The Law and Practice on Philippine Corporate Governance

*Cesar L. Villanueva**

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* '05 D.J.S. San Beda Graduate School of Law; '89 LL.M., Harvard Law School; '81 LL.B., *cum laude* (Class Valedictorian), Ateneo de Manila University School of Law. The author is the Dean of the Ateneo de Manila University School of Law, and is a professorial lecturer in Corporate Law and Sales. He is the Chairman of the Commercial Law Department of the Philippine Judicial Academy, a member of its Academic Council, and Executive Director of its Consultants Group. He is a Senior Name Partner in the Law Firm of Villanueva Gabionza & De Santos. He has also authored the following books: PHILIPPINE CORPORATE LAW, LAW ON SALES and COMMERCIAL LAW REVIEW. His previous works in the *Journal* include: *The Evolution of the Philippine Commercial Law System,* 50 ATENEO L.J. 690 (2005); *Defining the Gravamen: The Bar Reform Movement,* 48 ATENEO L.J. 624 (2004); *Revisiting the Philippine "Laws" on Corporate Rehabilitations,* 43 ATENEO L.J. 183 (1999); *The Law on Contratos Innominados,* 42 ATENEO L.J. 242 (1998); *Corporate Contract Law: Unifying Theme on Theories Relating to Promoter's Contracts, De Facto Corporations, Corporations by Estoppel, Articles of Incorporation, By-Laws and Ultra Vires Acts,* 38 ATENEO L.J. 1 (1994); *Restatement of the Doctrine of Piercing the Veil of Corporate Fiction,* 37 ATENEO L.J. 19 (1993); *The Fiduciary Duties of Directors and Officers Representing the Creditor Pursuant to a Loan Workout Arrangement: Parameters under Philippine Corporate Setting,* 35 ATENEO L.J. 11 (1991); *Philippine Close Corporations,* 32 ATENEO L.J. 30 (1988); *The Trust Fund Doctrine under Philippine Corporate Setting,* 31 ATENEO L.J. 30 (1987); *Non-Punishable: Issuance of a Check as a Guarantee for Payment of an Obligation,* 29 ATENEO L.J. 67 (1984); *Tax Inquiries, Surveillance, Warranteless Searches and Seizures: Their Constitutional Limitations,* 25 ATENEO L.J. 41 (1981); and *The Conscientious Objector under the New Labor Code,* 24 ATENEO L.J. 27 (1980).

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I. INTRODUCTION

This Article delves into the existing law and legal practice on Corporate Governance in the Philippines, as well as the evolving theory and management practice on the broader area of Corporate Social Responsibility (CSR).

In particular, the system of corporate governance in the Philippines will be analyzed on its theoretical and legal bases, in the various fields in Corporate Law and Practice to which it has been applied to, namely among public companies[1] in general, and the banking and insurance industries in particular (covered companies).

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1. The system of corporate governance provided under the Securities and Exchange Commission (SEC) Code of Corporate Governance covers what are termed in this Article as "Public Companies," which by express enumeration are limited to the following:

   (a) Corporations whose securities are registered or listed;

   (b) Widely-held private corporations: with assets in excess of Php50,000,000, and having 200 or more stockholders each holding at least 100 shares of a class of securities;

In essence, the Article undertakes an evaluation of the evolving "standing" of the identified stakeholders, and the resulting duties and responsibilities of the Boards of Directors of covered companies, the extent to which their powers and authority have been affected, their legal responsibilities expanded, and the nature and extent of the personal liabilities they may incur under a new Philippine regime of "good corporate governance."

A. Various Theories on Corporate Governance

The theoretical basis upon which corporate governance is pursued in any legal jurisdiction greatly influences the objectives for which the corporation is to be managed, the power, duties and obligations of the Board of Directors, as well as the extent of the personal liabilities they may expose themselves to, and the rights of the persons, i.e., constituencies or stakeholders, who would have legal standing to draw upon such duties and responsibilities.

1. Doctrine of Maximization of Shareholder Value versus Theory on Corporate Social Responsibility (CSR)

a. Maximization of Shareholder Value

Under the Corporation Code of the Philippines, the generally accepted goal of the corporation is one that is based on maximization of shareholder value,[2] which means that the primary obligation of directors of a corporation is "to seek the maximum amount of profits for the corporation."[3] It is otherwise referred to as the "Stockholder Theory."

(c) Grantees of SEC permits, licenses and secondary franchise, namely: finance companies; investment houses, brokers and dealers of securities, investment companies, pre-need companies, and stock and other securities exchanges;

(d) Philippine branches or subsidiaries of foreign corporations whose securities are registered or listed.

Section VIII of the SEC Code of Corporate Governance provides, however, that unless mandated by law, other corporations are likewise encouraged to observe the Code in the absence of any mandated corporate governance rules adopted by other agencies.

2. Niceto S. Poblador, Stakeholdership, Corporate Responsibility and the Ethics of Managerial Conduct, *available at* http://clvcorporategovernance.blogspot.com/2007/09/theories-of-corporate-governance.html (last accessed Oct. 29, 2008).

3. Prime White Cement Corp. v. Intermediate Appellate Court, 220 SCRA 103, 103 (1993).

Milton Friedman concluded that "there is one and only one social responsibility of business — to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."[4]

Friedman discussed several grounds on his opposition to the implication that business in general, and corporations in particular, have a "social responsibility," that is that business should not be only concerned with profits, but "also with promoting desirable social ends."[5] Firstly, he stated that "in a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers ... to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom."[6] Secondly, he posited that businessmen are trained to make profits, and do not possess specific competence in promoting public welfare, and that it would be specially difficult to measure whether businessmen are complying with such duty for social responsibility.[7] He discussed that there are no parameters under "social responsibility" theory to guide them to determine how much cost on such social activities they can impose on the corporate venture.[8] Finally, he suggested that many "social responsibility" practices are merely self-serving or window-dressing, when in fact the real motivation was to gain an advantage to the corporation in furtherance of profits.[9] Implicit in Friedman's paper was his support for Adam Smith's "hidden hand" principle: by allowing business to freely and fully function in its own specific competence of profit-making, society will be better served in the long run.

The theory of maximization of shareholder value as the lone pursuit of a corporate enterprise has been criticized to be based on a flawed premise, which is that it is the capital initially invested in the corporation that creates the wealth, when in fact it is the various sectors that work within the corporate enterprise that actually generate the wealth, including the

4. Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, NEW YORK TIMES, Sep. 13, 1970, at 33.

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.*

protection and business environment provided by government.[10] Others have argued that although management bears a fiduciary relationship to the owners to run the business in their behalf, such duty to make profits cannot override his other obligations in running a company, such as to deal fairly with suppliers, to provide good working conditions to his employees, provide safe products to customers, etc.[11] It is also opined that engaging in activities for the public welfare does not require such a high degree of competence which is beyond the capabilities of the ordinary businessman; that contrary to the "hidden hand" theory, businesses, if left to themselves, would enrich themselves while impoverishing society.[12]

Former Dean Robert Clark[13] explains that the real meaning of the maximization of profit[14] theory is that "it tells corporate managers what their residual goal is — or, in economic jargon, what the company's "objective function" is. The duties to all other groups need simply be satisfied — they function as constraints — but the duty to shareholders is open-ended: "Profits should be made as large as possible, within the constraints."[15]

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10. *See* Marjorie Kelly, The Stockholder Myth, *available at* http://www.earthisland.org/eijournal/fall2000/fe_fall2000stockmyth.html (last accessed Oct. 29, 2008).

11. Emmanuel Q. Fernando, Theories of Corporate Governance, *available at* http://clvcorporategovernance.blogspot.com/2007/09/theories-of-corporate-governance_20.html (last accessed Oct. 29, 2008).

12. *Id.*

13. ROBERT CHARLES CLARK, CORPORATE LAW (1986 ed.).

14. In philosophical discussions, Dean Clark refers to the maximization-of-profit theory as "dualism," where the dualist "regards the private and public spheres as having distinct functions that ought to be kept distinct. Accordingly, from the traditional legal viewpoint, a corporation's directors and officers have a fiduciary duty to maximize shareholder wealth, subject to numerous duties to meet specific obligations to other groups affected by the corporation." *Id.* at 677-678.

15. *Id.* He elucidates on the view that under the theory, "we gain a lot from strict profit maximization in terms of private-sector performance, but we don't really jeopardize the attainment of public policies." *Id.* at 679. He continues to say that:

> On the other side, no one needs to be made worse off by the corporation's having a single goal of profit maximization. The interests of nonshareholder groups like employees can be protected by contract, common law developments, and special legislation. Negative externalities like pollution can be corrected by tort law or pollution laws telling companies not to pollute or taxing them when they do. The production of public goods and the redistribution of wealth from rich to poor can be better accomplished by actual governments, which have a more legitimate claim to do these things. And corporate resources can still be diverted to these governmental activities, in small

b. Corporate Social Responsibility (CSR)

The World Business Council for Sustainable Development defines CSR as "the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large."[16]

Professor Emmanuel Q. Fernando discusses that in the Philippines, the rise of the issue that corporations ought to have a social or public purpose came out of a sense of the gross imbalance of wealth within our society, where most of it is concentrated in the hands of an elite few, and that most of the great profits were being raked in by large multinational companies at the expense of the Filipino consumers; he observes that there are three reasons to support the claim for corporate social responsibility.[17] First, the corporation wields great economic power within our society rivaling that of the government.[18] Second, since corporations exist and thrive under conditions that the government and society provide, then as a matter of gratitude, corporations must reciprocate by undertaking social or public purpose activities.[19] Third, every corporation is granted by the state with a legal personality, and like any other citizen, should have duties and responsibilities towards the community.[20]

> or great measure, as elected representatives set fit, because governments can tax both corporations and their shareholders. Profit maximization is therefore a legitimate and desirable goal for business corporations.

16. Tom Fox, Halina Ward & Bruce Howard, Report for the The World Bank on Public Sector Roles in Strengthening Corporate Social Responsibility: A Baseline Study, *available at* http://www.mpdf.org/ifcext/economics.nsf/AttachmentsByTitle/CSR-CSR_interior.pdf/$FILE/CSR-CSR_interior.pdf (last accessed Oct. 29, 2008).
17. Fernando, *supra* note 11.
18. *Id.* They have the power to create great wealth, provide jobs for the multitude, advance the frontiers of science and technology by financing and conducting research, either maintain the ecological balance of or pollute the environment, create goods and services that increase the safety, health and welfare of its consumers, provide basic needs, affect the stock market and the economy for better or worse, and the like. Clearly, with such awesome power comes the corresponding responsibility
19. *Id.*
20. *Id.*

According to *The Economist*,[21] there is clear evidence to support the proposition that CSR practice has taken a central role in global executives' management practice and that "[b]usiness schools, for their part, are adding courses and specialised departments to keep their [Master of Business Administration] MBA students happy." The following were the reasons for the phenomenon: (a) "companies are having to work harder to "protect their reputation — and, by extension, the environment in which they do business"[22] because of the series of scandals that have hit large institutions, such as Enron, WorldCom, and the great media and public activism that has sprang-up monitoring companies' behavior; (b) the great concern over the environment and global warming, which is "probably the biggest single driver of growth in the CSR industry of late;"[23] (c) the demand among investors who seek to invest in areas now categorized as "socially responsible investment;"[24] and (d) the strong demand for CSR from the employees who "want to work at a company where they share the value and the ethos."[25] But even then the special report noted that:

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21. The Good Company: A Survey of Corporate Social Responsibility, *available at* http://www.charleswarner.us/articles/EconomistTheGoodCompany.htm (last accessed Oct. 29, 2008); Just Good Business: A Special Report on Corporate Social Responsibility, *available at* http://www.economist.com/specialreports /displaystory.cfm?story_id=10491077 (last accessed Oct. 29, 2008).

22. Just Good Business: A Special Report on Corporate Social Responsibility, *available at* http://www.economist.com/specialreports/displaystory.cfm?story _id=10491077 (last accessed Oct. 29, 2008).

23. *Id.*

24. *Id.*

25. *Id.* The article provides further that:

> CSR is now made up of three broad layers, one on top of the other. The most basic is traditional corporate philanthropy. Companies typically allocate about 1% of pre-tax profits to worthy causes because giving something back to the community seems "the right thing to do." But many companies now feel that arm's length philanthropy — simply writing cheques to charities — is no longer enough. Shareholders want to know that their money is being put to good use, and employees want to be actively involved in good works.
>
> ...
>
> Hence the second layer of CSR, which is a branch of risk management. Starting in the 1980s, with environmental disasters such as the explosion at the Bhopal pesticide factory and the *Exxon Valdez* oil spill, industry after industry has suffered blows in their reputation. Big pharma was hit by its refusal to make antiretroviral drugs available cheaply to HIV/AIDS sufferers in developing countries. In the clothing industry, companies like Nike and Gap came under attack for use of child labour. Food companies face a backlash over growing obesity.

> The business of trying to be good is confronting executives with difficult questions. Can you measure CSR performance? Should you be co-operating with NGOs, and with your competitors? Is there really competitive advantage to be had from a green strategy? How will the rise of companies from China, India and other emerging markets change the game?[26]

2. Narrower CSR Focus: The Stakeholder Theory

According to Prof Fernando, the rather open-ended theory of Corporate Social Responsibility found its "systematic and theoretical underpinnings" by the evolvement of the *Stakeholder Theory* for corporate governance, which takes into account ethical and public concerns into the system of business decision-making, and not just profit making.[27]

Professor Nicanor S. Poblador observes that the theory "has no concept of what economists call '*equilibrium*,' the imaginary point towards which a system tends to gravitate. But more seriously for the practicing manager, *it provides no rational basis for action*."[28] Thus, he summarizes the "crux" of what is lacking in the stakeholder theory:

> In more precise terms, our main concerns are twofold: (1) How do we specify the firm's ultimate objective or goal? (2) How can we pursue this goal in such a way as to satisfy the needs of all groups that have a stake in the enterprise? If we can come up with a precise statement of the firm's ultimate goal (that is, specify clearly what economists call its "objective function"), then we have a basis for defining *rationality*. If we can come up with a set of criteria for meeting the needs of all corporate stakeholders, then we have defined in operation terms *what is and what is not ethical behavior*.[29]

...

> All this is largely defensive, but companies like to stress that there are also opportunities to be had for those that get ahead of the game. The emphasis on opportunity is the third and trendiest layer of CSR: the idea that it can help create value.

26. *Id.*

27. *Id.* The moral environment of the stockholder principle was tightly constrained, focused as it was only on the duties of management toward the stockholders to maximize the profits of the corporation. Stakeholder theory, on the other hand, opened the door to bringing fundamental moral principles to bear on corporate activity, for under that theory, the obligation of business was not [merely] to seek profit for its stockholders, but to coordinate stakeholder interests.

28. Poblador, *supra* note 2.

29. *Id.*

The essence of the first criticism is that:

> [a]lthough the first stakeholder theories acknowledge the existence of other stakeholders and the moral duties the corporation had toward them, they did not sufficiently explain the nature of these duties, how they are to be weighed and measured against each other in case of conflict and whether there was an ethical difference between them.[30]

The second criticism to the stakeholder theory is that it asserts that the responsibility of management towards its owners or stakeholders is of a distinct or special kind, not to be put on the same level as its responsibility toward other stakeholders.[31] It is this second criticism to the original version of the stakeholder theory that prompted the emergence of intermediary theories.[32]

a. Evolving Versions of the Stakeholder Theory

The first intermediate theory, which Professor Fernando tags as the *Moral Minimum Stakeholder Theory*, requires that the corporation must not behave toward the other stakeholders of the corporation below a certain moral minimum.[33] The second intermediate theory, referred to by Professor Fernando as *Strategic Management Theory*, requires that the corporation, in honoring its fiduciary duty toward stockholders to increase profits, should treat other stakeholders strategically, which allows business to act within the moral minimum and even to go beyond it by undertaking humanitarian endeavors which help solve social problems.[34]

Even the intermediate theories have been criticized, for they allow the possibility of unethical behavior, "for acting strategically is treating stakeholders only as a means towards the end of profit. Hence, if it were not profitable to treat stakeholders ethically, then management would soon abandon such behavior."[35]

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30. Fernando, *supra* note 11.

31. *Id.*

32. *Id.*

33. *Id.* Thus:

> This moral minimum involves duties not to cause avoidable harm, or to honor individual stakeholder rights or to adhere to ordinary canons of justice. It can go about its fiduciary duty of making profit for the stockholders of the corporation so long as it does not transgress the requirements of the moral minimum. Corporation actions, humanitarian in character with a social or public goal, are not required, although they may be encouraged.

34. *Id.*

35. *Id.* Thus, Professor Fernando posits that "even if the corporation is acting morally, it is practicing a deception. For … corporations should disguise their

Professor Poblador echoes the observed flaws of the stakeholder theory, thus:

> (a) It fails to specify corporate goals in terms of a single, well-defined variable, and thus fail to provide a rational basis of choice. This puts decision makers at a loss in deciding whether one course of action is to be preferred over another;
>
> (b) This lack of proper guideline effectively "empowers" managers to exercise their discretion, and thus be "able to maneuver within their specified areas of accountability and can divert corporate resources in pursuit of their own interest. This enhances what economists call "agency costs;"
>
> (c) The theory unnecessarily politicizes the corporation by sharply drawing the boundaries between the interest of one group and those of the others.[36]

To this author, two imperatives appear from the various literature covering the evolving theories that compete with the stockholder theory: (a) that the various sub-theories implementing the stakeholder theory would still have the maximization of profits of the business enterprise as the primary responsibility of the Board of Directors and Management, even if they must consider the interests of other stakeholders; and (b) stakeholder theory, and its sub-theories, and in fact the whole CSR theory, appear to still be in gestation, constituting what may be termed as "works-in-progress," and their adoption into any legal jurisdiction would engender a situation where corporate managers and various stakeholders would have to sort out the final workings of such a system of governance, to be adopted to the peculiar national settings upon which they are to operate.

B. Prevailing Principle under the Corporation Code of the Philippines[37]

The prevailing theory on corporate governance under our Corporation Code is the doctrine of maximization of stockholder value, where the Board of Directors and Management owe fiduciary duties to the stockholders, and in the words of the Supreme Court, their main obligation is "to seek the

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intentions and instead make it appear to the public that they are motivated purely by ethical considerations." This position beckons to the "window-dressing" complaint of Friedman.

36. Poblador, *supra* note 2.

37. The Corporation Code of the Philippines [CORPORATION CODE], Batas Pambansa Blg. 68 (1980).

maximum amount of profits for the corporation."[38] In *Gokongwei v. Securities and Exchange Commission*,[39] the Court characterized the fiduciary relation of the Board of Directors to the stockholders of the company "[a]s agents entrusted with the management of the corporation for the collective benefit of the stockholders, 'they occupy a fiduciary relation, and in this sense the relation is one of trust.'"[40]

The Corporation Code does recognize some duty to other stakeholders, but only in a narrow sense.[41] However, the recognition of liability to other persons other than the stockholders or members of the corporation, as in Section 31 of the Code, has not been recognized or even operationalized, except in the area of the application of the "trust fund doctrine" in favor of corporate creditors.

The imposition of solidary liability on offending directors and officers for what is primarily a corporate liability springs from the concept of "joint tortfeasor,"[42] and perhaps is an indication that the recognition of liability to parties outside of the corporation relates more to damages caused to the public based on corporate torts, as non-compliance with the duty of diligence would connote more an act of negligence or tort on the part of corporate directors and officers.

Professor Fernando recognizes two old decisions of the Supreme Court where he posits that an application of the stakeholder theory had in fact been done. In *Montelibano v. Bacolod-Murcia Milling Co., Inc.*,[43] the Supreme Court upheld the board resolutions granting gratuitous concessions to sugar planters by saying that "[a]s the resolution in question was passed in good faith by the board of directors, it is valid and binding, and whether or not it will cause

38. Prime White Cement Corp. v. Intermediate Appellate Court, 220 SCRA 103, 110 (1993).

39. Gokongwei v. Securities and Exchange Commission, 89 SCRA 337 (1979).

40. *Id.* at 367.

41. For example, in defining in statutory terms the common law duty of diligence, Section 31 provides that when directors or trustees 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 interests in conflict with their duty as directors or trustees, they "shall be liable jointly and severally for all damages resulting therefrom suffered by the corporation, its stockholders or members *and other persons*" (emphasis supplied).

42. Article 2194 of the Civil Code provides: "The responsibility of two or more persons who are liable for a quasi-delict [tort] is solidary."

43. Montelibano v. Bacolod-Murcia Milling Co., 5 SCRA 36 (1962).

losses or decrease the profits of the central, the court has no authority to review them."[44]

One may get the impression that the afore-quoted statement of the Supreme Court was a declaration that the Board of Directors owes a social responsibility to uphold its contractual concessions to the planters, even at the expense of the stockholders. This was not the *ratio decidendi* of *Montelibano*, for such was meant to emphasize only the primacy of the *business judgment rule*, which holds that the exercise by the Board of Directors of its business judgment, absent fraud, bad faith or gross negligence, is binding on both the stockholders and the courts; and that if a business transaction is entered into in good faith by the Board of Directors with intentions of maximizing the profits of the company, but it turned out later on that losses were sustained, such fact does not make the directors personally liable for any breach of duty.[45]

The *Montelibano* decision took pains to show that the giving of concessions to the planters was supported with valuable consideration received on the part of the milling company. If in fact, the concessions were given without consideration, or gratuitously to the planters, the decision clearly indicated that it would have held the board resolutions as being contrary to the corporate principle that board of directors have no business giving away the assets of the corporation; that any act of a board that tends to minimize the profits of the company would be *ultra vires* and void.

The second decision is *Board of Liquidators v. Heirs of Maximo M. Kalaw*,[46] where the Board's resolution ratifying contracts to deliver copra to various companies at a loss, the prices of copra in the market having skyrocketed due to the ravages brought about by four typhoons, was held to be a matter of the business judgment and was an act of simple justice and in line with the basic dictates of fairness.[47]

However, the main issue resolved in *Kalaw* was whether the member of the Board of Directors could be held personally liable for having ratified the contracts that were entered into by its general manager, after it was obvious that servicing them would cause severe losses to the company. Therefore,

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44. *Id.* at 42.

45. *Id.* ("[The c]ourt is without authority to substitute its judgment to that of the board of director; the board is the business manager of the corporation, and so long as it acts in good faith its orders are not reviewable by the courts.") (citing 2 FLETCHER CYLCOPEDIA CORPORATIONS at 390).

46. Board of Liquidators v. Heirs of Maximo M. Kalaw, 20 SCRA 987 (1967).

47. *Id.* at 1007-08.

the *Kalaw* decision went into verifying the nature and extent of the *business judgment rule*. Nonetheless, the language of the decision does indicate a notion of social responsibility of boards of directors to engage in fair dealings with parties outside the intra-corporate relationships, even when to do so would prejudice the profit interests of the stockholders. It is interesting to note though, that in justifying a board resolution that sought to uphold fair dealings with customers, the decision went out of its way to indicate that in the end, the primary motivation for such an act of fairness is still ultimately profit maximization consideration.[48]

In *Pirovano v. De la Rama Steamship Co.*,[49] the Court upheld the validity of the board resolution which essentially donated to the surviving children of the deceased general manager the proceeds received by the company from the keyman insurance policy it had maintained over the life of said executive officer "out of gratitude" for his services that saw him derive huge profits for the company."[50] The decision held —

> [T]he donation was a corporate act carried out by the corporation not only with the sanction of its Board of Directors but also of its stockholders. It is evident that the donation has reached the stage of perfection which is valid and binding upon the corporation and as such cannot be rescinded unless there exist legal grounds for doing so. In this case, we see none.[51]

In finding that the donation was not *ultra vires*, the decision found that the articles of incorporation expressly granted the corporation every power to "[t]o invest and deal with the moneys of the company not immediately required … and to aid … any person, association, or corporation of which any obligation or in which any interest is held by this corporation or in the affairs or prosperity of which this corporation has a lawful interest."[52] The

48. *Id.* "The truth, then, of the matter is that … the ratification of the contracts was 'an act of simple justice and fairness to the general manager *and the best interest of the corporation whose prestige would have been seriously impaired by a rejection by the board of those contracts which proved disadvantageous*'" (emphasis supplied).

49. Pirovano v. De la Rama Steamship Co., 96 Phil. 335 (1954).

50. *Id.* at 350. The decision described the essence of the transactions to be a remunerative donation by the corporation, thus:

> [I]t clearly appears that the corporation thought of giving the donation to the children of the late Enrico Pirovano because he 'was to a large extent responsible for the rapid and very successful development and expansion of the activities of this company;' and also because he 'left practically nothing to his heirs and it is but fit and proper that this company which owes so much to the deceased should make some provision to his children,' and so the donation was given 'out of gratitude to the late Enrico Pirovano.'

51. *Id.* at 352-53.

52. *Id.* at 354.

decision determined that acts of generosity or gratuity to employees of the company, which have never been questioned in the past, justify the act of gratitude given to a deceased key officer of the company.[53] The corporate basis for upholding donations and other forms of gratuity to directors, officers and employees was:

> But although business corporations cannot contribute to charity or benevolence … they are not forbidden from recognizing moral obligations of which strict law takes no cognizance. They are not prohibited from establishing a reputation for broad, liberal, equitable dealing which may stand them in good stead in competition with less fair rivals.[54]

The *Pirovano* decision went on to say that indeed if such act of donation were *ultra vires* the stockholders have ratified such donation, thus, the infirmity of the corporate act, if any, had been obliterated. [55]

Thus, *Pirovano* emphasized that an act of charity on the part of the Board of the company may only be to the extent that it does not prejudice the interest of the stockholders, or that if it does, the questioned act must receive confirmatory blessing from the stockholders. In other words, when the Board of Directors of a company pursues such social or civic ends, they must be within reasonable terms, meaning that they are engaged into primarily to engender a greater capacity for the company to better earn profits.[56]

II. FORMAL ADOPTION OF THE STAKEHOLDER THEORY IN PHILIPPINE JURISDICTION

A. Historical Background and Recent Developments

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53. *Id.* at 356.
54. *Id.* at 358, (citing ARTHUR MACHEN, 1 MODERN LAW OF CORPORATIONS 82 (1908)).
55. Pirovano v. De la Rama Steamship Co., 96 Phil. 335, 359 (1954).
56. Even Section 36 of the Corporation Code recognizes formally the power of every corporation —

> 9. To make *reasonable donations*, including those for the public welfare or for hospital, charitable, cultural, scientific, civic, or similar purposes.
>
> …
>
> 10. To establish pension, retirement, and other plans for the benefit of its directors, trustees, officers and employees ...

But such provisions, which are certainly directed for the benefit of stakeholders other than the stockholders, are still permeated within the maximization of profits philosophy (emphasis supplied).

The 1997 Asian Financial Crisis was caused by the lack of transparency and fair dealings of business enterprises in the Asian corporate system.[57] The prognosis was that unless Asian countries adopted world-class standards (i.e., Western standards) of corporate governance, then Asian business enterprises would not be able to reform themselves in a manner that would allow for local and foreign investors confidence in Asian corporate systems. In the 1990's, various multi-lateral agencies started a push towards the adoption of world-standards of corporate governance across the region.

1. Corporate Governance in the Banking Industry.

It was the Bangko Sentral ng Pilipinas (BSP) that first responded to the call made by both the public and private sectors for the reformation of corporate governance systems that would adhere to world-class standards. It promulgated a series of circulars that effected changes in its Manual of Regulations (BSP Circulars on Corporate Governance, or BSP CG Circulars) that began to formally recognize the stakeholder theory within the banking industry.[58]

2. Corporate Governance for Public Companies

Subsequently, the SEC promulgated the Code of Corporate Governance[59] (SEC Code), providing for a system of corporate governance (patterned after the BSP CG Circulars) for public companies. The SEC Code was

57. In particular, the self-dealing culture that permeated large but family-controlled companies were primarily blamed in creating inefficiency and wastage of corporate resources and excluding minority shareholders from partaking of their rightful share in corporate profits.

58. Bangko Sentral ng Pilipinas, Power and Authority of the Board of Directors, Circular No. 283, Series of 2001 (May 17, 2001); Bangko Sentral g Pilipinas, Directors' Qualifications and Disqualifications, Circular No. 296, Series of 2001 (Sep. 17, 2001); Bangko Sentral ng Pilipinas, Guidelines Against Unsafe and Unsound Manner of Conducting Business, Circular No. 341, Series of 2002 (Aug. 6, 2002); Bangko Sentral ng Pilipinas Qualifications of Independent Directors, Disqualification Procedures, Confirmation of Qualification, Circular No. 391, Series of 2003 (Jul. 17, 2003); Bangko Sentral ng Pilipinas, Audit Committee, Corporate Governance Committee, and Risk Management Committee, Circular No. 456, Series of 2004 (Oct. 4, 2004); Bangko Sentral ng Pilipinas, Audit Committee and Internal Audit Function, Circular No. 499, Series of 2005 (Nov. 25, 2005); Bangko Sentral ng Pilipinas, Procedures for Disqualifying Directors/Officers of Closed Banks and Financial Institutions, Circular No. 584, Series of 2007 (Sep. 28, 2007); Bangko Sentral ng Pilipinas, Rules on Interlocking Directorships and/or Officerships, Circular No. 592, Series of 2007 (Dec. 28, 2007).

59. Securities and Exchange Commission, Code of Corporate Governance, SEC Memorandum Circular No. 2, Series of 2002 (Apr. 5, 2002).

supplemented later on by SEC Memorandum Circular No. 16[60] providing for the guidelines on the nomination and election of independent directors.

3. Corporate Governance for the Insurance Industry.

In September 2005, the Insurance Commission (IC) promulgated IC Circular No. 31-2005, entitled "Code of Corporate Governance Principles and Leading Practices," (IC Circular) to establish within the insurance industry a similar system of corporate governance.[61]

One of the key features in both the BSP CG Circulars and the IC Circular is the requirement for qualification for directors appointed in the Board of banking and insurance companies to attend an orientation seminar on corporate governance principles with duly accredited providers. A similar practice is now being practiced for public companies covered by the SEC Code. [62]

4. Attempts at Corporate Governance Regime for State-Owned Enterprise.

Calls for the promulgation of similar codes of corporate governance for government-owned-or--controlled corporations have remained unheeded despite the introduction of some bills regarding such a Code in Congress.[63]

5. Corporate Governance Scorecard Project

The Institute of Corporate Directors (ICD) in the Philippines initiated in 2005 the Corporate Governance Scorecard Project[64] (CG Scorecard) in the

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60. Securities and Exchange Commission, Guidelines on the Nomination and Election of Independent Directors, SEC Memorandum Circular No. 16, Series of 2002 (Nov. 28, 2002).

61. Insurance Commission, Code of Corporate Governance Principles and Leading Practices, Circular No. 31-2005 (Sep. 26, 2005).

62. There has been a formal accreditation of seminar providers, one of the leading ones would be the Philippine Securities Consultancy Corporation (PHILSECC), which has been founded by former senior officers of the SEC, and the Institute of Corporate Directors, which has received formal recognition not only by international agency, but also by the Executive Department.

63. Parenthetically, in June 2003, President Gloria Macapagal Arroyo issued Executive Order No. 220, directing the adoption of the Code of Good Governance for the Professions in the Philippines.

64. This CG Scorecard rated publicly-listed companies through a questionnaire that carefully assessed their transparency standards and disclosures to investors and the general public. The results enabled public-listed companies to determine what the acceptable corporate governance practices were, and how they

Philippines. In 2006, the CG Scorecard Project invited the Ateneo de Manila Law School (ALS) to become the academic institutional partner by which the actual rating of public companies could be done, and to put greater integrity into the process where the results would be even more acceptable to the public companies. In 2007, ICD invited both the SEC and the Philippine Stock Exchange (PSE), with the ALS, to become partners-institutions in the project. In addition, both SEC[65] and PSE[66] issued covering memoranda to public companies directing them to participate as respondents in the CG Survey using the CG Scorecard as the survey instrument.

B. Corporate Governance Background, Concepts and Definitions

The BSP CG Circulars never used, much less defined, the term "corporate governance." Therefore, the use of the technical term "corporate governance" may be deemed to have been legally incorporated into the Philippine legal system in 2002 with the promulgation of the SEC Code, as it defined the term as follows: "A system whereby shareholders, creditors and other stakeholders of a corporation ensure that management enhances the value of the corporation as it competes in an increasingly global market place."[67]

In 2005, the IC Circular gave another, more process-driven definition of corporate governance to mean "the system by which companies are directed and managed. It influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimized."[68]

While SEC Code definition adheres more to establishing the theoretical basis of the system of corporate governance and is value-laden by the terms found within its definition, the IC Circular definition looks at corporate governance from its process-oriented point of view, and treats corporate governance as a system of management of corporate affairs. Yet, the operative provisions of the SEC Code and the IC Circular, as well as the BSP CG Circulars, essentially follow the same format: provide for

compare with other companies, both locally and abroad, with a view to ultimately enhancing corporate governance practice in the Philippines to a higher level of professionalism, consistent with international best practices.

65. Securities and Exchange Commission, Participation in the Corporate Governance Survey, SEC Memorandum Circular No. 2, Series of 2007 (Aug. 9, 2007).

66. Philippine Stock Exchange, Participation in the Corporate Governance Survey, Memo for Brokers No. 392-2007 (Aug. 24, 2007).

67. SEC Memorandun Circular No. 2, § I (B).

68. IC Circular No. 31-2005, § I (I).

governance principles, supported by leading practices and procedures to implement the covered corporate governance principle.

C. Introduction of the Stakeholder Theory into the Philippine Legal System

1. Paradigm Shift: Adoption of the Stakeholder Theory for Covered Companies

The effect of the three agency codes on corporate governance, under a quasi-legislative norm, is the adoption of the *stakeholder theory* for all covered companies, in contrast to the existing *stockholder theory*. Thus, the agency codes have effectively expanded the legal constituencies of Boards of Directors and Management of covered companies beyond merely that of the stockholders.

The threshold legal issue that has to be resolved is this: Was it lawful for the BSP, the SEC, and the IC, in the exercise of their rule-making powers, to expand the legal constituencies of Boards of Directors of covered companies beyond the profit-maximization doctrine provided for in the Corporation Code?

There seems to be little debate to the proposition that the BSP, the SEC and the IC each have administrative powers to adopt in their respective jurisdictions the more expansive stakeholder theory. The stakeholder theory takes its essence from the underlying business enterprise of the corporate set-up. Consequently, it is the governing agencies which are vested by their charters the direct responsibility to evolve the policy growth and development and provide proper administration over the corporate players within their respective industries. When administrative agencies impose a greater measure of responsibilities to the corporate players, this would be consistent with such agencies' powers and functions.

2. The Stakeholders in the Banking Industry

BSP Circular No. 283[69] confirms that "[t]he position of bank/quasi-bank/trust entity director is a position of trust," but goes on to provide "[*a*] *director assumes certain responsibilities to different constituencies or stakeholders*," specifically the banking institution itself, its stockholders, depositors and other creditors, its management and employees and the public at large.[70] It

69. Bangko Sentral ng Pilipinas, Power and Authority of the Board of Directors, Circular No. 283, Series of 2001 (May 17, 2001).

70. *Id.* § 2 (emphasis supplied).

further adds that "these constituencies or stakeholders have the right to expect that the institution is being run in a prudent and sound manner."[71]

This is reinforced by Section 1 of the Circular which provides that "[t]he powers of the board of directors as conferred by law are original and cannot be revoked by the stockholders. The directors hold their office charged with the duty to act for the bank/quasi-bank/trust entity in accordance with their best judgment." The language, when taken with the expanded definition of constituencies under the Circular, emphasizes that bank directors and officers cannot hide behind the fiduciary obligations to the principal stockholders as a shield to not meet their fiduciary obligations to other specified stakeholders.

This responsibility of Boards of Directors of banking institutions towards "expanded constituencies" is strengthened by the Circular's following provisions:

(a) To ensure that the bank/quasi-bank/trust entity have beneficial influence on the economy, the board has a continuing responsibility to provide those services and facilities which will be supportive of the national economy.[72]

(b) A director shall "act honestly and in good faith, with loyalty and in the best interest of the institution, its stockholders, regardless of the amount of their stockholding, and other stakeholders such as its depositors, investors, borrowers, other clients and the general public."[73]

(c) While a director should always strive to promote the interest of all stockholders, he should also give due regard to the rights and interest of other stakeholders.[74]

In addition to the rather general statements or principles relating to stakeholders enumerated above, the circular refers to stakeholders when it provides for the selection of bank officers[75] and enumerates the "Specific Duties and Responsibilities of a Director."[76] The Guidelines Against Unsafe and Unsound Manner of Conducting Business[77] provides that "[i]n determining whether a particular act or omission … may be deemed as

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71. *Id.*

72. *Id.* § 3 (12).

73. *Id.* § 4 (2).

74. *Id.*

75. BSP Circular No. 283, § 3 (12).

76. *Id.* § 4 (2).

77. Bangko Sentral ng Pilipinas, Guidelines Against Unsafe and Unsound Manner of Conducting Business, Circular No. 341, Series of 2002 (Aug. 6, 2002).

conducting business in an unsafe or unsound manner, the Monetary Board … shall consider"[78] whether —

> The act or omission has resulted or may result in material loss or damage, or abnormal risk or danger to the safety, stability, liquidity or solvency of the institution;
>
> The act or omission has resulted or may result in material loss or damage or abnormal risk to the institution's depositors, creditors, investors, stockholders or to the *Bangko Sentral* or to the public in general.[79]

The BSP CG Circulars thus formally institutionalized into the BSP's Manual of Regulations the stakeholder theory on expanded constituencies and good corporate governance under the direct supervision and control of the BSP. Issues of what banking practices are mandatory, rather than merely recommendatory, to the Boards of Directors and officers of banking institutions were thereby removed.

3. The Stakeholders in Public Companies

The SEC Code provides for the following duties and obligations of the Board of Directors of a public company to its stakeholders as distinguished from the stockholders, thus:

(a) It contains the same provisions found in the BSP CG Circulars that as part of "General Responsibility," a director assumes certain responsibilities to different constituencies or stakeholders, who have the right to expect that the institution is being run in a prudent and sound manner;[80]

(b) In enumerating the "Duties and Functions" of the Board of Directors, its opening paragraph holds that "to insure a high standard of best practice for the company and its stakeholders, the Board should conduct itself with utmost honesty and integrity in the discharge of its duties, functions and responsibilities."[81] In particular, it says that the Board has the obligation to "identify the corporation's major and other stakeholders and formulate a clear policy on communicating or relating with them accurately, effectively and sufficiently. There must be an accounting rendered to them regularly in order to serve their legitimate interests;"[82]

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78. *Id.* § 1 (b).

79. *Id.*

80. SEC Memorandum Circular No. 2, § II (6) (a).

81. *Id.* § II (6) (b).

82. *Id.* § II (6) (b) (iv).

(c) In terms of "Audit and Accountability," the Board of Directors of a public company is directed to "maintain a sound system of internal control to safeguard stakeholders' investment and the company's assets;"[83] and

(d) In terms of "Disclosure and Transparency," it mandates that "the Board shall commit at all times to full disclosure of material information dealings. It shall cause the filing of all required information for the interest of the stakeholders."[84]

Other than in the afore-quoted sections, no other provision in the SEC Code refers to stakeholders other than stockholders, and in certain financial and operational provisions, the language of the SEC Code limits itself only to having application to stockholders.

Good corporate governance for public companies would now require from the Boards of Directors and corporate officers a more panoramic approach in decision-making and in the exercise of their business judgment, which must include the balancing of the interests of various stakeholders who do not have the same priorities, towards a general objective. This would involve "enhancing the value of the corporation as it competes in an increasingly global market place."[85] Thus, the SEC Code imposes upon the Board of Directors of a public company the duty "to foster the long-term success of the corporation and secure its sustained competitiveness in a manner consistent with its fiduciary responsibility, which it should exercise in the best interest of the corporation and its shareholders."[86]

Although there is no doubt that the SEC has introduced into our system of public companies the stakeholder theory, there seems to be difficulties on the part of SEC in putting flesh into a general framework of stakeholdership, much less providing a system of decision-making in cases if of conflicts arising from the varied interests of the identified stakeholders. This is understandable in the case of the SEC, because unlike the BSP and the IC whose industries are supported by matured set of statutory system upon which they rely on operationalizing the stakeholder system, public companies are governed by the Corporation Code and the Securities

83. *Id.* § IV (1) (d).

84. *Id.* § VII.

85. *Id.* § I (B).

86. SEC Memorandum Circular No. 2, § II (6) (It would have been more appropriate for the section to have used the word "stakeholders" instead of "shareholders," which currently gives the impression that the obligation of the Board of Directors to foster the long-term success of the corporation and secure its sustained competitiveness is owed only to the corporation and its stockholders, which is contrary to SEC Memorandum Circular No. 2's very definition of "Corporate Governance.").

Regulation Code, which still embody the central theory of stockholder theory. The challenge therefore is to evolve a system of stakeholdership for public companies that takes into account the circumstances prevailing in the Philippine corporate scene, which is consistent with global standards of what constitute best corporate governance practice.

The granting of "legal standing" to stakeholders, other than the stockholders, the "right to expect that the institution is being run in a prudent and sound manner," although relevant in the banking industry which handles funds coming from the public, may not always be relevant or appropriate to all public companies. Although it is clear that stockholders have a direct stake in the operations of the corporate business enterprise, it is difficult to see how other stakeholders, such as employees and suppliers, should have a direct legal standing to insist upon meddling into the business judgment of the Board of Directors of a public company in the running of the corporate affairs. Most of stakeholders other than the stockholders have their interest firmly planted not on the profitability of the corporation, but on the terms of the underlying contractual relationship with the company. Worse is the aspect of having a situation where other stakeholders' insistence on how the company should be conflicts with the stockholders' expectation that profit-maximization should be the primary motivation of the Board of Directors in making decisions on company affairs.

In addition, the provision in the SEC Code mandating that the Board of Directors of a public company must "[m]aintain a sound system of internal control to safeguard *stakeholders' investment* and the company's assets,"[87] seems to recognize that it is not only the stockholders who have a pecuniary investment into the company, but that other stakeholders as well. What is the nature and proper valuation of other "stakeholders' investment" in the company is not defined under the SEC Code. The concept of "stakeholders' investment" is a radical concept which has yet to be developed, since the SEC Code mandates that it is part of what the Board of Directors of a public company should safeguard and for which a regular accounting is instructed.

Therefore, one of the major developments in Philippine corporate governance system that can be expected is the resolution of what may be the proprietary or pecuniary valuation of the "legal right and standing" of stakeholders, other than stockholders, which is quite distinct and apart from the equity claims of stockholders. The following are some legal issues that would probably arise in resolving the nature of the application of the stakeholder theory for public companies.

87. *Id.* § IV (1) (d) (emphasis supplied).

The first issue is whether the legal standing granted under the SEC Code to stakeholders other than stockholders means that bank directors and officers owe them the same fiduciary duties of obedience, loyalty, diligence, and to inform that under common law they owe to stockholders. If so, do stakeholders, other than stockholders, now have the same common law rights that stockholders enjoy, such as the right to inspect and copy corporate records, and the right to file a derivative suit? More interestingly, would stakeholders other than stockholders, now begin to have "ratificatory" standing that stockholders also enjoy under the Corporate Law principles, and what would be the nature and extent of such ratificatory role of such stakeholders?

The author's position is that eventually the resolution of what constitutes stakeholders' (other than stockholders) "investment" in the company's business enterprise and its assets does not amount to a proprietary or pecuniary claim, but merely defines a standing to demand from the Board of Directors and Management of a covered company to operate the corporate business enterprise in a manner that even as they seek the maximization of profits, they must take into account the interests of other stakeholders. This is more consistent with the definition of "Corporate Governance" under the SEC Code as it recognizes the standing of all stakeholders of a public company in "ensur[ing] that management enhances the value of the corporation as it competes in an increasingly global market place."[88] The term "enhancing the value of the corporation" goes beyond just maximization of profits, but goes into management of the business enterprise that takes into consideration the interests of other stakeholders.[89] But more to the point in answering these questions is the structure of the SEC Code itself that limits those common law rights only to stockholders under Section 5 thereof. [90]

Legal practitioners on corporate governance should advise their corporate clientele, particularly the Boards of Directors of public companies, that when it comes to evaluating their duties and responsibilities towards stakeholders other than stockholders, they must take already the bull by the horn, otherwise, they risk being shoved unto them a greater form of

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88. *Id.* § 1 (B).

89. Examples of this are: (1) sacrificing short-term profits towards achieving long-term goals of efficiency and stability; (2) diverting some of the resources of the company from profit-making to funding compliance with environmental safeguards to avoid incurring administrative penalties and/or enhancing the corporate goodwill in the market place; and (3) terminating profitable arrangements with contractors and suppliers that do not adhere to child-labor standards, to avoid public backlash against the company's products.

90. SEC Memorandum Circular No. 2, § V (Stockholders' Rights and Protection of Minority Stockholders' Interests).

fiduciary duty and obligation, and thereby run the risk of incurring greater personal liabilities. In other words, the provision in the SEC Code that stakeholders or constituencies have a right to expect that the corporation is run in a sound and prudent manner,[91] is an too all-encompassing norm and subject to so much interpretation based on who appropriates it for their own advantage and benefit.

Since Boards of Directors of public companies are legally mandated under the SEC Code to identify company's major and other stakeholders, to formulate a clear policy on communicating or relating with them accurately, to effectively and sufficiently render a fair accounting to them regularly in order to serve their legitimate interests, and to develop an investor relations program that reaches out to all shareholders and fully inform them of corporate activities, then they should already include in their manual of corporate governance specific provisions that identify their stakeholders, define their "legitimate interests" in the corporate affairs, and then undertake proper communication system with each of them. In that manner, the Boards of Directors of public companies are more or less assured that they have legally and reasonably channeled what each group of stakeholders standing would be when it comes to their code-given right to expect that the institution is being run in a prudent and sound manner.

4. Stakeholders in the Insurance Industry

The IC Circular particularly defines the term "stakeholders" to refer "to the group of company owners, officers and employees, policyholders, suppliers, creditors and the community."[92] More importantly, the IC Circular expressly provides that its objectives "are to enhance the corporate accountability of insurers and intermediaries, promote the interest of their stakeholders specifically those of the policyholders, claimants and creditors."[93]

Other than the foregoing provisions, the IC Circular treats of stakeholders only in six other instances.[94] On the premise that the IC

91. *Id.* § 2 (6) (d).

92. IC Circular No. 31-2005, § 1 (18).

93. *Id.* ¶ 2.

94. *Id.* § II (A) ("[E]stablish an appropriate compensation package for all personnel that are consistent with the interest of all its stakeholders."); § II (C) (1) ("Act honestly, in good faith, and with loyalty to the best interest of the institution, its stockholders, (regardless of the amount of their stockholdings) and other stakeholders such as its policyholders, investors, borrowers, other clients and the general public."); § II (C) (1) ("A director must always act in good faith with

Circular had been patterned after the SEC Code, one may get the impression that the language of the IC Circular takes a parallel approach in distinguishing between the primary duty it has to stockholders, and what seems to be a secondary duty to all other stakeholders.[95] A closer look at the provisions of IC Circular would not support such an impression.

First, the provisions where the IC Circular refer to stakeholders happen to be the only provisions that also refer to stockholders, unlike in the SEC Code where various provisions are limited to defining the obligations of the Board of Directors only to stockholders, especially when it comes to financial matters. Second, unlike the BSP CG Circulars and the SEC Code, the IC Circular begins with an opening paragraph that is meant to make all its provisions applicable to all its stakeholders.[96] Third, the IC Circular defines the role of the Board of Directors in terms of their obligations to the insurance industry, and therefore primarily driven towards promoting the best interest of those stakeholders who are most affected.[97]

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care which an ordinarily prudent man would exercise under similar circumstances, while a director shall always strive to promote the interest of all stockholders. He shall also give due regard to the rights and interests of other stakeholders."); § III (C) (6) ("Corporate Independence shall be maintained so as not to compromise the interests of policyholders, claimants, creditors, minority shareholders and other stakeholders."); § IV (1) ("There shall be a dialogue with shareholders based on the mutual understanding of objectives. The Board as a whole has the responsibility for ensuring that a satisfactory dialogue with shareholders takes place."); § IV (1):

> The Board must maintain an effective communications policy that enables both the Board and management to communicate effectively with its shareholders, stakeholders and the general public. This policy must effectively interpret the operations of the company to the shareholders and must accommodate feedback from them, which should be factored into the company's business decisions.

95. IC Circular No. 31-2005, § II (E) (C) (1) ("While a director shall always strive to promote the interest of all stockholders," he must [only] "give due regard to the rights and interests of other stakeholders.").

96. *Id.* ¶ 2 ("The objectives of this Circular are to enhance the corporate accountability of insurers and intermediaries, promote the interests of their stakeholders specifically those of the policyholders, claimants and creditors.").

97. *Id.* § II (E) (A) (1):

> Directors sitting on the board in any insurance entity shall be possessed of the necessary skills, competence and experience, in terms of management capabilities preferably in the field of insurance or insurance-related disciplines. In view of the judiciary nature of insurance obligations, directors shall also be persons of integrity and credibility;

Therefore, as in the case of the banking industry, the IC Circular seeks to implement a mature system of stakeholdership that comes with the nature of the insurance industry. Unlike the SEC Code, both the IC Circular and the BSP CG Circulars do not require of the Boards of Directors of covered companies to identify their stakeholders or the nature of their "investments" in the companies, for by the nature of their businesses and the governing laws of each of such industries, the Boards know, or ought to know, fully well the sectors of the public, other than their stockholders, who are affected directly by their operations.

5. Common Law Duty of Directors to Corporate Creditors under the Trust Fund Doctrine

An area where corporate practice and jurisprudence have evolved a system of stakeholdership would be in the area of the *Trust Fund Doctrine*.

The limited liability feature of the corporation brings with it the enforcement under common law of the trust fund doctrine.[98] The definition of the trust fund doctrine that has been much adhered to in Philippine jurisdiction is one given by Fletcher: "The capital stock of a corporation, or the assets of an insolvent corporation representing its capital, is a trust fund for the benefit of the company's creditors."[99]

Our Supreme Court had formally adopted the principle of the doctrine in *Philippine Trust Co. v. Rivera,*[100] when it held that:

> [S]ubscriptions to the capital of a corporation constitute a fund to which the creditors have a right to look for satisfaction of their claims and that the assignee in insolvency can maintain an action upon any unpaid stock subscription in order to realize assets for the payment of its debts.[101]

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§ V ("As a custodian of public funds, insurance corporations and insurance intermediaries shall ensure that their dealings with the public are always conducted in a fair, honest, and equitable manner.").

98. Since stockholders are entitled to the profits of the corporation, then it also means that they must sustain the losses incurred from operations; consequently, since the creditors of the corporation have no legal right to enforce their claims against stockholders when the corporate assets are insufficient, it becomes necessary that during the life of the corporation no asset will be returned to the stockholders outside of distribution of profits to ensure that all corporate assets are first available and applied to answer all liabilities of the corporation.

99. 15 A FLETCHER, CYCLOPEDIA CORPORATIONS § 7369.

100. Philippine Trust Co. v. Rivera, 44 Phil. 469 (1923) (reiterated in Lumanlan v. Cura, 59 Phil. 746, 749 (1934)).

101. Philippine Trust Co., 44 Phil. at 470.

Under the aegis of the Corporation Code, the Supreme Court in *Boman Environmental Dev't. Corp. v. Court of Appeals*[102] reaffirmed the application of the doctrine in our jurisdiction.[103]

The SEC Rules Governing Redeemable and Treasury Shares[104] also expressly adopts the doctrine as follows:

> The outstanding capital stock of a corporation, including unpaid subscriptions, shall constitute a trust fund held by the corporation for the benefit of its creditors which shall not be returned to the stockholders by repurchase of shares or otherwise, except in the manner as provided for under the Corporation Code and these rules.

The trust fund doctrine usually applies in four cases:

(a) Where the corporation has distributed its capital among the stockholders without providing for the payment of creditors;[105]

(b) Where it had released the subscribers to the capital stock from their subscriptions;[106]

(c) Where it has transferred the corporate property in fraud of its creditors;[107] and

(d) Where the corporation is insolvent.[108]

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102. Boman Environmental Dev't. Corp. v. Court of Appeals, 167 SCRA 540 (1988).

103. *Id.* at 548:

> The requirement of unrestricted retained earnings to cover the shares is based on the trust fund doctrine which means that the capital stock, property and other assets of a corporation are regarded as equity in trust for the payment of corporate creditors. The reason is that creditors of a corporation are preferred over the stockholders in the distribution of corporate assets. There can be no distribution of assets among the stockholders without first paying corporate creditors. Hence, any disposition of corporate funds to the prejudice of creditors is null and void.

104. Securities and Exchange Commission, Rules Governing Redeemable and Treasury Shares (1982).

105. Steinberg v. Velasco, 52 Phil. 953 (1929); Garcia v. Lim Chu Sing, 59 Phil. 562 (1934); Boman Environmental Dev't Corp. v. Court of Appeals, 167 SCRA 540 (1988); Yamamoto v. Nishino Leather Industries, Inc. 551 SCRA 447 (2008).

106. Velasco v. Poizat, 37 Phil. 802 (1918); Philippine Trust Co. v. Rivera, 44 SCRA 496 (1923); Ong Yong v. Tiu, 401 SCRA 1 (2003).

107. Steinberg v. Velasco, 52 Phil. 953 (1929).

108. *Id.*; Velasco v. Poizat, 37 Phil. 802 (1918); Lumanlan v. Cura, 59 Phil. 746 (1934); CESAR LAPUZ VILLANUEVA, PHILIPPINE CORPORATE LAW 558 (2001

In these cases, the action of the Board of Directors would be void as being violative of the rights of the corporate creditors, and for which they can be made personally liable, as was the judgment in *Steinberg v. Velasco.*[109]

Inherent in the trust fund doctrine is the principle of the legal preference in payment from corporate properties of the creditors vis-à-vis equity investors. Since creditors put no stake in the corporate operations and their rights are based on contract, then the corporate venture must, in case of insolvency, devote and prefer all corporate assets towards the payment of its creditors. On the other hand, since the equity investors clearly undertook to place their investment to the risk of the venture, they can only receive a return of their investment only from the remaining assets of the venture, if any, after the payment of all liabilities to creditors.[110]

Only recently, in *Ong Yong v. Tiu,*[111] the Supreme Court reiterated its support of the trust fund doctrine and although the suit involved parties to subscription agreement, it prohibited the rescission of a subscription agreement even when there was substantial breach thereof, because it would undermine the protection accorded to the creditors of the corporation.

6. Other Areas Where Stakeholdership Principles Have Evolved

A sense of stakeholdership principle has also evolved when it comes to the welfare of company employees. In *A.C. Ransom Labor Union-CCLU v. NLRC,*[112] the Court enunciated the principle that the highest officer of a corporation should stand liable with the corporate employer for the labor claims of illegally dismissed employees when there are not enough corporate assets to fully satisfy those claims.[113] However, the Supreme Court has now

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ed.) (citing G.C. Arnold v. Willits & Patterson, Ltd., 44 Phil. 634 found in THOMPSON 3427).

109. Steinberg v. Velasco, 52 Phil. 953 (1929).

110. The closest injunction in the Corporation Code upholding the principles of the doctrine would be Section 122 thereof governing dissolution of corporations and their liquidation when it provides that "[e]xcept by decrease of capital stock and as otherwise allowed by this Code, no corporation shall distribute any of its assets or property except upon lawful dissolution and after payment of all its debts and liabilities."

111. Ong Yong v. Tiu, 401 SCRA 1 (2003).

112. A.C. Ransom Labor Union-CCLU v. NLRC, 142 SCRA 269 (1986).

113. *Id.* at 274 (holding that essentially, the responsible officer of the employer corporation can be held personally, not to say even criminally, liable for non-payment of backwages and that in the absence of definite proof as to the identity of an officer or officers of the corporation directly liable for failure to

and then, not on a consistent basis, rejected the universal application of the *A.C. Ransom* doctrine for being contrary to the main Corporate Law principle expressed under Section 31[114] of the Corporation Code. Thus, only the responsible officer of a corporation who had a hand in illegally dismissing an employee should be held personally liable;[115] and for the separate juridical personality of a corporation to be disregarded, the wrongdoing must be clearly and convincingly established.[116]

III. STATUTORY AND COMMON LAW BACKDROP FOR PHILIPPINE CORPORATE GOVERNANCE

To properly understand the systems of corporate governance introduced under the agency codes, it would be necessary to understand the source of the power and competence of the Board of Directors, their constituencies, and the objectives that each Board is mandated to achieve, under the Philippine Corporate Law setting.

A. The "Corporate Package"

The corporate vehicle has become the prevalent business medium because it offers strong juridical personality, centralized management, limited liability to investors, and free-transferability of units of ownership. Corporate Governance is essentially based on, and treats of, the corporate feature of

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pay backwages, the responsible officer is the president of the corporation jointly and severally with other presidents of the same corporation).

114. The provision imposes personal liability on a corporate director or officer only when he is shown to have acted with fraud, bad faith or gross negligence.

115. Chua v. NLRC, 182 SCRA 353 (1990); Gudez v. NLRC, 183 SCRA 644 (1990); Maglutac v. NLRC, 189 SCRA 767 (1990); AHS/Philippines v. Court of Appeals, 257 SCRA 319 (1996); Reahs Corp. v. NLRC, 271 SCRA 247 (1997); Uichico v. NLRC, 273 SCRA 35 (1997); Brent Hospital, Inc. v. NLRC, 292 SCRA 304 (1998); Nicario v. NLRC, 295 SCRA 619 (1998); Bogo-Medellin Sugarcane Planters Asso., Inc. v. NLRC, 296 SCRA 108 (1998); Complex Electronics Employees Assn. v. NLRC, 310 SCRA 403 (1999); Malayang Samahan ng mga Mangagagawa sa M. Greenfields v. Ramos, 357 SCRA 77 (2001); Land Bank of the Philippines v. Court of Appeals, 364 SCRA 375 (2001); H.R. Carlos Construction, Inc. v. Marina Properties Corp., 421 SCRA 428 (2004); Acesite Corp. v. NLRC, 449 SCRA 360 (2005); Coca-Cola Bottlers Phils., Inc. v. Daniel, 460 SCRA 494 (2005); Suldao v. Cimech System Construction, Inc., 506 SCRA 256 (2006); Pamplona Plantation Company v. Acosta, 510 SCRA 249 (2006); Supreme Steel Pipe Corp. v. Bardaje, 522 SCRA 155 (2007); McLeod v. NLRC, 512 SCRA 222 (2007); Elcee Farms, Inc. v. NLRC, 512 SCRA 602 (2007); Uy v. Villanueva, 526 SCRA 73 (2007).

116. Del Rosario v. NLRC, 187 SCRA 777 (1990).

centralized management and its accompanying common law doctrine of business judgment rule.

A corporation's management is centralized in the Board of Directors. Therefore, in its legal relationship, a corporation presents a more stable and efficient system of governance and dealings with third parties. By imposition of law, and except in particularly designated instances, stockholders are bound by the management decisions and transactions of the Board.

B. Power of Board Directly Vested by Law: The Doctrine of Centralized Management

Although the stockholders, by provision of the Corporate Code, have the power to both elect and remove the members Board of Directors, nonetheless, directors are not agents of the stockholders, nor are the powers of the Board considered to be delegated powers of the stockholders. This doctrine of "directly vested authority" (as contrasted from "delegated authority"), which considers the Board powers as directly vested by law and not merely being delegated power from the stockholders, is the dominant rule in Philippine Corporate Law, as affirmed by Section 23[117] of the Corporation Code. The section clearly indicates that the totality of corporate powers[118] is given to the Board of Directors, except only for the particular instances found in the Corporation Code that requires stockholders' ratification. More importantly, it clearly rejects the central doctrine in the Law on Agency that the agent is merely a representative of the principal and acts under his complete will.[119]

As early as 1918, the Supreme Court, in *Ramirez v. Orientalist Co.*[120] refused to recognize any veto power on the part of the stockholders vis-à-vis

117. CORPORATION CODE, § 23.

> The Board of Directors or Trustees — Unless otherwise provided in this Code, *the corporate powers of all corporations formed under this Code shall be exercised, all businesses 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 (emphasis supplied).

118. Namely, to exercise all corporate powers, to conduct all corporate businesses, to control and hold all corporate property.

119. Article 1868 of the Civil Code defines an agent as "a person [who] binds himself to render some service or to do something in representation or on behalf of another, with the consent or authority of the [principal]."

120. Ramirez v. Orientalist Co., 38 Phil. 634 (1918).

the power of the Board of Directors.[121] In *San Miguel Corp. v. Kahn*,[122] the Court held that "[it is] a director's duty to vote according to his own independent judgment and his own conscience as to what is in the best interests of the company."[123]

The nature of the stockholders' ownership of the corporation is limited to that of being "beneficial owners," as it is to their benefit that the entire corporate business enterprise is being operated and managed. The Board of Directors therefore owe fiduciary duties and obligations to the stockholders, not as agents of the latter, but as trustees who must act with diligence and loyalty towards the best interests of the beneficial owners of the corporate business enterprise.

The theory that "the corporate business enterprise and assets constitute the corpus of a trust relationship," with the directors of the Board assuming the position of trustees has lately begun to take jurisprudential expression, although still not universally accepted in Philippine Corporate Law. In *Gokongwei, Jr. v. Securities and Exchange Commission*,[124] the Court said:

> Although in the strict and technical sense, directors of a private corporation are not regarded as trustees … their character is that of a fiduciary insofar as the corporation and the stockholders as a body are concerned. As agents entrusted with the management of the corporation for the collective benefit of the stockholders, "they occupy a fiduciary relation, and in this sense the relation is one of trust." "The ordinary trust relationship of directors of a corporation and stockholders", according to *Ashaman v. Miller*, "is not a matter of statutory or technical law. It springs from the fact that directors have the control and guidance of corporate affairs and property and hence of the property interests of the stockholders. Equity recognizes that stockholders are the proprietors of the corporate interests and are ultimately the only beneficiaries thereof."[125]

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121. *Id.* at 654:

> The theory of a corporation is that the stockholders may have all the profits but shall turn over the complete management of the enterprise to their representatives and agents, called directors. Accordingly, there is little for the stockholders to do beyond electing directors, making by-laws, and exercising certain other special powers defined by law … [W]here a meeting of the stockholders is called for the purpose of passing on the proprietary of making a corporate contract, its resolutions are at most advisory and not in any wise binding on the board.

122. San Miguel Corp. v. Kahn, 176 SCRA 447 (1989).

123. *Id.* at 463.

124. Gokongwei, Jr. v. Securities and Exchange Commission, 89 SCRA 336 (1979).

125. *Id.* at 367-368 (1979) (quoting 3 FLETCHER, CYCLOPEDIA CORPORATIONS § 838 and Ashman v. Miller, 101 F.2d 85 (6th Cir. 1939)) (This was reaffirmed in

1. Treatment of Agency Codes of the Principle of Centralized Management

Corporate governance principles under the SEC Code, the BSP CG Circulars, and the IC Circular do not digress from the principle of centralized management embodied under the Corporation Code. In fact, it is the primary objective of each of those agency codes to institutionalize within their respective areas of jurisdiction the principle of primacy of the Board of Directors on the governance of the company.

BSP Circular No. 283 directly copies the wording of Section 23 of the Corporation Code, and then adds in clear terms the principle of "original authority." [126] In addition, Section 2 sets out the general responsibilities that the Board of Directors of every banking institution must discharge.[127] Thus, while it may be true that the Board of Directors may still retain the services of experts and good counsel, the section emphasizes that the Board cannot escape liability for failing to discharge such direct duties by alleging that it had left the matter to Management and expert consultants.

The primacy of the Board is also the central theme under the SEC Code, which provides that "the Board of Directors is primarily responsible for the governance of the corporation. It needs to be structured so that it provides an independent check on management. As such, it is vitally

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the more recent case of Prime White Cement Corp. v. Intermediate Appellate Court, 220 SCRA 103 (1993)).

126. BSP Circular No. 283, § 1 (adding to subsections X141.3 and 4141Q.3 to the Manual of Regulations):

> The corporate powers of a bank/quasi-bank/trust entity shall be exercised, its business conducted and all its property shall be controlled and held by its board of directors. The powers of the board of directors as conferred by law are original and cannot be revoked by the stockholders. The directors hold their office charged with the duty to act for the bank/quasi-bank/trust entity in accordance with their best judgment.

127. *Id.* § 2:

> The board of directors is *primarily responsible* for Corporate Governance of the bank/quasi-bank/trust entity. To ensure good governance, the board of directors should establish strategic objectives, policies and procedures that will guide and direct the activities of the bank/quasi-bank/trust entity, and the means to attain the same as well as the mechanism for monitoring management's performance. While the management of the day-to-day affairs of the institution is the responsibility of the management team, the board of directors is, however, responsible for the monitoring and overseeing management action.

important that a number of board members be independent from management."[128]

The SEC Code defines "Management" as "the body given the authority to implement the policies determined by the Board in directing the course/business activity/ies of the corporation,"[129] and while it may give the impression that the role of the Board of Directors in public companies is merely to set the policies, the operative provisions demonstrate beyond doubt that the SEC Code has instituted the principle of "command responsibility" on the Boards of public companies.[130] Further, the SEC Code follows the same language as that appearing in the BSP CG Circulars of laying down general principles of corporate governance, and details of the procedures and processes that must be followed by the Board and its key members/officers to meet the primacy of its obligations to be "responsible for the governance of the corporation," and discharge its accountability directly to the stockholders.

The same principle is reiterated in the IC Circular which provides that "[e]very company should be headed by an effective Board to lead and control the company and ensure its success."[131] More importantly, the IC Circular defines the "Board of Directors" as "the collegial body that exercises the corporate powers of all corporations formed under the

128. SEC Memorandum Circular No. 2, § II.

129. *Id.* § I (E).

130. This principle is illustrated in the following provisions of SEC Memorandum Circular No. 2:

§ II: The Board of Directors (Board) is primarily responsible for the governance of the corporation. It needs to be structured so that it provides an independent check on Management. As such, it is vitally important that a number of the board members be independent from Management.

§ II (6): It is the Board's responsibility to foster the long-term success of the corporation and secure its substantial competitiveness in a manner consistent with its fiduciary responsibility, which it should exercise in the best interest of the corporation and its shareholders.

§ II (6) (a): To ensure good governance of the corporation, the Board should establish the corporation's vision and mission, strategic objectives, policies and procedures that may guide and direct the activities of the company and the means to attain the same as well as the mechanism for monitoring Management's performance. While the management of the day-to-day affairs of the institution is the responsibility of the Management team, the Board is, however, responsible for monitoring and overseeing Management action.

§ IV (1): The Board is primarily accountable to the Shareholders and Management is primarily accountable to the Board.

131. IC Circular No. 31-2005, § II.

Corporation Code. It conducts all business and controls or holds all properties of such corporations."[132]

The IC Circular, while embodying the same principle of primacy of the Board in the pursuit of corporate governance for insurance companies and intermediaries, adopts the definition of "Management"[133] given in the SEC Code. This harks back to the antediluvian notion that the role of the Board is merely to lay down policies, and the hard work of governing pertains primarily to Management. Nonetheless, it is clear from the statement of general principles, as well as in the providing for the general responsibilities of the Boards of Directors in the insurance industry, that the IC Circular seeks to establish the same format of "command responsibility" on the Board.[134]

The agency codes, therefore, do not move away from the Corporation Code's primary doctrine of centralized management, and in fact not only do they reiterate it, but they actually spell out in details, under principles of best practice, how the Boards of Directors of covered corporations are to properly exercise their primary and directly-vested powers of corporate governance. In essence, the agency codes reiterate as a principle of good corporate governance that Boards of Directors of covered companies must realize that they assume their office saddled with great responsibilities, as the direct possessors of all corporate powers of the company, and they cannot escape such responsibilities by merely relying upon their Management to assume their roles, duties and responsibilities. Thus, the coverage of the Board's duties and responsibilities to a larger pool of stakeholders is not only increased, but also enhanced, thereby increasing the possibilities of personal

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132. *Id.* § I (2).

133. *Id.* § I (3).

134. *Id.* § II (Principles):

> Every company should be headed by an effective Board to lead and control the company and ensure its success –
>
> Provide entrepreneurial leadership of the company within the framework of prudent and effective controls which enable risks to be assessed and managed;
>
> Set the companies' strategic aims;
>
> Ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance;
>
> Set the companies' values and standards;
>
> Ensure that its obligation to shareholders and others are understood and met.

liabilities of the Directors of covered companies. In other words, the agency codes managed to change the very configuration of the Business Judgment Rule in their respective spheres of jurisdictions.

C. The Business Judgment Rule

1. Rationale for Business Judgment Rule

One of the advantageous features of the corporation is that it acts in the business world through a centralized management. Investors and creditors of the corporation, as well as those who deal or are affected by its operations, can rely upon the law-directed fact that the corporation shall be bound only through its Board of Directors, or representatives duly authorized by the Board. In any organizational set-up, the congruence of authority and responsibility in the same person, committee, or board always promotes efficiency. This is the rationale for the Business Judgment Rule.

The Business Judgment Rule was recognized by the Supreme Court in *Montelibano v. Bacolod-Murcia Milling Co., Inc.*,[135] as previously discussed in this article. Further, *Gamboa v. Victoriano*[136] held that courts cannot supplant the discretion of the Board on administrative matters as to which they have legitimate power of action, and contracts which are *intra vires* entered into by the Board are binding upon the corporation and courts will not interfere unless such contracts are so unconscionable and oppressive as to amount to a wanton destruction of rights of the minority. *Philippine Stock Exchange, Inc. v. Court of Appeals*,[137] establishes another theoretical basis for the Business Judgment Rule vis-à-vis the power of control of the State, based on the recognition of the corporation merely as an association of individuals who, through the Board, do not give up through the medium of the corporation their management prerogatives on business matters.

The Business Judgment Rule thereby emphasizes not only a point of supreme corporate power, but necessarily also the highest corporate responsibility expected from the Board of Directors.

2. Coverage of Business Judgment Rule

The Business Judgment Rule actually has two applications, namely:

(a) Resolutions and transactions entered into by the Board of Directors within the powers of the corporation cannot be reversed by the courts not even on the behest of the stockholders of the corporation; and

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135. Montelibano v. Bacolod-Murcia Milling Co., Inc., 5 SCRA 36 (1962).

136. Gamboa v. Victoriano, 90 SCRA 40 (1979).

137. Philippine Stock Exchange, Inc. v. Court of Appeals, 281 SCRA 232 (1997).

(b) Directors and officers acting within such business judgment cannot be held personally liable for the consequences of such acts.

When directors or trustees violate their duties, however, they can be held personally liable,[138] thus:

(a) When the director willfully and knowingly votes for patently unlawful acts of the corporation;[139]

(b) When he is guilty of gross negligence or bad faith in directing the affairs of the corporation;[140] and

(c) When he acquires any personal or pecuniary interest in conflict with his duty as such directors.[141]

These are also the three instances when courts are authorized to supplant the decision of the Board, which is deemed to be biased and may prove detrimental to the corporation.

3. General Rule that Directors and Officers Cannot Be Held Personally Liable for Corporate Acts and Contracts

The doctrine of non-personal liability of directors and officers flows from two policy considerations. Firstly, if the system would make directors and officers liable for corporate debts and liabilities, then no sane individual would ever accept being elected to the board of any company or be appointed an officer for fear that their personal assets would be exhausted from claims of corporate creditors. Secondly, it is an accepted business risk of a corporation that in some of the transactions and contracts, as well as their execution and compliance, human error or some form of negligence would come in. A system cannot impose personal liability for individuals who act as directors and officers when business risks and valuation have, and must, accept that mistakes and losses would be incurred in the usual course of

138. Since the Board of Directors and their officers are considered agents insofar as the corporation is concerned, the business judgment doctrine flows form leading doctrines in the Law on Agency, that agents who act in behalf of the principle do not incur liabilities arising from the contract and transactions they entered into for and in behalf of the principal, except when they have acted in excess of their powers, or are guilty of fraud, negligence or bad faith in performing their duties under the agency arrangement.

139. CORPORATION CODE, § 31.

140. *Id.*

141. *Id.* §§ 31 & 34.

business operations. It is only when such damage or losses are caused by fraud, gross negligence or bad faith, items which are humanly possible to avoid, can personal liability visit upon the individual at fault.

The common law measure of compliance with the duty of diligence has been expressed into statutory norm under Section 31 of the Corporation Code.[142] Consequently, it is very difficult to impose personal liability on directors and officers for corporate contracts and transactions, since the general rule is that when they act within their business judgment, they are deemed insulated from personal liability. Thus, *Carag v. NLRC*[143] held that "a director is not personally liable for the debts of the corporation, which has a separate legal personality of its own. Section 31 of the Corporation Code lays down the exception to the rule."[144] Further, *Carag* stated that in order to make a director personally liable, as an exception to the doctrine of separate juridical personality, "the bad faith or wrongdoing of the director must be established clearly and convincingly … [T]he wrongdoing approved or assented to by the director must be a patently unlawful act. … Patently unlawful acts are those declared unlawful by law which imposes penalties for commission of such unlawful acts."[145]

In 1994, the Supreme Court in *Tramat Mercantile, Inc. v. Court of Appeals*,[146] issued a jurisprudential formula on determining when directors and officers can be held personally liable for corporate debts and liabilities, thus:

> Personal liability of a corporate director, trustee or officer along (although not necessarily) with the corporation may so validly attach, *as a rule, only when* —
>
> (1) He assents (a) to a patently unlawful act of the corporation, or (b) for bad faith or gross negligence in directing its affairs, or (c) conflict of interest, resulting in damages to the corporation, its stockholders or other persons;

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142. *Id.* § 31:

> *Liability of directors, trustees or officers.* – 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.

143. Carag v. NLRC, 520 SCRA 28 (2007).

144. *Id.* at 48.

145. *Id.* at 49-50.

146. Tramat Mercantile, Inc. v. Court of Appeals, 238 SCRA 14 (1994).

(2) He consents to the issuance of watered stocks or who, having knowledge thereof, does not forthwith file with the corporate secretary his written objection thereto;

(3) He agrees to hold himself personally and solidarily liable with the corporation;

(4) He is made, by a specific provision of law, to personally answer for his corporate action.[147]

The *Tramat* formula for director or officer personal liability has since been adhered to consistently in an unbroken line of decisions of the Supreme Court.[148]

IV. PARADIGM SHIFT IN DUTIES AND RESPONSIBILITIES FOR DIRECTORS AND OFFICERS IN COVERED COMPANIES

The adoption by the BSP, the SEC, and the IC of agency codes on corporate governance effected the following shifts in paradigm from the original framework of corporate governance under the Corporation Code, namely:

(a) *Paradigm Shift No. 1*: Expanding the constituencies of the Board of Directors of covered companies, and thereby shifting the primary company objective from "maximization of profits" to that of "enhancing the value of the corporation."

(b) *Paradigm Shift No. 2*: Recalibrating the standards of the Business Judgment Rule, and thereby imposing a higher level of responsibility and accountability on directors and officers of covered companies.

(c) *Paradigm Shift No. 3*: Enlarging the powers of the Boards of Directors of covered companies, and thereby seeking to evolve the principles of corporate governance under the Corporation Code.

Paradigm Shift No. 1 has been thoroughly discussed in the previous sections of this Article. The rest of the paper will be devoted to discussing

147. *Id.* at 19 (emphasis supplied).

148. MAM Realty v. NLRC, 244 SCRA 797 (1995); NFA v. Court of Appeals, 311 SCRA 700 (1999); Atrium Management Corp. v. Court of Appeals, 353 SCRA 23 (2001); Malayang Samahan ng mga Manggawgawa sa M. Greenfield v. Ramos, 357 SCRA 77 (2001); Powton Conglomerate, Inc. v. Agcolicol, 400 SCRA 523 (2003); H.L. Carlos Construction, Inc. v. Marina Properties Corp., 421 SCRA 428 (2004); McLeod v. NLRC, 512 SCRA 222 (2007).

the legal implications pertaining to the other two paradigm shifts mentioned above.

In both management and corporate practices, directors are not expected to be hands-on managers. This is a consequence of the fact that directors are not formally employed by the company; hence, they are only able to focus their attention to company affairs during limited times (i.e., during directors' meetings) Moreover, they do not receive remunerations from the company, and are granted only *per diems* for meetings actually attended. Therefore, much leeway is granted to directors in the manner by which they discharge their duties and setting the course for the company. Unless there are glaring or extraordinary circumstances to show gross negligence, not much operational liability is expected to visit upon directors. The members of the Board are treated as business dignitaries who should concern themselves only with laying down the policies and general directions of the company, and merely overseeing the work of Management. The hard work of operating the company belongs to the Management, headed by the President as the Chief Executive Officer, who are all formally employed and remunerated by the company.[149]

This structure of corporate management seems to be well-complemented by the legal structure of corporate governance under the Corporation Code.[150] The agency codes now seek to change the foregoing public perception of the proper role of the Board of Directors.

149. SEC Memorandum Circular No. 2, § I (E); IC Circular No. 31-2005, § I (3). This concept is reflected in the definition under the agency codes of "Management" as referring to "the body given the authority *to implement the policies determined by the Board in directing the course/business activity/ies of the corporation*" (emphasis supplied).

150. Thus, in spite of the clear injunction under Section 23 that Boards of Directors are the repository of all corporate powers, the Corporation Code would consider their position as being merely honorific and gratuitous, by denying them under Section 30 any right to compensation unless the same is provided in the company by-laws or approved by stockholders representing majority of the outstanding capital stock; and even the per diem that is given to them should be limited to being "reasonable", which by definition means that the amounts they receive should cover only the cost that has been incurred by a director in attending the meeting. By default rule under Section 54, the Board of Directors shall be presided by the President, who essentially represents Management interests, unless otherwise provided in the company by-laws, which means that the position of Chairman is not a statute-mandated position. By default rule again under Section 53, special meetings of the Board of Directors shall be held upon the call of the President, unless contrary provisions appear in the company by-laws.

A. Evolving a More Responsive and Accountable Façade to the Business Judgment Rule for Covered Companies

1. Jurisprudential Shift to Characterize Industries as "Vested with Public Interest"

Even before the promulgation of the BSP CG Circulars, the Philippine commercial system had already begun to shift the standards of diligence required of banks, their directors and officers, as reflected in decisions of the Supreme Court. The shift came from a societal determination that the banking industry is one that is vested with public interest.

In *Philippine Bank of Commerce v. Court of Appeals*,[151] the Supreme Court held: "In the case of banks [in dealing with their depositors], the degree of diligence required is more than that of a *good father of a family*. … [B]anks are duty bound to treat the account of their clients with the *highest degree of care*."[152] This was affirmed in *Philippine Commercial International Bank v. Court of Appeals*,[153] where the Court held that "[t]ime and again, we have stressed that banking business is so impressed with public interest where the trust and confidence of the public in general is of paramount importance *such that the appropriate standard of diligence must be very high, if not the highest, degree of diligence*."[154]

This standard of diligence has since been the consistent standard used in resolving issues of responsibility and liability for damages and other reliefs sought against banks by depositors and other sectors of the public dealing with the banks.[155] In addition, the Court has characterized the obligations of banks to exercise the highest degree of diligence when they deal with the public as a "fiduciary duty;"[156] and extended this principle to the manner by

151. Philippine Bank of Commerce v. Court of Appeals, 269 SCRA 695 (1997).

152. *Id.* at 708-709 (emphasis supplied).

153. Philippine Commercial international Bank v. Court of Appeals, 350 SCRA 446 (2001).

154. *Id.* at 472 (emphasis supplied).

155. Philippine Bank of Commerce v. Court of Appeals, 269 SCRA 695 (1997); Canlas v. Court of Appeals, 326 SCRA 415 (2000); Bank of Philippine Islands v. Court of Appeals, 326 SCRA 641 (2000); Philippine Banking Corp. v. Court of Appeals, 419 SCRA 487 (2004); Bank of P.I. v. Casa Montessori Internationale, 430 SCRA 261 (2004); Associated Bank v. Tan, 446 SCRA 282 (2004); Philippine National Bank v. Pike, 470 SCRA 328 (2005).

156. Simex International, (Manila) Inc. v. Court of Appeals, 183 SCRA 360 (1990); Cadiz v. Court of Appeals, 474 SCRA 232 (2005); Bank of P.I. v. IAC, 206 SCRA 408 (1992); Citytrust Banking Corp. v. IAC, 232 SCRA 559 (1994);

which they select and discipline their employees,[157] deal with accepting real estate as collaterals for the loans they extend to borrowers,[158] and in how they handle foreclosure proceedings.[159] The jurisprudential development recognizes what may be considered a doctrinal truism: extending the fiduciary obligations of banks, their Boards of Directors and their officers to one that truly goes into expanded constituencies, and one that has recognized the operative norms of the stakeholder theory.

The application of the "highest degree of diligence" legally means that banks, their directors and officers, in the performance of banking functions, practically have no room for error; and if loss or damage is caused to a member of the dealing public, the banks and their responsible officers and directors shall be made to bear the same. As a consequence, depositors and the dealing public need only prove the amount of damages sustained by them in their official dealings with the banks, in order for the presumption of negligence to apply. The burden of proof will be on the bank's part to show that they have exercised the highest diligence required by law.

The Supreme Court clarified, however, in *Reyes v. Court of Appeals*,[160] that such "highest degree of diligence" rule is not expected of all banks all the time, but in instances only when the bank is bound as a fiduciary.[161] In *Reyes*, the bank which acted in a commercial transaction that was not inherently a banking function was held only to the level of reasonable diligence. This doctrine is of important consideration in looking at the provisions of the BSP CG Circulars.

Tan v. Court of Appeals, 239 SCRA 310 (1994); Metropolitan Bank & Trust Co. v. Court of Appeals, 237 SCRA 761 (1994); Philippine Bank of Commerce v. Court of Appeals, 269 SCRA 695 (1997); Firestone v. Court of Appeals, 353 SCRA 601 (2001); BPI Family Savings Bank, Inc. v. First Metro Investment Corp., 429 SCRA 30 (2004).

157. Philippine Commercial International Bank v. Court of Appeals, 350 SCRA 446 (2001); Philippine Commercial International Bank v. Cabrera, 454 SCRA 792 (2005); Cadiz v. Court of Appeals, 474 SCRA 232 (2005); Philippine National Bank v. Pike, 470 SCRA 328 (2005).

158. Canlas v. Court of Appeals, 326 SCRA 415 (2000); Development Bank v. Court of Appeals, 331 SCRA 267 (2000); Rural Bank of Sta. Ignacia v. Dimatulac, 401 SCRA 742 (2003); Consolidated Rural Bank (Cagayan Valley) v. Court of Appeals, 448 SCRA 347 (2005); Heirs of Eduardo Manlapat v. Court of Appeals, 459 SCRA 412 (2005); Ursal v. Court of Appeals, 473 SCRA 52 (2005); Keppel Bank Philippines, Inc. v. Adao, 473 SCRA 372 (2005); Private Dev. Corp. of the Phil. v. Court of Appeals, 475 SCRA 591 (2005).

159. Ibaan Rural Bank v. Court of Appeals, 321 SCRA 88 (2000).

160. Reyes v. Court of Appeals, 363 SCRA 51 (2001).

161. *Id.* at 60.

2. Formal Statutory Recognition that Banks Owe Fiduciary Duties in their Dealings with the Public

The General Banking Law of 2000[162] (GBL 2000) formally adopted such a jurisprudential shift in the degree of diligence required of banking institutions, their directors and officers. In its declaration of State policy, Section 2[163] of GBL 2000 has declared that "the fiduciary nature of banking that requires high standards of integrity and performance." This state of things was described in the decision in *Philippine Banking Corp. v. Court of Appeals*,[164] where the Court affirmed that the statutory law has adopted the jurisprudential ruling on fiduciary duty of the banks being vested with public interest.[165] In addition, the GBL 2000 formally adopted the "fit and proper" rule[166] for bank directors.[167] It also adopts a provision on "unsafe and unsound manner"[168] of conducting banking business.[169]

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162. An Act Providing for the Regulation of the Organization and Operation of Banks, Quasi-Banks, Trust Entities, and For Other Purposes [GENERAL BANKING LAW OF 2000], Republic Act No. 8791 (2000).

163. *Id.* § 2:

> *Declaration of Policy.* - The State recognizes the vital role of banks in providing an environment conducive to the sustained development of the national economy and the fiduciary nature of banking that requires high standards of integrity and performance. In furtherance thereof, the State shall promote and maintain a stable and efficient banking and financial system that is globally competitive, dynamic and responsive to the demands of a developing economy.

164. Philippine Banking Corp. v. Court of Appeals, 419 SCRA 487 (2004).

165. In Philippine National Bank v. Pike, 470 SCRA 328, 347 (2005), the Court has considered said section of GBL 2000 as a confirmation that the diligence required of banking institutions of the high standard, thus: "Section 2 of Republic Act No. 8791, which took effect on 13 June 2000, which makes a categorical declaration that the State recognizes the fiduciary nature of banking that requires high standards of integrity and performance." *See also* Associated Bank v. Tan, 446 SCRA 282 (2004).

166. GENERAL BANKING LAW OF 2000, § 16:

> *Fit and Proper Rule.* – To maintain the quality of bank management and afford better protection to depositors and the public in general, the Monetary Board shall prescribe, pass upon and review the qualifications and disqualifications of individuals elected or appointed bank directors or officers and disqualify those found unfit.
>
> After due notice to the board of directors of the bank, the Monetary Board may disqualify, suspend or remove any bank director or officer who commits or omits an act which render him unfit for the position.

The issue that must be resolved is as to what standard or degree fiduciary duties must be measured. This is where the language of the Circular does not jive with the jurisprudential rule.

If we accept, as we must under the terms and language of BSP Circular No. 283, that bank directors also owe a fiduciary duty to creditors and the public at large, then the doctrine of highest degree of diligence in practically all of its dealings must kick in.[170] Yet Section 4 (2) of the Circular provides:

> In determining whether an individual is fit and proper to hold the position of a director or officer of a bank, regard shall be given to his integrity, experience, education, training, and competence.

167. In turn, BSP Circulars No. 296 and 391 have provided for specific provisions covering the qualifications and disqualifications of bank directors and officers.

168. GENERAL BANKING LAW OF 2000, § 56:

> *Conducting Business in an Unsafe or Unsound Manner.* – In determining whether a particular act or omission, which is not otherwise prohibited by any law, rule or regulation affecting banks, quasi-banks or trust entities, may be deemed as conducting business in an unsafe or unsound manner for purposes of this Section, the Monetary Board shall consider any of the following circumstances:
>
> 56.1. The act or omission has resulted or may result in material loss or damage, or abnormal risk or danger to the safety, stability, liquidity or solvency of the Institution;
>
> 56.2. The act or omission has resulted or may result in material loss or damage or abnormal risk to the institution's depositors, creditors, investors, stockholders or to the Bangko Sentral or to the public in general;
>
> 56.3. The act or omission has caused any undue injury, or has given any unwarranted benefits, advantage or preference to the bank or any party in the discharge by the director or officer of his duties and responsibilities through manifest partially, evident bad faith or gross inexcusable negligence; or
>
> 56.4. The act or omission involves entering into any contract or transaction manifestly and grossly disadvantageous to the bank, quasi-bank or trust entity, whether or not the director or officer profited or will profit thereby.
>
> Whether a bank, quasi-bank or trust entity persists in conducting its business in an unsafe or unsound manner, the Monetary Board may without prejudice to the administrative sanctions provided in Section 37 of the New Central bank Act, take action under Section 30 of the same and/or immediately exclude the erring bank from clearing, the provisions of law to the contrary notwithstanding.(n)

169. In turn, BSP Circular No. 341 has provided specific rules and guidelines covering the conduct of banking business in an unsafe and unsound manner.

170. Reyes v. Court of Appeals, 363 SCRA 51, 60 (2001).

"A director must always act in good faith, *with care which an ordinarily prudent man would exercise under similar circumstances*."[171] The Circular itself does not characterize the banking industry as one vested with public interests, although the language used exudes such policy. Since the Supreme Court has by jurisprudence classified the banking industry as one vested with public interests, and it has decreed that the degree of diligence owed to depositors (to whom there was no mandated fiduciary duty) cannot just be that of a good father of family, then it would be hard for the Court to thereby back down from its ruling that the degree of care and diligence required of banks, their directors and officers is of the highest degree, especially now that the Circular has expressly included depositors, creditors, management, employees, and the public at large, to come within the constituencies of the Board of Directors of banking institutions.

3. IC Circular Declares the Insurance Industry as Vested with Public Interest

Under Section 2 on "Constitution of an Effective Board," the IC Circular effectively declared that the insurance industry imbued with public interests.[172] Under Section 5 on "Public Accountability" the IC Circular affirms the nature of the insurance industry as one imbued with public interest.[173]

Being vested with public interest, insurance companies and intermediaries, as is the case in the banking industry, owe a fiduciary duty to the policy holders and other stakeholders that have been clearly identified under the IC Circular. The diligence required of insurance companies, intermediaries, and their directors and officers, is not merely due diligence of a good father of a family, but one of a much higher order, perhaps even equivalent to the highest diligence required in the banking industry. Consequently, when a party is able to show that it is a stakeholder under the terms of the IC Circular, he only needs to prove the damages he sustained in an area where the insurance company is supposed to cover. Thereupon, the presumption arises that the insurance company, and its directors and responsible officers, are in breach and thereby liable on the reliefs sought,

171. BSP Circular No. 283, § 4 (2) (emphasis supplied).

172. IC Circular No. 31-2005, § II (B) (4) ("Considering that the insurance business is imbued with public interest, the role of the Chairman and Chief Executive Officer shall in principle be separate, to ensure an appropriate balance of power, increased accountability and greater capacity of the Board for independent decision making.").

173. *Id.* § V (Principle) ("As a custodian of public funds, insurance corporations and insurance intermediaries shall ensure that their dealings with the public are always conducted in a fair, honest, and equitable manner.").

and they have the burden to show that they have discharged the extraordinary diligence required of them in order to exempt themselves from such liabilities.

4. Public Interest Considerations for Public Companies

For public companies covered by the SEC Code (i.e., other than banking institutions and insurance companies and intermediaries), it is rather difficult to adopt a policy that they are also vested with public interest; and in fact no such declaration appears in the SEC Code. As is clear in the banking and insurance sectors, what is imbued with public interest is not the corporate medium under which they operate, but rather the business enterprises they pursue. Both banking and insurance industries deal primarily with the public, and the special laws that govern them focus on the safeguarding the public that deal with such companies. It is in these industries that principles of stakeholdership have their most appropriate application.

Such considerations do not necessarily apply to public companies governed by the SEC Code, for their relationship to the public is built not necessarily on the nature of the business enterprise, but by reason of an underlying contractual relationship. The primary reason why there is a sort of "public" interest in public companies covered by the SEC Code is because they have established large and extensive contractual relationships with the investing public, or their operations are so large that they affect the economy in a large financial manner. This perhaps is the main reason why a policy of vesting companies with public interest has not been formally adopted under the SEC Code, for in actual operation such policy may unduly harm the business sector at large. This should not be made to apply in areas where the process of negotiation and entering into contracts at arms-length should be understood to allow each party to properly protect their interests in the bargain.

What is therefore worrisome under the SEC Code is the provision that mimics that of the BSP CG Circulars declaring that "[a] director assumes certain responsibilities to different constituencies or stakeholders, who have the right to expect that the institution is being run in a prudent and sound manner."[174]

The inclusion of such a provision in the BSP CG Circulars makes sense for the banking industry because its business enterprise is certainly vested with public interest, and most of its primary stakeholders, other than the stockholders, namely depositors, have a direct interest that their banks operate their business affairs in a prudent and sound manner. But when it comes to public companies which do not issue securities and are not custodians of public funds, it is difficult to see how such a conservative norm

174. SEC Memorandum Circular No. 2, § II (6) (a).

of operations would directly be the business of other stakeholders. The danger with granting stakeholders in general the standing to insist that the institution is "being run in a prudent and sound manner," is that their interests do not always jive with those of the main stakeholders, the stockholders, and that even among themselves they may have conflicting views of what it constitutes. More importantly, infusing stakeholders of public companies with such a legal standing undermines the very foundation of centralized management, which grants to the Boards the use of their best judgment to determine the running of the affairs of the corporation.

a. Exacting Duties and Responsibilities Lead to Exacting and Expanded Liabilities

(i) General Responsibilities of the Board of Directors

Each of the BSP CG Circulars, the SEC Code, and the IC Circular provide for the following "General Responsibilities" or "Principles" for the Boards of Directors of covered companies, thus:

BSP CG Circular:

> The Board of Directors is primarily responsible for corporate governance of the institution. To ensure good governance, the Board should establish strategic objectives, policies and procedures that will guide and direct the activities of the institution and the means to attain the same. It must establish the mechanism for monitoring Management's performance.[175]

SEC Code:

> The Board of Directors (Board) is primarily responsible for the governance of the corporation. It needs to be structured so that it provides an independent check on management. As such, it is vitally important that a number of the board members be independent from management.[176]
>
> It is the Board's responsibility to foster the long-term success of the corporation and secure its sustained competitiveness in a manner consistent with its fiduciary responsibility, which it should exercise in the best interest of the corporation and its shareholders.[177]
>
> To ensure good governance of the corporation the Board should establish the:
>
> (a) corporation's vision and mission

175. BSP Circular No. 283, § 2 (reworded for easy reference).

176. SEC Memorandum Circular No. 2, § II.

177. *Id.* § II (6).

(b) strategic objectives

(c) policies and procedures that may guide and direct the activities of the company and the means to attain the same

(d) mechanism for monitoring management's performance.[178]

IC Circular:

Every company should be headed by an effective Board to lead and control the company and ensure its success.

Provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enable risk to be assessed and managed.

Set the company's strategic aims.

Ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance

Set the company's values and standards.

Ensure that its obligation to shareholders and others are understood and met.[179]

These principles emphasize that the buck stops with the Board, and it cannot escape liability for failing to discharge such direct duties by alleging that it had left the matter to Management and expert consultants. This point is driven home by the subsequent provision appearing in both quoted sections of the BSP Circular No. 283 and the SEC Code, thus: "While the management of the day-to-day affairs of the institution is the responsibility of the management team, the board of directors is, *however,* responsible for monitoring and overseeing management action"[180]

In the section on "Accountability and Audit," the SEC Code provides that:

The Board is primarily accountable to the Shareholders and Management is primarily accountable to the Board.

The Board should provide the shareholders with a balanced and understandable assessment of the corporation's performance, position and prospects on a quarterly basis.

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178. *Id.* § II (6) (a) (reformatted for easy reference).

179. IC Circular No. 31-2005, § II (Principles).

180. BSP Circular No. 283, § 2 s. 2001 and SEC Memorandum Circular No. 2, § II (6) (a) (emphasis supplied).

> The Management should provide all members of the Board with a balanced and understandable account of the corporation's performance, position and prospects on a monthly basis.[181]

The language of the SEC Code seems to establish a corporate principle of "command responsibility" on the part of the Board of Directors: that it remains directly accountable to the stockholders, and cannot wash its hands from the dereliction of duty of the Management, which is directly accountable to the Board.

2. Specific Duties and Responsibilities of the Board of Directors

To ensure that the Boards of Directors of covered companies cannot hide behind the cloak of generality, the BSP CG Circulars, the SEC Code, and the IC Circular, after providing for the general principles, go immediately to enumerate in detail the "Specific Duties and Responsibilities" of the Board of Directors,

3. Specific Duties and Responsibilities of Every Director

Further, the agency codes clarify that each director is not only part of a group vested with collective responsibility, but an individual officer of the company, who is burdened with individual duties and responsibilities.

4. Legal Implications of the Structuring of the Agency Codes

The specifications of the general and specific duties and responsibilities of the Board as such, and the specific duties and responsibilities of the individual directors and specified officers, are couched in clear and dynamic language and impose the obligation to take one's job seriously. There is an attempt therefore in our jurisdiction to instruct professional managers for public companies to imbibe the general principles of corporate governance, and to match this by action and expected results. The failure to comply with the provisions of the codes is met with serious consequences: under the IC Circular, infractions could lead to permanent disqualification from even sitting in any board; under the BSP CG Circulars, there are specific penalties imposed for first, second and third offenses, and eventual permanent disqualification.

Since the public companies covered by the SEC are quite varied in the enterprises they pursue, the management style applicable, and business and industry environments prevailing, the SEC Code directs each public company to properly evaluate the system of corporate governance they must

181. SEC Memorandum Circular No. 2, § IV (1) (reformatted for easy reference).

follow, "individualize" the SEC Code to their respective company situations, and file a manual of corporate governance with the SEC[182] that thereby becomes the basis upon which they must measure up to.

All three agency codes ensure that no director can hide behind the defense that he is not an active member of the Board of Directors and cannot be made personally liable for corporate activities over which he or she had not participated in. Thus, all codes provide that it is the specific duty of every director of a covered company to devote time and personal resources to learn about the company and its operations, and to attend board and committee meetings and participate actively in them. Consequently, if anything goes seriously wrong with the operations of the company, the fact that a director has been inactive in corporate affairs or has not been attending board and committee meetings itself becomes proof that he or she has not performed his or her obligation to oversee company affairs. He or she becomes personally liable for the consequent loss suffered by the company.

Finally, the BSP CG Circulars and the IC Circular ensure that the Board and its members may not hide behind the defense of not being aware of his or her duties and responsibilities, by providing similar provisions that read:[183]

> Each director shall be furnished by the banking institution with a copy of the specific duties and responsibilities of the directors under the Circular, within thirty (30) banking days from the promulgation of the Circular and at the time of election;
>
> Each director shall acknowledge receipt of the copies of such specific duties and responsibilities; and
>
> Each director shall certify that he or she fully understands the same.

In the case of the SEC Code, it requires that each public company "shall promulgate and adopt its corporate governance rules and principles in accordance with this Code. Said rules shall be in manual form and available as reference by the directors."[184]

The message under the agency codes is clear: bank directorship is one of the highest order because the banking industry is one vested with public interest; "[i]f a person cannot give sufficient time and attention to the affairs of the institution, he should neither accept his nomination nor run for election as member of the Board;"[185] otherwise, he runs the risk of exposing himself to serious personal financial obligation to a host of constituencies.

182. SEC Memorandum Circular No. 2, § VIII.

183. BSP Circular No. 283, § 5 and IC Circular No. 31-2005, § II (C) (1).

184. SEC Memorandum Circular No. 2, § VIII.

185. BSP Circular No. 283, § 4 (3) and IC Circular No. 31-2005, § II (C) (1).

V. EVOLVING THE POWERS OF THE BOARD OF DIRECTORS OF COVERED COMPANIES

The agency codes attempt to institute a sense of empowerment upon such Boards to take a more dynamic stance in how they are constituted, the manner by which they seek out talents, and providing for attractive compensation packages. In short, the agency codes seek to institutionalize "professional directorship" as a system which provides to covered companies a set of very talented men and women, who look to spend their careers providing responsible stewardships for the companies they serve in, and dispensing a deep sense of "public service" in the most important areas of the private sectors.

A. Operating Paradigm of "Good Corporate Governance" under the Corporation Code

In order to fully understand the fundamental shift that the BSP CG Circulars, the SEC Code, and the IC Circular, seek to effect on the existing "corporate governance principles" in Philippine Corporate Law, the general principles and the rules provided under the Corporation Code and related jurisprudence on the rules and doctrines pertaining to the composition of the Board, those of the qualifications and disqualifications, election, disciplining and removal, of directors, are summarized into the following general statements:

> (a) The size and composition of the Board of Directors can only be based on provisions contained in the Corporation's articles of incorporation and by-laws.[186]
>
> (b) Other than in those cases specifically provided by law, any qualification or disqualification pertaining to the members of the Board of Directors shall be valid only when expressly provided in the Corporation's articles of incorporation and by-laws.[187]
>
> (c) Boards of Directors have no power by mere exercise of their business judgment, to provide for their own qualifications and

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186. CORPORATION CODE, § 14 (6) (expressly requires to be contained in the articles of incorporation of every corporation a provision that "[t]he number of directors or trustees, which shall not be less than five (5) nor more than fifteen (15)." This ensures that the size of the Board of any corporation is one that is within optimum range, so as not to be so small to be ineffective, but not too large to be unwieldy and inefficient).

187. *Id.* § 47 (5) and § 47 (7) (in addition, Sections 23, 24 and 27 provide for the manner of election, term of office, and for the statutory qualifications and disqualifications of directors).

disqualifications.[188] Outside of specific statutory empowerment, the power elect, compensate, discipline, and remove any member of the Board of Directors is vested by law with the Stockholders.[189]

(d) The directors, as such, are not generally entitled to remunerations.[190]

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188. *Id.* § 28 (essentially provides that the power to remove a director is not within the business judgment capability of the Board of Directors, but is vested only with the stockholders representing two-thirds (2/3) of the outstanding capital stock of the corporation; and that in fact, when it comes to the removal of a director elected through minority cumulative voting, such removal by the stockholders can only be for cause. This principle is re-affirmed in Section 29 which empowers the Board still with quorum to fill-up any vacancy that has occurred "*other than by removal by the stockholders,*" which confirms that the power to elect, remove and replace a Director lies within the legal prerogative of the stockholders, not the Board).

189. This position is bolstered by comparison of the parallel provisions of Section 31 and Section 34 of the Corporation Code, which both cover the obligation to return to the corporation the profits earned from violating the duty of loyalty. Section 34 provides that when a director of a stock corporation has breached his duty of loyalty, he has no option but to refund the profits obtained from the business opportunity taken from the corporation, and the power to forgive him is not within the business judgment of the Board of Directors. Only the stockholders, by a vote of at least two-thirds (2/3) of the outstanding capital stock, have the power to forgive him and allow him to keep the fruits of his misdeed. This is in stark contrast to the provisions of Section 31 which is the general provision that applies to the breach of the duty of loyalty of directors, trustees and officers, which provides for a similar forfeiture of the profits earned, but does not prevent the exercise by the Board of Directors of the use of its business judgment under Section 23 of the Corporation Code, to formally adopt a resolution allowing the culprit trustee or officer to keep the fruits of his misdeed.

190. CORPORATION CODE, § 30:

> *Compensation of directors.* – In the absence of any provision in the by-laws fixing their compensation, the directors shall not receive any compensation, as such directors, except for reasonable *per diems*; Provided, however, That any such compensation (other than *per diems*) may be granted to directors by vote of the stockholders representing at least a majority of the outstanding capital stock at a regular or special stockholders' meeting. In no case, shall the total yearly compensation of directors, as such directors, exceed ten (10%) percent of the net income before income tax of the corporation during the preceding year. (The only "return" that directors can expect for their services "as such" to the corporation is to be given "reasonable" *per diems* as expenses to cover attendance at meetings. The basic tenor of Section

In addition to these, the Corporation Code mandates a specific system of elections for stock corporations called cumulative voting. This ensures that minority stockholders have a reasonable chance of electing their nominees into the board. It embodies the "good governance principle" that the Board of Directors of every stock corporation should have varied representation that allows the airing of the concerns and interests of the minority stockholders. The Corporation Code also provides that there be no permanent directors in the Board; that directors must renew their mandate on an annual basis, so that they remain accountable and responsive to the stockholders.[191]

B. Agency Code Provisions on Composition of the Board of Directors, and Qualifications/Disqualifications of Directors

All three agency codes adhere closely to the mandate of both the Corporation Code and the Securities Regulation Code that the Boards of Directors of covered companies:

(a) Shall be composed of at least five but not more than 15 members, elected by the stockholders;[192]

(b) At least two of which are independent directors or such independent directors shall constitute at least 20% of the Board membership, whichever is lesser;[193]

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30 therefore is that directors serve as fiduciaries of the corporation and stockholders, and they serve out of a sense of trust and honor).

Western Institute of Technology v. Salas, 278 SCRA 216 (1997), however, implies that the Board of Directors of any corporation retains the power to provide for compensation for members of the board who occupy at the same time "officer" position, such as Chairman, Corporate Secretary, Corporate Treasurer, etc. But in such case, their compensation really pertains to their position as officers, not as directors as such. This situation is amply covered by provisions of SEC Memorandum Circular No. 2 and IC Circular No. 31-2005 that refer to compensation for executive directors

191. Grace Christian High School v. Court of Appeals, 281 SCRA 133 (1997) (holding that a by-law provision or company practice of giving a stockholder a permanent seat in the Board would be against the provisions of the Corporation Code which requires member of the board of corporations to be elected).

192. CORPORATION CODE, § 14 (6); SEC Memorandum Circular No. 2, § II (1); BSP Circular No. 296, § 2; IC Circular No. 31-2005, § II (B) (1).

193. SEC Memorandum Circular No. 2, § II (1); BSP Circular No. 296, § 2; IC Circular No. 31-2005, § II (B) (2).

(c) Every director shall own at least one share of the capital stock of the corporation, which share shall stand in his name in the books of the corporation;[194] and

(d) The qualifications of independent directors,[195] consistent with those provide in the Securities Regulation Code.

1. On the Composition of the Board of Directors

Section 2 (1) of the SEC Code provides for broad rules on the "Composition of the Board," which have been copied in the IC Circular:

> 1.Composition of the Board
>
> …
>
> The Board may include a balance of executive and non-executive directors (including independent non-executives), having a clear division of responsibilities such that no individual or small group of individuals can dominate the Board's decision-making.[196]
>
> The non-executive directors should be of sufficient qualifications, stature and number to carry significant weight in the Board's decisions. ...[197]
>
> 2. Multiple Board Seats
>
> The *Board may consider guidelines* on the number of directorships for its members. The optimum number is related to the capacity of a director to perform his duties diligently in general … In any case, the capacity of directors to serve with diligence shall not be compromised.[198]

In this relation, the IC Circular provides for the constitution and power of the Nomination Committee of the Board of Directors, thus:

> a. Nomination Committee
>
> a.1. Shall be composed of at least three members of the board of directors, one of whom must be independent.
>
> …
>
> a.3. *For the appointment of the Chairman, it should prepare job specifications, including an assessment of the time commitment expected of him … The*

194. SEC Memorandum Circular No. 2, § II (4) and IC Circular No. 31-2005, § II (E) (A) (no particular provision on this matter in the BSP CG Circulars).

195. BSP Circular No. 296, § 2 and IC Circular No. 31-2005, § II (E) (A) (3) (no separate listing of qualifications and disqualifications for independent directors under SEC Memorandum Circular No. 2).

196. IC Circular No. 31-2005, § II (B) (3) and § II (C) (1).

197. *Id.* § II (C) (3).

198. *Id.* § II (C) (Multiple Board Seats).

> *Chairman's other significant commitments shall also be disclosed to the Board before his appointment and included in the annual report ...*
>
> a.4. *The terms and conditions of appointment of non-executive directors shall be made available for inspection ... Their other significant commitments shall be disclosed to the Board before appointment ...*
>
> a.5. *The Nomination Committee shall consider the following guidelines in the determination of the number of directorship for the Board.*
>
> 1. The nature of the business of the corporation, where he is a director.
>
> 2. Age of the director.
>
> 3. Number of director/active memberships and officership in other corporations or organizations; and
>
> 4. Possible conflicts of interest.
>
> a.6. Generally, the optimum number shall be proportional to the capacity of a director to perform his duties diligently.[199]

Both the SEC Code and the BSP CG Circulars contain similar broad provisions on the Nomination Committee.[200]

The afore-quoted provisions of the agency codes seem to "empower" the Boards of Directors of covered companies, as well as the Nomination Committee of insurance companies, to use their good judgment to provide for a balance of executive and non-executive directors. These may be interpreted to allow the Board to provide by resolution sufficient qualifications for non-executive directors so that their "stature and number carry significant weight in the Board's decision;" and to adopt guidelines on adopting an optimum number for multiple seats by directors to ensure that they would perform their duties diligently. Undoubtedly, the intention of the SEC Code is to grant the Board of public companies as much leeway to bring together a team that can best serve the company.

However, the discretion granted to the Board cannot be understood to mean that it is within their power to set the terms for composition and qualification therein by mere resolution. Any construction or understanding

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199. *Id.* § II (D) (5) (emphasis supplied).

200. SEC Memorandum Circular No. 2, § II (9) (B) (a) and BSP Circular No. 283, § 9 ("The Nomination Committee which may be composed of at least three (3) members, one of whom should be an independent director may review and evaluate the qualifications of all persons nominated to the Board as well as those nominated to other positions requiring appointment by the Board and provide assessment on the Board's effectiveness in directing the process of renewing and replacing Board members.").

that would grant such power and discretion to the Board of Directors of any public company under the language of the SEC Code would contravene the well-defined policy under the Corporation Code, and would thus be challenged as being void.[201] It would be more prudent to construe these as "guidelines" given to the Board of Directors of public companies in undertaking their executive search and recruitment process in filling-in vacancies or effecting changes in the composition of the Board and presenting the list of nominees to the stockholders for election; or to direct them to take appropriate by-law amendments to formally express such requirements as part of the qualifications of members of the Board.

2. Qualifications of the Directors of Covered Companies

The SEC Code provides for the qualifications of directors of a public company.[202] The provisions show that there is an attempt to empower the Board of Directors of public companies "to provide for additional qualifications of a director."[203] Further, there is a thrust towards providing for "value-laden" qualifications for directors, such as virtues of integrity, probity or assiduousness.

The language used in the SEC Code is in stark contrast to the "additional qualifications" provisions of BSP CG Circulars.[204] Here, there is

201. Consequently, the provisions of the SEC Memorandum Circular No. 2, § II (2) on "Multiple Board Seats" cannot be construed to authorize the Board to disqualify, suspend or even terminate a member of the Board who does not meet with the "guidelines" or "rules" (i.e., resolution) set by the Board on issues relating to multiple board suits, when such "rules" do not find themselves expressed as provisions in the by-laws of the public companies. Boards of Directors do not have the power to set by mere resolution the qualifications and disqualification of their members.

202. SEC Memorandum Circular No. 2, § II (4):

> Qualifications of Directors: Every director shall 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 in the books of the corporation.
>
> *The Board may provide for additional qualifications of a director such as,* but not limited to, the following:
>
> Educational attainment;
>
> Adequate competency and understanding of business;
>
> Age requirement;
>
> Integrity/probity;
>
> Assiduousness (emphasis supplied).

203. *Id.*

204. BSP Circular No. 296, § 3:

no attempt to grant to the Board of Directors of banking institutions the power to provide for additional qualifications in the exercise of the business judgment; and although it provides for "value-laden" qualifications, such as integrity, probity, and diligence, such matters fall within the administrative powers of the BSP to enforce under its "fit-and-proper" rules. The IC Circular also follows the approach of the BSP CG Circulars when it comes to the qualifications and disqualifications of directors.[205]

> Qualification of Director. – A director shall have the following minimum qualifications:
>
> 1. He shall be at least twenty-five (25) years of age at the time of his election or appointment;
>
> 2. He shall be at least a college graduate or have at least five (5) years experience in business;
>
> 3. He must have attended a special seminar for Board of Directors conducted or accredited by the BSP x x x;
>
> 4. He must be fit and proper for the position of a director of the bank/quasi-bank/trust entity. In determining whether a person is fit and proper for the position of a director, the following matters must be considered:
>
> integrity/probity;
>
> competence;
>
> education;
>
> diligence; and
>
> experience/training.

The foregoing qualifications for directors shall be in addition to those required or prescribed under R.A. No. 8791 and other existing applicable laws and regulations.

205. IC Circular No. 31-2005, § II (E) (A):

A. Qualifications

Directors

Directors sitting on the board in any insurance entity shall be possessed of the necessary skills, competence and experience, in terms of management capabilities preferably in the field of insurance or insurance-related disciplines. In view of the fiduciary nature of insurance obligations, directors shall also be persons of integrity and credibility.

Every director shall own at least one (1) share of the capital stock of the corporation whose share should be in his name and recorded in the books of the corporations.

Each director shall be at least twenty-five (25) years of age at the time of his appointment.

Note must be taken of the difference in approach between the BSP CG Circulars and IC Circular on one hand, and the SEC Code on the other: while the BSP CG Circulars and the IC Circular impose the enumerated qualifications to directors of their covered institutions, the SEC Code provides only general guidelines of what those additional qualification would be and seems to grant to the Boards of public companies the power to adopt such additional qualifications proper to their particular corporate circumstances. The difference in approach is understandable: the BSP and the IC each oversee industries that are highly specialized, and their history of supervision over such companies has given both of them background, experience, and resources of what additional qualifications they should impose on directors of such companies. On the other hand, the SEC is overseeing various sectors of public companies engaged in various business enterprises. Thus, the SEC is without means to evolve a set of qualifications and disqualifications that "fits all," and it would have been foolish to do so. Instead, it empowers every Board of Directors to be able to look at their particular company in the industry it operates, and provides them with the means to improve a set of qualifications and disqualifications.

The SEC Code requires that each public company adopt and formally register with the SEC a manual for corporate governance. This ensures that public companies translate the corporate governance principles and leading industry practices to their particular corporate situation and the unique demands of their industry. The result would be that each public company would "own" the governance principles and practices which it has adopted under the terms of the manual; and the manual itself, being submitted formally with the SEC, serves as a contractual commitment on the part of each public company, its Board of Directors and Management, to which it can be made accountable, and the failure to comply with its terms and conditions would always be construed against the company itself, for it is the very proponent of the terms thereof.

3. Disqualifications of Directors of Covered Companies

The system of qualification and disqualification for directors and officers of banking institutions is one that is within supervision and control of the BSP, that no director or officer can enter into his functions unless his nomination into the board of a banking institution has been confirmed by the BSP.[206] In addition, directors and officers elected or appointed without possessing the qualifications mandated shall not be confirmed by the confirming authority;[207] and directors and officers possessing any of the disqualifications

Each director must have attended a special seminar on corporate governance conducted be a training provider accredited by the Insurance Commission.

206. BSP Circular No. 296, § 4.

207. *Id.* § 5 (c).

shall be subject to formal disqualification procedures.[208] "Watchlisting" of directors and officers is allowed "[t]o provide the BSP with a central information file to be used as reference in passing upon and reviewing the qualifications of persons elected or appointed as director or officer of a bank, quasi bank or trust entity."[209]

The IC, being the regulatory agency for the insurance industry, has followed the same "permanent" and "temporary" disqualification rules as BSP. The IC Circular empowers the Board to "establish a fixed retirement age policy for directors;" however, there is the issue of whether this constitutes invalid quasi-legislation, as it grants the Board the power to fix the qualifications for directors outside of formal provisions in the by-laws.

The SEC Code paralleled the "permanent" and "temporary" disqualification rules of the BSP, except that it granted to the Boards of Directors of covered companies the power to provide for such disqualifications, which is a grant of disciplining power to the Board. It is doubtful whether Boards of public companies can be legally granted any power of actual discipline over their members. The system seems contrary to Section 5 (1)[210] of the SEC Code, that Boards of Directors of public companies do not have power and discretion to remove, whether permanently or temporarily, or suspend, one of their members based on grounds that they may choose from. If the grounds enumerated in particular provisions of the SEC Code are deemed to be "disqualifications," then by their occurrence or existence, the culprit director should cease to be a member of the Board.[211] Yet, the language used actually grants the Board the ability to decide whether to suspend an erring member or not. If the grounds exist by which the a member of the Board is subject to temporary disqualification, and yet the Board did not exercise its SEC Code-given power to suspend him, is the Board then deemed to have been remised and thereby incur collective and individual personal liability?

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208. *Id.* § 5 (d).

209. *Id.* § 5 (e).

210. SEC Memorandum Circular No. 2, § V (1) ([s]hareholders have the right to elect, *remove and replace* directors and vote on certain corporate acts in accordance with the Corporation Code) (emphasis supplied).

211. Some of the grounds given to the Board to effect temporary disqualification should operate to disqualify a member from even being nominated or elected into the Board in the first place, such as the nondisclosure of business interests as required under the Securities Regulation Code and its Implementing Rules and Regulations.

It would be more reasonable to construe these particular provisions of the SEC Code as mandating an obligation to the Board to use internal measures to convince an erring member of the Board to take a leave or excuse himself from participating from Board activities until he "corrects" the error under clear warning that if no remedy is taken, then proper administrative action shall be taken by the Board to have him declared disqualified by the SEC or other appropriate agency.

4. Agency Codes on Remunerations of Directors

The BSP CG Circulars, other than obligating the Boards of Directors of banking institutions to "establish an appropriate compensation package for all personnel which shall be consistent with the interest of all stakeholders,"[212] do not provide for compensation rules for directors. Thus, they adhere to the principle that generally directors as such are not entitled to compensation or remuneration. In contrast, both the SEC Code and the IC Circular provide sections governing compensation for members of the Board of Directors.[213]

212. BSP Circular No. 283, § 3 (1).

213. SEC Memorandum Circular No. 2, § II (8):

8. Remuneration of the Members of the Board and Officers

> Levels of remuneration shall be sufficient to attract and retain the directors, if any, and officers needed to run the company successfully. Corporations, however, should avoid paying more than what is necessary for this purpose. A proportion of executive directors' remuneration may be structured so as to link rewards to corporate and individual performance.
>
> Corporations may establish a formal and transparent procedure for developing a policy on executive remuneration and for fixing the remuneration packages of individual directors, if any, and officers. No director should be involved in deciding his or her own remuneration.
>
> The corporations' annual reports, information and proxy statements shall include a clear, concise and understandable disclosure of all plan and non-plan compensation awarded to, earned by, paid to, or estimated to be paid to, directly or indirectly to all individuals serving as the CEO or acting in a similar capacity during the last completed fiscal year, regardless of the compensation level and the corporation's four (4) most highly compensated executive officers other than the CEO who were serving as executive officers at the end of the last completed year.
>
> To protect the funds of the corporation, the Commission may regulate the payment by the corporation to directors and officers of compensation, allowance, fees and fringe benefits in very exceptional cases, e.g., when a corporation is under receivership or rehabilitation.

IC Circular No. 31-2005, § II (F):

Both the SEC Code and the IC Circular seek to establish director's compensation as one of the cornerstones in good corporate governance practice. Indeed, a system of "professional directorship" for covered companies must include necessarily formal compensation system that would "attract and retain the quality of directors to run the company successfully." Nonetheless, because of the limitation under the Corporation Code against the grant of any form of remuneration or compensation to directors as such, outside of formal stockholders' grant and provisions in the by-laws, it would

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F. Board Remuneration

Essential Standards:

1. Levels of remuneration shall be sufficient to attract and retain the quality of directors to run the company successfully.

2. Significant proportion of executive directors' remuneration is structured so as to link rewards to corporate and individual performance.

3. Levels of remuneration of non-executive directors shall reflect their experiences, responsibilities and performances.

4. The performance-related elements of remuneration shall form a significant proportion of the total remuneration package of executive directors and shall be designed to align their interests with those of shareholders and to give these directors keen incentives to perform at the highest levels.

5. Designate amount of remuneration which shall be at sufficient level to attract and retain directors and officers needed to run the company successfully.

6. Levels of remuneration for non-executive directors shall reflect the time commitment and responsibilities of the office or position. Remuneration for non-executive directors shall not include share options. If, options are granted, shareholders approval shall be sought in advance and any share acquired by way of an exercise of an option shall be held until at least one year after the non-executive director leaves the board. Holding of share options is relevant to determine the non-executive director's independence.

7. Notice or contract periods shall be set at least one year or less. If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods shall be reduced to one year or less after the initial period.

8. There shall be formal and transparent procedures for developing policy on executive remuneration and for fixing the remuneration packages of individual directors.

9. No director shall be involved in deciding his or her own remunerations.

be difficult, and perhaps also highly suspicious, to develop a system within a covered company by which a system of director's compensation would fall within the business judgment control of the Board of Directors. Consequently, the provisions of the SEC Code and the IC Circular on compensations for non-executive directors[214] (given precisely for their role as directors only) become problematic to implement based three grounds.

Firstly, the granting and setting of compensation or remuneration for directors as such is outside of the legal competence and power of the Board of Directors of any corporation.[215] Therefore, the adoption by the Board of a system of compensation for directors outside of by-law provisions, cannot be implemented by mere board resolution, and would require stockholders' approval representing at least two-thirds of the outstanding capital stock. This would be a difficult system to enforce because the stockholders' meeting is held once a year, and the setting of a special meeting of the stockholders and obtaining a two-thirds ratificatory vote would be extremely expensive, and may not engender obtaining the best and brightest of candidates who are elected into the board for a term of only one year. Moreover, a general clause that would grant the Board of Directors the power to adopt a system of directors' compensation even when placed in the by-laws of the company may itself be vulnerable to legal attack because this would contravene the public policy behind Section 38 of the Corporation Code, and therefore would be void.

Secondly, any system that allows the Board of Directors to provide for compensation for individual directors would amount to a measure of "disciplining" in the hands of the Board, and would be contrary to the "good governance" principle under the Corporation Code that prohibits any form of "punishment and reward" in the hands of the Board with respect to any of their members.

Thirdly, matters on directors' compensation are inherently conflict-of-interests situations for the Board, and are areas which are treated as matters that cannot be dealt with in the Board's exercise of business judgment.

VI. INDEPENDENT DIRECTORS AND BOARD OFFICERS

A. Defining the Role of Independent Directors

214. IC Circular No. 31-2005, § II (F) (3) ("Levels of remuneration of non-executive directors shall reflect their experiences, responsibilities and performances.") and § II (F) (6) ("Levels of remuneration for non-executive directors shall reflect the time commitment and responsibilities of the office or position.").

215. CORPORATION CODE, § 38.

1. Cumulative Voting System as the Means to Provide Board Accountability under the Corporation Code

The present legal structure of "independent director" does not exist under the Corporation Code, where the aspect of "minority" representation is covered by the requirement of cumulative voting for directors under Section 24 thereof,[216] which makes it mathematically possible for minority shareholders to pool their voting powers to a pre-computed number of nominees to ensure that they would have minority representation in the Board of Directors. Consonant with this principle, Section 28 of the Code provides that the majority stockholders have no power to remove a director elected by cumulative voting except for cause.[217]

2. Securities Regulation Code Sets-Up System of Independent Directors

The Securities Regulation Code of 2000[218] (SRC) institutionalized a separate system of "independent directors" when it required under Section 38 thereof for all public companies to have "at least two independent directors or such independent directors, which shall constitute at least twenty percent of the members of such board, whichever is the lesser." The section defines an independent director as "a person other than an officer or employee of the

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216. *Id.* § 24:

> At all elections of directors or trustees, there must be present, either in person or by representative authorized to act by written proxy, the owners of the majority of the outstanding capital stock … 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 shares owned by him as shown in the books of the corporation multiplied by the whole numbers of directors to be elected.

217. *Id.* § 28:

> 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 removal without cause 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.

218. The Securities Regulation Code [SRC], Republic Act No. 8799 (2000).

corporation, its parent or subsidiaries, or any other individual having a relationship with the corporation, which would interfere with the exercise of independent judgment in carrying out the responsibilities of a director."[219]

Section 38.1 of the SRC Rules defines an independent director by detailing the rules on disqualifications. Therefore, the independence of an independent director comes from the utter lack of official, professional or business connection with the public company which would interfere with the exercise of independent judgment in carrying out the responsibilities of a director; he is one who must be completely independent from management of the company. The measure of independence comes from the fact that there could arise no situation in his directorship dealings with the company that would put him in any degree to a conflict-of-interest situation of any kind. The defining characteristic of an independent director from all the rest of the members of the Board is that he would be above suspicion from any kind of conflict-of-interests dealings.

The SRC role for an independent director is a clear break from the rationale behind the requirement under Section 23 of the Corporation Code that every director "must own at least one share of the capital stock of the corporation of which he is a director, which shares shall stand in his name on the books of the corporation." This particular qualification has been used as the basis to show that one who serves as a director must be one who is not a stranger to the corporation and the stockholders, and therefore would serve for the benefit of the stockholders and that they will be motivated to act for the best interest of the corporation and the stockholders

In order to qualify to their office, independent directors are still required to own a qualifying share in the corporation, but such shareholdings shall remain "nominal," since it is provided that he is automatically disqualified when he holds securities in the company in excess of ten percent of the entire issue.

3. Issues Relating to the Independent Directors System

The foremost objection to the imposition of independent directors for public companies is that it dilutes the system of Board responsibility towards the corporation, the stockholders and other stakeholders.

219. *Id.* § 38 is the only other section which treats of independent directors, and requires that the board of an exchange to include "no less than fifty one percent (51%) of the remaining members of the board to be comprised of three (3) independent directors and persons who represent the interests of issuers, investors, and other market participants, who are not associated with any broker or dealer or member of the Exchange for a period of two (2) years prior to his/her appointment," and that "[n]o officer or employee of a member, its subsidiaries or affiliates or related interests shall become an independent director."

The formal adoption of the stakeholder theory for public companies makes the relevance of independent directors questionable, since all directors, whether independent or not, are now mandated to take into consideration the interests of all stakeholders, and not just the stockholders. Is their main task to champion the interests of stakeholders other than the stockholders? If this be so, then independent directors merely duplicate the function of non-independent non-executive directors.

The second criticism is the presumption that the independent director is non-partisan, as opposed to an ordinary director who must necessarily be partisan to well-identified constituencies: the corporation, the stockholders, and now other stakeholders. The position of independent director is therefore equated to a "quasi-public" office. This quasi-public characterization of the office of independent director is contrary to the very essence of the nature and function of the Board of Directors.

Thirdly, the system of independent directorship presumes that only independent directors can exercise independent judgment on corporate matters, and that all other directors cannot do the same. If that were so, the independent directors, who are always a minority, would always be out-voted by the majority who is not capable of independent judgment, or who would act for the benefit of, or to cover-up the shortcomings of management.

The fourth area of concern is that the system of independent directors seems to promote a culture of confrontation within the Boards of public companies, which is contrary to the Asian culture of non-confrontation or "smooth interpersonal relationship." However, any system adopted that is inconsistent with the cultural underpinnings to which it is placed is doomed to fail.

Finally, the SRC's implementing rules on disqualifications for independent directors would qualify very few competent individuals for independent directors since they would most likely have business or professional dealings in the industry where the public company operates. The remaining competent candidates for independent directorship would be few, and would thereby become expensive commodities. The other individuals who would qualify may be just starting on their careers, or are individuals who come from outside the industry. In either case, such independent directors may lack the moral and professional influence for their views to carry much weight in Board discussions. In the end, since these directors will be receiving remuneration and *per diems* from the Boards that they serve and will be dependent upon them for professional growth, they would, in the tradition of agency capture, consciously or unconsciously align their judgment along with the group that butters their bread.

The important questions that are asked are these: When independent directors sit in the Boards of Directors of public companies, for whose benefit are they supposed to exercise their business judgment? If all non-independent directors are anyway supposed to act for the benefit of the corporation and all the stakeholders, then what greater or other interest are the independent directors supposed to champion?

The foregoing will be considered in evaluating the implementing provisions of the agency codes on independent directors.

B. Agency Codes Provisions on Independent Directors

The BSP CG Circulars formed the basis of implementing the SRC provisions on independent directorship. For public companies, SEC Memo No. 16,[220] was issued "[t]o properly guide the companies in the nomination and election of independent directors and to have uniform procedures on the same."[221] Many of the key provisions of the BSP CG Circulars, the SEC Code and SEC Memo No. 16, and the IC Circular, follow the pattern of the SRC Rule 38.1.

1. Definition and Expected Role of Independent Directors in Covered Companies

BSP Circular No. 296 defines the term "independent director" by essentially adopting the enumerative disqualification provisions of SRC Rule 38.1, but adds an all-encompassing prohibition against any dealings with the covered company. This was subsequently amended under BSP Circular No. 391 to cover more detailed acts or relationships to disqualify an individual from being nominated and elected as an independent director.[222]

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220. Securities and Exchange Commission, Guidelines on the Nomination and Election of Independent Directors, Memorandum Circular No. 16, Series of 2002 (Nov. 28, 2002).

221. *Id.*

222. Bangko Sentral ng Pilipinas, Qualifications of Independent Directors, Disqualification Procedures, Confirmation of Qualification, Circular No. 391, Series of 2003 (July 17, 2003), § 1 (6):

> Is not retained as professional adviser, consultant, agent or counsel of the institution, any of its related companies or any of its substantial shareholders, either in his personal capacity or through his firm; is independent of management and free from any business or other relationship, has not engaged and does not engage in any transaction with the institution or with any of its related companies or with any of its substantial shareholders, whether by himself or with other persons or through a firm of which he is a partner or a company of which he is a director or substantial shareholder, other than transactions which are

The SEC Code and SEC Memo No. 16 synthesized together some of the key provisions of SRC Rule 38.1 to provide for a formal definition of "independent director" as "a person other than an officer or employee of the corporation, its parent or subsidiaries, or any other individual having any relationship with the corporation, which would interfere with the exercise of independent judgment in carrying out the responsibilities of a director."[223] This means that apart from the directors' fees and shareholdings, he should "be independent of management and free from any business or other relationship which could materially interfere with the exercise of his independent judgment."[224] SEC Memo No. 16 provides for the same disqualification rules as those found in SRC Rule 38.1, but provides for additional qualifications for independent directors.[225] An independent director shall also be disqualified during his tenure under certain instances or causes enumerated therein. [226]

The IC Circular tracts the SEC's definition of independent director[227] and follows the disqualification rules under SRC Rule 38.1. Further, it adds

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conducted at arms length and could not materially interfere with or influence the exercise of his judgment.

223. SEC Memorandum Circular No. 2, § I (C).

224. *Id.*

225. SEC Memorandum Circular No. 16, § II (C):

i. He shall have at least one (1) share of stock of the corporation;

ii. He shall be at least a college graduate or he shall have been engaged or exposed to the business of the corporation for at least five (5) years;

iii. He shall possess integrity/probity; and

iv. He shall be assiduous.

226. *Id.* § II (D):

i. He becomes an officer or employee of the corporation where he is such member of the board of directors/trustees, or becomes any of the persons enumerated under letter (A) hereof;

ii. His beneficial security ownership exceeds 10% of the outstanding capital stock of the company where he is such director;

iii. Fails, without any justifiable cause, to attend at least 50% of the total number of Board meetings during his incumbency unless such absences are due to grave illness or death of an immediate family;

iv. Such other disqualifications which the company's Manual on Corporate Governance provides.

227. IC Circular No. 31-2005, § I (6).

a definition of "independence" to refer "to that environment which allows the person to carry out his/her work freely and objectively."[228]

2. Composition of the Board

As required under the SRC, the SEC Code,[229] the BSP CG Circulars,[230] and the IC Circular,[231] all require that covered companies shall have at least two independent directors or such independent directors shall constitute at least 20% of the members of such Board, whichever is the lesser. SEC Memo No. 16 provides that public companies may choose to have more independent directors in their boards than as above required.

Both the SEC Code and the IC Circular mandate that the Board may include a balance of executive and non-executive directors (including independent non-executives), "having a clear division of responsibilities such that no individual or small group of individuals can dominate the Board's decision making."[232] In other words, the SEC Code and IC Circular, in defining an "effective Board composition," draw the line more between executive directors on one hand, and the non-executive directors on the other (rather than just the independent directors), and provide that "[t]he non-executive directors should be of sufficient qualifications, stature and number to carry significant weight in the Board's decisions,"[233] with the "non-executive directors considered by the Board to be independent being properly identified in the annual report."[234]

3. Rules on Nomination, Election, and Termination of Independent Directors

The BSP CG Circulars do not provide separate rules for the nomination and election of independent directors, as indeed the BSP considers all directorship and officership positions in banking institutions to be essential fiduciary positions, and provides detailed rules[235] on confirmation of the election/appointments of directors and officers, effects and proceedings in the event of non-possession of qualification or possession of disqualifications,

228. *Id.* § I (15).

229. SEC Memorandum Circular No. 2§ II (1).

230. BSP Circular No. 296.

231. IC Circular No. 31-2005, § II (B) (2).

232. SEC Memorandum Circular No. 2, § II (1) and IC Circular No. 31-2005, § II (C) (1).

233. *Id.*

234. SEC Memorandum Circular No. 2, § II (1) and IC Circular No. 31-2005, § II (C) (3).

235. BSP Circular No. 296.

formal disqualification procedures, and providing for a system of watchlisting. This seems to be the same attitude under the IC Circular which does not provide for separate rules of nomination and election of independent directors. In other words, in both the banking and insurance industries, neither the BSP nor the IC see anything more special and separate of independent directors from the other directors as to provide a different mode of nomination and election.

In contrast, SEC Memo No. 16 provides detailed and separate rules on the nomination and election of independent directors for public companies.[236] It provides that in case of resignation, disqualification or

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236. SEC Memorandum Circular No. 16, § 4:

> (1) Nomination Committee shall have at least three (3) members, one of whom is an independent director. It shall promulgate the guidelines or criteria to govern the conduct of the nomination. .... The members of the Nomination Committee of the Exchange shall be cleared by the [SEC].
>
> (2) Nomination of independent director/s shall be conducted by the Committee prior to a stockholders' meeting. All recommendations shall be signed by the nominating stockholders together with the acceptance and conformity by the would-be nominees.
>
> (3) It shall pre-screen the qualifications and prepare a final list of all candidates and put in place screening policies and parameters to enable it to effectively review the qualifications of the nominees for independent director/s.
>
> (4) After the nomination, the Committee shall prepare a Final List of Candidates which shall contain all the information about all the nominees for independent directors, as required under SRC Rule 12, ... which list, shall be made available to the [SEC] and to all stockholders. The name of the person or group of persons who recommended the nomination of the independent director shall be identified in such report including any relationship with the nominee.
>
> (5) Only nominees whose names appear on the Final List of Candidates shall be eligible for election as Independent Director/s. No other nomination shall be entertained after the Final List of Candidates shall have been prepared. No further nomination shall be entertained or allowed on the floor during the actual annual stockholders'/ memberships' meeting.
>
> (6) Election of Independent Director/s
>
> i. Except as those required under this Circular and subject to pertinent existing laws, rules and regulations of the Commission, the conduct of the election of independent director/s shall be made in accordance with the standard election procedures of the company or its by-laws.

cessation of independent directorship and only after notice has been made with the SEC within five days from such resignation, disqualification or cessation, shall the vacancy be filled by the vote of at least a majority of the remaining directors, if still constituting a quorum, upon the nomination of the Nomination Committee. Otherwise, said vacancies shall be filled by the stockholders in a regular or special meeting called for that purpose. An independent director so elected to fill a vacancy shall serve only for the unexpired term of his predecessor in office.

4. Distinct Duties and Responsibilities Placed on Independent Directors

The agency codes attempt to empower independent directors to play key roles in Board proceedings and in the discharge of Board responsibilities, thus:

a. Quorum

Under the SEC Code, for purposes of quorum in board meetings, it is required that "[a]n independent director should always be in attendance;" and that his absence may not affect the quorum requirements if he is duly notified of the meeting but deliberately and without justifiable cause fails to attend the meeting.[237] Justifiable causes may only include grave illness or death of immediate family and serious accidents.[238]

b. Audit Committee

All three agency codes mandate the importance of, and the critical role and functions of the Audit Committee, and specifically provide that it shall be composed of an independent director.[239]

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ii. It shall be the responsibility of the Chairman of the Meeting to inform all stockholders in attendance of the mandatory requirement of electing independent director/s. He shall ensure that an independent director/s is/are elected during the stockholders' meeting.

iii. Specific slot/s for independent directors shall not be filled-up by unqualified nominees.

iv. In case of failure of election for independent director/s, the Chairman of the meeting shall call a separate election during the same meeting to fill up the vacancy.

v. The covered companies shall amend its by-laws in accordance with the foregoing requirements as soon as practicable.

237. SEC Memorandum Circular No. 2, § II (7).

238. *Id.*

239. BSP Circular No. 283, as amended by BSP Circular No. 456, § I (a) ("The Audit Committee shall be composed of members of the Board of Directors, at least two (2) of whom shall be independent directors, including the Chairman, preferably with accounting, auditing, or related financial management expertise

c. Nomination Committee

Under the SEC Code and the IC Circular, the Nomination Committee which may be composed of at least three members, one of whom should be an independent director, which shall review and evaluate the qualifications of all persons nominated to the Board as well as those nominated to other positions requiring appointment by the Board and provide assessment on the Board's effectiveness in directing the process of renewing and replacing Board members.[240]

d. Corporate Governance Committee

BSP Circular No. 456[241] provides that the Corporate Governance Committee shall be composed of at least three members of the Board of Directors, two of whom shall be independent directors. The Committee shall assist the Board of Directors in fulfilling its corporate governance responsibilities; it shall review and evaluate the qualifications of all persons nominated to the board as well as those nominated to other positions requiring appointment by the board of directors.

e. Compensation Committee

Under the SEC Code, the Compensation or Remuneration Committee may be composed of at least three members, one of whom should be an independent director. It may establish a formal and transparent procedure for developing a policy on executive remuneration and for fixing the remuneration packages of corporate officers and directors, and provide oversight over remuneration of senior management and other key personnel

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or experience."); BSP Circular No. 283, § 3 (9) (a), as amended by BSP Circular No. 456 (SEC Memorandum Circular No. 2 directs that the committee shall be composed of three members, one of whom shall be an independent director who shall be its chairman and who should be responsible for inculcating in the minds of the Board members the importance of management responsibilities in maintaining a sound system of internal control and the Board's oversight responsibility); IC Circular No. 31-2005, § II (D) (5) (b) (IC Circular No. 31-2005 seems to provide for only independent directors to compose the audit committee of insurance companies and intermediaries, thus: "The Audit Committee … [s]hall be comprised of independent board members, preferably with accounting and finance experiences.").

240. SEC Memorandum Circular No. 2, § II (9) (B) (a) and IC Circular No. 31-2005, § II (D) (5) (a).

241. BSP Circular No. 456, § I (b).

ensuring that compensation is consistent with the corporation's culture, strategy and control environment.[242]

In effect, by placing independent directors on the same side as other non-executive directors and by mandating that they constitute or chair important Board committees, the agency codes are ensuring that operationally, independent directors are able to wield power to be able to always project the disinterested view on Board deliberations. Notwithstanding the foregoing, the primary role of independence that is asked of independent directors is nonetheless being exacted by each of the agency codes on all directors. In addition, even in the area of qualification and competence, there is really nothing "special" for independent directors, for each of the agency codes requires all directors, not just independent directors, to have fit their fiduciary roles. What seems apparent from the special qualifications provided for directors under the agency codes is that, although it may have started out as an innovative feature under the SRC, the system of independent directorship has been overtaken, and rendered as a costly redundancy, with the adoption of the stakeholder theory under the various agency codes applicable to the covered companies.

C. Board Officers

The term "board officers" refers to company officers whose primary duties pertain to fulfilling the Board's responsibilities towards promoting good governance, rather than providing assistance to Management in the conduct of the day-to-day affairs of the company. In this category would fall the Chairman, the Corporate Secretary, the Compliance Officer, the Internal Auditor. Board officers serve as a check upon Management and are critical in supporting the Board in dispensing with its responsibilities towards good corporate governance, but would qualify to receive remunerations for their services.

1. Chairman of the Board

Both the SEC Code and the IC Circular provide extensive provisions to delineate the functions and responsibilities of the Chairman of the Board of Directors, and the importance of segregating the position of Chairman from that of the President or CEO of the company.

a. Chairman under the SEC Code

The SEC Code provides that "[t]he roles of the Chairman and the Chief Executive Officer (CEO) may be separate to ensure an appropriate balance of power, increased accountability and greater capacity of the Board for

242. SEC Memorandum Circular No. 2, § II (9) (B) (b).

independent decision-making;"[243] and mandates that "[t]he company shall disclose the relationship between the Chairman and the CEO upon their election."[244] The SEC Code does not impose upon public companies the requirement that the position of Chairman and President/CEO should be separate, mindful perhaps of the provision under Section 54 of the Corporation Code that does not even provide for the position of Chairman, and mandates that in the absence of provisions in the by-laws providing for such position, then the President shall act as chairman in all board meetings.[245]

It is important therefore that the person who sits as Chairman should identify himself primarily with fulfilling the responsibilities of the Board, and to take an independent view from Management. In such situation, the SEC Code states what may be provided as the Chairman's responsibilities[246] and mandates that "[t]he responsibilities set out in the above guidelines may pertain only to the Chairman's role in respect to the Board proceedings. It should not be taken as a comprehensive list of all the duties and responsibilities of a Chairman."[247] In fact, the responsibility of ensuring adherence to the corporate governance code and practices"[248] is placed upon the Chairman.

b. Chairman under the IC Circular

The circular letter signed by the Insurance Commission that accompanied the issuance of the IC Circular states clearly that one of "[t]he key features of

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243. *Id.* § II (3).

244. *Id.*

245. Where both positions of the Chairman and CEO are unified, there is clearly one leader to provide a single vision and mission. In this instance, checks and balances should be clearly provided to help ensure that independent, outside views, perspectives, and judgments are given proper hearing in the Board.

246. SEC Memorandum Circular No. 2, § II (3):

> (a) schedule meetings to enable the Board to perform its duties responsibly while not interfering with the flow of the company's operations;
>
> (b) prepare meeting agenda in consultation with the CEO;
>
> (c) exercise control over quality, quantity and timeliness of the flow of information between Management and the Board; and
>
> (d) assist in ensuring compliance with company's guidelines on corporate governance.

247. *Id.* § II (3).

248. *Id.* § VIII.

the code are the new definitions of the role of the board, the chairman and non-executive officers."

The IC Circular mandates that "the company's annual report shall identify the chairman, the vice-chairman (if there is one), the independent director and the chairmen and members of the nomination, audit and remuneration committees,"[249] and that "[c]areful deliberation and consideration shall be done to ensure that appointees have enough time for the job ... particularly important in the case of the Chairmanship."[250] It goes on to say that "the role of the Chairman and Chief Executive Officer shall in principle be separate, to ensure an appropriate balance of power, increased accountability and greater capacity of the Board for independent decision making."[251]

The IC Circular follows the SEC Code's provision that where the roles of Chairman and CEO are combined, there shall be a strong independent element on the Board: "Check and balance shall be clearly provided for, to help ensure that independent outside views, perspectives and judgments are given proper hearing on the Board. The Chairman of the Board shall be a non-executive director."[252] The IC Circular also directs the Nomination Committee to "prepare job specifications, including an assessment of the time commitment expected of him, recognizing the need for his availability in the event of crisis."[253] The Chairman's other significant commitments shall also be disclosed to the Board before his appointment and included in the annual report; and that any change thereof shall be reported to the Board and included in the next annual report.[254] The non-executive directors, led by the senior independent director, shall meet annually (and on other such occasions deemed appropriate) without the Chairman's presence to appraise or evaluate his performance, taking into account the views of executive directors.[255]

2. Corporate Secretary

The BSP CG Circulars do not contain detailed provisions on the Corporate Secretary of a banking institution. Only BSP Circular No. 296 contains a provision that the Board of Directors shall act on the report on a disqualification of a director or an officer of a banking institution not later

249. IC Circular No. 31-2005, § II (3).

250. *Id.* § II (D) (3).

251. *Id.*

252. *Id.* § II (B) (5).

253. *Id.* § II (D) (5) (a.3).

254. *Id.*

255. IC Circular No. 31-2005, § II (6) and § II (G) (4).

than the following board meeting, and that "[w]ithin seventy-two (72) hours thereafter, the Corporate Secretary shall report to the Governor of the BSP through the appropriate supervising and examining department the name of the director or officer involved, the ground for his disqualification and the action taken by the board."[256]

a. Corporate Secretary under the SEC Code

Under the SEC Code, the Corporate Secretary, who must be a Filipino citizen, is designated as an officer of the corporation, on whom is expected perfection in performance, and no surprises are expected of him. Likewise, his loyalty to the mission, vision and specific business objectives of the corporate entity come with his duties.[257] This near-impossible qualification of perfection is matched by the requirements that he be a jack of all trades, and master of all.[258]

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256. BSP Circular No. 296, § 3.

257. SEC Memorandum Circular No. 2, § II (10).

258. *Id.* (a) Like the CEO, he should work and deal fairly and objectively with all the constituencies of the corporation, namely, the Board, management, stockholders and other stakeholders. As such, he should be someone his colleagues and these constituencies can turn to, trust and confide with on a regular basis;

(b) He should have the administrative skills of the chief administrative officer … and the interpersonal skills of the chief human resources officer;

(c) If [he] is not the general counsel, then he must have the legal skills of a chief legal officer;

(d) He must also have the financial and accounting skills of a chief financial officer;

(e) He must have the vision and decisiveness of the CEO;

(f) Since there are different individuals on top of various corporate activities, [he] should be fully informed and be part of the scheduling … of the different activities;

(g) As to agendas, he should have the schedule thereof at least for the current year and should put the Board on notice before every meeting. It is a very important discipline to get the Board to think ahead. He should serve as an adviser to director's responsibilities and obligations; and

(h) [He] should make sure that directors have before them everything that they need to make an informed decision. When the Board makes a decision, it is covered by a business judgment that can be arrived at by the members acting in good faith with the assistance of the Corporate Secretary who should review carefully the information presented to the directors at the time they are to make a decision.

There would be very few individuals who would possess all the qualifications required of a Corporate Secretary for a public company; and of the few "supermen" who would qualify for the job, it is doubtful that they would take on such a position with so much responsibilities, when they would obviously be more qualified to be Chairman of the Board, or President/CEO of the company.

b. Corporate Secretary under the IC Circular

Section 2 of the IC Circular provides "Directors should appoint a Corporate Secretary who shall be a Filipino citizen capable of carrying out the duties to which the post entails and his removal shall be a matter for the entire Board to decide." The code provides for the directed responsibilities of the Corporate Secretary.[259]

3. Other Board Officers

a. Chief Audit Executive

The only other Board officer defined under the SEC Code is the "Chief Audit Executive," which refers to the "top position within the organization responsible for internal audit activities."[260]

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259. IC Circular No. 31-2005, § II (A) (16):

> The Board shall be entitled to the services of a Corporate Secretary who must ensure that:
>
> all appointments are properly made;
>
> all necessary information are obtained from directors, both for the company's own records and for the purposes of meeting statutory obligations, as well as obligations arising from the requirements of the Insurance Commission and other regulatory agencies;
>
> He shall submit to the Insurance Commission, at the end of every fiscal year, an annual certification as to the attendance of the directors during Board meetings;
>
> He shall, through the Chairman, be responsible for advising the Board about governance matters; and
>
> All directors shall have access to the advices and services of the Corporate Secretary, who is responsible … for ensuring that Board procedures are complied with.

260. SEC Memorandum Circular No. 2, § I (M):

> In a traditional internal audit activity, this would be the internal audit director. In the case where internal audit activities are obtained from outside service providers, the chief audit executive is the person responsible for overseeing the service contract and the overall quality assurance of these activities, and follow-up of engagement results. The

b. Compliance Officer

The IC C provides for the appointment of a "Compliance Officer" "who shall be responsible for coordinating, monitoring and facilitating compliance with existing laws, rules and regulations."[261]

c. Independent Director as Chairman of Board Committee

An independent director does not qualify to be classified as an officer and be entitled to receive remunerations outside of a by-law provision or by stockholders' confirmation, since by definition an "independent director" refers to "a person other than an officer or employee of the corporation."[262]

Perhaps the way to achieve the goal of the agency codes for "[l]evels of remuneration [that] shall be sufficient to attract and retain the directors, if any, and officers needed to run the company successfully,"[263] is for chairmanship in Board committees to be considered as an allowable "officer" position for which proper remunerations can be provided by the Board. Since independent directors are mandated to be members of audit committee, remuneration committee and other key committees, their designation therein should be considered as compensable apart from the *per diem* entitlement as members of the Board of Directors. This would be a function that is well within the defined duties of the Remuneration Committee.

VII. CONCLUSION

The SEC, the PSE, and the ICD has constituted a committee which would look into collating and evaluating all the various issuances, rules and regulations that cover the system of corporate governance among public companies, with the objective of providing for a revision of the SEC Code of Corporate Governance. It is the fondest hope of the author that some of the issues discussed herein would be covered by the amendments once they officially come out.

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term also includes such titles as general auditor, chief internal auditor, and inspector general.

261. IC Circular No. 31-2005, § II (A) (15) and § V (also provides that "[t]o insure adherence to [IC Circular No. 31-2005], the Chairman of the Board shall designate a Compliance Officer who shall hold at least the position of Vice President or its equivalent. He shall have direct reporting responsibilities to the Chairman of the Board).

262. SRC, § 38; SEC Memorandum Circular No. 2, § I (C); IC Circular No. 31-2005, § I (6); BSP Circular No. 296.

263. SEC Memorandum Circular No. 2, § II (7).

Dean Clark, a renowned corporate thinker in the United States, has written that "government failure" is one of the leading rationale for adopting the stakeholder theory, in that:

> [E]xplicit lawmaking and regulatory activities are flawed since legislature and agencies suffer from informational problems, perverse agenda-setting processes, captured by vested interests, nonrepresentation of diffuse interests, poor incentives structures and role definitions for the lawmakers and regulators, and more. In view of these failures, it seems prudent to encourage private enterprise, perhaps only on an experimental basis, to participate actively in the definition and execution of public policies. Since the setting and implementation of public policy is in such bad shape, so the argument goes, we must try something new.[264]

The comment seems appropriate for the underdevelopment setting of the Philippines.

He refers to the stakeholder theory as the doctrine of "high idealism" and poses this warning: "High idealism, if it were ever adopted, would simply spread the basic failure of government, confusion of ends and absorption of energies in the endless squabbling of interest groups, while destroying the chief virtue of business corporations, their capacity to achieve definite goals efficiently."[265]

In the Philippines, we have bitten the bullet, so to speak, and have taken on this form of high idealism, in our belief that in the face of government inefficiencies, the private sector can help build a more caring society. The legal consequences of the provisions of the agency codes on corporate governance have truly effected a shift in paradigm: whereas under general principles of Corporate Law, directors have duties and responsibilities only towards the corporation and it stockholders, now such duties and responsibilities extend to non-corporate parties, to other stakeholders of the business enterprise. Consequently, the exercise of business judgment by the Boards of Directors of public companies, banks and insurance companies, goes beyond determining what is best for the company and its shareholders — they must also seek a balance or consideration of the interests of other stakeholders affected by the business decisions.

There can be no doubt that *Corporate Social Responsibility* has taken fundamental rooting in the Philippine legal system in that by formally incorporating the stakeholder theory, there are now both philosophical and legal bases by which in the banking, insurance and public companies sectors (by far the most important corporate segments of our country's economic and financial systems) can undertake a system of corporate social responsibility that will eventually develop into full bloom, both in practice,

264. CLARK, *supra* note 13, at 691.

265. *Id.* at 702.

regulation and jurisprudence, based upon the peculiar setting of the Philippines. With the obligation to provide transparency in corporate affairs and to improve corporate communication with the public, stakeholder dynamism can lead to better results at making directors and corporate officers responsible and accountable.

Beyond the volatile boundaries of the stakeholder theory, there is no gainsaying that the broad principles of *Corporate Social Responsibility* have not been given legal imprimatur as to make it the legal obligations of directors and officers of covered companies to consider it their residual obligation to use the corporate business enterprise to pursue public or governmental interests. While there is little doubt that CSR practice is here to stay, it is yet difficult to anticipate how much it would move the corporate tectonic plates. In *The Economist*, special report on corporate social responsibility, John Ruggie of the Harvard University's Kennedy School of Government was quoted as saying: "The theological question — should there be CSR? — is so irrelevant today … Companies are doing it. It's one of the social pressures they've absorbed."[266]

In the field of corporate law, as in most other areas of commercial law, it is management practice and innovations that will drive legal developments, and it is in jurisprudence that we can observe the initial legal acceptance of such developments.

266. Corporate Social Responsibility: The next question, *available at* http://www.economist.com/specialreports/displaystory.cfm?story_id=1049105 (last accessed Nov. 20, 2008).