stockholder who is a minor and who is married may be elected as director, because his marriage emancipated him from legal incapacity.[23]

In addition to the qualifications prescribed by the Corporation Code, various laws require that a certain minimum percentage of the board of directors of different corporations engaged in certain lines of businesses be made up of Filipinos. This can be tabulated as follows:

1. One hundred per cent (100%)
   a) Rural banks[24]
   b) Private development banks[25]
   c) Cottage industries[26]
   d) Mass media[27]
   e) Educational institutions[28]
2. Two-thirds (2/3)
   a) Banks[29]
   b) Savings and loan associations[30]
   c) Financing companies[31]
   d) Domestic air commerce or air transportation[32]
3. Majority
   a) Investment houses[33]

Section 2-A of the Anti-Dummy Law also forbids the election of aliens to the board of directors of wholly nationalized enterprises, such as retail trade[34] and private security agencies.[35] In the case of enterprises which are practically nationalized like the operation of public utilities,[36] the exploitation of natural resources,[37] and pawn shops,[38] aliens may be elected to the board of directors in proportion to the allowable share of aliens in the capital stock.[39]

The by-laws may prescribe qualifications for directors in addition to those imposed by law.[40] Section 47 of the Corporation Code provides:

> "Subject to the provisions of the Constitution, this Code, other special laws, and the articles of incorporation, a private corporation may provide in its by-laws for:
>
> xxx xxx xxx
>
> "5. The qualifications, duties and compensation of directors or trustee, officers and employees;"

Thus, the by-laws may require all directors to be residents of the Philippines.[41] The by-laws may require directors to own not only one share but a certain minimum number of shares.[42]

C. *DISQUALIFICATIONS*

The disqualifications of directors may also be statutory or conventional.

First of all, Section 27 of the Corporation Code provides:

> "No person convicted by final judgment of an offense punishable by imprisonment for a period exceeding six (6) years, or a violation of this Code, committed within five (5) years prior to the date of his election or appointment, shall qualify as a director, trustee or officer of any corporation."

A person convicted for a violation of the Corporation Code is disqualified even if the penalty imposed upon him was merely a fine. If he was convicted for violation of another law, if the penalty imposed upon him was a fine or imprisonment for not more than six (6) years, he is not disqualified. The five-year period of disqualification is counted from the date of the commission of the offense and not from the date of final conviction.

Many of the disqualifications imposed by law are imposed upon public officers to prevent a conflict of interests.

1. The President,[43] 'the Prime Minister, members of the Cabinet, members of the Executive Committee,[44] and the members of the Civil Service Commission, Commission on Elections, and the Commission on Audit[45] cannot become director of any private corporation.

2. No full-time appointive or elective public official shall serve as director of a private bank,[46] rural bank,[47] private development bank,[48] or savings and loan association[49] except in cases where it is incidental to any financial assistance given by the government or a government-owned or controlled corporation.

3. Personnel of the Central Bank are prohibited from being directors of any institution subject to the supervision or examination of the Central Bank except nonstock savings and loan associations and provident funds organized exclusively for the employees of the Central Bank.[50]

4. It is unlawful for a public official or any member of his family to be a director of a private corporation which has pending official business with him during the pendency or within one year after its termination.[51]

The by-laws may impose additional disqualifications for directors. The by-laws may disqualify a stockholder from being elected to the board if he is also a director in a corporation whose business is competitive to prevent a conflict of interests.[52]

II. POWERS

A. *NATURE*

The powers of a corporation may be classified into three: (1) those expressly granted; (2) those impliedly granted, as reasonably incident and necessary to the carrying out of the express powers; and (3) those incidental to the existence of the corporation.[53]

The express powers are those granted by law or contained in the articles of incorporation.[54] The implied powers have to do with the means and methods of attaining those objects and purposes.[55] The incidental powers are those that are inherent in the corporation as a legal entity. They pertain to every corporation without regard to its express powers and are incident to its existence.[56]

Among the incidental powers of a corporation are the power to sue and be sued; power of succession; power to adopt and use a corporate seal; and power to adopt by-laws.[57]

The following are among the implied powers of corporations:

1. Acts in the usual course of business, e.g., borrowing money, executing promissory notes, and issuing checks;

2. Acts to protect debts owing to the corporation, e.g., purchasing property of the debtor at public auction;

3. Embarking in a different business, e.g., temporarily conducting an outside business to collect a debt;

4. Acts in part or wholly to protect or aid employees, e.g., building homes, places of amusement or hospitals for employees; and

5. Acts to increase business.

Thus, a hotel may enter into a contract for the hiring of vaudeville entertainments, orchestras, and acrobatic exhibitions to entertain its guests and attract patronage.[59] A mining company may enter into a contract for the opening of a post office at its mining camp to service its employees, as this concerns the benefit, convenience and welfare of its employees.[60]

A corporation may own a piece of land and a building for its office and lease the other parts it does not need.[61] A cement company may operate an electric power plant, for it is necessarily connected with the manufacture of cement.[62] A sugar central may acquire shares of stock in a corporation engaged in the manufacture of sugar bags as this is in pursuance of its corporate purpose.[63] A corporation which has a computer may sell the computer time in excess of its needs.[64]

On the other hand, a corporation organized to deal in automobiles and automobile accessories and to transport passengers by water could not operate a taxicab service, as this has no necessary connection with its business.[65]

B. *EXERCISE OF POWERS*

As a rule the powers of a corporation are vested upon the board of directors.[66] Thus, it is the board of directors that has the power to enter into contracts,[67] to agree to a novation of a contract,[68] to borrow money from a bank,[69] to sue,[70] to compromise a case in court,[71] and to sell real property owned by the corporation.[72]

If a power is lodged with the board, an action taken on the matter by the stockholders will not bind the corporation even if the stockholders were unanimous.[73] This rule is subject to the following exceptions:

1. The corporation is a mere *alter ego* of one stockholder, who is using it merely as a mere business conduit. In such a case, the separate juridical personality of the corporation may be disregarded.[74]

2. A principal stockholder, who is the president and general manager, enters into a contract in behalf of the corporation with the tacit consent of two other directors, the three of them constitute the majority, and the corporation received benefits from the contract.[75]

3. The board adopted the action taken by the stockholders.[76]

4. The articles of incorporation of a close corporation vests the management upon the stockholders.

Section 97 of the Corporation Code reads in part:

> "The articles of incorporation of a close corporation may provide that the business of the corporation shall be managed by the stockholders of the corporation rather than by a board of directors."

To bind the corporation, the directors must act together as a body. They cannot give their consent separately without holding a meeting.[77]

Presence in the board meeting by an electronic transceiver is not allowable.[78]

To be competent to transact business, the board must have a quorum. The quorum is the majority of the entire membership of the board, irrespective of any vacancies in the board.[79]

The directors must be personally present. They cannot send a proxy to attend the meeting. Their position requires the exercise of personal judgement. This cannot be delegated.[80] That is why an alternate director cannot be elected to take the place of an absent director.[81]

In the case of close corporations, the directors may act without the need of a meeting. Section 101 of the Corporation Code provides:

> "Unless the by-laws provide otherwise, any action by the directors of a close corporation without a meeting shall nevertheless be deemed valid if:
>
> "1. Before or after such action is taken, written consent thereto is signed by all the directors; or
>
> "2. All the stockholders have actual or implied knowledge of the action and make no prompt objection thereto in writing; or
>
> "3. The directors are accustomed to take informal action with the express or implied acquiescence of all the stockholders; or
>
> "4. All the directors have express or implied knowledge of the action in question and none of them makes prompt objection thereto in writing.
>
> "If a directors' meeting is held without proper call or notice, an action taken therein within the corporate powers is deemed ratified by a director who failed to attend, unless he promptly files his written objection with the secretary of the corporation after having knowledge thereof.

In the voting, those who abstain are deemed to have acquiesced in the result of the voting although the votes cast may fall short of a majority.[82]

While minors emancipated by marriage may serve as directors, their votes cannot be counted in corporate acts involving the borrowing of money, the alienation or encumbrance of real property of the corporation, or the filing of suits by or against the corporation.[83] The apparent reason for this is that since under Article 399 of the Civil Code a minor cannot perform these acts for himself, he cannot do them for another.

C. DELEGATION

Since the board of directors cannot attend to all the business affairs of a corporation, it may delegate is powers.

1. Executive Committees

Recognizing the long-standing practice of creating executive committees, Section 35 of the Corporation Code provides:

> "The by-laws of a corporation may create an executive committee, composed of not less than three members of the board to be appointed by the board. Said committee may act, by majority vote of all its members, on such specific matters within the competence of the board, as may be delegated to it in the by-laws or on a majority vote of the board, except with respect to: (1) approval of any action for which shareholders' approval is also required; (2) the filling of vacancies in the board; (3) the amendment or repeal of by-laws or the adoption of new by-laws; (4) the amendment or repeal of any resolution of the board which by its express terms is not so amenable or repealable; and (5) the distribution of cash dividends to the shareholders."

Thus, the following matters cannot be delegated to the executive committee, because they require approval by the stockholders:

1. Amendment of articles of incorporation;[84]
2. Removal of directors;[85]
3. Grant of compensation to directors;[86]
4. Ratification of contracts between a director and the corporation;[87]
5. Ratification of acquisition by director of a business opportunity which should belong to the corporation;[88]
6. Extension or shortening of corporate term;[89]
7. Increase or decrease of capital stock or creation or increase of bonded indebtedness;[90]
8. Denial of right of pre-emption over shares to be issued in exchange for property or in payment of a pre-existing debt;[91]
9. Sale or disposition of all or substantially all assets of the corporation;[92]
10. Investment of funds in another corporation or business;[93]
11. Declaration of stock dividend;[94]
12. Conclusion of management contract;[95]
13. Approval of merger or consolidation; and[96]
14. Voluntary dissolution of corporation;[97]

The directors cannot delegate to the executive committee entire supervision and control of the corporation.[98] In fact, while the board may with some exceptions delegate to the executive committee any matter within its competence, the law requires the delegation must be on specific matters and should not be a blanket one.[99]

In determining whether or not the executive committee is acting within its competence, two questions should be asked: (a) Is the business of such a nature that the board can delegate it to the executive committee? and (b) Has the board in fact so delegated its power?[100] Once a power of the board has been a validly delegated to the executive committee, the corporation will be bound by its acts without the need for board approval.[101]

However, if a meeting of the board has been called to act on a specific matter, the authority of the executive committee to act on that matter is automatically suspended.[102]

Since the board is entrusted with management, it retains control over the executive committee.[103] Thus, the board retains the power to reverse the executive committee.[104]

The members of the executive committee are liable for mismanagement under the same conditions as the directors.[105]

The creation of an executive committee does not relieve the board from the responsibility imposed upon it by law.[106] Thus, the directors will still be liable if they are guilty of gross negligence.[107] The same holds true if they knew of the irregularities committed by the executive committee and failed to act to correct them.[108]

2. *Other Committees*

The board may delegate the committees even those powers which involve the exercise of judgment and discretion.[109]

However, there are several limitations on the power of the directors to delegate authority.

1. The directors cannot delegate to a committee the entire supervision and control of the corporation.[110]

2. The directors cannot delegate the exercise of discretionary powers which under the articles of incorporation, the general laws, by-laws, vote of the stockholders or usage is vested exclusively in the board.[111] Thus, the directors cannot delegate the power to make calls.[112]

3. Where special power is conferred upon the board by resolution of the stockholders and the exercise of this power involves discretion, the discretion cannot be delegated.[113]

3. *Management Contracts*

Realizing the abuses committed through management contracts, the Corporation Code seeks to regulate these. Section 44 of the Corporation Code provides:

> "No corporation shall conclude a management contract unless such contract shall have been approved by the board of directors and by stockholders owning at least a majority of the outstanding capital stock, or by at least a majority of the members in the case of a non-stock corporation, of both the managing and the managed corporation, at a meeting duly called for the purpose: Provided, That (1) where a stockholder or stockholders representing the same interest of both the managing and the managed corporations own or control more than one-third (1/3) of the total outstanding capital stock entitled to vote of the managing corporation; or (2) where a majority of the members of the board of directors of the managing corporation also constitute a majority of the members of the board of directors of the managed corporation, then the management contract must be approved by the stockholders of the managed corporation owning at least two-thirds (2/3) of the total outstanding capital stock entitled to vote, or by at least two-thirds (2/3) of the members in the case of a non-stock corporation. No management contract shall be entered into for a period longer than five years for any one term.
>
> "The provisions of the next preceding paragraph shall apply to any contact whereby a corporation undertakes to manage or operate all or substantially all of the business of another corporation, whether such contracts are called service contracts, operating agreements or otherwise: Provided, however, That such service contracts or operating agreements which relate to the exploration, development, exploitation or utilization of natural resources may be entered into for such periods as may be provided by pertinent laws or regulations."

Thus, by virtue of a management contract, the managing corporation may take over the management of all the business of the managed corporation. The management contract may be renewed, but at each instance it must not be for more than five (5) years.

The managed corporation will be bound by acts of the managing corporation within the scope of its authority.[114]

A management contract is not a contract of agency but for lease of services. Hence, the managed corporation cannot terminate the contract any time at will.[115]

If because of the management contract between a parent corporation and its subsidiary, the business, financial and management policies of both are directed towards the same end, this is one of the factors that may be considered to disregard the separate juridical personality of the subsidiary.[116]

In another case, the corporation managing another was held liable for unfair labor practice by reason of its control over the managed corporation.[117]

D. *ULTRA VIRES TRANSACTIONS*

1. *Nature*

Ultra vires acts are acts which the corporation cannot perform because they are outside those conferred by law or by its articles of incorpoation and are not necessary or incidental to the exercise of the powers so conferred.[118]

2. *Ratification by Stockholders*

The stockholders may ratify a contract which is *ultra vires.*[119] However, the ratification must be made by all stockholders. A single stockholder who does not ratify the contract may question it in court.[120]

If in addition to being outside the powers of the corporation, the *ultra vires* contract is contratry to law, morals, public order or public policy, it is void and cannot be ratified.[121] For instance, banks are prohibted by Section 74 of the General Bank Act from guaranteeing any obligation.

3. *Enforcement*

If an *ultra vires* contract is not also illegal, enforceability is governed by the following rules:

First, if it has been fully performed by both parties, it cannot be set aside.[122]

Secondly, if it has been performed by one party, he can enforce it. The other party is estopped. After receiving the benefits of the contract, the other party cannot invoke its invalidity as a defense.[123]

Thirdly, if neither party has performed the contract, it cannot be enforced.[124]

4. *Personal Liability of Directors*

Section 31 of the Corporation Code reads in part:

> "Directors or trustees who willfully and knowingly 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 or acquire any personal or pecuniary interest in conflict with their duty as such directors or trustees shall be liable jointly and severally for all damages resulting therefrom suffered by the corporation, its stockholders or members and other persons."

Thus, insofar as *ultra vires* transactions are concerned a director will be personally liable only if the act is patently unlawful or he is guilty of gross negligence or bad faith.

Gross negligence is want of any or even slight care and diligence.[125] It involves such want of care as to raise a presumption that the person in fault, conscious of the probable consequences of carelessness, is indifferent to the danger of injury to the person or property of others.[126] It involves breach of duty which is flagrant and palpable.[127] It requires conscious indifference to consequences, pursuit of a course of conduct which would naturally and probably result in injury, and utter disregard of consequnces.[128]

On the other hand, bad faith imports 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.[129] It involves performance of an act with knowledge that one is violating the law or right.[130] It connotes a serious willingness and deliberate intent on the part of the erring party to do wrong or cause damage to another.[131]

A difficult question of law may be the basis of good faith.[132]

The fact that a director acted on the basis of the advice of legal

counsel may serve as a defense for personal liability for an *ultra vires* contract.[133] If the fact that the transaction is *ultra vires* is plain and explicit, the advice of legal counsel will not afford protection to the director.[134]

The directors cannot evade liability under Section 31 of the Corporation Code by having the by-laws amended so as to shift the liablity to the managing director only or the executive vice president.[135]

III. CONTROL BY STOCKHOLDERS

There are various devices by which stockholders are able to exercise control over the directors to a certain extent.

First, the directors are elected by the stockholders.[136]

Secondly, the directors cannot award themselves any compensation.[137] They are not entitled to any compensation unless this is granted by a resolution of the stockholders or a provision in the by-laws.[138] Neither can the directors increase the compensation given them by the stockholders.[139] A resolution giving the directors compensation cannot be retroactive.[140]

Thirdly, the stockholders may remove a director. Section 28 of the Corporation Code reads in part:

> "Any director or trustee of a corporation may be removed from office by a vote of the stockholders holding or representing two-thirds (2/3) of the outstanding capital stock, or if the corporation be a non-stock corporation, by a vote of two-thirds (2/3) of the members entitled to vote: Provided, That such removal shall take place either at a regular meeting of the corporation or at a special meeting called for the purpose, and in either case, after previous notice to stockholders or members of the corporation of the intention to propose such removal at the meeting."

Thus, to be valid, the notice for the meeting must expressly mention the proposal to remove the director.[141] A director cannot be removed by simply electing a new one in his stead.[142]

Section 28 of the Corporation Code further reads:

> "Removal may be with or without cause: Provided, That removal without cause may not be used to deprive minority stockholders or members of the right of representation to which they may be entitled under Section 24 of this Code."

As a rule, a director may be removed even without cause.[143] While the law protects a director representing minority stockholders, the power to remove cannot be used against such a director only if it is without cause.[144]

Fourthly, if the directors are guilty of breach of trust, a stockholder may file a derivative suit.[145] In that derivative suit, the stockholder may ask that the corporation be placed under receivership.[146]

Fifthly, the adoption of important and fundamental actions require approval by the stockholders. These actions were earlier enumerated in the discussion of the matters which cannot be delegated to the Executive Committee.

The majority stockholders cannot repudiate a derivative suit filed by the minority stockholder. Otherwise, no such action will ever prosper.[147]

To enable him to use these levers of control intelligently, the law grants the stockholder the right to inspect and copy the records of all business transactions of the corporation.[148]

IV. OFFICERS

A. ELECTION

The officers should be elected by the members of the board and not by the stockholders.[149]

B. QUALIFICATIONS

The president must be a director.[150] Since the president must be a director, a vice president cannot become acting president if he is not a director.[151] The secretary of a domestic corporation must be a resident and citizen of the Philippines.[152]

A director may serve in any other capacity unless it is prohibited by the articles of incorporation, the by-laws or if the functions are incompatible.[153]

Thus, Section 25 of the Corporation Code provides:

> "Any two (2) or more positions may be held concurrently by the same person, except that no one shall act as president and secretary or as president and treasurer at the same time."

C. *COMPENSATION*

The officers cannot grant themselves compensation.[154] Their compensation must be fixed by the board if it is not so provided in the by-laws.[155] If the officers are also directors, they are disqualified from voting on the question of their own compensation.[156] A resolution fixing the salaries of the officers cannot be retroactive.[157]

D. *REMOVAL*

The officers hold office at the will of the directors and are removable anytime except when the exercise of this power is limited by a provision in the contract with a particular officer.[158]

E. *POWERS*

1. *Scope*

Since the power to enter into contracts is vested upon the board, a president cannot enter into a contract without the authority of the board.[159] The power to enter into contracts may be delegated expressly or impliedly.[160]

A contract entered into by an officer beyond the authority granted him by the board does not bind the corporation unless ratified by it.[161] If an officer enters into a contract against a resolution of the board, the corporation is not bound, because he is acting outside the scope of his authority.[162]

Without need of special authority from the board, an officer vested with general management may perform all acts of an ordinary nature which by usage or necessity are incident to his office and may bind the corporation by contracts in matters arising in the usual course of business.[163] Thus, he can enter into a contract for the purchase of merchandise in which the corporation is dealing.[164] He can rent a crane to load scrap iron in which the corporation is dealing in.[165] He can hire employees.[166] He may authorize the filing of suit if it is in the ordinary and usual course of business.[167] He can borrow money if it is required by the usual and ordinary business.[168]

If an act is in the ordinary and usual business of the corporation, i.e., it involves the day-to-day operations, the person entrusted with general management can bind the corporation even if there are limitations on his authority of which the third person dealing with him is not aware. Such limitation will not prejudice third parties.[169]

If the contract is not within the ordinary course of business of the corporation, the officer vested with general management cannot bind the corporation.[170] Thus, the general manager of a corporation organized to do business as an insurance agency has no authority to purchase beer with twenty thousand pesos.[171]

If a corporation clothes an officer with authority to bind it and a third party dealing with him did not know of his actual want of authority but relied on appearance, the corporation will be bound.[172]

2. *Ratification*

Ratification of an unauthorized act may be done expressly or impliedly such as by acquiescence, acts showing approval or adoption of the contract, or acceptance or retention of benefits.[173] If an unauthorized act is not repudiated within a reasonable time, acquiescence is implied.[174] The acceptance of benefits from the contract due to performance by the other party amounts to ratification.[175]

In order that an unauthorized contract may be validly ratified, its existence must be brought to the full knowledge of the board of directors, the one empowered to ratify it.[176] The ratification cannot be made by the same officers who entered into the unauthorized contract.[177] Thus, the fact that the proceeds of the contract entered into by the president were turned over to the treasurer does not lend itself to ratification, as the acceptance of the benefits is not known by the board.[178]

If similar acts have been approved by the board as a matter of general practice, custom and policy, a general manager may bind the corporation without the need for formal authorization of the board.[179]

Ratification of an unauthorized act retroacts to the time of the act.[180]

3. *Personal liability*

An officer signing a contract in behalf of a corporation within the scope of his authority is not personally liable under the contract.[181]

Similarly, a manager who acted within the scope of his authority in dismissing an employee is not personally liable for damages.[182]

V. DISPUTES INSIDE THE BOARD

Frequent deadlocks within the board may paralyze a corporation. To remedy such a situation, several options are available.

First, the stockholders may agree that if the deadlock paralyzes the corporation for a certain period of time, one group will have the option to buy the shares of the other group at a specified price or according to a designated formula.[183]

Secondly, the corporation may be dissolved. To dissolve the corporation voluntarily, a majority vote of the board of directors and the approval by stockholders owning at least two-thirds (2/3) of the outstanding capital stock is required.[184]

The corporation may be dissolved involuntarily at the instance of minority stockholders.[185] However, dissolution will be ordered only if there is no other adequate remedy available and the rights of the stockholders cannot be protected in some other way.[186] Dissolution can be granted only when the deadlock is so discordant as to prevent efficient management and the object of the existence of the corporation cannot be attached.[187]

Thirdly, in case of a deadlock which will result in paralyzation of business operations, the Securities and Exchange Commission may appoint a management committee to take over the management of the corporation.[188]

Fourthly, if the business is divisible, the stockholders can split up the business and spin off a separate corporation for each faction.[189]

Fifthly, the dispute may be resolved by arbitration.[190] Arbitration offers the advantage of breaking the deadlock without having to dissolve the corporation.

In the case of close corporations, upon the written petition of any stockholder, the Securities and Exchange Commission may arbitrate the dispute. In the process, it may issue an order: (1) cancelling or altering any provision in the articles of incorporation, by-laws or stockholders' agreement; (2) cancelling, altering or enjoining any resolution or act of the corporation or its board of directors, stockholders, or officers; (3) directing or prohibiting any act of the corporation or its board of directors, stockholders, officers, or other persons party to the action; (4) requiring the purchase at their fair value of shares of any stockholder, by the corporation regardless of the availability of unrestricted retained earnings, or by other stockholders; (5) appointing a provisional director; (6) dissolving the corporation; or (7) granting other relief warranted by the circumstances.[191]

VI. DIRECTOR AS PRINCIPAL STOCKHOLDER

The obvious pitfall which a director who is a principal stockholder should avoid is to see to it that in his actuations he recognizes the separate legal personality of the corporation. If the corporation is merely his alter ego and he uses it as a business conduit for his benefit, its separate personality might be disregarded.[192] For instance, the funds of the corporation should not be deposited in the name of the principal stockholder.[193]

The second point to remember is that a director who is a principal stockholder owes a fiduciary duty to the minority stockholders. Justice Louis Brandeis has very aptly put it:

> "The majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority; as much so as the corporation itself or its officers and directors."[194]

As a consequence of this fiduciary duty, in managing the corporate affairs a director who is a principal stockholder should not favor himself to the detriment of the minority stockholders. This violates the implied understanding that the corporate affairs will be managed in the best interests of the corporation.[195]

A principal stockholder who uses corporate property for his own benefit violates his fiduciary duty.[196] Thus, a director who was the controlling stockholder saddled the corporation with personal expenses and used its property for his farming project breached his fiduciary duties.[197]

The usurpation by the principal stockholder of an opportunity properly belonging to the corporation is also a breach of his fiduciary duty.[198] Thus, the controlling stockholders of a corporation engaged in film production who formed another corporation that also produced films were ordered to account to the minority for the profits earned by the new corporation.[199]

If the controlling directors enter into a contract which is so unconscionable and oppressive as to amount to a wanton destruction of the rights of minority, the contract may be set aside.[200] For instance, the controlling directors surreptitiously passed a resolution authorizing the sale to them of unissued shares without giving the minority stockholders the right of pre-emption.[201]

Where a majority stockholder and director who negotiated a contract

which increased the value of the shares of stock bought the shares of a minority stockholder at a much lower price because he did not disclose this, the sale was rescinded on the ground of fraud.[202]

VII. FIDUCIARY DUTIES

A. NATURE OF FIDUCIARY POSITION

The fiduciary nature of the position of directors means that a director is obligated by his mere occupancy of that office to act in all matters affecting the corporation and its stockholders solely with an eye to their best interests, unhampered by any pecuniary interest of his own.[203]

> "He who is in such a fudiciary position cannot serve himself first and his cestuis second. He cannot manipulate the affairs of the corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot, by the intervention of a corporate entity, violate the ancient precept against serving two masters. He cannot, by the use of the corporate device, avail himself of privileges normally permitted outsiders in a race of creditors. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements."[204]

The fiduciary nature of the position of directors entails several consequences:

1. Directors must exercise the utmost good faith in all transactions touching their duties to the corporation and its property and in their dealings with and for the corporation they are held to the same strict rule of honesty and fair dealing between themselves and their principals as other agents.

2. As a rule, all their acts must be for the benefit of the corporation and not for their own benefit.

3. They are not permitted to profit as individuals by virtue of their position.

4. Any profits received by them from the company's property or business belong to the company, and they hold the profits as trustees for the benefit of the corporation and its stockholders.[205]

B. INTERLOCKING DIRECTORS

As a rule, a stockholder may concurrently be a director of two corporations which deal with each other.[206]

However, the law prohibits interlocking directorships in certain instances.

Thus, no person can concurrently be a director of an insurance company and an adjustment company.[207]

Because Article 186 of the Revised Penal Code penalizes combinations in restraint of trade, one cannot serve concurrently as director of two competing corporations if they control a substantial segment of the market.[208]

Unless authorized by the Monetary Board, no director or officer of an investment house can concurrently be a director of a bank.[209]

The Central Bank has imposed the following rules on interlocking directors:

> "1. Except as may be authorized by the Monetary Board or as otherwise provided hereunder, there shall be no concurrent directorships between banks or between a bank and a non-bank financial intermediary.
>
> "2. Without the need for prior approval of the Monetary Board, concurrent directorships between the following entities shall be allowed in the following cases:
>
> "a. Banks not belonging to the same category: Provided, That not more than one of the banks shall have quasi-banking functions;
>
> "b. A non-bank financial intermediary, other than an investment house, not performing quasi-banking functions, and a bank;
>
> "c. A bank not performing quasi-banking functions and a non-bank financial intermediary, other than an investment house, performing quasi-banking functions; and
>
> "d. A bank with expanded commercial banking authority or a commercial bank, and one or more financial institution other than investment houses in each of which majority interest is held by the bank."[210]

A provision in the articles of incorporation that except in case of fraud no contract will be affected by the fact that any director is interested in the contract or is a director of the other corporation entering into the contract and that all directors are relieved from liability by reason of any contract with the corporation whether it be for his benefit or for

the benefit of the other corporation of which he is also a director, is void.[211]

Thus, a director may enter into a contract with a corporation just like a stranger if it is in good faith and for an adequate consideration.[212]

C. *CONFLICTS OF INTEREST*

1. *Dealings between Directors and Corporations*

Section 32 of the Corporation Code provides:

> "A contract of the corporation with one or more of its directors or trustees or officers 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 for such meeting;
> "2. That the vote of such director or trustee was not necessary for the approval of the contract;
> "3. That the contract is fair and reasonable under the circumstances; and
> "4. That in the case of an officer, the contract with the officer has been previously authorized by the board of directors.
>
> "Where any of the first two conditions set forth in the preceding paragraph is absent, such contract may be ratified by the vote of the stockholders representing at least two third (2/3) of the outstanding capital stock or of two-thirds (2/3) of the members in a meeting called for the purpose: Provided, That full disclosure of the adverse interest of the directors or trustees involved is made at such meeting: Provided, however, That the contract is fair and reasonable under the circumstances."

To insure independent representation of the corporation, the presence of the director involved must not be necessary to constitute a quorum and his vote must not be necessary for the approval of the contract. It does not necessarily follow that there was independent representation if these requirements were complied with. There will still be independent representation if the other directors are mere dummies who do whatever the disqualified director asks them to do.[213] The same holds true if the other directors are his close relatives.[214]

A mere majority of a quorum of the board of directors is sufficient to authorize a contract under Section 32 of the Corporation Code.[215]

If the approval of the contract by the required independent directors cannot be obtained for lack of quorum, then the contract may be ratified by the stockholders.

The overwhelming majority of the decision hold that in the meeting of the stockholders to ratify the contract, the director dealing with the corporation may vote.[216] The rulings to the contrary are isolated.[217]

For the ratification to be valid, the stockholders must be provided with full knowledge of all the material facts.[218]

The stockholders cannot ratify the contract if it is against the law.[219] The same holds true if the contract is unfair or fraudulent.[220]

Thus, under all instances the contract must be fair and reasonable. In the long analysis, fairness is really the norm.

Fairness means under all circumstances the transaction carries the earmarks of an arm's length bargain.[221]

Fairness does not necessarily preclude the director from making any profit.[222]

On the other hand, to annul the contract, it is not necessary that there be actual fraud. It is enough that it was not fair, e.g., the price paid by a director for the purchase of corporate property is inadequate.[223] Neither is it necessary to show corruption or dishonesty.[224] The fact that the means used by the director dealing with the corporation are not illegal is of no moment.[225]

An action to annul a contract under Section 32 of the Corporation Code should be filed within a reasonable time. Otherwise, it will be barred by laches.[226]

2. *Dealings between Corporations with Interlocking Directors*

Section 33 of the Corporation Code provides:

> "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: 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 latter corporation or corporations are concerned.
>
> "Stockholdings exceeding twenty percent (20%) of the outstanding

capital stock shall be considered substantial for purposes of interlocking directors."

In computing the twenty percent (20%) benchmark, both voting and non-voting shares of stock are included, as the law makes no distinction.[227]

Thus, a contract between two corporations with interlocking directors is valid so long as there is no fraud and it is fair and reasonbale. If a director owns more than twenty percent (20%) of the outstanding capital stock of one corporation and twenty percent (20%) or less of the outstanding capital stock of the other corporation, the contract will be subject to the same rules as a contract between a director and the corporation in accordance with Section 32 of the Corporation Code.

C. *BUSINESS OPPORTUNITIES*

Section 34 of the Corporation Code states:

"Where a director, by virtue of his office, acquires for himself a business opportunity which should belong to the corporation, thereby obtaining profits to the prejudice of such corporation, he must account to the latter for all such profits by refunding the same, unless his act has been ratified by a vote of the stockholders owning or representing at least two-thirds (2/3) of the outstanding capital stock. This provision shall be applicable, notwithstanding the fact that the director risked his own funds in the venture."

On this point, the following observations of Prof. O'Neal are enlightening:

"In determining whether an opportunity seized by an officer or director rightly belongs to the corporation several factors are relevant. Did the corporate official discover the opportunity by reason of his position in the corporation or activities on its behalf? Upon discovery of the opportunity did he disclose it to the corporation? Was the opportunity within the existing or prospective scope of the corporation business? To what extent, if any, was the corporation then seeking such an opportunity? Was the corporation financially and otherwise able to take advantage of it? Did the official manipulate corporate operations to prevent it from capitalizing on such an opportunity? Did the other parties to a contract or those otherwise providing the opportunity think they were dealing with the corporation? By seizing the opportunity for himself, did the official place himself in a competitive or otherwise adverse position to the corporation? These factors and probably others are helpful but considerations of this kind should not be myopically applied and allowed to obscure the fairness of the transactions as whole, keeping in mind the reasonable expectations of the corporation's minority shareholders as to whether it is entitled to capitalize on such an opportunity. Accordingly, the absence of one or even most of the factors mentioned should not automatically lead to a finding that the opportunity did not properly belong to the corporation."[228]

Thus, it is the duty of a director to communicate to the corporation any business opportunity.[229] If after full disclosure of all the material facts the corporation rejects the opportunity, the director may avail of it.[230] If the corporation cannot engage competitively in the business opportunity because of its established policy, the director may divert the business opportunity to another corporation of which he is also a director.[231]

If a director has already resigned Section 34 of the Corporation Code will not apply to him.[232] However, if he made all the preparations and arrangements before resigning, he cannot evade his liability under this provision by resigning.[233]

Absence of bad faith is not a defense to liability under this provision, e.g., the director erroneously assumed that it was proper for him to seize the opportunity.[234]

Neither is the fact that the corporation suffered no loss a defense, since the liability is for the gains the director acquired. [235]

D. *SECRET PROFITS*

Section 31 of the Corporation Code reads in part:

"when a director, trustee or officer attempts to acquire or acquires, in violation of his duty, any interest adverse to the corporation in respect of any matter which has been reposed in him in confidence, as to which equity imposes a disability upon him to deal in his own behalf, he shall be liable as a trustee for the corporation and must account for the profits which otherwise would have accrued to the corporation."

A director cannot profit from the performance of his duties.[236] Outside of his proper compensation and expenses, any gain of the director for peforming his duties should inure to the benefit of the corporation. Unless otherwise agreed, a director, who makes any profit in connection with a transaction he conducted in behalf of the corporation, must turn over such

profit to the corporation.[237] Thus, he must account for commissions he earned in conducting a transaction for the corporation.[238]

The fact that the profits were not earned secretly but openly does not defeat the duty of the director to account for them. It is the violation of his fiduciary duty that is decisive.[239]

Thus, a director must account for the following: (1) profits earned by the use of corporate assets; and (2) money received through a breach of trust.[240]

If a director devoted company funds for his own benefit, he must account to the corporation for the profits he earned from such funds.[241] This holds true even if the transaction in which he engaged is *ultra vires* for the corporation.[242]

Bribes given to a director to influence his official action must be yielded to the corporation.[243] The same holds true for rebates for service contracts.[244]

An honest intention is not a defense for liability to account for secret profits.[245] The fact that there was no injury to the corporation is of no moment.[246] The fact that the transaction in which the director made a secret profit was beneficial to the corporation is immaterial.[247]

CONCLUSION

The fiduciary nature of the position of a director is best summed up in the following words of Lord Justice Bowen:

> "The director is really a watch-dog, and the watch-dog has no right, without the knowledge of his master, to take a sop from a possible wolf."[248]

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FOOTNOTES

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