Infusing Principles of Corporate Governance in Corporate Law: A Proposed Hierarchy of Director Accountabilities to Various Stakeholders

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I. INTRODUCTION

> *The things that will destroy us are: politics without principle; pleasure without conscience; wealth without work; knowledge without character; business without morality; science without humanity; and worship without sacrifice.*[1]
>
> *- Mahatma Gandhi*

Corporate Law exists primarily to regulate the corporation as a form of doing business and focuses on the duties of parties belonging to the corporate family such as directors and shareholders. Since Corporate Law regulates a means of doing business, it naturally points towards *profit maximization* as the end of the corporate existence. The corporation is an inanimate conglomeration of contracts and properties; as such, it cannot act on its own. Thus, the law vests the control of property and the conduct of its business on directors.[2] The duty of the directors towards shareholders is imposed with the end of maximizing profit. Although there is no specific clause found in the Corporation Code on the duty to maximize profit, it has received recognition in Supreme Court rulings.

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1. Mahatma Gandhi, *Seven Blunders of the World that Lead to Violence*, *at* http://www.quincy.edu/~ hardeja/flag.html (last accessed Aug. 27, 2003).

2. The Corporation Code of the Philippines [CORPORATION CODE], Batas Pambansa Blg. 68, § 23 (1980).

In *Prime White Cement Corp. v. Intermediate Appellate Court*,[3] the call to directors to maximize profit was used to avoid a contract which was grossly disadvantageous to a corporation: "[The] unfairness in the contract is also a basis which renders a contract entered into by the president, without authority from the board of directors, void or voidable, although it may have been [entered into] in the ordinary course of business."[4] The Supreme Court further held:

> [A] director of a corporation holds a position of trust.... As corporate managers, directors are committed to seek the maximum amount of profits for the corporation. This trust relationship "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."[5]

The attributes of the corporation make it an attractive vehicle to conduct business. It is folly not to take advantage of these attributes when engaging in large business transactions, which involve great risks. These attributes are: its strong legal personality, limited liability to investors, free transferability of investment, and centralized management.[6] Based on a head count, sole proprietorships and partnerships far outnumber corporations as a business vehicle in the Philippines. However, the corporation is still the dominant form of organization by which key business activities are conducted.[7]

As a form of doing business, there are hardly any restrictions on what forms of activity may be entered into in the corporate form. The Corporation Code does not limit the activities that may be entered into,

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3. Prime White Cement Corporation v. Intermediate Appellate Court, 220 SCRA 103 (1993).
4. *Id.* at 112-13.
5. Gokongwei v. Securities and Exchange Commission, 89 SCRA 336 (1979), *cited in Prime White Cement Corporation*, 220 SCRA at 110-11 (*emphasis supplied*).
6. ROBERT CLARK, CORPORATE LAW 2-5 (1986); CESAR L. VILLANUEVA, PHILIPPINE CORPORATE LAW 20-24 (2001) [hereinafter VILLANUEVA, CORPORATE LAW].
7. Interview with Cesar L. Villanueva, Associate Dean for Academic Affairs, Ateneo Law School (Mar. 13, 2003) [hereinafter Villanueva, March Interview].

save restrictions on corporate *purposes* which are unconstitutional, illegal, immoral, or contrary to government rules and regulations.[8] Very few restrictions are found elsewhere. In fact, the few limitations that exist pertain to the ownership of stocks. Special laws[9] provide a minimum paid-up capitalization in recognition of the fact that under-capitalization can harm certain interests. The Constitution and other special laws provide for limitations on stocks of certain corporations that may be subscribed by foreigners.[10]

Instead of restricting the activities that the corporation cannot enter into, certain activities are in fact restricted to the corporate form of doing business – one of which is banking. All these factors have led to the dominance of the corporation by which important business activities are conducted.

The absence of restrictions as to the activities that the corporation may engage in is logical. The law has created in the corporation a convenient means by which to do business and provides it with several advantages in order to encourage investment and to develop industries.

These benefits are given to shareholders precisely so that they may take advantage of the corporate means of doing business. To be sure, the corporation is burdened more heavily than its other counterparts, particularly in terms of tax liabilities. But apart from these limitations, the Corporation Code does not impose any interest to be served by the corporation other than the shareholders.[11] The concern of the Legislature over corporations can be observed as minimal. It has

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8. CORPORATION CODE, § 17.

9. *See, e.g.,* The Insurance Code of the Philippines, Presidential Decree No. 1460, § 188 (1978) (provides that the minimum paid-up capital for insurance companies is P5,000,000.00). *See* CESARIO TEOPIANCO, THE INSURANCE CODE 32 (1993) (saying that as of Dec. 31, 1987, the paid-up capital stock has been raised to ten million pesos). *See* General Banking Act of 2000, Republic Act No. 8791, § 8 (2000) (for banks, such paid-up capital is to be determined by the monetary board).

10. VILLANUEVA, CORPORATE LAW, *supra* note 6, at 20-24 (stating that the 1987 Philippine Constitution limits the foreign ownership of the following corporations in relation to: exploitation of natural resources (PHIL. CONST. art. XII, § 2); owning and operating public utilities (PHIL. CONST. art. XII, § 11); mass media (PHIL. CONST. art. XVI, § 11(1)); and advertising (PHIL. CONST. art. XVI, § 11(2)).

11. *Id.* at 17.

reduced the corporation's duty to merely complying with the law and with shareholder's interests.

But recent events merit a re-examination of the director's position in the company. In 2001, Enron filed a report to the United States Securities and Exchange Commission admitting that it had broken accounting rules; and that correcting those errors would erase $586 million from its bottom line.[12] Not long from this announcement, WorldCom faced accusations of an alleged $4 billion accounting fraud.[13] Many other corporations worldwide face similar problems. As of the year 2000, the world economy was said to be "littered with some $2 trillion in failed or failing corporate giants…."[14] Based on the dictum that corporation exists to obtain profit from its shareholders, these recent events show the *dereliction* of boards of directors.

A. The Director's Powers and Duties in the Corporation

Having identified *profit maximization* as the prime mover of all corporate dealings, it is important to point out how this has shaped the role, powers, and duties of boards of directors. The Corporation Code separates the shareholder's ownership of corporate property and the conduct of its business and vests the latter with the director, thus:

> Unless otherwise provided in this Code, the corporate powers of all corporations formed under this Code shall be exercised, all business conducted and all property of such corporations controlled and held by the board of directors or trustees to be elected from among the holders of stocks, or where there is no stock, from among the members of the corporation….[15]

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12. Peter Behr & April Witt*, Hidden Debts, Deals Scuttle Last Chance* (Aug. 1, 2002), *at* http://www.washingtonpost.com/wp-dyn/articles/A28822-2002Jul31.html (last accessed Aug. 27, 2003) [hereinafter Behr & Witt, *Hidden Debts*].

13. Jonathan Krim, *WorldCom Scandal's Deep Roots* (Aug. 29, 2002), *at* http://www.monitordaily.com/story_page.cfm?News_id=7354&type=Special (last accessed Aug. 27, 2003).

14. *Id.*

15. CORPORATION CODE, § 23.

The law provides guidelines on how the corporate director will proceed in so managing. These guidelines are the duties of obedience, diligence and loyalty.[16] Since the Code imposes these three duties, it is logical that a director be sanctioned should he violate these duties as mandated by the law. But in recognition of the truism that corporations exist in order to maximize profit, the violations of these duties do not immediately cause attachment of liability to the erring director. The director obtains protection primarily from the *Business Judgment Rule*.

The *Business Judgment Rule* states that the business judgment of the directors will not be challenged nor overturned by courts or shareholders, and the directors will not be held liable for the consequences of the exercise of their business judgment, even for judgments that appear to be clear mistakes, unless certain exceptions apply.[17] American common law and the Philippine Law on Evidence has raised this to the level of a *presumption* – that in making a business decision, the directors of a corporation acted on an informed basis in good faith and in the honest belief that the action was taken in the best interests of the company.[18] Thus, using the *Business Judgment Rule*, the Supreme Court has upheld the resolution of the board even if it goes against a shareholder resolution,[19] allowed a contract although it decreases the profits of a corporation,[20] and upheld the board prerogatives even against the control of the Securities and Exchange Commission (SEC).[21]

The three duties imposed on the directors are non-negotiable and a violation of any of these duties lets the director incur liability. But it is interesting to note how the specter of liability *steps aside* when the act of the director is in pursuit of the holy grail of profit maximization.

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16. VILLANUEVA, CORPORATE LAW, *supra* note 6, at 322; JOVITO SALONGA, PHILIPPINE LAW ON PRIVATE CORPORATIONS 211 (1958) (citing WORMSER, FRANKENSTEIN, INC., 125-36 and 3 FLETCHER, § 990); CLARK, *supra* note 6, at 123.
17. CLARK, *supra* note 6, at 123.
18. *Id.* at 124 (citing Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Pogostin v. Rice, 480 A.2d 619 (Del. 1984)). *See also* 1997 REVISED RULES OF COURT, rule 131, § 3 (d), (p), (q) on Disputable Presumptions.
19. Ramirez v. Orientalist, 38 Phil. 634 (1918).
20. Montelibano v. Bacolod-Murcia Milling Co., Inc., 5 SCRA 36 (1962).
21. Philippine Stock Exchange v. Court of Appeals (CA), 281 SCRA 232 (1997).

Here, the *Business Judgment Rule* tempers the liability of directors even when they seem to violate their duties.

The following is an analysis of the means by which the goal of profit maximization has shaped the duties of the director.

• *Duty of Obedience* – The shareholders invested the capital into the venture so they should be able to determine the risks that their capital will be subjected to. This control is exercised through the purpose clauses of the articles of incorporation, which is supposed to limit the scope of the transactions which the directors can enter into. By virtue of the *ultra vires* doctrine, it would seem that a contract entered into by the corporation beyond those which are permitted in the purpose clauses in the articles of incorporation are void. But courts have had the tendency to tone down the application of the *ultra vires* doctrine.[22] This is because the courts seek to give the public more freedom in dealing with corporation, knowing that it cannot avoid compliance by merely alleging that such contract was beyond the powers of the corporation to enter into, as a contrary holding will serve to diminish confidence in commercial contracts.[23] Thus, in *Uy Siuliong v. Director of Commerce and Industry*,[24] it was held that the purpose of the corporation, to engage in *mercantile business*, sufficiently included the purchase and discount of promissory notes and bills of exchange. By allowing directors the leeway to adopt corporate policies and to engage in transactions, as they deem best for the corporation,[25] businesses are given more freedom to deal with the world through the corporate medium.[26]

• *Duty of Diligence* – Directors are required to discharge the duties of their office in good faith and with the diligent care and skill which ordinary prudent men would exercise under similar circumstances in like positions.[27] But the director's duty of diligence differs from a

22. VILLANUEVA, CORPORATE LAW, *supra* note 6, at 161.

23. *Id.* at 164.

24. Uy Siu Long v. Director of Commerce and Industry, 40 Phil. 541 (1919).

25. Baretto v. La Previsora Filipina, 57 Phil. 649 (1932).

26. VILLANUEVA, CORPORATE LAW, *supra* note 6, at 161.

27. SALONGA, *supra* note 16, at 212.

natural person's duty to act with the diligence of a good father of a family in his ordinary dealings. In the Civil Code of the Philippines, illegal acts, negligence,[28] and bad faith[29] are all sources of liability. But in Corporate Law, both statute and case law set the standard of liability not at *simple* illegality or negligence. The act must be *patently* unlawful or it must be attended with *gross* negligence.[30]

The Corporation Code stringently penalizes the violation of the duty of diligence. It states:

> 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…shall be liable jointly and severally for all damages resulting therefrom suffered by the corporation, its stockholders or members and other persons.[31]

Thus, liability is incurred when the director who votes for patently unlawful acts, is guilty of gross negligence or bad faith.[32]

But the *Business Judgment Rule* creates a presumption of good faith on the directors, who may not be held liable for honest mistakes of judgment. Therefore, while it is easy to hold a director liable where there is simple failure to engage in the basic activities of the role of director,[33] the director enjoys a presumption of good faith when he acts diligently. Thus, he can take calculated risks, which are intended to further the financial ends of the corporation. The *Business Judgment Rule* protects the director so that when he acts within such business judgment, he cannot be held personally liable for the consequences of such acts.[34] A director can therefore afford not to be conservative and passive – he can act to take advantage of opportunities that present themselves to the corporation when he deems that this will earn profits for the corporation. Certainly, this presupposes that prior to making a business decision he has to inform himself with the use of all material

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28. An Act to Ordain and Institute the Civil Code of the Philippines [CIVIL CODE], Republic Act No. 386, art. 1170 (1950).

29. *Id.* art. 2176.

30. Board of Liquidators v. Kalaw, 20 SCRA 987 (1967) (*emphasis supplied*).

31. CORPORATION CODE, § 31.

32. *Id*.

33. CLARK, *supra* note 6, at 124-25.

34. VILLANUEVA, CORPORATE LAW, *supra* note 6, at 284.

information reasonably available.[35] But so long as he acts within such business judgment, he cannot be personally liable.

• *Duty of Loyalty* – All corporate property and conduct of business having been entrusted to the director, a fiduciary relation exists between the director and the shareholder. Thus, he cannot acquire any personal or pecuniary interest in conflict with his duty as director.

The Corporation Code reserves the most stringent guidelines in imposing liability for the self-dealing director precisely because here, the corporate director transgresses the profit maximization objective of the corporation by arrogating corporate profits for himself. Thus, Section 31 of the Corporation Code states that "[d]irectors or trustees who…acquire any personal or pecuniary interest in conflict with their duty as such directors or trustees shall be liable…for all damages resulting therefrom suffered by the corporation, its stockholders…."

When a director, trustee or officer attempts to acquire or acquires, in violation of his duty, any interest adverse to the corporation with respect to any matter which has been reposed in him in confidence, as to which equity imposes a disability upon him to deal in his own behalf, he shall be liable as a trustee for the corporation and must account for the profits which otherwise would have accrued to the corporation.[36]

B. Springboard for the Analysis

The modern world has seen the emergence of the corporation as the choice vehicle for the conduct of business. As a form of doing business, the *maximization of profit* is its main objective. But doing business in the corporate form is unique because ownership and control of capital is separate – ownership resides in shareholders, and control of corporate property and conduct of corporate business resides in the director. From this fiduciary relation, the duties of obedience, diligence and loyalty are guidelines for the director as he performs his tasks. Despite being burdened with these duties, the law, in fact, has bent over

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35. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

36. CORPORATION CODE, § 31 (states that the Corporation Code also places strict guidelines on dealings of directors, trustees or officers with the corporation and dealings between corporations with interlocking directors).

and has been reshaped in order to strengthen the corporation as a business enterprise. The *ultra vires* doctrine, although present in the Corporation Code, has been rendered inutile in application. The *Business Judgment Rule* tempers the director's liability when he takes risks in furtherance of the profit-oriented goal of the corporation. Thus, liability is strictest for the self-dealing (disloyal) director and is most lenient for the disobedient, albeit profit-motivated, director.

That public and shareholder interest should be mentioned in the same breath is *antithetical* – the corporation is a vehicle for doing business. Shareholders invest in the corporation not to help public interest but to earn profits, and the main role of the board of directors is profit maximization.

Corporate Law grants the corporation a juridical personality that is distinct and separate from the shareholder and the corporate director.[37] Corporations can sue, be sued, and be held liable for debts, liabilities and damages.[38] In addition, the corporate director is not liable for the commission of fault and negligence – only in instances of gross fault and patent illegality is such corporate director liable. This is in stark contrast with the liability rules in the Civil Code for individuals – such individuals are held liable for their acts and omissions involving simple fault and negligence, when these acts cause injury to third persons.[39]

But the capital that corporations hold and control, and the capacity for greater effects that it may have on public interest, behooves a re-examination of the nature of a corporation, along with the duties of the agents through which the corporation acts, which are the corporate directors. This Note will outline the developments, which have lead to the growth of the doctrine that certain corporations are vested with *public interest* by virtue of the great wealth they hold. This public interest translates to a duty of corporations to maintain public interest because of the social fiduciary obligation of the corporations. Certain irreconcilable conflicts arise from this concurrent duty of the board of directors to maximize profit for the corporation and to exercise the fiduciary duties towards the public. This Note proposes a hierarchy of values in which the board of directors can measure actions in trying to satisfy conflicting demands against the corporation. This Note shall then take the initial steps to enflesh the precise nature of this social

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37. *Id.* § 5.

38. CIVIL CODE, art. 46.

39. *Id.* art. 2176.

fiduciary duty of the director to named constituencies who can make demands against the corporation by virtue of these parties' own stake in the corporation.

1. Scope

This study examines the role of the board of directors who, under the Corporation Code, are called upon to maximize profit and were previously held answerable only to shareholders. Currently, under the principles of corporate governance as found in the SEC Code of Corporate Governance and *Bangko Sentral ng Pilipinas* (BSP) Circular No. 283 Series of 2001, are now called upon to enhance the corporate value and are now answerable to increased constituencies. This emerging re-orientation gives rise to certain implications. Foremost is that these increased constituencies will have seemingly conflicting and contradictory claims against the directors. In order to discharge the duties towards these constituencies, it is imperative to identify precisely what the claims of these constituencies are, and how the boards of directors are mandated to act under the principles of corporate governance to satisfy these seemingly conflicting claims. This study then proposes a manner by which these claims can be harmonized under principles of commercial law.

2. Limitations of Scope

This Note investigates on the role of the directors of corporations in settings where the profit motive is most evident, and these are in (a) banks and (b) public corporations as defined under the Code of Corporate Governance, among which are corporations whose shares are listed, and "any corporation with a class of equity securities listed in an Exchange or with assets in excess of Fifty Million Pesos (P50,000,000.00) and having two hundred (200) or more stockholders each holding at least one hundred (100) shares of a class of its securities."[40] This Note is likewise limited to the corporate form of doing business, which excludes the sole proprietorship, the partnership, and the general professional partnership. Corporations

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40. Securities and Exchange Commission, Code of Corporate Governance, SEC Memorandum Circular No. 2, Series of 2002 (Apr. 5, 2002) [hereinafter CODE OF CORPORATE GOVERNANCE].

which do not fall under the definition of a *public corporation* are excluded as well. Quasi-banks and trust entities are included within the term *banks*.

A general overview of all acts, which involve a corporate entity's fault and negligence, will be taken. This study will contain studies of particular examples such as accounting frauds as seen in Enron, WorldCom and the Philippine Long Distance and Telecommunications Company takeovers, as well as damage to society in employment practices, environmental management, creditor fraud and consumer protection. This will be done in an effort to illustrate the effects of ordinary fault and negligence. This Note will not attempt an exhaustive resolution of these cases nor a solution for them in particular.

II. SHIFTING PARADIGMS IN THE CHARACTER OF CORPORATIONS

A. Prefatory Statements

> *See human beings as though they were in an underground cave-like dwelling with its entrance, a long one, open to the light across the whole width of the cave. They are in it from childhood with their legs and necks in bonds so that they are fixed, seeing only in front of them, unable because of the bond to turn their heads all the way around. Their light is from a fire burning far above and behind them. Between the fire and the prisoners there is a road above, along which see a wall, built like the partitions puppet-handlers set in front of the human beings and over which they show the puppets.*[41]
>
> *- Plato, The Republic*

The theories for its existence point to the corporation as a private affair between the members of the corporate family. The doctrines on the formation of a corporation reinforce this theory that the corporation is purely private in nature and operation.

In the *theory of concession*,[42] the corporation is said to owe its life to the state, its birth being purely dependent on the latter's will.[43] Thus, the corporation may exercise only powers expressly provided by law, or those considered inherent or incidental to juridical persons. The law has not mandated any public function for the corporation. Thus, it is not required to look beyond the goal of profit maximization. In the

41. PLATO, THE REPUBLIC, book VII, § 514a (Allan Bloom trans., 1991).

42. VILLANUEVA, CORPORATE LAW, *supra* note 6, at 11-12.

43. *Id.* (citing Tayag v. Benguet Consolidated, Inc., 26 SCRA 242, 252 (1968)).

theory of enterprise entity,[44] the corporate entity takes its being from the reality of the underlying enterprise. The corporation is considered a network of contracts – between the shareholders, the director and the corporate entity. Thus, only those bound in this network of contracts will be able to have claims against the corporation. Anyone not bound by the contracts are non-entities to the corporation. Therefore, from a strict Corporate Law point of view, directors have no direct duties to third parties such as the government or the society where the business operates or the ecology.

However, current events have sparked a re-examination of this inviolable truth. Dean Cesar L. Villanueva has observed a shift in the paradigm of the corporation as a private enterprise concerned only with profit maximization.[45] Several of legislations have reflected the government's shift toward this thought. Presidential Decree No. 902-A[46] lays down several of the government's policies towards corporations, and the Code of Corporate Governance[47] provides a higher degree of standard for corporate governance.

This part of the Note summarizes the turning of the tide against the traditionally accepted norm of profit maximization as the end-all and be-all of corporate existence, and the current status of corporate social responsibility research. The real issue, however, is how to characterize this apparently new doctrine on the *social* responsibilities and duties of directors of for-profit corporations.

B. Rationalizing Profit Maximization

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44. VILLANUEVA, CORPORATE LAW, *supra* note 6, at 12-15.

45. Cesar L. Villanueva, Legal and Regulatory Issues for Bank Directors 8 (2002) (unpublished manuscript, on file with Author) [hereinafter Villanueva, Bank Directors]; Interview with Cesar L. Villanueva, Dean, Ateneo Law School (Feb. 17, 2003).

46. Reorganization of the Securities and Exchange Commission with Additional Powers and Placing the Said Agency Under the Administrative Supervision of the Office of the President, Presidential Decree No. 902-A (1976).

47. CODE OF CORPORATE GOVERNANCE.

The profit maximization norm falls under the *dualist* thought, described by Dean Robert Clark as the traditionalist view, which 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."[48]

The *dualist* thought certainly does not mean that corporations and their managers have no legal obligations to persons other than shareholders. Corporations are bound to employees under labor law, to consumers under consumer protection law, to the government under corporate and tax law, and even to the environment under environmental law. However, profit is considered the company's objective function and its residual goal. The duties to all other groups need simply be complied with. They are considered constraints, and profit is to be as large as possible, within these constraints.[49]

The *profit maximization* viewpoint is legally consistent with the view that the corporation exists as a vehicle to conduct business. Business and profit maximization are legally and logically inconsistent with the corporation pursuing or fulfilling other non-aligned interests or goals.

Recent events in the corporate world have made imperative a re-examination of the maxim that a corporation exists only to earn profit within the bounds of law. The fall of Enron and WorldCom, and the mining disaster of Marcopper in Marinduque, are cases in point.

To compete in the deregulated energy market, Enron resorted to questionable, but arguably legal, accounting techniques in order to reflect a high profit and raise shareholder confidence. A report[50] revealed that Enron's investment in a risky Internet start-up called Rhythms Net Connections had jumped $300 million in value. Because of a security restriction, Enron could not sell the stock immediately. But the company could and did count the paper gain as profit, which would allow Enron to hold on to that windfall if the *tech boom* collapses and

48. CLARK, *supra* note 6, at 677-79.

49. *Id.* at 678.

50. Peter Behr & April Witt, *Visionary's Dream Led to Risky Business Opaque Deals, Accounting Sleight of Hand Built an Energy Giant and Ensured its Demise*, *at* http://www.washingtonpost.com/ac2/wp-dyn/A9783-2002Jul27? (last accessed Sept. 21, 2005).

the stock drops.[51] Using such a model, Enron created a private partnership that would hedge its earnings, locking in the gain. This was used as an accounting trick, providing an arrangement, which would pay Enron to cover any losses if the stock price drops. In essence, Enron was insuring itself.[52] Enron hired an auditor, which aimed to please it, approving risky partnership investments that propped up Enron's finances.[53]

By 2001, in a report to shareholders and the U.S. Securities and Exchange Commission, the company admitted that it had broken accounting rules in a deal with Fastow's LJM1 partnership and Chewco. Correcting those errors would force Enron to restate its profit figures as far back as 1997. That would erase $586 million from its bottom line.[54]

It can be argued that the profit maximization concept cannot be validly attacked with the example of Enron because Enron had fallen *beyond* the constraints imposed by the dualist principle – that of compliance with the law. However, Enron, to a certain extent, had complied with the law in the reporting of its income. It was only when the creative accounting extended to a cooperative external auditor and false tax reporting that it violated the law, thus exceeding the constraints. Enron is the perfect example of the aim of profit maximization *gone wrong* because at the expense of such goal, it had severely damaged employee, investor and creditor interest, beyond that which is mandated by the legal obligations imposed by law on each party.

A year after Enron's announcement came WorldCom's own staggering revelation. In 2001 and the first quarter of 2002, the company counted as capital investments $3.8 billion that it spent on everyday

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51. *Id.*
52. *Id.*
53. Peter Behr & April Witt, *Concerns Grow Amid Conflicts Officials Seek to Limit Probe, Fallout of Deals* (Aug. 27, 2003), *at* http://www.washingtonpost.com/ac2/wpdyn?pagename=article&node=&contentId=A188762002Jul29¬Found=true (last accessed Sept. 21, 2005).
54. Behr & Witt, *Hidden Debts, supra* note 12.

expenses.[55] WorldCom was the second largest long-distance company in the United States who had the role of the biggest carrier of Internet traffic.[56]

WorldCom did this because counting everyday expenses as capital investments boosts net income. This was done by spreading out expenses, which was otherwise supposed to be counted in one quarter, over several years. The company originally reported net income of $1.4 billion in 2001 and $172 million in the first quarter of 2002. In its announcement, the company claimed that during the whole time, it was losing money.[57] In perpetrating this fraud, WorldCom also conspired with its auditing firm, who, while reporting that the company complied with all accounting standards, actually permitted huge discrepancies in its financial reports.

WorldCom is thus another example of how profit maximization as an end can lead directors to perpetrate acts of fraud for the bottom-line. Analysts wrote that the company's announcement was not merely a business page scandal – it was a *national scandal*, which wiped out stockholders, causing damage also to its bondholders and other creditors. Further, the huge misstatements had effects that would undermine the faith of investors, foreign and domestic, in the United States financial market.

The last illustration is the case of the Marcopper mining disaster. Marinduque welcomed Marcopper and the promise of 1,000 jobs some 30 years ago. An additional inducement was power, since electricity was essential for mining operations.[58] During its peak, Marcopper produced 30,000 tons of copper ore each day.[59] But the mining process produced two by-products: a heavy silt of rocks and sand, and the more dangerous tailings – a fine, grey mix of heavy metals, including lead,

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55. Yahoo! News, UK & Ireland, *How to Hide $3.8 Billion in Expenses*, *at* http://uk.biz.yahoo.com/020628/244/d27x1.html (last accessed Jun. 28, 2002) [hereinafter *How to Hide*].
56. Allan Sloan, *Dialing the Wrong Numbers*, NEWSWEEK, Jul. 8, 2002, at 14.
57. *How to Hide*, *supra* note 55.
58. Keith Damsell, *Island's Deadly Legacy*, *at* http://www.probeinternational.org/pi/mining/index.cfm?DSP=content&ContentID=4817 (last accessed Aug. 27, 2003) [hereinafter Damsell, *Island's Deadly Legacy*].
59. *Id.*

zinc, and sulphur.[60] Waste from the site was dumped in the surrounding countryside, including the nearby Boac River. The river was diverted to supply water to the pit and a dam was built to collect waste. By 1975, with the approval of the government, three separate pipelines were constructed to funnel waste from Tapian down to Calancan Bay. Rather than burying the fine tailings deep below the surface of the bay, the waste was pumped out at shore level.[61]

The waste damaged the environment. Villagers complained that the dumping was reducing fish stocks. Surveys[62] confirmed a reduction in plant and animal life in the bay.[63] A class action suit against the company was filed in 1988, demanding an immediate halt to the dumping. Marcopper's dumping permit expired and due to petitions filed before the Pollution Adjudication Board, Marcopper was ordered to cease operations.[64] But this stoppage in operation cut the electric supply to the island. Mining was allowed to resume along with the dumping. As a concession, Marcopper agreed to contribute to a fund to rehabilitate the bay.[65]

But from 1975 until 1991, Marcopper had essentially pumped the environment with its waste. A 16-kilometer stretch of metal pipe delivered a poisonous brew of waste from a copper mine high in the island's hills to the waters of the bay.[66] In 1992, the firm began mining a second pit. The bulk of the tailings was stored in the first pit while heavy silt was dumped in the nearby Mogpog River.[67]

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60. *Id.*

61. *Id.*

62. A series of annual surveys in the late 1970s and early 1980s by Synergistics Consultants Inc. of the University of the Philippines.

63. Damsell, *Island's Deadly Legacy*, *supra* note 58.

64. *Id.*

65. *Id.*

66. *Id.*

67. Keith Damsell, *Philippines set to launch probe into Marcopper, Placer Dome*, Financial Post, *at*

In 1995, mine waste was discovered seeping through the groundwater near the Boac River. The source of the leak was the 2.25 kilometer drainage tunnel running from the Tapian pit to the Boac River. To relieve pressure and monitor the problem, engineers drilled a hole down to the two-meter tunnel.[68] On 24 March 1996, the tunnel's plug gave way, releasing 1.6 million cubic meters of tailings into the Boac River.

The United Nations sent a mission team to the Philippines to survey the disaster. The United Nations Mission final report, 73 pages all told, contains an extensive ecotoxicological assessment, an evaluation of the impact on human health and well-being, and general discussion on the causes, as well as recommendations to avoid future disasters.[69]

While it is true that a purely profit oriented corporation still has to operate within its bounds, and that the example of Marcopper contributes nothing to the analysis of the deficiency of the profit maximization motive of corporations, the incident shows that a corporation which is driven purely by profit motives, aims to internalize all possible gains from the community, and also to externalize all possible costs onto the community.[70] The corporation treats itself almost as if it were a sovereign entity, free to utilize corporate assets in any way it sees fit.

C. Profit Maximization as Myopic View of Corporate Environment

Using profit maximization as the criteria by which to judge all corporate actions assumes that only shareholders have made inputs into the firm. Since shareholders have invested capital, it is the shareholder, which should obtain all the gains in the venture. This is both untrue and even anachronistic.

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http://www.probeinternational.org/pi/mining/index.cfm?DSP=content&ContentID=4816 (last accessed Aug. 27, 2003).

68. Damsell, *Island's Deadly Legacy*, *supra* note 58.

69. United Nations Department of Humanitarian Affairs - DHA-Online, Joint UNEP/DHA Environment Unit, Relief Co-ordination Branch Joint UNEP/DHA Environment Unit, *The Marinduque Island Mine Disaster, Philippines, Assessment Mission Conducted Under the Leadership of UNEP/Water Branch*, *at* http://www.reliefweb.int/ocha_ol/programs/rcb/unep4.html (last accessed Sept. 18, 2005).

70. MARJORIE KELLY, THE DIVINE RIGHT OF CAPITAL: DETHRONING THE CORPORATE ARISTOCRACY 26 (2001).

Analysts agree that there are persons or groups with legitimate interests in participating in an enterprise.[71] These parties, called *stakeholders*, are those groups without whose support the corporate business enterprise would cease to exist.[72] One of these is the investor. But together with him are the customers, the communities where the firm operates, the employees, the trade associations, the firm's suppliers, the government where the firm operates, and the political groups of that government.[73] The idea that corporations have stakeholders is now commonplace in management literature.

One of the means by which the anachronistic view of profit maximization has been retained is the view that the boards of directors are the *agents* of the shareholders. Shareholders have the power to vote directors into their positions, and so even if the Corporation Code vests the power to direct and control corporate affairs with the director, it is the shareholder who ultimately decides who shall sit in the company's board of directors. The relationship of the shareholder and the director as thus described and analyzed is that the director is the *agent* of the shareholder, who is the principal. The agent is thus obliged to act in favor of the principal.

The main defect of this argument is that the shareholder is not the only body which has made inputs into the corporation. Several other bodies provide inputs to the corporation, without which the corporation shall cease to survive.

The second defect of the restrictive belief that the director is a mere agent of the shareholder also stems from the notion of the corporation as *property*. Since the shareholders own the corporation, is it not true that the shareholders are entitled to decide how corporate affairs will proceed? Granting that there are several other bodies holding stakes in the corporation, is it not the shareholder who has been the prime mover in corporate existence, having provided the capital which

71. Thomas Donaldson & Lee E. Preston, *The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications*, 20 ACAD. MGMT. REV. 65 (1995).

72. *Id.* (citing Stanford Research Institute (1963)).

73. *Id. See* Figure 2 – Contrasting Models of the Corporation: The Stakeholder Model.

spurred its existence, such that the corporation is his, with which to do as he pleases?

The answer to these questions takes one beyond the conventional understanding of Corporate Law concepts. Shareholders cannot decide how corporate affairs will proceed and they cannot do with the corporation just anything as they please. The rationale is because such power has been vested by law in the directors, and, more importantly, because the director is not recognized as an agent of the shareholder.[74]

In the very early case of *Ramirez v. Orientalist*,[75] the Supreme Court stated in unequivocal term the nature of this relationship:

> [b]oth upon principle and authority it is clear that the action of the stockholders, whatever its character, must be ignored. The functions of the stockholders of a corporation are, it must be remembered, of a limited nature. 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.[76]

In this case, the directors of the company adopted a contract to obtain film rights. But when presented to the shareholders, it was disapproved by a resolution which was passed during a meeting. The film rights were then not paid for, and the defense raised was that the shareholders disapproved the agreement entered into by the directors. The Supreme Court ruled that the company was *liable*, and virtually disregarded the mandate of the shareholders: "[w]here a meeting of the stockholders is called for the purpose of passing on the propriety of making a corporate contract, its resolutions are at most advisory and not in any wise binding on the board."[77]

The view that the investor, after having placed capital into the venture, loses control over his funds may seem to have frightening

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74. Villanueva, March Interview, *supra* note 7.

75. Ramirez v. Orientalist, 38 Phil. 634 (1918).

76. *Id.*

> Accordingly, there is little for the stockholders to do beyond electing directors, making by-laws, and exercising certain other special powers defined by law. In conformity with this idea it is settled that contracts between a corporation and third persons must be made by the directors and not by the stockholders. The corporation, in such matters, is represented by the former and not by the latter.

77. *Id.*

implications. But it is this attribute of the corporation, that of centralized management, which allows the corporation to function as an attractive business venture.

To better understand this concept, Dean Villanueva analyzes the relationship of the shareholder and the director using the framework of a *trust* or *guardianship*.[78]

Both the trust and the guardianship are fiduciary relationships. A *trust* is a fiduciary relationship involving property, vesting the title of the property and its equitable duties on one party and imposing upon him the duty to deal with it for another's benefit.[79] On the other hand, *guardianship* is a relationship where the legal authority and duty to care for another's person or property is vested with a guardian, because of the other's infancy, incapacity, or disability.[80]

The concept of trust and guardianship are not in all fours with the director-shareholder relationship. But it is true – to the extent that the shareholder relinquishes control over his capital upon investing in the corporation and the director exercises control over corporate property and affairs in favor of the shareholder. In both the trustee-beneficiary and guardian-ward relationship, the one whose affairs are controlled has no power over the affairs concerning his property. This is premised on disability of some sort, which spurred the creation of the fiduciary relationship.

In the corporate setting, control is relinquished not because of disability, but out of convenience and utility. This makes possible a more stable and efficient system of governance and of dealing with third parties, such that shareholders are bound by the management decisions and transactions of the board of directors of the corporation whether they like it or not.[81] With this realization, the commonly found by-law provision that no owner of a competing company may become the director of a company without providing any limitation as to ownership becomes logical. Because without having the power to sit in

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78. Villanueva, March Interview, *supra* note 7.

79. BLACK'S LAW DICTIONARY 1513 (7th ed. 1999).

80. *Id.* at 712.

81. VILLANUEVA, CORPORATE LAW, *supra* note 6, at 23.

the board, the advantage of owning stock in a competitor company is substantially diminished.

This rule of jurisprudence first emanated from the view that the corporation cannot hold the director out to the world as capable of entering into contracts in its behalf and then repudiating that authority with a shareholder resolution. The first expression of this sentiment is found in *Ramirez*.[82]

But the concept has evolved to include concepts that are far wider than that from which it originated. In *Barretto v. La Previsora*,[83] which was an action of directors against the corporation to collect a portion of the corporation's net profits which was granted to them by the shareholders in a validly adopted amendment to the company's by-laws, the Supreme Court observed that the provision which the claimants relied upon was merely a *by-law provision* adopted by the shareholders of the corporation, without any action having been taken in relation thereto by its board of directors. It is settled that contracts between a corporation and third persons must be made by or under the authority of its board of directors and not by its shareholders. Hence, the action of the shareholders in such matters is only advisory and not in any wise binding on the corporation.[84]

The shareholders argued that they had signed the resolution themselves and thus, the amendment should be considered a directive of the board of directors. This argument was not countenanced:

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82. *Ramirez*, 38 Phil. at 634.

> In passing upon the liability of a corporation in cases of this kind it is always well to keep in mind the situation as it presents itself to the third party with whom the contract is made. Naturally he can have little or no information as to what occurs in corporate meetings, and he must necessarily rely upon the external manifestations of corporate consent. The integrity of commercial transactions can only be maintained by holding the corporation strictly to the liability fixed upon it by its agents in accordance with law.... As already observed, it is familiar doctrine that if a corporation knowingly permits one of its officers, or any other agent, to do acts within the scope of an apparent authority, and thus holds him out to the public as possessing power to do those acts, the corporation will, as against any one who has in good faith dealt with the corporation through such agent, be estopped from denying his authority...

83. Baretto v. La Previsora Filipina, 57 Phil. 649 (1932).

84. *Id.*

> The truth is that, at that time, they all attended the meeting in their capacity as stockholders and, strictly speaking, that was a stockholders' and not a directors' meeting. For this same reason, the…contention that the act of the directors, in connection with said by-laws, constitutes a ratification or confirmation of the alleged contract is untenable.[85]

In *Wolfson v. Manila Stock Exchange*,[86] the shareholders adopted a resolution whereby the petitioner was elected honorary member of the corporation for life with all the rights and privileges. The board of directors *rescinded* this in a subsequent resolution and petitioner filed for mandamus to reinstate him in his position. The Supreme Court ruled that the powers vested in the directors or trustees of a corporation must be exercised by them, and cannot be exercised by the shareholders. The shareholders' action can be sustained only in some circumstances, which dispense with the directors' action as a mere formality. The fact that all of the members were present at the meeting does not imbue any measure of validity on the act, and such act is not binding on the corporation.[87]

The recognition that the power over the corporation is exercised by the director and not by the shareholder is valuable. From this concept, it is clear that although the director is accountable to the shareholders by virtue of his fiduciary duties, the performance of his duties is not subject to shareholder control. If the State cannot interfere with the director's manner of fulfilling his duties by virtue of the *Business Judgment Rule*, much less can the shareholder do so. Since the shareholder cannot control the manner by which the director performs his duty, the director cannot be rightfully considered as merely an *agent* of the shareholder. It is wrong therefore, to consider the director as serving only shareholder interest. The corporate director is called upon to maximize shareholder value by virtue of his duties to the shareholder, but this is not his only duty. He has a duty to the other parties, parties without whom the corporation shall cease to exist, which have been earlier identified as *stakeholders*.

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85. *Id.*

86. Wolfson v. Manila Stock Exchange, 72 Phil. 492 (1941).

87. *Id.*

Writers would posit that modern boards should be viewed as a *steward* whose behavior is ordered such that pro-organizational, collectivist behavior has higher utility than individualistic, self-serving goals.[88] The theory of the corporate director as a *steward* recognizes that there will be competing stakeholder and shareholder objectives, and the director will be called upon to make decisions that he perceives are in the best interest of the group. Thus, he is to maximize not shareholder value but organizational performance, thereby satisfying the competing interests of stakeholders.[89]

D. Modern Recognition of the Public Corporation

Thus far, the analysis has presented nothing ground-breaking. The recognition of the director as *not* a mere agent of the shareholder has been existent in more than two decades of research in management literature. The Board serves parties whose interests are co-extensive with the corporation. Thus, the corporate director is recognized to have duties to these stakeholders.

But what is ground-breaking is that this analysis has already been reflected in the means by which the law regulates certain corporate interests that are recognized by law not to be a sole affair between shareholders and other members of the corporate family, but as *intrinsically linked* to public welfare.

In the case of a corporation operating a common carrier, the carrier must exercise extraordinary diligence.[90] In the transportation of passengers, the bar is raised even higher – it is bound to carry its passengers safely as far as human care and foresight can provide, using the utmost diligence of a very cautious person, with due regard for all circumstances.[91] In fact, the law creates a presumption against the

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88. James H. Davis et. al., *Toward a Stewardship Theory of Management*, 22 ACAD. MGMT. REV. 20 (1997); L. Donaldson & J. Davis, *Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns*, 16 AUST. J. MGMT. 49 (1991); M.A. Fox & R.T. Hamilton, *Ownership and Diversification: Agency Theory or Stewardship Theory*, 31 J. MGMT. STUD. 69 (1994).

89. *Davis, et al.*, *supra* note 88, at 20.

90. CIVIL CODE, art. 1755.

91. Baliwag Transit, Inc. v. CA, 256 SCRA 746 (1996).

carrier, and it is his duty to rebut this presumption, failing which, the court shall find it liable.[92]

The banking business is even more stringently regulated. The State recognizes the vital role of banks providing an environment conducive to the sustained development of the national economy and therefore recognizes the fiduciary nature of banking that requires high standards of integrity and performance.[93]

Thus, in the case of a common carrier business and banking business, law and jurisprudence provide that the concept of the "business entity existing solely for the benefit of those who invested capital in it"[94] simply cannot stand. These businesses are vested with public interest and their operation is inextricably linked to the communities wherein it operates. Professor Sulpicio Guevarra posits that businesses affected with a public interest are only of three classes:

> 1. Those which are carried on under the authority of a public grant of privileges which either expressly or impliedly imposes the affirmative duty of rendering a public service;
>
> 2. Certain occupations regarded as exceptional, that public interest attaching to which, recognized from earliest times, has survived the period of arbitrary laws for regulating all trades and callings;
>
> 3. Businesses which though not public at their inception may be fairly said to have risen to be such and have become subject in consequence to some government regulation, having come to hold such a peculiar relation to the public that this is superimposed upon them.[95]

For the first class, Guevarra cites railroads and other common carriers and public utilities as examples; for the second, he cites keepers of inns,

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92. CIVIL CODE, art. 1733 ("Such extraordinary diligence in the vigilance over the goods is further expressed in arts. 1734, 1735, and 1745, Nos. 5, 6, and 7, while the extraordinary diligence for the safety of the passengers is further set forth in arts. 1755 and 1756.").

93. General Banking Act of 2000, Republic Act No. 8791, § 2 (2000).

94. Sulpicio Guevarra, *The Social Function of Private Corporations*, 34 PHIL. L.J. 464 (1959).

95. *Id.* at 466-67 (citing Wolf Co. v. Industrial Court, 262 U.S. 522 (1923)).

cabs, and gristmills.[96] Curiously, he cites no example for the third. Conventional understanding of Corporate Law principles is at odds with any law granting public character to the enterprise. The corporation is the property of the shareholder, so he is the only entity who may control it.

But a party has *complete property* in the thing only when the totality of interests, *i.e.*, rights, privileges, powers, and immunities, which it is legally possible to have with respect to a thing, reside in a party for a reason other than merely because he is a member of society. When a person has *complete property* in a thing, it is said that he is the owner of a thing.[97]

The owner of real estate undoubtedly has complete totality of interest over his real property. But the totality of interests over the corporation does not reside with the shareholder. While he possesses legal title over the corporation, the right to conduct business and to possess the property resides in the board of directors. In the same manner, the shareholder does not have totality of interest over the corporation, because unlike real estate, which is mostly idly used for residential purposes, corporations do business, employ workers, serve consumers, produce waste products, borrow from creditors, and use natural resources. The "real and obvious truth" about corporations is that once they do business in a community, they become at once members of that community, and acquire duties and obligations.[98] Guevarra observes that these duties and obligations are "not far different from the duties and obligations ordinarily expected of members in an organized, progressive, and progressing society."[99] Thus, American law has expressly authorized corporations to make donations to charity, discarding the traditional defense of shareholders that any benefit to entities other than themselves are *ultra vires* and impermissible.[100]

Philippine Corporate Law, in reaction to the slew of corporate controversies involving director malfeasance, has further recognized the interest that the public has in the way corporate directors manage the corporation.

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96. *Id.* at 467.

97. ROGER A. CUNNINGHAM ET AL., THE LAW ON PROPERTY 5 (1984).

98. Guevarra, *supra* note 94, at 468.

99. *Id.*

100. *Id.* at 470.

The Preamble of the Securities and Exchange Reorganization Act[101] lays down several of the government's policy towards corporations. The government encourages more active public participation in the affairs of private corporations and enterprises through which desirable activities may be pursued for the promotion of economic development,[102] and also seeks to promote a wider and more meaningful equitable distribution of wealth.[103]

Legal developments in the Philippines have gone beyond more than merely encouraging public participation and promoting the equitable distribution of wealth. The Code of Corporate Governance,[104] passed by the SEC very recently, raises the stakes of the corporation's accountability to the public, at least, in theory.

The banking industry has followed suit. In recognition of the fact that the banking industry is affected with public interest, the Monetary Board of the BSP promulgated a circular,[105] which states in unequivocal terms that, due to this public interest, a director assumes certain responsibilities to different constituencies or stakeholders.[106] Dean Villanueva writes that under this circular, the general principles of Corporate Law where the directors have no fiduciary obligation to corporate creditors who must rely on their contractual relations to stake a cause of action against the corporation bank has been *abrogated*. Now, the fiduciary obligations of the directors of banking institutions have expanded and now include practically the entire community in which it operates.[107]

In summary, despite the seeming legal and practical logic of profit maximization as the primordial end of corporate existence, modern

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101. Securities and Exchange Reorganization Act, Presidential Decree No. 902-A (1976).

102. *Id.* Preamble.

103. *Id.*

104. CODE OF CORPORATE GOVERNANCE.

105. Banko Sentral ng Pilipinas, Circular No. 283, Series of 2001 (May 17, 2001).

106. *Id.* § 2.

107. Villanueva, Bank Directors, *supra* note 45, at 11.

scholarship veers away from this notion as irresponsible and dangerous. Directors may further the ends of social responsibility in ways that will positively affect the profit bottom-line, not merely as a public relations tool. Indeed, the *Business Judgment Rule* exists in order to shield the director from court interference of his decisions and from liability for his honest mistakes. But this was granted not for his blind pursuit of profit but in order for him to devise the best means to run the business.

Traditional Corporate Law imposes no end on the corporation other than profit maximization. But recent events have shown how an orientation towards this end has damaged various sectors in society including employees, creditors, the environment and the community wherein, which the corporation operates. Although detrimental to society, these events seem to be legitimate exercise of owned property on the part of directors. Under traditional Roman law, property belongs to the owners, and it is theirs with which to build, profit, and even to destroy.

Constitutional provisions however recognize the folly in such thinking. Property has a public element and the government can have a hand in its use.[108] Corporations, being property, fall under this governmental regulation. The clearest recognition of this is the Code of

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108. *See* PHIL. CONST. art. XII, § 6 (The Constitution recognizes the public dimension of all property, thus it states that "*the use of property bears a social function*, and all economic agents *shall contribute to the common good*. Individuals and private groups, including *corporations*, cooperatives, and similar collective organizations, shall have the right to own, establish, and operate economic enterprises, subject to the duty of the State to promote distributive justice and to intervene when common good so demands.") (*emphasis supplied*). *See also* JOAQUIN G. BERNAS, THE 1987 CONSTITUTION OF THE REPUBLIC OF THE PHILIPPINES: A COMMENTARY 1028-29 (1996 ed.) (Constitutionalist Fr. Joaquin Bernas, S.J. states that this provision is a rejection of *laissez faire* and adopts the principle of solidarity. Thus, where needed for common good, the state may intervene in the operation, even of corporations.). *See* also PHIL. CONST. art. XIII, § 1 (The Constitution further provides the power of the State to intervene in affairs corporate; thus it states that "[t]he Congress shall give highest priority to the enactment of measures that protect and enhance the right of all the people to human dignity, reduce social, economic, and political inequalities, and remove cultural inequities by equitably diffusing wealth and political power for the common good. *To this end, the State shall regulate the acquisition, ownership, use, and disposition of property and its increments.*") (*emphasis supplied*).

Corporate Governance, which imposes strict duties on the chairman of the board, the board of directors, and individual directors.

The *public corporation* is thus a vehicle not only for profit maximization, since by virtue of its great capacity for destruction, owing to the capital under its control, it is vested with public interest. The role of the public corporation devolves to its directors, being the repository of control in corporate business. This inescapably leads to the conclusion that the director of the public corporation has a fiduciary duty not only to the corporation and shareholders, but also to third parties, a violation of which may expose the director to liability.

III. SCRUTINIZING CURRENT PHILIPPINE LEGISLATION ON CORPORATE GOVERNANCE: ACHIEVEMENTS AND SHORTCOMINGS

A. Prefatory Statements

> *"Fiduciary" is a vague term, and it has been pressed into service for a number of ends.... My view is that the term "fiduciary" is so vague that plaintiffs have been able to claim that fiduciary obligations have been breached when in fact the particular defendant was not a fiduciary* stricto sensu *but simply had withheld property from the plaintiff in an unconscionable manner.*[109]
>
> *- Donovan Waters*

The shift in the paradigm from strict profit maximization in favor of the shareholders to a recognition of increased accountabilities to the various constituencies of a corporation are best reflected in the codes of corporate governance passed by the BSP for the banking industry and the SEC for public corporations. These two entities are the embodiment of corporations, which are absolutely oriented towards earning profits for shareholders. The fact that these are the first two sectors that the State imposes duties of corporate governance on reflects the resoluteness and determination of the State in pursuing corporate reform and accountability.[110] This part of the Note analyzes

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109. BLACK'S LAW DICTIONARY, *supra* note 79, at 640 (citing DONOVAN W. WATERS, THE CONSTRUCTIVE TRUST 4 (1964)).

110. Interview with Cesar L. Villanueva, Dean, Ateneo Law School (May 23, 2003) [hereinafter Villanueva, May Interview].

how far these two pieces of legislation have gone and the problem that it has brought to decision makers in the board of directors.

B. The SEC's Code of Corporate Governance

The SEC passed the Code of Corporate Governance under its rule-making authority. Such rule-making power is recognized both by the Corporation Code and the Securities Regulation Code.[111] The Securities Regulation Code even seems to have granted SEC the discretion to override the prohibitory or mandatory rules of the Securities Regulation Code itself, and the power to suspend the application of the Corporation Code.[112] And rules duly promulgated by an administrative agency such as the SEC has the force and effect of law.[113]

The aims of the Code of Corporate Governance are laudable: to raise investor confidence, to develop capital market and to help achieve high-sustained growth for the corporate sector and the economy.[114] And the Code of Corporate Governance is applicable to the following corporations, collectively termed as *public corporations*:

1. Corporations whose securities are registered or listed;
2. Corporations which are grantees of permits/licenses and secondary franchise from the SEC;
3. Public companies, defined as any corporation with a class of equity securities listed in an Exchange or with assets in excess of Fifty Million Pesos (P50,000,000.00) and having two hundred (200) or more stockholders each holding at least one hundred (100) shares of a class of its securities;[115] and
4. Branches or subsidiaries of foreign corporations operating in the Philippines whose securities are registered or listed.

Despite the great power vested in the board of directors, the day-to-day operation of the corporation is usually vested, not with the

111. CORPORATION CODE, § 143; The Securities Regulation Code, Republic Act No. 8799, § 72 (2000).

112. Cesar L. Villanueva, Legal and Regulatory Issues for Directors of Public Corporations 15 (2002) (unpublished manuscript on file with Author) [hereinafter Villanueva, Directors of Public Corporations].

113. HECTOR DE LEON & HECTOR DE LEON, JR., ADMINISTRATIVE LAW: TEXT AND CASES 75-78 (2001) [hereinafter DE LEON & DE LEON].

114. CODE OF CORPORATE GOVERNANCE, Preamble.

115. *Id.* § I d.

directors, but with officers appointed by the directors, such as the president, the vice president, the treasurer, the secretary, and the general manager. Robert Clark observes that with respect to the broadest business policies, it is the officers who generally initiate and shape the decisions, and that the directors simply approve them, and occasionally offer advice or raise questions.[116] The board of directors typically meets only for their monthly directors' meetings and is unable to go through the merits of corporate business decisions thoroughly and they receive a flat yearly fee, which removes incentives for performing their duties diligently.[117]

The Code of Corporate Governance thus sets in broad strokes the precise duties of the directors in the corporation, at a time when its own vast powers, as vested by the Corporation Code,[118] have all but dissipated to the officers. The Code of Corporate Governance sets down the duty of *governance*,[119] which refers to the duty of *enhancing the value of the corporation*, and imposes this duty on the Board of Directors.[120] It further mandates that the board needs to be structured so that it provides an independent check on management. It then recognizes that it is vitally important that a number of board members be independent from management.[121]

Thus, the Code of Corporate Governance re-defines the accountabilities of the board of directors. When the board's decisions damage stakeholder interest, it can no longer hide behind the shareholders and the commitment to maximize profit, because the Code of Corporate Governance recognizes the duty of the board towards stakeholders. And by making a distinction between governance and management, directors have clear duties even when they are not involved in the actual day-to-day management of the corporation.

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116. CLARK, *supra* note 6, at 108.

117. *Id.* at 108-109.

118. CORPORATION CODE, § 23.

119. CODE OF CORPORATE GOVERNANCE, § I b (*emphasis supplied*).

120. *Id.* § II (*emphasis supplied*).

121. *Id.*

The Code of Corporate Governance defines *corporate governance* as 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.[122] To this end, it defines the duties, functions and responsibilities of directors:

> 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.[123]

As to the general responsibilities of corporate directors, the Code of Corporate Governance states:

> A director's office is one of trust and confidence. He should act in the best interest of the corporation in a manner characterized by transparency, accountability and fairness. He should exercise leadership, prudence and integrity in directing the corporation towards sustained progress over the long term. *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*.[124]

The specific duties of a director under the Code of Corporate Governance are:

1. To conduct fair business transactions and to ensure that personal interest does not bias Board decisions.[125]
2. To devote time and attention necessary to properly discharge his duties and responsibilities.[126]
3. To act judiciously. Before deciding on any matter brought before the Board of directors, every director should thoroughly evaluate the issues, ask questions and seek clarifications when necessary.[127]

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122. *Id.* § I b.

123. *Id.* § II (6).

124. CODE OF CORPORATE GOVERNANCE, § II (6) a (*emphasis supplied*).

125. *Id.* § II (6) c i.

126. *Id.* § II (6) c ii.

127. *Id.* § II (6) c iii.

4. To exercise independent judgment.[128]

5. To have a working knowledge of the statutory and regulatory requirements affecting the corporation.[129]

6. To observe confidentiality.[130]

7. To ensure the continuing soundness, effectiveness and adequacy of the company's control environment.[131]

The Code of Corporate Governance is invaluable in the recognition that corporations whose capital is of a certain amount have a public character and as a result, has certain accountabilities to a wider set of constituencies, rather than the shareholders alone. The Code of Corporate Governance is the unmistakable indication that the State has recognized this fact. This Code allows stakeholders the following claims:

1. The right to demand that the Board of Directors engage in their role of corporate governance,[132] where stakeholders, together with shareholders and creditors, "ensure that management enhances the value of the corporation as it competes in an increasingly global market place;"[133]

2. The right to expect that the institution is being run in a prudent and sound manner;[134]

3. The right to demand that the Board conduct itself with utmost honesty and integrity in the discharge of its duties, functions and responsibilities which includes the right to demand that there be a

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128. *Id.* § II (6) c iv.

129. CODE OF CORPORATE GOVERNANCE, § II (6) c v.

130. *Id.* § II (6) c vi.

131. *Id.* § II (6) c vii.

132. *Id.* § II.

133. *Id.* § I (1) b.

134. CODE OF CORPORATE GOVERNANCE, § II (6) a.

clear policy on communicating or relating with them accurately, effectively and sufficiently;[135]

4. The right to demand that there must be an accounting rendered to them regularly in order to serve their legitimate interests;[136]

5. The right to demand that the corporate secretary work and deal fairly and objectively with all the constituencies of the corporation, namely, the Board, management, stockholders and other stakeholders, and that he be someone whom his colleagues and these constituencies can turn to, trust and confide with on a regular basis;[137]

6. The right to demand that there be maintained a sound system of internal control to safeguard stakeholders' investment and the company's assets;[138] and

7. The right to demand that the Board commit at all times to full disclosure of material information dealings and that the Board cause the filing of all required information for the interest of the stakeholders.[139]

C. The BSP Circular 283 Series of 2001[140]

BSP Circular 283 (Circular 283) was passed by the BSP pursuant to its rule-making powers.[141] As such, Circular 283 constitutes *subsidiary legislation* and has the force of law.[142]

Circular 283 introduces amendments to the Manual of Regulations on the powers and authority of the board of directors. In these amendments, it appears that the Circular has apparently introduced, as

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135. *Id.* § II (6) b & b iv.

136. *Id.* § II (6) b iv.

137. *Id.* § II (10).

138. *Id.* § IV (1) d.

139. CODE OF CORPORATE GOVERNANCE, § VII.

140. Circular Providing Additional Sections to the Manual of Regulations on the Powers and Authority of the Board of Directors, Bangko Sentral ng Pilipinas, Circular No. 283, Series of 2001 (May 10, 2001) [hereinafter BSP Circular No. 283].

141. New Central Bank Act, Republic Act No. 7653, § 15 (a).

142. Villanueva, Bank Directors, *supra* note 45, at 1. *See also* DE LEON & DE LEON, *supra* note 113, at 75-78.

part of the Manual, the equivalent of the Code of Corporate Governance similar to that promulgated by the SEC. Circular 283 thus raises the stakes, perhaps to the highest level.[143]

As to the general responsibility of the board of directors, the Circular provides that, "[t]he position of a bank/quasi-bank/trust entity director is a position of trust."[144] This demonstrates the clarion call for a very high degree of corporate governance and warns of the dire consequences of ignoring such call.[145]

And similar to the Code of Corporate Governance, Circular 283 provides the increased constituencies of the Board of Directors of the banking corporation. The Circular states, "[a] director assumes certain responsibilities to different constituencies or stakeholders."[146] These stakeholders are: (1) the bank itself, (2) its shareholders, (3) its depositors, (4) its other creditors, (5) its management, (6) its employees, (7) and the public at large.[147] "These constituencies or stakeholders have the right to expect that the institution is being run in a prudent and sound manner."[148] The Circular unequivocally recognizes that the shareholder is merely one of the stakeholders of the corporation. Thus, the bank director cannot evade his fiduciary obligations to the specific stakeholders by hiding behind his obligations to the bank's shareholders.[149]

Circular 283 provides for the general responsibilities of the director:

1. The board of directors is primarily responsible for the corporate governance of the bank;

2. It must establish strategic objectives, policies and procedures that will guide and direct the activities of the bank;

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143. Villanueva, Bank Directors, *supra* note 45, at 1-2.

144. BSP Circular No. 283, § 2.

145. Villanueva, Bank Directors, *supra* note 45, at 1.

146. BSP Circular No. 283, § 2.

147. *Id.*

148. *Id.*

149. Villanueva, Bank Directors, *supra* note 45, at 12.

3. It must establish the mechanism for monitoring management's performance.[150]

The specific duties and responsibilities of the board of directors are:

1. To select and appoint officers who are qualified to administer the bank effectively and soundly;
2. To establish objectives and draw up a business strategy for achieving them;
3. To conduct the affairs of the institution with high degree of integrity;
4. To establish and ensure compliance with sound written policies;
5. To prescribe a clear assignment of responsibilities and decision-making authorities, incorporating a hierarchy of required approvals from individuals to the board of directors;
6. To effectively supervise the bank's affairs;
7. To monitor, assess and control the performance of management;
8. To adopt and maintain adequate risk management policy;
9. To constitute committees to manage certain areas of the business, namely, audit and nomination;
10. To meet regularly;
11. To keep the individual members of the board and the shareholders informed;
12. To ensure that the bank has beneficial influence on the economy;
13. To assess at least annually its performance and effectiveness as a body, as well as its various committees, the chief executive officer and the bank itself;
14. To keep their authority within the powers of the institution as prescribed in the articles of incorporation, charter, by-laws and in existing laws, rules and regulations.[151]

In addition, not only does Circular 283 provide for specific duties and responsibilities of the board of directors, it also provides for specific duties and responsibilities of a director.[152]

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150. BSP Circular No. 283, § 2 (paraphrasing supplied in Villanueva, Bank Directors, *supra* note 45, at 13).

151. *Id.* § 3 (*formatting supplied*).

Lastly, Circular 283 goes beyond the Code of Corporate Governance. Whereas the only penal provision in the Code of Corporate Governance is the imposition of a fine of P100,000.00 for failure to adopt a manual of corporate governance as specified therein,[153] Circular 283 directly penalizes corporate directors for violations or omissions of duties imposed on them therein.[154]

D. Implications of the Current Philippine Legislation on Corporate Social Responsibility

The Code of Corporate Governance and BSP Circular 283 expands the common law and statutory obligations of the board of directors and its officers, as well the parties and constituencies towards whom the director exercises fiduciary obligations to. To be sure, the fact that corporations may be vehicles by which goals other than profit maximization may be pursued is not novel. The Corporation Code, in providing for the formation of non-stock corporations, educational corporations, and religious corporations, recognizes that the corporation may indeed be an avenue for ends other than profit.

These corporations are the direct opposite of for-profit corporations, in that although there are *members* in a non-stock corporation, these corporations are proscribed from retaining profit for distribution to its members, and any profit that may be obtained as an incident to its operations shall be used for the furtherance of the purposes for which the corporation was organized.[155] The non-stock corporation can serve *only* the eleemosynary purposes[156] for which it was created, as an end in itself.

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152. *Id.* § 4.

153. CODE OF CORPORATE GOVERNANCE, § IX.

154. BSP Circular No. 283, § 6.

155. CORPORATION CODE, § 87.

156. *Id.* § 88 ("Non-stock corporations may be formed or organized for charitable, religious, educational, professional, cultural, recreational, fraternal, literary, scientific, social, civic service, or similar purposes, like trade, industry, agriculture and like chambers, or any combination thereof.").

In contrast, the for-profit corporation serves its shareholders by fulfilling the purpose clauses in its articles of incorporation as a means to an end – to obtain profit for its shareholders. This is not to say that such profit corporations do not have social responsibilities. But these are treated in other pieces of law, such as labor law, tort law, criminal law, environmental law, and tax law.[157] Under this set-up, so long as the corporation pays minimum wages, does not act in bad faith or contrary to penal laws and does not damage the environment, neither the courts nor any party may file a suit to challenge decisions of the board of directors. This is enshrined in the doctrine of the *Business Judgment Rule*.

But the SEC Code of Corporate Governance and the BSP Circular 283 have changed the rules of the game. Now, when corporate directors act, they do so not only in favor of shareholders; they now exercise fiduciary obligations in favor of increased constituencies under the aegis of *enhancing the value of the corporation*. What then, are the implications of this set-up?

1. Re-orientation of the Business Judgment Rule

Under current law, any action to enforce the board of directors' fiduciary duty will have to surmount the powerful shield of the *Business Judgment Rule*. The effect of this doctrine greatly tempers the liabilities that may arise on the part of the director as he goes about his duties. The *Business Judgment Rule* has two recognized applications:

1. Resolutions and transactions entered into by the Board of Directors within the powers of the corporation cannot be reversed by the courts not even at the behest of the stockholders of the corporation; and
2. Directors and officers acting within such business judgment cannot be held personally liable for the consequences of such acts.[158]

The only exceptions to the *Business Judgment Rule* are contained in the second branch of the rule, when the director can be held liable for certain acts. The court can never reverse resolutions entered into by the board, lest it create a contract between parties where there is none, thus violating the non-impairment of contracts clause of the Constitution. However, the director may be liable even when acting in favor of the business in the following instances:

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157. VILLANUEVA, CORPORATE LAW, *supra* note 6, at 892-93.

158. *Id.* at 284.

1. When the director willfully and knowingly votes for patently unlawful acts of the corporation;
2. When he is guilty of gross negligence or bad faith in directing the affairs of the corporation; and
3. When he acquires any personal or pecuniary interest in conflict with his duties as such directors.[159]

In *Tramat v. Court of Appeals*,[160] a director of a corporation was sought be held jointly and severally liable with the corporation for the damages arising from the sale of a defective tractor. The Court held that since he acted not in his personal capacity, but as an officer of a corporation and since the corporation has a distinct and separate personality, the officer acting in its behalf is free from liability. The Court held that personal liability of a corporate director along with (although not necessarily) the corporation may so validly attach, only when:

1. He assents (a) to a patently unlawful act of the corporation, or (b) for bad faith gross negligence in directing its affairs, or (c) for conflict of interest, resulting in damages to the corporation, its stockholders or other persons;
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; or
4. He is made, by a specific provision of law, to personally answer for his corporate action.[161]

But the *Business Judgment Rule* loses much of its vitality, when it is recognized that the director now answers not only to the shareholders but also to his other constituencies such as the employees, the community, and the creditors.

159. *Id.* at 285.

160. Tramat v. CA, 238 SCRA 14 (1994).

161. *Id.*

The first branch of the *Business Judgment Rule* is therefore severely diluted and watered down. Under the conventional application of the *Business Judgment Rule*, the courts are prohibited from interfering with the judgment even when the minority stockholders allege want of judgment or lack of efficiency in the administration of corporation affairs.[162] This is because the corporation was *then* treated as owing duties only to the shareholders, whose only demand was profit. The Supreme Court held in *Montelibano v. Bacolod-Murcia Milling Co., Inc.*,[163] that since 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 losses or decrease the profits of the central, the court has no authority to review them.[164] But the SEC Code of Corporate Governance and the BSP Circular 283 now consider the corporation as owing duties to increased constituencies called stakeholders. The test to prevent courts from interfering with corporate affairs that *the corporation acted within its powers* is no longer valid, because the Board can act within its powers and yet violate its duties to stakeholders. When the corporation violates stakeholder interest, courts may now exert their will on corporations because the test is now no longer the fact that the act was within corporate powers.

The second branch, on the other hand, has to be expanded in its application. The current application provides that in order for the directors to avoid personal liability for the consequences of their acts, he should have been acting within the bounds of his authority in pursuit of corporate goals and not in *bad faith*, which the Supreme Court has defined as acts which "import a dishonest purpose or some moral obliquity and conscious doing of wrong. It means a breach of a known duty through some motive or interest of ill-will, partaking of the nature of fraud."[165] In view of the increased constituencies of the director and officers, they must be able to avoid liability when they act in favor of the stakeholders of the corporation, even as against the stakeholders of the same corporation.

2. Confusion in Pursuing Duties Towards Stakeholders

Now that the director is called upon to serve various interests in his actions, he is caught in a quagmire. The parties toward whom he has

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162. Villanueva, Directors of Public Corporations, *supra* note 112, at 7.

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

164. *Id.*

165. Philippine Stock Exchange, Inc. v. CA, 181 SCRA 669 (1990).

fiduciary obligations have interests that are, more often than not, conflicting interests in particular corporate actions. Dr. Niceto Poblador writes, "As a consequence, the enterprise emerges as a zero-sum game, and the stakeholders are put in a confrontational relationship *vis-à-vis* one another. Lost is the idea that their concerns are mutually interrelated."[166]

In a world where the board of directors is mandated to maximize profit, there is no dilemma for directors in choosing between several paths of action, because a director merely has to select that which can bring more profits for the corporation. But the paradigms have shifted – unlike the standard of maximizing shareholder value, which provides the board of directors with a single objective, the "stakeholder theory directs corporate managers to serve 'many masters.'"[167] Ancient scripture has this to say: "No one can serve two masters. He will either hate one and love the other, or be devoted to one and despise the other."[168] Thus, if the standard to be used in measuring the performance of the board of directors is *how well he maximizes the value of each stakeholder of the corporation*, his office will be a sham, and he may very well run the corporation down in trying to satisfy each individual claim.

Thus, in order for the corporate director to fulfill his duties towards these stakeholders, a *hierarchy of values* must be established which will serve as a compass by which the board of directors can use in arbitrating stakeholder claims.

IV. THE STAKEHOLDER'S HIERARCHY OF CLAIMS

A. Prefatory Statements

166. Niceto Poblador, Stakeholdership, Corporate Responsibility, and the Ethics of Managerial Conduct 4-5 (unpublished manuscript, on file with Author).

167. Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APP. CORP. FIN. 3 (2001).

168. *Matthew 6:24*, The New American Bible (1991).

> *The task of management in today's corporation is akin to that of King Solomon.*[169]
>
> *- R. Edward Freeman*

The knowledge that parties other than shareholders exist which may claim against the corporation may lead one to think that companies may serve one, or the other, but not both, one only at the expense of the other, in a zero-sum game, "The workers can get paid more, or the shareholders can have a dividend. The state can have its tax bills paid, or the company can invest for the future. In other words, money cannot be spent twice…."[170]

But the daily operations of for-profit corporations, particularly *public corporations* in this case, and the mandates of corporate law, labor law, contract law, and environmental law, point out that corporate governance cannot be a zero-sum game where the satisfaction of one group of stakeholders is mutually exclusive. The board of directors is called upon to satisfy demands of various stakeholders *simultaneously*. Thus, it is important to identify the core of the claims and demands of the stakeholders against the corporation. Having identified what it is that the stakeholders demand from the corporation, a test has to be fashioned by which the claims of the stakeholders may be satisfied.

This is the heart of the analysis presented in this Note, and it is important in order for the duties of the director to be real and palpable. No one will argue the need for directors to act in an honest and prudent manner with regard to its expanded constituencies. But without a defined duty, there is no rational basis for action for the practicing manager and the concept of stakeholdership "may turn out to be more

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169. R. Freeman & W. Evan, *A Stakeholder Theory of Modern Corporation: Kantian Capitalism*, *in* ETHICAL THEORY AND BUSINESS (Beauchamp & Bowie eds., 1988).

170. Anne Simpson, *Shareholders and Stakeholders: The Tyranny of the Or*, Asia Corporate Governance Roundtable, Third Meeting, Singapore (Apr. 3, 2001).

> [A]nd at least one function of the corporate governance regime is to mediate between the competing claims different groups have on the corporation. In this vision of the board's role, the hapless directors spend their time making trade offs - caught between the demands of investors and employees, between the short term and the long term, between investing to protect the environment or communities and investing for growth.

of a catchy phraseology than a theory....”[171] This hierarchy will also be useful for the courts as they may look forward to litigations where stakeholders can raise the causes of action granted to them under the Code of Corporate Governance.

B. Identifying the Stakeholders

Various definitions of *stakeholder* have been posited. The major ones are:

- Those groups without whose support the organization would cease to exist.[172]
- Those who can affect the achievement of an organization’s objectives or who are affected by the achievement of an organization’s objective; those on which the organization is dependent for its continued survival.[173]
- Constituents who have a legitimate claim on the firm, established through the existence of an exchange relationship who supply the firm with critical resources and in exchange each expects its interests to be satisfied.[174]
- Parties who have some sort of risk as a result of having invested some form of capital, human or financial, something of value in a firm, or are placed at risk as a result of a firm’s activities.[175]
- Persons or groups with legitimate interests in procedural and/or substantive aspects of corporate activity.[176]

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171. *Id.* at 3.

172. *Donaldson & Preston*, *supra* note 71 (*citing* Stanford Memo).

173. Ronald K. Mitchelle et al., *Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts*, 22 ACAD. MGMT. REV. 853 (1997) (citing R.E. Freeman & D.L. Reed, *Stockholders and Stakeholders: A New Perspective on Corporate Governance*, 25(3) CAL. MGMT. REV. 93 (1983)).

174. *Id.* (citing C.W.L. Hill & T.M. Jones, *Stakeholder-Agency Theory*, 29(2) J. MGMT. STUD. 131 (1992)).

175. *Id.* (citing M.B.E. Clarkson, *A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance*, 20 ACAD. MGMT. REV. 92 (1995)).

Based on these definitions, the list of stakeholders in public corporations has been drawn to include customers, shareholders, employees, suppliers, creditors, the community, management, and the environment.[177] BSP Circular 283 gives a similar recognition to these parties as the corporation's stakeholders.[178] By virtue of their ties to the corporation, the duty of the directors on corporate governance is rightfully limited to them. Stakeholders are persons or groups who have, or claim, ownership, rights, or interests in a corporation and its activities, past, present, or future. Such claimed rights or interests are the results of transactions with, or actions taken by, the corporation, and may be legal or moral, individual or collective.[179]

Stakeholders can include an indefinitely large number of groups with some interest in corporate operations. But they can be divided into primary and secondary stakeholders.[180] A *primary stakeholder group* is one without whose continuing participation the corporation cannot survive as a going concern. Primary stakeholder groups are comprised of shareholders and investors, employees, management, together with what is defined as *public stakeholder group*: the governments and communities. There is a high level of interdependence between the corporation and its primary stakeholder groups.

Secondary stakeholder groups are defined as those who influence or affect, or are influenced or affected by, the corporation, but are not engaged in the transactions with the corporation and are not essential for its survival. The media and a wide range of special interest groups are considered as secondary stakeholders under this definition,[181]

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176. *Id.* (citing *Donaldson & Preston*, *supra* note 71).

177. KELLY, *supra* note 70, at 149.

178. BSP Circular No. 283, § 2.

> The position of a bank/quasi-bank/trust entity director is a position of trust. A director assumes certain responsibilities to different constituencies or stakeholders (*e.g. the bank/quasi-bank/trust entity itself, its stockholders, its depositors and other creditors, its management and employees, and the public at large*). These constituencies or stakeholders have the right to expect that the institution is being run in a prudent and sound manner.

179. *Clarkson*, *supra* note 175.

180. *Id. See also,* ANTHONY F. BUONO & LARY NICHOLS, CORPORATE POLICY, VALUES AND SOCIAL RESPONSIBILITY 5 (1985).

181. *Clarkson*, *supra* note 175.

including religious groups, suppliers, customers, competitors, even advocacy groups.[182] They have the capacity to mobilize public opinion in favor of or in opposition to a corporation's performance. But the corporation is not dependent for its survival on such group, even if such groups can cause significant damage to a corporation.[183]

The stakeholders that the call to corporate governance seek to protect should therefore properly include only those considered *primary stakeholders*, or those individuals and groups who are most directly affected by the activities of the firm, and who make some tangible contribution to its functioning,[184] because only these groups may claim against the corporation by virtue of their investment in the corporation. They are the following: shareholders, employees, creditors, communities and the management.

C. Characterizing the Claims of the Various Stakeholders

The identification of the stakeholders will immediately show that each stakeholder group has different claims, and these claims are disparate as they are conflicting. Shareholders demand dividends, employees and managers demand compensation, creditors demand interest and principal payments, and the community demands taxes. But identifying the *core* of all these demands shows that as disparate as the claims of these stakeholders are, they can all be satisfied by proceeding towards the direction of enhancing the value of the corporation.

The Code of Corporate Governance states that corporate governance "refers to 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."[185] This mandate of the SEC does not call upon corporations to assume broader social responsibility, that is, to build day-care centers for employees, to build schools and churches for the communities or to take responsibility to improve the peace and order

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182. HEIDI VERNON, BUSINESS AND SOCIETY: A MANAGERIAL APPROACH 87 (1988).

183. *Clarkson*, *supra* note 175.

184. BUONO & NICHOLS, *supra* note 180, at 5.

185. CODE OF CORPORATE GOVERNANCE, § I b.

situation in a locality. Its mandate is clear – managers and directors are mandated simply to *enhance the value of the corporation.*

BSP Circular 283 echoes this same provision. Banks are not called upon to be philanthropic or altruistic and to turn their backs against profit motives. The Circular states that a bank director assumes certain responsibilities to different constituencies or stakeholders and "…[t]hese constituencies or stakeholders have the right to expect that the institution is being run in a prudent and sound manner."[186]

It has been recognized in a seminal article by noted economist Milton Friedman that the only responsibility of a business is to increase its profits. Friedman would even consider this a *moral responsibility.*[187] This is a valid thesis, and he outlines several points in favor of this argument. Primarily, for the director to engage in philanthropic and altruistic acts would be a violation of the precepts of a principal-agent relationship. In the pursuit of some objective other than that mandated by shareholders, "[t]he corporate executive would be spending someone else's money for a general social interest."[188] Friedman recognizes that as an individual, the director may be motivated and may act on his own eleemosynary interests.

> But in these respects he is acting as a principal, not an agent; he is spending his own money or time or energy, not the money of his employers or the time or energy he has contracted to devote to their purposes. If these are 'social responsibilities,' they are the social responsibilities of individuals, not business.[189]

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186. BSP Circular No. 283, § 2.

> The board of directors is primarily responsible for the corporate governance of the bank/quasi-bank/trust entity. To ensure good governance of the bank/quasi-bank/trust entity, 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.

187. Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, NEW YORK TIMES, Sept. 13, 1970, *available at* http://www-rohan.sdsu.edu/faculty/dunnweb/rprnts.friedman.dunn.html [hereinafter Friedman, *The Social Responsibility of Business is to Increase its Profits*].

188. *Id.*

189. *Id.*

Furthermore, if the director pursues social objectives, he is "to be simultaneously legislator, executive and jurist and he becomes in effect a public employee, a civil servant, even though he remains in name an employee of a private enterprise. The doctrine of 'social responsibility' taken seriously would extend the scope of the political mechanism to every human activity."[190]

The mandate of corporate governance deals with the existence of a corporation as a business enterprise. Dean Villanueva explains that in the corporate setting, there are three levels of existence. First, the corporation is a creature of the State, possessing only such powers as are provided by the State. Second is the corporation as a nexus of contracts, between the corporation and its agents, its shareholders, and outsiders such as employees, creditors and its customers. Third is the corporation as a business enterprise, or an entity that exists in order to obtain profit.[191]

The SEC Code of Corporate Governance and the BSP Circular do not require the corporation to follow the law or prohibit the director from transgressing the law in serving stakeholder interest. This is because complying with the law is in the first level of the existence of a corporation, as a creature of the law. There has never been any argument that directors may not subvert the law to perform their functions in the corporation.

Neither do the SEC Code or the BSP Circular mandate the corporation and its directors to honor the contracts that it enters into. Contracts have the force of law between the corporation and the parties with which it contracts. The corporation is free to enter into contracts so long as they do not contravene the law, morals, good custom, public order and public policy.

The concern of the SEC Code and the BSP Circular is only in the corporation as a money-making venture or the business enterprise. They recognize that shareholders are not the only parties who have made investments in the corporation, and that other parties have made investments in the corporation also, and so requires the corporation to be accountable towards them. But the claim allowed to stakeholders is

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190. *Id.*

191. VILLANUEVA, CORPORATE LAW, *supra* note 6, at 15.

limited. In the SEC Code of Corporate Governance, they can only look to the directors to enhance corporate value. In the BSP Circular, the stakeholders can only demand that the bank be run in a prudent and sound manner, and for the directors to establish strategic objectives to guide the bank. It appears that the mandate to directors and corporations are limited to merely attaining financial goals for these stakeholders, hence enhancing corporate value and running the enterprise in a prudent and sound manner. *Is this sufficient for the stakeholders' interests?*

Corporate governance deals with the corporation primarily as a business enterprise. The claims of the stakeholders are directed to the business enterprise of the corporation as a going concern. The demands of employees, management, creditors and the community are not satisfied when the corporation makes charitable donations, or builds good corporate goodwill. It is satisfied when the corporation exists profitably, because the common interest of stakeholders is in the financial well-being of the corporation. Under this proper understanding of the claims of the various stakeholders, the corporation is mandated to satisfy their claims not out of a sense of altruism nor by considerations of selfish gain in terms of publicity or because to satisfy stakeholder claims is profitable for the business. The corporation has to satisfy the claims of stakeholders precisely because they hold stakes in the corporation.

Stake is defined as money or something valuable risked on the result of a game, race, or cast or die, or on any chance.[192] *To hold a stake on a thing* means that one has invested something into a venture, and such capital may be entirely lost based on the results of such venture. In the *stakeholder theory*, because of the possibility that the one holding the stake may lose what he has invested, he has the power to influence the results of the operation. The duty is not voluntary, but it arises out of the fact that parties who have invested something into the corporation have a corresponding right to make certain demands on the corporation.[193]

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192. 2 THE WORLD BOOK DICTIONARY 2039 (Clarence L. Barnhard & Robert K. Barnhart eds., 1988).

193. *Clarkson*, *supra* note 175.

> If any primary stakeholder group…becomes dissatisfied and withdraws from the corporation system, in whole or in part, the corporation will be seriously damaged or unable to continue as a going concern. [The failures of Dow Corning, A. H. Robbins, and AT&T can be attributed to] the disruption of their stakeholder

D. The Test to Determine the Hierarchy

Determining the order by which the board of directors should satisfy the competing claims of the stakeholders to the corporate business enterprise requires a means to impose a priority. It has been previously discussed that stakeholders can make claims against the corporations because they have made investments in the corporation. The stakeholders that will be dealt with are the shareholders, employees, management, creditors and the community of the corporation. In order to do justice to the claims of these stakeholders, the test must involve ascertaining what it is that these stakeholders have invested into the corporation, determining the value or the cost of these contributions in terms of how it helps the corporation to function as a business enterprise, and with this valuation, determine the place which each respective stakeholder will have in the hierarchy of the corporate directors.

In brief, the hierarchy should be determined by finding out which party has made the *greater* investments in the corporation, because these parties should be in a position to reap the greater portion of the profits that arise in the corporation. This is an accepted consequence in law, as observed in civil law and commercial law.

Under property law, the provisions on co-ownership, where the ownership of an undivided thing or right belongs to different persons, the share of the co-owners, in the benefits as well as the charges, shall be proportional to their respective interests. Any stipulation to the

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> systems and the *ensuing bankruptcies were the consequences of their inability to manage satisfactorily their relationships with primary stakeholder groups.* From this corporation itself can be defined as a system of primary stakeholder groups, a complex set of relationships between and among interest groups with different rights, objectives, expectations, and responsibilities. The corporation's survival and continuing success depend upon the ability of its managers to create sufficient wealth, value or satisfaction for those who belong to each stakeholder group, so that each group continues as a part of the corporation's stakeholder system. Failure to retain the participation of a primary stakeholder group will result in the failure of that corporate system.

contrary shall be deemed void.[194] In this particular instance, the law does not merely provide a default rule, which may be rendered inoperative by the stipulation of the parties. The law has specifically provided that in a co-ownership, the parties may not share the gains or losses in the co-owned property except in accordance to the proportional basis of their ownership. Similarly, resolutions of the majority of the co-owners are required for decisions on the administration of the property owned in common, and majority pertained to the vote of such number of co-owners as representing the controlling interest in the object of the co-ownership.[195] The provisions on co-ownership reflect an area in law where the law recognizes the primacy of those who have greater involvement or interest in a particular transaction.

Under the law on sales, any risk or benefit attaches to the owner of the subject matter of the sale. Therefore, as to the deterioration, fruits and improvements of the good subject of the sale, the goods remain at the seller's risk until the ownership is transferred to the buyer. But when the ownership is transferred to the buyer, they are at the latter's risk whether actual delivery of the goods has been made or not.[196]

There are several examples found in commercial law as well. Under Corporate Law, certain classes of shares may be classified as preferred. The Corporation Code provides that no share may be deprived of voting rights except these preferred shares. But shareholders holding preferred shares may be given preference in the distribution of the assets of the corporation in case of liquidation and in the distribution of dividends, provided that the preference appears in the corporation's articles of incorporation.[197] This envisions a scenario where a corporation needs funds from an investor but requires the freedom to proceed with its business, which is present in a loan. Preferred shareholders are thus a hybrid between the common shareholder and the creditor. This class of shareholder invests both funds and the risk of not being able to control corporate affairs. In exchange, it obtains first priority in the distribution of assets or dividends.

Another example found in Corporate Law where more is given to the parties who have greater claims in the enterprise is in voting rights. During the instances where the votes of the shareholders are required,

194. CIVIL CODE, art. 485.

195. *Id.* art. 492.

196. CESAR L. VILLANUEVA, PHILIPPINE LAW ON SALES 168 (1998 ed.).

197. CORPORATION CODE, § 6.

shareholders who have amassed a greater bloc of shares may hold great control over the outcome of the votes. In the election of the members of the board of directors, the total votes, which may be cast by the directors, shall be the number of shares owned by each shareholder multiplied by the whole number of directors to be held.[198] Appropriately, the same provision provides that no delinquent share shall be voted on.[199] Further, in cases, which require varying percentages of shareholder vote, it is always the course of action endorsed by the group of shareholders representing the greater number of shares, which will be pursued.

Another field in commercial law, which reflects the policy that those who have greater pecuniary investment stand to obtain more benefits is in Negotiable Instruments Law. In this field of law, a holder in due course of a negotiable instrument holds the instrument free from: any defect of title of prior parties, and defenses available to prior parties among themselves; and he may enforce payment of the instrument for the full amount thereof against all parties liable thereon.[200] But when the instrument is in the hands of any holder other than a holder in due course, the negotiable instrument is subject to the same defenses as if it were non-negotiable.[201] Therefore, a holder not in due course will be subject to personal defenses, that is, defenses belonging personally to one of the parties in the negotiation of the instrument, such as absence or failure of consideration, want of delivery of a complete instrument, fraud in inducement, mistake, and the fact that the negotiation was done in breach of faith.[202] And one of the most important considerations in determining whether one is a holder in due course is when the holder took the instrument for value.[203]

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198. *Id.* § 24.

199. *Id.*

200. The Negotiable Instruments Law, Commonwealth Act No. 2031 [NEGOTIABLE INSTRUMENTS LAW], § 57 (1911).

201. *Id.* § 58.

202. AGUEDO F. AGBAYANI, I COMMENTARIES AND JURISPRUDENCE ON THE COMMERCIAL LAWS OF THE PHILIPPINES 298-304 (1992 ed.).

203. NEGOTIABLE INSTRUMENTS LAW, § 52.

This survey of civil and commercial law demonstrates that the test of giving *greater priority* to those who have invested more in a venture and correspondingly have more to lose should the venture fail, is accepted and commonplace in law. The fact that the claims and demands of the parties who have lesser investment in the venture will not be satisfied is not immoral or malevolent because it would be unjustified to try to satisfy the claims of all who make such demands upon an entity. To do so would ignore the apparent disparity in the risks staked in a venture and offends the equal protection that should be accorded to all parties by failing to make a distinction where it is proper to do so.

E. Identification of the Stakeholder's Investment in the Corporation

This section of the Note will simultaneously identify the contribution of each stakeholder in the corporation and then place a value on such contribution. These contributions and investments will then be weighed based on their ability to influence the return on investments of the corporation. This is because in economic terms, stakeholders possess power only if their resources influence the elements of return on investment.[204]

Using the precept that stakeholders possess more power depending on how their investments influence the elements of return on investment,[205] an analysis of *return on investment*[206] is required. The

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204. VERNON, *supra* note 182, at 105 (citing MICHAEL E. PORTER, COMPETITIVE ADVANTAGE 5 (1985)).

205. *Id.*

206. Return on investment, is a calculation used in business to determine whether a proposed investment is wise, and how well it will repay the investor. It is calculated as the ratio of the amount gained (taken as positive), or lost (taken as negative), relative to the basis. The formula for the return on investment is:

$$\text{Return on Investment (ROI)} = \frac{\text{Operating Income}}{\text{Total Assets}}$$

The *Dupont formula approach*, from the original format supplied by the management at the Du Pont Corporation, is useful for breaking down ROI into margin and turnover is well-known and well-utilized. Under the Dupont expansion of the ROI, the formula is as follows:

$$\text{ROI} = \frac{\text{Operating Income}}{\text{Sales}} \text{ X } \frac{\text{Sales}}{\text{Total Assets}}$$

value of each stakeholder will be judged on the effect of the departure or non-existence of such stakeholder on the corporation's return on investment, which is composed of the following elements, in a corporation's financial statements:

$$\text{ROI} = \frac{\text{Operating Income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Total Assets}}$$

The study that follows creates a mock corporation, whose stakeholders are weighed against each other. Certain assumptions have been made in this mock corporation. First, the mock corporation is assumed to be a traditional corporation wherein the shareholders have made the largest financial investments, and where creditors have been resorted to in order to fund comparatively small ventures that the corporation is undertaking. Second, the corporation is assumed to be self-sufficient, such that it sources its own raw materials. This is not always the case. For instance, a manufacturing corporation may have other stakeholders such as its suppliers, and a service corporation, its utilities suppliers. For reasons that will be explained later, the hierarchy of stakeholders (and the stakeholders themselves), may change according to the unique circumstances of each company.

1. Shareholders

Understanding the contributions and investments of the shareholders will require delving deeper than the obvious, which is, that the shareholders are the founders of the corporate business enterprise, having supplied the capital by which the organization and operation of the business was spurred.

In this case, economist Adam Smith brings the analysis to the individual man. When a man possesses no more than what is sufficient to maintain himself for a few days or a few weeks, he seldom thinks of deriving revenue from it:

> He consumes it as sparingly as he can, and endeavors by his labor to acquire something which may supply its place before it be consumed altogether. His revenue is, in this case, derived from his labor only. This is the state of greater part of the laboring poor in all countries.[207]

207. ADAM SMITH, THE WEALTH OF NATIONS 302-304 (Edwin Cannan ed., 2000).

Therefore, it is important for such amount of stock to be amassed that man will be able to satisfy his immediate consumption needs in order for him to be able to acquire revenue from the remaining capital. Shareholders provide this needed storage of capital in order to spur economic production.

After this, the accumulation of capital is needed in carrying on the improvement in the productive powers of labor.[208]

Thus, if the shareholders had not chosen to invest in the corporate business enterprise, the assets of the corporation would be non-existent, and there would be no return on investment whatsoever to speak of. The shareholders, therefore, have a very large impact on the return on investment of the corporation.

2. Employees

Employees are entitled to salaries in compensation for the services they render to the corporation. Smith points out that this is not the original state of things, since in that time which preceded the appropriation of land and accumulation of stock, the whole produce of labor belongs to the laborer.[209] He says that the produce of almost all labor is liable to the deduction of profit.[210]

There is thus a disparity between pecuniary wages that labor or employees receive and the income earned by the corporation. As

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208. *Id.* at 300.

> As the accumulation of stock must, in the nature of things, be previous to the division of labor, so labor can be more and more subdivided in proportion only as stock is previously more and more accumulated. The quantity of materials which the same number of people can work up, increases in a great proportion as labor comes to be more and more subdivided subdivided; and as the operations of each workman are gradually reduced to a greater degree of simplicity, a variety of new machines come to be invested for facilitating and abridging those operations.

209. *Id.* at 73.

210. *Id.* at 74-75.

> In all arts and manufactures the greater part of the workmen stand in need of a master to advance them the materials of their work, and their wages and maintenance till it be completed. He shares in the produce of their labor, or in the value, which it adds to the materials upon which, it is bestowed; and in this share consists his profit.

corporations increase in their income, there will be a corresponding increase in the wages of employees, if only to keep continued employment attractive to its employees. This disparity between the wages of the employees and the income of the corporation is the *profit* of the corporation.

But the tangible products of the labor of employees are not their only contribution. In the world where corporations survive by serving customer needs better than its competitors, it needs to constantly innovate. These ideas, translated into the copyright, industrial designs, and patents, which, corporations exploit, are likewise produced by employees. These intangibles include not only discounted future value, patents, and reputation but also "a company's knowledge base, its *living presence.*"[211]

Kelly raises the question: "What is a corporation worth without its employees?" She cites an interesting example:

> This question was acted out…when the owners of [a corporation] decided to sell the company…which meant layoffs were looming, and [the employees] wanted none of it. [They] decided to rebel. They phoned clients and found them happy to join the rebellion. And so at one blow, the employees and clients were leaving.
>
> Thus arose a fascinating question: What exactly did the "owners" of the office now own? A few desks and files? Without employees and clients, what was the London branch worth? *One dollar, it turned out. That was the purchase price…*[212]

Employees thus give the corporation its talent and energy, which can never be compensated by ordinary remuneration.[213] Thus, in *Madrigal & Co., Inc. v. Zamora*,[214] the corporation engaged in capital reduction, allegedly, because of the desire of the shareholders to phase out the operations of the company due to lack of business incentives and prospects, and in order to prevent further losses. With this, it

211. KELLY, *supra* note 70, at 46 (*emphasis supplied*).

212. *Id.* at 49 (*emphasis supplied*).

213. Interview with Cesar L. Villanueva, Dean, Ateneo Law School (June 19, 2003).

214. Madrigal & Co., Inc. v. Zamora, 151 SCRA 355 (1987).

applied for clearance to retrench its employees. The Court did not countenance this claim. It found that the reduction in capital stock was just a mask for the purge of union members, who, by then, had agitated for wage increases: "They were nothing but a premature and plain distribution of corporate assets to obviate a just sharing to labor of the vast profits obtained by its joint efforts with capital through the years. Surely, we can neither countenance nor condone this. It is an unfair labor practice."[215] Therefore, the security of tenure clause has been explicitly recognized as greater than the *Business Judgment Rule*.

Thus, if the contribution of the employees were totally withdrawn, a significant portion of the corporation's assets would be absent arising from the recognition that the employees are the corporation's living presence.[216] The corporation's operating income would likewise be lessened. Corporate profit is derived precisely from what is given up by laborers and employees from his supposed produce in favor of the employer corporation.[217] Therefore, since the operating income and the total assets of the corporation are elements of the return on investment,[218] the employee affects both these elements, which comprise the return on investment.

3. Creditors

A creditor, usually a bank or other financing institution, lends financial resources to the business in exchange for onerous consideration. This comes in the form of the payment of interest, and by property against which the transaction is secured. But Adam Smith gives one an alternate perspective from which to view the loan, which allows one to fully appreciate what the creditors, as stakeholders, provide to the firm.

Smith writes that the creditor always considers the stock, which is lent at interest, as capital. But what the corporate borrower really wants, and what the creditor really supplies him with, is *not the money, but the money's worth, or the goods, which it can purchase.*[219] As it were, "[b]y means of the loan, the lender…assigns to the borrower his right to

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215. *Id.* at 368.

216. KELLY, *supra* note 70, at 46.

217. SMITH, *supra* note 207, at 74.

218. ARTHUR J. KEOWN ET AL., BASIC FINANCIAL MANAGEMENT 99 (1998).

219. SMITH, *supra* note 207, at 381-82 (*emphasis supplied*).

a certain portion of the annual produce of the land and labor of the country, to be employed as the borrower pleases."[220]

Thus, although the creditor is, theoretically, a mere alternative source of financial resources for the corporation, the resources which the creditor furnishes is not any less in utility than that supplied by the shareholders. The loan is but the *deed of assignment* which conveys from one hand to another the capital which its owners, the creditors, do not care to employ themselves. Understood in this sense, what the creditors assign to the borrower is not merely fund or capital, but the power to make purchases, or more generally, the power to run the corporate business enterprise.[221] In assigning the capital to the corporation, the creditor forfeits its own right to acquire a share in the annual produce: "A capital lend at interest may, in this manner, be considered as an assignment from the lender to the borrower of a certain considerable portion of the annual produce…."[222]

In this analysis, since these assets are used by the corporation to finance its operations, the cash loaned by the creditor to the corporate debtor is treated, by fiction of this analysis, as part of the corporation's assets. The asset of the corporation is one of the elements in the return on investments of the corporation. Therefore, should a creditor be non-existent or should he withdraw his participation in the corporate business enterprise, the only effect would be to lessen the total assets that can be used by the corporation to finance its operations.

4. Communities

The local government unit (LGU) where the corporation functions makes several contributions to the corporate business enterprise which may or may not be quantified in financial terms.

The communities where the businesses operate grant the corporation the permission to operate within its territory. Along with this, the community grants the corporation the use of the infrastructure and services already present in the community such as its road and

220. *Id.* at 382.

221. *Id.* at 382-84.

222. *Id.* at 383.

bridges, the maintenance of peace and order within the community, transport and traffic management, flood control and sewerage management, health and sanitation, urban protection, and pollution control, and public safety.

In cases where the corporation utilizes the resources of a community such as mining companies, the community likewise provides the corporation the natural resources to obtain profit. Although it may be argued that under the *Regalian Doctrine*,[223] all wealth belongs to the national government and the local community holds no stake in the natural resources, the Constitution recognizes that the local community is entitled to an equitable share in the proceeds of the utilization and development of the national wealth within their respective areas.[224] This is an unmistakable recognition by the Constitution of the stake of local communities in operations which use the resources within their territory.

The corporation, which engages in manufacturing, will also have waste products. These waste products, whether they are first neutralized and rendered harmless, are deposited in certain local communities. This allows the corporation to internalize all possible gains from the community, and to externalize all possible costs onto the community.[225]

The community may likewise provide the corporation with tax incentives or abatements and provide it with subsidies, contracts, and franchises in order to ensure the profitability of the corporation.[226]

It is apparent therefore, that apart from the instance where the local community provides the corporation with its natural resources as raw materials for its production, the only element that the community affects in the corporation's return on investment is the corporation's operating income – in the form of expenses. Without a community to provide for the services, which are considered governmental, the corporation would have to incur increased expenses in order to perform the governmental functions by itself. As to the local community, which provides the corporation with natural resources, the natural resources may be considered replaceable, and unequal in status with what is contributed and invested by the creditors. Whereas the

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223. *See* PHIL. CONST. art. XII, § 2.

224. PHIL. CONST. art. X, § 7.

225. KELLY, *supra* note 70, at 26.

226. *Id.* at 124.

creditors provide the power to enter into transactions and this delegated power is given with an ever-present risk of the corporate debtor's default, the natural resources of the local community contributed to the enterprise is done so for the development of the community itself. Therefore, it may be considered as capable of substitution or exchange.

5. Managers

The directors and officers of the corporation are statutorily mandated to control and hold the property, and to conduct the business of the corporation. This allows for the centralized management of the corporation. The board of directors contributes immensely to the corporation by virtue of his expertise and dedication in managing the corporate business enterprise. Capitalists with large amounts of funds but with no knowledge on how to go about running a business can invest in a corporation and the boards become responsible to maximize the shareholder value. The board of directors also contributes by lowering transaction costs for the corporation. Since the control of the corporation is held in only one body, third parties need not negotiate with all of the corporation's shareholders. Third parties can negotiate with the board alone, and its decision binds the corporation. Officers may be treated distinctly from the directors of such corporation, because the nature of the duty of the officers is similar to the employees. It is common for certain corporate officers to be recruited and treated as highly prized assets because of their skills.

The contribution of the directors and officers are two-fold. First, they contribute organizational skills in directing the corporation as an enterprise and in negotiating with the third parties with whom the corporation deals with. These skills are valuable to the corporation because it lowers transaction costs for the corporation as it deals with third parties, contributing by lowering the costs for such. Second, and similar to employees, they contribute to the corporation in the same way as employees do, and are assets of the corporation.

F. The Hierarchy of Stakeholders

Since the claims of the shareholders, employees, creditors and the community arise from the fact of their having invested or risked into the corporate business enterprise, the greater their contribution or investment in the corporation, the higher they rank in the hierarchy.

The following hierarchy is proposed:

1. Shareholders
2. Employees
3. Creditors
4. Local Community
5. Managers

The duty of the board of directors to the shareholders is the greatest. When the corporate director enhances corporate value, the most immediate cause is the initial investment of the shareholders, and they are likewise the most immediate beneficiaries, in terms of dividends and the market prices of the shares as traded in the market. The shareholder also enjoys the most number of claims against the corporation and its board of directors under the Corporation Code, being able to command the directors to comply with the duties of obedience, diligence and loyalty.[227] Also, under the *Porter Test* of the stakeholders' ability to influence the elements of the return on investment as determinative of his power to make claims on the corporation, the shareholders figure the greatest. The absence of shareholders means the total absence of any investments. Without investments, returns would be impossible to obtain.

The employees come next in the accountability. Employees are part of the corporation in its operations. They contribute greatly to the sustainability of the corporation as a business enterprise. This is evident from the priority granted to employees in the concurrence and preference of credits of an insolvent corporation.[228] The power of the employees to influence the corporation is not as strong as that which is exercised by the shareholder. The corporation may very well replace a major part of employees with machines, which will perform their mechanical functions. But the framework of Kelly suggests that employees are not mere outsiders of the corporation, as they are themselves assets of the corporation.[229] As such, they must be treated

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227. Villanueva, May Interview, *supra* note 110.

228. A Decree Instituting a Labor Code, Thereby Revising and Consolidating Labor and Social Laws to Afford Protection to Labor, Promote Employment and Human Resources Development and Inure Industrial Peace Based on Social Justice [LABOR CODE], Presidential Decree No. 442, art. 110 (1974).

229. KELLY, *supra* note 70, at 46-47.

as insiders, as full-fledged members of the corporate business enterprise, with a claim on profits, in the form of profit bonuses. Even if the Constitution limits their participation in corporate affairs to issues which those which directly affect them,[230] and does not grant labor membership in boards, it guarantees labor participation in arriving at those decisions which affect their rights and benefits, through grievance procedures, collective bargaining and negotiations.[231] The principle of shared responsibility referred to in the third paragraph pertains only to the mutual compliance to foster industrial peace.[232]

Employees are able to affect both the elements of margin and turnover in the return on investment of the corporation, and this reflects that their participation in the corporation is even greater than that of the corporate shareholders. But it is the shareholders who place the greater risk in the business enterprise. Therefore, their position is higher than employees. However, because of the high level of involvement of employees in the enterprise, they rank next right after the shareholders.

Next are the corporation's creditors. The participation of creditors in the corporate business enterprise is as limited as the shareholders. Whereas the power of the latter is strictly limited by virtue of the Corporation Code, which states that all business is conducted by the board of directors and not the shareholders, the former's rights are strictly circumscribed by the contract of loan it enters into with the corporation. The contribution of shareholders and creditors is similar – financial resources. In certain cases, the business of the corporation may be sustained solely by the proceeds it obtains from the loan. However, the capital contribution of the shareholders spurs the creation of the business enterprise. The financial resources provided by creditors are merely additional funding, not something necessary to bring the business enterprise into existence. As the corporation leverages on outside financial resources in order to expand and sustain corporate activities, the creditors are entitled to the corporate assets as

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230. PHIL. CONST. art XIII, § 3.

231. BERNAS, *supra* note 108, at 1064.

232. CESARIO A. AZUCENA, LABOR CODE: COMMENTS AND CASES 12 (1999 ed.).

a trust fund in the event that the corporation incurs more debts than it is able to do so.

The claims of the local community rank come next in the hierarchy of accountabilities. The community's contribution to the corporation affects only one element in the corporation's return on investment, and that is in the form of expenses, which will increase should the community not provide certain governmental services.

The claims of management, directors, and officers of the corporation rank last in the hierarchy. The contribution of management to the business enterprise is definitely greater than that of the local community, and may even be greater than that of the employees and creditors. It is the director and the manager who brokers the transactions for the corporations, and the corporation acts through them. But the director's interests on the corporation are strictly circumscribed by law – by his duties of loyalty. As an agent of the corporate stakeholders, he cannot take profit for himself, for he would then be violating the fundamental principles in the Law on Agency,[233] as the law penalizes the agent who prefers his own interest, should a conflict arise between his interests and those of his principal.[234] Therefore, the director may not acquire any interest adverse to the corporation in respect of any matter, which has been reposed in him in confidence.[235] Management, by virtue of their contribution to the corporate business enterprise, is entitled to certain claims in the corporation. The law severely restricts the nature of his claims on the corporation by virtue of his duty of loyalty towards the stakeholders. However, while he cannot act in order to entrench himself in his position as director, his claims as an employee entitled to compensation, and as a shareholder entitled to dividends, are protected.

This hierarchy of duties of the board of directors is not an exclusive enumeration of the duties of the board of directors. Statutory law and common law provide various duties of the board of directors to these stakeholders. These obligations arising from labor law, contract law, and environmental law are distinct from the obligations of banks and public corporations mandated by the SEC Code of Corporate Governance and the BSP Circular.

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233. Interview with Cesar L. Villanueva, Dean, Ateneo Law School (Aug. 25, 2003).

234. CIVIL CODE, art. 1889.

235. CORPORATION CODE, § 31.

This seemingly cold and calculating standard must be complied with by the board of directors in their actions with a mode of conduct that can be described as *arbitrating*, rather than deciding. Thus, the directors must act in an informed, transparent, independent, and informed manner in order to avoid liability against stakeholders.

H. Limitations of the Hierarchy

The hierarchy provided above is based on the principle earlier enunciated: that those who have greater pecuniary investment stand to obtain more benefits. Truly, this statement is the heart of the proposed hierarchy, and with this guiding principle, a hierarchy may be fashioned for a corporation's unique circumstances.

For instance, a hierarchy of the stakeholders of a corporation whose very ability to continue as a going concern is subject to the mercy of creditors, as in corporations who need to undergo rehabilitation and in the meantime suspend payments to creditors, may possibly have creditors ranking higher than its shareholders in the hierarchy. There is implicit recognition of this in the Interim Rules of Procedure Governing Intra-Corporate Controversies,[236] which provides for the appointment of a management committee for a corporation undergoing rehabilitation.[237] This is a departure from the Interim Rules on Corporate Rehabilitation,[238] which seemed to recognize only the appointment of a rehabilitation receiver.[239] The provision allowing the creation of a management committee is important because it recognizes creditor participation in the rehabilitation of a corporation, as creditors are supposed to be represented in such management committee.

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236. Interim Rules of Procedure Governing Intra-Corporate Controversies, Administrative Matter No. 01-2-04-SC (Mar. 13, 2001).

237. *Id.* rule 9, § 1.

238. Interim Rules on Corporate Rehabilitation, Administrative Matter No. 008-10-SC (Nov. 21, 2000).

239. *Id.* rule 4, § 2 j, § 4, § 6, § 7, § 9.

Thus, the hierarchy presented above is illustrative of the core guiding principle and is not meant to be an inflexible standard, which will apply for all public corporations and their stakeholders.

V. TESTING THE FEASIBILITY OF THE PROPOSED HIERARCHY

A. Prefatory Statements

> *The problem…with mixing off the principle-base and the rule-base systems is that accountability may in fact become difficult to enforce…It may give Boards collectively, and directors, individually, the notion that by closely adhering to the letter of the Code of Corporate Governance, then they are "doing good Corporate Governance," leaving wholly the "moving spirit" behind good Corporate Governance.*[240]
>
> *- Dean Cesar L. Villanueva*

As mandated by the Code of Corporate Governance of the SEC and BSP Circular 283, SEC Commissioner Lilia Bautista disclosed that 98% of listed corporations have passed their good corporate governance manuals, while 86% from financing companies have done the same.[241] If this is taken as an indication that corporate boards of directors recognize, in its daily undertakings, that in maximizing profit, it should recognize its accountabilities to stakeholders as well, then the figures cited are inspiring.

However, while the SEC Code of Corporate Governance and the BSP Circular break ground in mandating a recognition by the boards of the stakeholders and goes on to list specific duties of the board, of the president of the board and of individual directors, these duties are limited to what the corporation owes the shareholders. Bautista reports the government's advocacy for good corporate governance lies in the core of the reforms that the SEC continues to implement for enhancing investor confidence and promoting the development of the capital market.[242] Thus, although the provisions of the Code on accountability of the directors to its shareholders have become operational, the means by which it operates to regulate conflicting stakeholder claims remains to be seen. Notably, although a duty has

240. Villanueva, Directors of Public Corporations, *supra* note 112, at 34.

241. Clara Mae Hortelano, *SEC Pushes for Good Corporate Governance*, *at* http://www.sunstar.com.ph/static/bac/2003/06/28/bus/sec.pushes.for.good.corporate.governance.html (last accessed Aug. 27, 2003).

242. *Id.*

been prescribed to the board of directors with regard the corporation's stakeholders, no hierarchy has been provided on how to resolve the conflicts that may arise.

The previous chapter proposes the foundations of a legal institution by which directors can construe its concurrent obligation to maximize profits and to govern, in the view of seemingly irreconcilable conflicts between the various stakeholders. Having done so, it is obvious that certain stakeholder groups may not be able to obtain full satisfaction of their claims, since in the emerging duties to enhance corporate value rather than to maximize profit, the corporation now looks to the long-term viability of the corporation, rather than the short-term profits. The theoretical framework, by which stakeholder claims can be ranked, merits an investigation of its precise implications, when tested against hypothetical scenarios that public corporations and banks may face in its operations.

B. Testing the Hierarchy against Corporate Actions

The director's duty is best fulfilled not by viewing his duty as settling short-term issues of dividends, employee compensation and constant investment in research and development to satisfy singular stakeholder demands. His duty, in corporate governance, is to *enhance corporate value* in order to make the corporation a sustainable vehicle that can satisfy stakeholder demands, as provided in the Code of Corporate Governance.[243]

The admonition to enhance corporate value means that the stakeholder theory need not be a zero-sum game where the survival of one stakeholder means the destruction of the others. The maximization of the long run value of the firm is the criterion for making the requisite tradeoffs among its stakeholders. Enlightened stakeholder theory, while giving attention on meeting the demands of all of the corporation's primary stakeholders, specifies that long-term value maximization as the firm's objective.[244]

> The intuition behind this criterion is simple: that value is created – and when I say "value" I mean "social" value – whenever a firm produces an output, or set of outputs, that is valued by its customers at more than the value of the inputs it consumes (as valued by their

243. CODE OF CORPORATE GOVERNANCE, § I b (*emphasis supplied*).

244. *Jensen*, *supra* note 167.

> suppliers) in the production of the outputs. Firm value is simply the long-term market value of this expected stream of benefits.[245]

And to be sure: "[N]o constituency can be given full satisfaction if the firm is to flourish and survive."[246] This means that while tradeoffs will be made in the short-term, these tradeoffs will eventually lead to the maximization of the corporation for all its stakeholders.

In 1984, R. Edward Freeman introduced the *stakeholder theory* in a valuable article.[247] In this article, he proposed the need to define the normative core of a corporation using theories such as the feminist standpoint and rethinking how to restructure *value-creating activity* along with principles of caring and connection, or the ecological normative core in accordance with the principle of caring for the earth.[248]

But while the contribution in identifying the problem was acknowledged, the proposed solution was challenged, in that it would allow corporations to construe their duties to stakeholders along

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245. *Id.*

> This means, for example, that we must give employees and managers a structure that will help them resist the temptation to maximize short-term financial performance (as typically measured by accounting profits or, even worse, earnings per share). Short-term profit maximization at the expense of long-term value creation is a sure way to destroy value. This is where enlightened stakeholder theory can play an important role. We can learn from stakeholder theorists how to lead managers and participants in an organization to think more generally and creatively about how the organization's policies treat all-important constituencies of the firm. This includes not just the stockholders and financial markets, but employees, customers, suppliers, and the community in which the organization exists. Indeed, it is a basic principle of enlightened value maximization that *we cannot maximize the long-term market value of an organization if we ignore or mistreat any important constituency*.

246. *Id.*

247. *Freeman & Evan*, *supra* note 169, at 66-76.

248. *Id.* at 72.

virtually any line they wish.[249] This would seem to advocate the passage of enabling legislation which will "force corporations to be managed in the interests of stakeholders but which will permit corporations to define those interests…in almost any way they wish."[250] The proposed hierarchy of corporate stakeholders addresses the concern the duty of the board of directors to enhance the value of the corporation will be reduced to a mere catch phrase rather than something which can be of real use. By setting a hierarchy, boards of directors can use this to reconcile the seemingly conflicting *short-term* demands of stakeholders. It will be interesting to test this proposed hierarchy against certain corporate actions. Note that the following scenarios will analyze instances where each action is perfectly legal and valid. It does not involve illegal acts or acts done in bad faith. Corporate governance is not concerned with patently illegal acts or gross negligence, because these are cases which deal with the corporation as a creature of law, thus possessed only of powers conferred by law and obliged to perform certain statutory and contractual duties to groups. This pertains to instances where the choice has to be made between two *right* alternatives, as to the business enterprise level of the corporation's existence – this means that the cost-benefit analysis should be made, paying particular attention to how losses to each stakeholder group will affect the corporation's return on investment.

1. Business Expansion

The duty of diligence, under the profit maximization norm, together with the *Business Judgment Rule*, permitted the directors to take calculated risks in taking advantage of opportunities in order for the corporation to earn profit.[251] Under the *Business Judgment Rule*, the courts cannot step in to set aside contracts entered into by the board, as long as these are within the corporate powers, and are done so in pursuit of corporate business.[252] Therefore, when the business expansion drives the corporation to the ground, the employees and creditors, and even the shareholders, would not have any cause of action against the directors in demanding either that the director be

249. James M. Humber, *Beyond Stockholders and Stakeholders: A Plea for Corporate Moral Autonomy*, 36 J. BUS. ETHICS 207(2002).

250. *Id.*

251. Interview with Cesar L. Villanueva, Dean, Ateneo Law School (Jul. 29, 2003) [hereinafter Villanueva, July Interview].

252. VILLANUEVA, CORPORATE LAW, *supra* note 6, at 284.

liable to them, or that the corporation be enjoined from proceeding with the proposed expansion. But under the principles of corporate governance as laid down in BSP Circular 283 and the Code of Corporate Governance, the stakeholders can expect that the corporation be run in a prudent and sound manner.[253] Should the directors proceed with the proposed expansion despite of the fact that such action will not be sound or prudent for the corporation in the long-term, thus diminishing corporate value, stakeholders have a cause of action to petition for an injunction against the proposed undertaking.[254] Therefore, the directors may be observed to now be exercising his duty of diligence not only to the shareholders, but also to all the stakeholders of the corporation.[255]

2. Corporate Acquisitions and Takeovers

Corporate mergers and acquisitions involve either mergers and consolidations, and acquisitions of corporate assets, equity, or its business enterprise. The effects of the corporate takeover or acquisition are not immediately apparent. As to the claims of employees, only in the transfer of all or substantially all of a corporation's assets is the transferee not bound to retain the employees of the transferor corporation, nor is it liable to the claims against the transferor.[256] In the transfer of business enterprise,[257] a transfer of mere equity,[258] mergers,[259] and consolidations,[260] the employees of the

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253. BSP Circular No. 283, § 2.

254. Villanueva, July Interview, *supra* note 251.

255. *Id.*

256. VILLANUEVA, CORPORATE LAW, *supra* note 6, at 618.

257. *Id.* at 620 ("The transferee of the business enterprise is bound to retain the employees but is not liable for the claims of the employees against the transferor.").

258. *Id.* at 629 ("The only result of an equity transfer is a change in the ownership or control of the corporate employees, so the employees remain with the employer in the same manner as before the equity transfer, and the purchaser does not assume any personal liability to the employees.").

corporation are retained. As to the claims of creditors, in cases of an asset-only transfer and an equity-only transfer bars the creditors from recovering against the transferee, the debts of the transferor, the exceptions being when there is an express or implied agreement to the contrary, and as to asset-only transfers, in case of fraud.[261] However, takeovers are sought in order to revive an ailing corporation. Despite the fact that the law provides default rules on assuming employees and debts, the corporation is still free to terminate employees on just and authorized causes, and the corporation is likewise free to shut down certain departments of a business enterprise.

Under the SEC Code of Corporate Governance and the BSP Circular, in recognizing the director's increased constituencies, managers have a duty to preserve the interests of the primary stakeholders of the corporation. Thus, during a takeover attempt, directors and managers would be charged with protecting not only the interests of shareholders, but also the interest of company employees, creditors, and the community in which the company operates. In this case, the concerns of the stakeholders would include employment security, financial soundness, continued tax revenues for local communities, and environmental interests.[262]

Since the duty of the board of directors in corporate governance is towards the enhancement of corporate value and ensuring that the corporation remains as a competitive venture, while taking into account stakeholder interests, the duty is best performed by not mounting an anti-takeover strategy when the takeover of control would benefit the corporation.

Using the *return on investment* (the ratio of net income to the assets of the corporation) as a gauge, a successful takeover will serve to streamline the corporation and infuse it with capital to keep the corporation existing as a business enterprise. It will then involve an addition to the corporation's assets, and a corresponding increase in

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259. CORPORATION CODE, § 80 (states that the surviving corporation must necessarily assume all the liabilities of the constituent corporation). Dean Villanueva is of the opinion that this includes contractual rights of employees and existing collective bargaining agreement, if any.

260. CORPORATION CODE, § 80, applies as well to the consolidated corporation.

261. VILLANUEVA, CORPORATE LAW, *supra* note 6, at 695 (citing Edward J. Nell v. Pacific Farms, Inc., 15 SCRA 415 (1965)).

262. Nancy L. Meade et al., *An Anti-Takeover Amendment for Stakeholders?*, 16 J. BUS. ETHICS 1651 (1997).

the net operating income of the corporation. Therefore, directors cannot resist takeover attempts without violating their duties of diligence, if the gains to the corporation are substantial, even at the expense of stakeholders. The use of the return on investment as a framework is just because it serves as a solid guideline by which to weigh the gains of the corporation *vis-à-vis* the losses that would accrue to stakeholders. For instance, takeovers that would cause great damage to the employees and the community but would amount to little in terms of gains to shareholders should be resisted.

The director must undertake all possible efforts to protect the stakeholders from the negative effects of the takeover. The stakeholders who stand to lose the most in a takeover situation are the employees and the local community. In a study of hostile takeovers, the losses of primary stakeholders may involve the damaging of the economies of towns by the closing of factories, reduction of wages and layoffs of employees, and damage to secondary stakeholders as well such as suppliers who may be shut out. However, it was shown that for each loss of the stakeholders, there was a significant increase in the stock price of the shareholders.[263] Therefore, even as the director has the obligation towards shareholders to allow the takeover, it has to exercise its obligations towards the other primary stakeholders of the corporation, particularly the employees and the community:

- The director must provide pertinent information regarding the takeover at the opportune time in order for these stakeholders.
- In the negotiations for the takeover of control of the corporation, the directors must negotiate in earnest with the transferees on provisions that will provide a smoother transition for the employees, recognizing the stake that the employees and the community have risked in the corporation which they stand to lose in the proposed takeover.

3. Transfer of Operations

Transferring the corporation is an exercise of management prerogative. Under the norms of profit maximization, whenever the transfer of the

263. *Id.* at 1655 (citing A. Shliefer & L.H. Summers, *Breach of Trust in Hostile Takeovers*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33-67 (Alan J. Auerbach ed., 1988)).

base of operations of a company's factory from one location to another increases the profits or cuts down on the expenses, the directors would be remiss in not undertaking the transfer. The transfer does not affect the liabilities of the corporation to its employees and its creditors – the transfer will not alter in any way the relationships and the rights and liabilities that have arisen from them. The transfer may, however, affect the employees who will not be willing or will be unable to transfer to the new location of the company, as well as the local community where the company has operated. The SEC Code of Corporate Governance provides that the board of directors must now recognize these stakeholders in making the decision. Instead of merely relying on the director's duties of obedience, diligence and loyalty, the director must govern, *i.e.,* enhance corporate value, considering the welfare of the stakeholders. Thus, while transfers may have been done at the whim of the directors in exercise of management prerogative, the SEC Code of Corporate Governance increases the factors to be considered in pursuing a transfer of a company's base of operations.

The framework of return on investment is used. A relocation can be justified only when following the proposed hierarchy of values, the benefits that would accrue to the corporation, in terms of income, would be so great that directors can be considered grossly negligent or self-serving should they choose not to relocate the operations of the business. Since the claim of the shareholders on the income is greatest, arising from his investments, his claim has priority over other stakeholders. Recognizing that the shareholder is highest in the accounting of corporate stakeholders, the board of directors may validly undertake the action even if the other stakeholders will be damaged, if in the long run, this will prove to enhance corporate value.

But a transfer of operations translates to massive lay-offs for the employees and loss of tax revenues to the local community where the corporation has operated. Thus, the corporation will have duties to the stakeholders whose claims may be unsatisfied by the transfer of the operations.

- In such a case, the plans on the proposed transfer must be given to the stakeholders in order for them to take positive steps to find employment and to engage in negotiations for other companies to use the premises currently occupied by the corporation.
- In deciding whether or not to relocate operations, to take into account the impact of the proposed move on stakeholders, to avoid the move if reasonably possible, to notify the affected parties as soon as possible if the decisions is to make the move,

and to take positive measures to ameliorate the effects of the move.[264]

4. Incurring Indebtedness

Due to business reverses, it might be needed for companies, in order to sustain the corporation as a business enterprise, to incur debts from financing institutions to pay off other more onerous debts, to engage in further research and development, and to finance its operations and marketing campaigns. To obtain credit in order to maintain the company is certainly beneficial to the corporation's stakeholders – should the operations funded by the loans be successful, it translates to dividends for shareholders, continued employment and better salaries for employees, continued tax payments for the local community, and interest income for the creditors. However, the use of financial markets for refinancing a company renders the creditor institutions sensitive to the trends in market rates.

The Japanese banking crisis has shown that the obtaining of loans to sustain ailing companies, which would never be able to make good on its loans, is disastrous to the entire economy. In 2000, Dai-Ichi Hotel chain went bankrupt. At the peak of the bubble, Dai-Ichi Hotel, Ltd. boasted ¥100 billion in real estate assets and ¥50 billion in buildings or other surface assets. Dai-Ichi Hotel had used these assets to borrow ¥80 billion from banks. But by the next year, the value of these two categories of assets had declined by as much as two-thirds, for a total of ¥45 billion in assets. This meant that with the decline in the value of the collateral, before the company knew what had hit it, the collateral had become insufficient to cover the loans. Moreover, due to the sluggish economy, competition within the hotel industry had become fierce, with discounting rampant, so that last year the Dai-Ichi chain recorded only about ¥4 billion in profit. With that level of profits, it would take the company at least 20 years to pay back its loans. When its major creditor, Shinsei Bank, decided that it could not wait, Dai-Ichi went

264. John P. Kavanagh, *Ethical Issues in Plant Relocation* (1983), *reprinted in* WILLIAM H. SHAW & VINCENT BARRY, MORAL ISSUES IN BUSINESS 243 (5th ed. 1992).

bankrupt.[265] But Dai-Ichi is an exception as "[t]he problem is a staggering backlog of bad loans resulting from the collapse of Japan's financial and property markets in the early '90s and the ensuing economic slowdown."[266]

Therefore, even if incurring the loan will translate to undeniable advantages to shareholders, employees, and the local community, the directors must not do so if it will be incapable of paying back these loans. To do so violates two precepts of corporate governance. First, it focuses on short-term gains whereas corporate governance is a mandate to enhance corporate value, which can be a long-term process. Second, it will lead to the ruin of one of the stakeholders of the corporation – that of the creditor –and eventually, the business enterprise itself, as it is plunged deep in compounded interest payments.

It was posited that one of the reasons for the dismal performance of banks in loans is that under the current assessment criteria for valuation of collateral in Japanese banks, there is room for discretionary decisions. "For example, some corporations are alleged to 'negotiate with banks to get a good asset rating.'"[267] This should not be

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265. Hiroshi Takeuchi, *The Bad Loan Problem and Japanese Banks*, *at* http://www.fpcj.jp/e/gyouji/br/2001/010427.html (last accessed Aug. 27, 2003).

266. Paul Wiseman & James Cox, *Japanese may Fumble Bank Reform Again*, *at* http://www.usatoday.com/money/markets/world/2002-10-27-japan_x.htm (last accessed Aug. 27, 2003).

> The government says banks are holding $345 billion in dud loans; private analysts say the real number could be two to four times higher. Japan has been reluctant to make the agonizing moves most economists believe are necessary: forcing banks to eat loan losses, pulling the plug on hopeless corporate borrowers and forcing others to restructure their businesses. The reticence is not surprising. Hundreds of businesses would fail, and perhaps 2 million Japanese would lose their jobs. But the cost of dithering is also high. Keeping zombie companies alive ties up people and capital that could be put to better use elsewhere and forces healthy Japanese companies into profit-draining competition with businesses that have nothing to lose. That's one reason Japan is caught in a relentless deflationary spiral: Prices fall month after month, taking corporate profits down with them.

267. Keiichiro Kobayashi, *Addressing the Japanese Non-performing Loans Problem: Toward Reestablishing the Principles of Capitalism in Japan,*

permissible under corporate governance. Thus, when a corporation negotiates with a bank for a loan, it must do so only when it based on an honest assessment of its financial standing – that it will be possible to turn around the performance of the company:

- The Board is obliged to enter into contracts of loan prudently, and no director shall vote for the incurring of a loan where there is no genuine capacity on the part of the corporation to pay back the proceeds of the loan.
- The board of directors must undertake an assessment of the corporation's prospective business performance. If the funds incurred in a debt will not allow a corporation to continue as a business enterprise but will merely allow it to pay off current and outstanding debts, thus pushing further behind an impending bankruptcy, this violates both the generally accepted accounting principle that the corporation must be viewed as a going concern, and violates the creditor interest in the corporation as an economic enterprise. Thus, before the corporation incurs a debt, the director must undertake a financial evaluation of the corporation.
- If the loan will not be incurred, the directors must undertake the best alternatives in resolving the financial problems of the corporation.

Does this means that resolving the issue violate the proposed hierarchy, which places shareholder interest at the top, by virtue of their investment in the company? Should the company not be sustained for as long as it is possible to do so, and with whatever means possible, to prevent dissolution? The shift in paradigm from profit maximization to corporate governance has inexorably led to a negation of shareholder primacy. In this case, stakeholders have a claim in the corporation – that it be run as a sound business enterprise. To sacrifice short-term sustainability to greater liability in the future would in fact violate shareholder claims, as well as that of the other stakeholders.

Research Institute of Economy, Trade and Industry (RIETI), Tokyo, *at* http://www.geocities.com/ecocorner/intelarea/kk.html (last accessed Aug. 27, 2003).

VI. CONCLUSION

> *The Enron fiasco has some cynics scoffing at the government and private sector efforts to push for good corporate governance…These scoffers might as well say that Christians should go without the 10 Commandments, the UN its Universal Declaration of Human Rights and republics their constitutions. Yes, these moral and legal codes are violated sometimes. But this is the incontrovertible fact:* Without these codes, immoral and illegal conduct would be more widespread — and violent.[268]

The duties imposed by the Code of Corporate Governance and the BSP Circular 283 on the boards of directors are a radical departure from the conventionally accepted norms found in the Corporation Code. Whereas under the Corporation Code, the director was answerable only to the shareholder as his only constituency, with the sole objective of maximizing profits, the principles of corporate governance both widens the constituencies of the board and expands the duty of profit maximization.

Corporate boards must now act, bearing in mind their concurrent duties to parties who have invested time, effort, assets, talent, and lives in the corporation as a business enterprise. These duties have ceased to be mere voluntary or moral obligations – the law gives them standing in the corporate family as *stakeholders*. These stakeholders have seemingly competing and contradictory claims against the corporation. But a deeper understanding of the call to the directors, no longer to maximize profit but to enhance the value of the corporation, reveals that this is not the case.

This is because the claims of the stakeholders on the corporation have its core in their own financial interests. These claims are satisfied by the corporation not as a charitable institution or as an institution of social change. These claims – dividends for the shareholders, compensation for the employees and managers, interest and principal payments for the creditors, and taxes for the community, are satisfied when the corporation, as a business enterprise, is run in a commercially viable and sustainable manner. With the shift from profit maximization to enhancing the value of the corporation, the orientation of the business decisions of the director should now be what will benefit the corporation in the long-term.

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268. *SEC, BOI and Corporate Governance*, THE MANILA TIMES, Feb. 22, 2002, *available at* http://www.manilatimes.net/national/2002/feb/22/opinion/20020222opi1.html (last accessed Aug. 27, 2003).

But in having the long-term goals in mind means that the corporation will have to make decisions during its day-to-day operations which may not equitably satisfy all the stakeholders of the corporation. This requires the creation of a hierarchy of stakeholders, which the directors can look to in deciding the present conflicting claims of stakeholders.

The corporation's shareholders, employees, managers, creditors, and the community where it operates are its primary stakeholders. To create the hierarchy, the test used is one, which is commonly found in civil law and commercial law – the party who has the greatest contribution or investment, is that whose claims are entitled to prior satisfaction, above those who may have given lesser contribution. With this test, the hierarchy is drawn where the shareholders rank first, the employees second, the creditors third, the local community fourth, and the managers last.

It is recognized that with the growing global competition for capital, investment funds will follow the path to those markets that have adopted efficient governance standards, such as acceptable levels of investor protection and board practices, as well as satisfactory accounting.[269] It also spells greater duties for the corporate director, the violation of which exposes the director to liability. By raising the stakes, corporate governance legislation may have deterred individuals from serving in boards of director, from fear of exposing themselves to liability.

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269. *Id.* In full, the section states:

> It is also recognized that with the growing global competition for capital, investment funds will follow the path to those markets that have adopted efficient governance standards, such as acceptable levels of investor protection and board practices, as well as satisfactory accounting and disclosure standards. Investor confidence stems in part from a country's or a market's reputation for good corporate governance. If investors are not confident with the level of disclosure, or if a country's accounting and reporting standards are perceived to be lax, funds will flow elsewhere. Thus, the ability of the market much-needed capital, in this highly competitive environment, is prejudiced.

There are various challenges to corporate governance reforms. Some of these are the lack of a clear causal link between good governance and financial performance,[270] and that for corporate boards of director to devote resources to anything other than increasing business profits, violates the principal-agent relationship between the directors and the shareholders.[271] These challenges are borne out of the fixation with the conventions of profit maximization. The SEC Code of Corporate Governance and the BSP Circular ignore these challenges by making the bold move of imposing change where the most ferocious objection may have been faced, that of banks and public corporations. Although the corporate governance codes may have been imposed to patch the loopholes in the law, which have made permitted past controversies, it is unmistakable in its implication that directors now have greater duties and accountabilities, not only to the shareholders, but to its stakeholders. And although the principles of corporate governance seem to have discarded profit maximization, this is not actually the case. Rather, profit maximization has been deepened and expanded. By calling the directors to enhance the value of the corporation, the directors still maximize the corporation's returns. But this time, he does so in favor of increased constituencies, with an orientation towards the long-term.

270. *Special Report: Corporate Boards, The Way We Govern Now*, THE ECONOMIST, Jan. 11, 2003.

271. Friedman, *The Social Responsibility of Business is to Increase its Profits*, *supra* note 187.