> . . . thus it comes about that all armed prophets have conquered and unarmed ones failed . . . Let a prince therefore aim at conquering and maintaining the state, and the means will always be judged honorable and praised by everyone . . . A certain prince . . . never does anything but preach peace and good faith, but he is really a great enemy to both, and either of them, had he observed them, would have lost him state or reputation . . .[96]

Business resembles politics in many respects. The stakes are high. Winning often becomes the end in itself. The price of losing is costly and its exaction can be merciless. Those who love it are a different breed of men. Their minds work differently. Their perception of threat, of danger especially, is quick and sanguine. Their instinct for survival is razor-sharp and their ingenuity at exploiting advantage, of itself, is a masterpiece of creation.

The business avocation adheres to the ethical norms of its players. No more than lip-service is paid to compliance with rules. The lustful desire is for money and after money, power, and through power, more money. No quarters are asked and none is given.

Today's "corporate state" of financial omnipotence has not at all changed from Machiavelli's world of the prince and the tyrants. Indeed, the latter have not dwindled in number. They have in fact proliferated, still adhering to the same basic philosophy of extracting too much for too little or nothing at all.

Given this premise of business and its politics, corporate control, as we have seen, has developed a confusing personality in modern management: it can be the investor's protector, but it can just as well be his exploiter. Unfortunately, the line separating one from the other is never steadfast and seems forever obscured by a haze of uncertainties. What is good for an investor one day may not be so the next and the reasons may be as varied, complex, and difficult to understand as understanding why some businesses fail and others succeed. But our task was never to point out where that line should be. Rather it was to affirm the one fundamental axiom of infighting for corporate control: the victor reaps his prize invariably at the expense of the vanquished. But an investor need not risk such a ruthless fate, for there are really just two things he ought never to entrust to another. The first is his life. The second is his money.

[96] R. BUSKIRK, MODERN MANAGEMENT AND MACHIAVELLI 13, 65 (1974).

BANKING LAWS OF THE PHILIPPINES: A TIME FOR REFLECTION

MELENCIO S. STA. MARIA*

Banks play a vital role in our economy. They are moneyed institutes founded to facilitate the borrowing, lending, and safekeeping of money, and to deal in notes, bills of exchange and credits.[1] Ideally, they can be highly efficient financial intermediaries between the providers and the users of funds, funnelling resources into the most beneficial investments in the economy. The more our people deposit their money in the banks, the more banks can lend out money to fund business enterprises. Significantly, banks do not merely deal in, but are actually a source of, money and credit. Indeed when a commercial bank, for instance, lends money by crediting the borrowers' demand deposits, it, in effect, augments the country's credit supply. Consequently, an active banking industry greatly helps in creating a robust and financially active business climate essential to a thriving and productive economy.

Banking is a business activity highly regulated by the government. Although transactions are for private profit, the business is of a pre-eminently public nature[2] in view of the fact that money in banks involves large deposits of people from all walks of life. Since funds of a bank are, in a sense, held in trust,[3] public interest dictates that close monitoring by the proper state authority should be constantly conducted in order that money lent by depositors to these banks will not be carelessly and recklessly invested.

The special governmental attention directed to banking institutions is

* Professor, Ateneo de Manila School of Law; LL.B., Ateneo de Manila School of Law (1982); LL.M. in Banking Law, Boston University (1987); Associate, Tanjuatco, Oreta, Tanjuatco Law Offices.

[1] Republic v. Security Credit and Acceptance Corporation, 19 SCRA 58 (1967), *citing* Talmage v. Pell, 7 N.Y. (3Seld) 328; Smith v. Kansas City Title & Trust Co., 41 S. Ct. 243, 255 U.S. 180, 210 (1910).

[2] Farmers & M Bank v. Federal Reserve Bank, 262 U.S. 649, 67 L. Ed. 1157, 43 S. Ct. 651; Engels v. O'Malley, 219 U.S. 128, 55 L. Ed. 128 (1910).

[3] Banco de Oro v. Bayuga, 93 SCRA 443 (1979).

thus greater in degree than that given to other juridical entities. This is so because, unlike the collapse of an ordinary corporation, the bankruptcy of even a single bank can sire damaging and telling repercussions on other sectors of our society. The serious effect of one bank failure could even extend to other banks which are otherwise in fine and healthy condition. Fearing other bank failures, depositors of stable banks can easily be tempted to withdraw posthaste their funds from these banks. Carefully managed banks may find their once stable operations in a precarious position.

> Demand depositors have a great incentive to remove their funds as soon as they believe a bank might fail. Hence, rumors about a bank's financial condition or the failure of similar banks might touch off runs on well-managed banks. Their failures, in turn, reduce the monetary base as people exchange fractional-reserve bank deposits for 100 percent currency, resulting in a multiple contraction of the money supply and the failure of more banks and other businesses.[4]

This "domino effect" can further lead to catastrophic bank panics that can result in more bank failures which, needless to state, take away the life savings of trusting depositors. More importantly, such bank crisis can effectively disrupt, if not destroy, economic activity.

A sound and stable banking system is thus dependent on the confidence and trust reposed by our millions of depositors in the system. Strengthening and maintaining this confidence are, on the other hand, the principal tasks of not only the people managing banking institutions but also, and more importantly, of bank regulators charged with the responsibility of safeguarding our national economic and financial interest. But bank regulators can only operate within the authority granted to them by the various banking laws enacted by Congress. Indeed, banking laws, of which all citizens are on notice, regulate banks' conduct of business generally, and if bank customers have any interest in or expectation of doing business with a bank, that interest or expectation is subject to the government's legitimate regulatory authority over the banks.

It would therefore be worthwhile to look into some provisions of our various banking laws and to examine whether or not they are designed to enhance public confidence in our banking system in order to strengthen the role of banks as effective financial intermediaries, and consequently, to foster a climate of sustained economic activity.

---

[4] Benston, *Deposit Insurance and Bank Failure,* Economic Review, March 1983 at 3.

CENTRAL BANK ACT

Republic Act No. 265, as amended, established the Central Bank and defined its powers and functions. It has been constituted as a government corporation[5] which generally can make vital monetary, financial and banking decisions which do not necessarily have to be ratified by the President of the Philippines or by one of his appointees in the executive branch of the government. In this sense, the Central Bank can be deemed as a "quasi-independent" entity within the government.

> To be sure, the Central Bank is a government instrumentality. But it was created as an autonomous body corporate to be governed by the provisions of its charter, Republic Act 265, "to administer the monetary and banking system of the Republic " (Sec. 1). As such, it is authorized "to adopt, alter, and use a corporate seal which shall be judicially noticed; to make contracts; to lease or own real and personal property; to sell or otherwise dispose of the same; to sue and be sued; and otherwise to do and perform any and all things that may be necessary or proper to carry out the purposes of this Act. The Central Bank may acquire and hold such assets and incur such liabilities as resulting directly from operations authorized by the provision of this Act " (Sec. 4). It has a capital of its own and operates under a budget prepared by its own Monetary Board and otherwise appropriates money for its operations and other expenditures independently of the national budget. It does not depend on the National Government for the financing of its operations; it is the National Government that occasionally resorts to it for needed budgetary accommodations. Under Section 14 of the Bank's charter, the Monetary Board may authorize such expenditures by the Central Bank as are "in the interest of the effective administration and operation of the Bank." Its prerogative to incur such liabilities and expenditures is not subject to any prerequisite found in any statute or regulation not expressly applicable to it.[6]
>
> However, for the Central Bank to have continuous contact with other policy-making groups within the government, it is mandated to publish and submit to the President of the Philippines, to the Senate, through its President, and to the House of Representatives, through its Speaker, an annual report on the condition

---

[5] *See* Central Bank Act, Republic Act 265 as amended, sec. 1.

[6] Central Bank v. Court of Appeals, 63 SCRA 431 (1975).

> of the Bank and a review of the policies and measures adopted by the Monetary Board during the past year and an analysis of the economic and financial circumstances which gave rise to such policies and measures.[7]

I. Central Bank Powers

The Central Bank has been granted enormous powers by its charter to ensure that growth in money and credit will be sufficient to encourage growth in the economy in line with its potential and with reasonable price stability, to equip it with the necessary means and authority to confront deflationary and inflationary pressures as they may occur, and to enable it to execute the various economic laws passed by Congress and approved by the President of the Philippines. For instance, it has been given the sole right or monopoly of note issue.[8] This gives the Central Bank a very effective means of regulating the flow of currency pursuant to the needs of business and of the general public as a whole. The Central Bank can also raise or lower discount and interest rates[9], purchase or sell securities in the open market[10], and increase or decrease the minimum requirements on cash reserves[11] as principal devices for the creation, expansion or contraction of credit.

To ensure adequate gross international reserves, the Central Bank likewise regulates the country's operation in gold and foreign exchange.[12] This is done to maintain the external value of our currency and to meet balance of payments deficits which our country may experience. Thus, in September 1989, when the value of the Philippine Peso hit the 22 to 1 exchange rate vis-a-vis the United States dollar, the Central Bank had to purchase heavily US dollars from commercial banks which were holding on to their dollar reserves and which were selling foreign exchange directly to importers at higher rates. This was a result of excess liquidity in the system. The Central Bank was constrained to undertake this measure to enable it to maintain an adequate and sufficient level of the country's gross international reserves in the hope of preventing the further devaluation of the Philippine Peso. In fact, it was reported that even before September 1989, the Central

[7] Republic Act 265 as amended, Sec. 37.

[8] *Id.* Sec. 52.

[9] *Id.* Sec. 91.

[10] *Id.* Sec. 96-98.

[11] *Id.* Sec. 100.

[12] *Id.* Sec. 72-78.

Bank had already purchased some $647.01 million in foreign currencies from commercials bank and other sources. To compel the commercial banks to unload their dollars, the Central Bank adopted a policy requiring the graduated increase to 20% of the banks' reserve requirements against deposits and deposit substitutes.

Moreover, the Central Bank functions as the fiscal agent and banker of the Government, its political subdivisions and instrumentalities.[13] It represents the country in all dealings, negotiations and transactions with the International Monetary Fund, the International Bank for Reconstruction and Development and in dealings with other foreign[14] or international financial institutions or agencies.[15] The Central Bank is also tasked with setting up guidelines relative to the operations of offshore banking units of foreign banks.[16]

Also, pursuant to its quasi-legislative power,[17] the Central Bank can issue circulars, rules and regulations prescribing specific guidelines on banking and other financial transactions, both domestic and foreign, designed to protect and strengthen the Philippine economy. These circulars, though not in themselves statutes, have the force and effect of law.[18] Any conduct of transactions or undertakings without complying with the requirements of any validly issued Central Bank circular make these operations illegal or misdemeanors.[19] In this regard, it has been stated that:

> No doubt can be entertained as to the adequacy of the standards to guide the Central Bank and the Monetary Board in promulgating regulations under the Central Bank Act . . . under the usual standards set up by various decisions of the Supreme Court, such as "public welfare", "necessary in the interest of law and order, "public interest", and "justice and equity and the substantial merits of the case".[20]

[13] *Id.* Sec. 115.

[14] *Id.* Sec. 116 & 117.

[15] *See* Central Bank v. Caluag, G.R. No. L-12361 (Sept. 28, 1975).

[16] *See* Presidential Decree 1034 (1976).

[17] Geotina v. Court of Tax Appeals, 40 SCRA 362 (1971).

[18] 3M Philippines, Inc. v. Court of Industrial Relations, 165 SCRA 778 (1988).

[19] People v. Exconde, 101 Phil 1125 (1957); Geotina, 40 SCRA 362.

[20] 1 R.P. Digest 354.

However, should the regulations or circulars conflict with the Constitution, the Central Bank Act itself or any other substantial banking law, the validity of the regulation cannot be sustained. This is consistent with the general rule in administrative law that "departmental zeal may not be permitted to out-run the authority conferred by statute".[21]

II. Central Bank Power to Rehabilitate or Close Banks

Needless to state, banks are the main concern of Central Bank regulations. Republic Act No. 265, as amended, contains a number of significant provisions designed to protect depositors and creditors of banking institutions. Perhaps the most potent power of the Central Bank to ensure the maintenance of public confidence on financial institutions flows out from its awesome, but necessary, regulatory authority to place under conservatorship,[22] receivership[23] or liquidation[24] a grossly mismanaged bank conducting unsafe and unsound financial operations detrimental to public interest. When a bank is closed or taken over by the proper official, the corporate power of the bank is thereby terminated, or at least suspended until a reopening of such bank is legally permitted. Such closure or take-over, however, does not destroy or transmute the corporate entity of the banking corporation.[25] After the Monetary Board has declared that a bank is insolvent and has ordered it to cease operations, the Board becomes the trustee of its assets for the equal benefit of all the depositors and creditors.[26] As a consequence, all court actions against such bank, whether pending or in which the judgment is being or is about to be executed, shall be abated by the fact that the bank has been placed either under conservatorship, receivership or liquidation. The purpose of this is to prevent the undue depletion or dissipation of the bank's assets to the prejudice of depositors and creditors, and in order not to give any undue advantage or preference to one creditor

[21] Hijo Plantation v. Central Bank, 164 SCRA 192 (1988).

[22] *See* Republic Act 265 as amended, sec. 28-A.

[23] *Id.* Sec. 29.

[24] *Id.*

[25] *See* Broderick v. Aaron, 103 A.L.R. 684 (N.Y. Ct. App. 1935); First State Bank v. Lee, 65 Okla 280, 166 P. 186 (1957).

[26] Philippine Veterans Bank v. Intermediate Appellate Court, G.R. No. 73162 (October 23, 1989).

over another by attachment, execution or otherwise.[27] The remedy of an aggrieved creditor of the bank is to intervene in the liquidation proceeding and not to maintain a separate action to enforce his rights.[28]

These measures are purely administrative[29] in nature, such that, intervention by the courts can be availed of, generally, only in two cases. First is when the Central Bank, through the Solicitor General, files a petition with the proper Regional Trial Court praying for the assistance of the said court in the liquidation proceeding.[30] The court shall have jurisdiction in the same proceeding to adjudicate disputed claims against the banks and enforce individual liabilities of the stockholders and do all that is necessary to preserve the assets of the banking institution and to implement the liquidation plan approved by the Monetary Board.[31] The rationale for judicial liquidation has been aptly stated by the Supreme Court in *Hernandez v. Rural Bank of Lucena, Inc.*[32], to wit:

> The fact that the insolvent bank is forbidden to do business, that its assets are turned over to the Superintendent of Banks, as a receiver, for conversion into cash, and that its liquidation is undertaken with judicial intervention means that as far as lawful and practicable, all claims against the insolvent bank should be filed in the liquidation proceeding. The judicial liquidation is intended to prevent multiplicity of actions against the insolvent bank. The law-making body contemplated that for convenience only one court, if possible, should pass upon the claims against the insolvent bank and that the liquidation court should assist the Superintendent of Banks and control his operations. In the course of the liquidation, contentious cases might arise wherein a full-dress hearing would be required and legal issues would have to be resolved. Hence, it would be necessary in justice to all concerned that a Court of First Instance (now Regional Trial Court) should assist and supervise the liquidation and should act as umpire and arbitrator in the allowance and disallowance of claims. The judicial liquidation is a pragmatic arrangement designed to establish due process and orderliness in

[27] *Id.*

[28] Central Bank v. Island Savings, 163 SCRA 482 (1988).

[29] *See In re* Chetwood, 165 U.S. 433, 41 L.ed. 782 (1897); Bushnell v. Leland, 164 U.S. 684, 41 L.ed. 548 (1897).

[30] Republic Act 265, sec. 29, *amended by* Executive Order 289 (July 25, 1987).

[31] *Id.*

[32] 81 SCRA 75 (1978).

> the liquidation of the bank, to obviate the proliferation of litigations and to avoid injustice and arbitrariness.(Remark in parenthesis supplied)

The second case where judicial intervention may be sought is when there is clear and convincing proof that the Monetary Board acted in grave abuse of discretion in placing a bank under conservatorship, receivership or liquidation. In this regard, it has been held that while all these measures are considered exercises of police power, the validity of such exercise of police power is subject to judicial inquiry and could be set aside if it is either capricious, discriminatory, whimsical, arbitrary, unjust, or a denial of the due process and equal protection clauses of the Constitution.[33]

Thus, in the landmark case of *Ramos v. Central Bank*,[34] the Supreme Court nullified Central Bank Resolution No. 1333 dated 13 August 1968 directing the liquidation of the Overseas Bank of Manila as the same was issued by the CB in grave abuse of discretion amounting to lack of jurisdiction. The Supreme Court, in thus taking action, relied upon the doctrine of promissory estoppel and Articles 1159 and 1315 of the New Civil Code enjoining compliance with contracts in good faith. The high court stated that the Central Bank acted in bad faith in evading and not honoring its categorical commitments to rehabilitate the bank and infuse the necessary funds for said purpose, despite the fulfillment of the bank's owners of all the conditions imposed by the CB for the bank's rehabilitation, including the placing of the bank's management under the supervision and direction of CB's team of nominees. Pertinently, the Supreme Court said that "discretion has its limits and has never been held to include arbitrariness, discrimination, or bad faith."

Similarly, in *Central Bank v. Court of Appeals*,[35] the Supreme Court affirmed the nullification of the Central Bank order of liquidation of Provident Bank as being issued arbitrarily and in bad faith. The Supreme Court noted that the financial deterioration of the bank was principally caused by the acts of the CB in pressuring the bank's owners to relinquish the management of the bank to a particular entity which did not have any intention of restoring the bank to sound financial condition, but whose interest was merely the recovery of its deposits from Provident, and in allowing such entity to mismanage the bank until it's closure.

[33] Central Bank v. Court of Appeals, 106 SCRA 143 (1982).

[34] 41 SCRA 565 (1971).

[35] 106 SCRA 143 (1981).

In determining whether or not there was abuse of discretion on the part of Central Bank in placing a bank under conservatorship, receivership or liquidation, the transcript and the tapes of the Monetary Board deliberations regarding the matter may be obtained by the aggrieved party by compulsory court processes, provided that the disclosure will not prejudice public interest. It is the burden of the public officer called upon to produce such transcript or tapes to show how public interest will suffer by the disclosure of said documents. Thus in *Banco Filipino v. Monetary Board*,[36] the Supreme Court held that

> [a]s to the tapes and transcripts of the Monetary Board deliberations on the closure of Banco Filipino and its meetings on July 27, 1984, and March 22, 1985, (Item No. 1), respondents contend that "it is obvious from the requirement (Sections 13 and 15 of the Central Bank Act) that the subject matter (of the deliberations), when resolved . . . shall be made available to the public but the deliberations themselves are not open to disclosure but are to be kept in confidence." This Court, however, sees it in a different light. The deliberations may be confidential but not necessarily absolute and privileged. There is no specific provision in the Central Bank Act, even in sections 13 and 15 thereof, which prohibits absolutely the courts from conducting an inquiry on said deliberations when these are relevant or material to a matter subject of a suit pending before it. The disclosure is here not intended to obtain information for personal gain. There is no indication that such disclosure would cause detriment to the government, to the bank or to third parties. Significantly, it is the bank itself here that is interested in obtaining what it considers as information useful and indispensably needed by it to support its position in the matter being inquired to by the court below.
>
> . . . .
>
> In the case at bar, the respondents have not established that public interest would suffer by the disclosure of the papers and documents sought by petitioner. Considering that petitioner bank was already closed as of January 25, 1985, any disclosure of the aforementioned letters, reports, transcripts at this time pose no danger or peril to our economy. Neither will it trigger any bank run nor compromise state secrets. Respondent's reason for their resistance to the order of production are tenuous and specious. If

[36] 142 SCRA 523 (1986).

> the respondent public officials acted rightfully and prudently in the performance of their duties, there should be nothing at all that would provoke fear of disclosure. On the contrary, public interests will be served by the disclosure of the documents. Not only the bank and its employees but also its numerous depositors and creditors are entitled to be informed as to whether or not there was valid and legal justification for the petitioner's bank closure.

Still it is important to emphasize that Court intervention is the exception rather than the rule. The courts should, as much as possible, defer to the Monetary Board's decision concerning the remedial measures it has imposed over a mismanaged bank. As held in *Rural Bank of Lucena v. Arca*, "[m]anifestly, whether a [rural] bank's continuance in business would involve probable loss to its clients or creditors, and that it cannot resume business with safety, is a matter of appreciation and judgment that the law entrusts primarily to the Monetary Board."[37]

The Central Bank is presumed to have the necessary technical knowledge and expertise in determining the remedial measures to be imposed upon a mismanaged bank. As a matter of fact, these cases present difficult questions of evaluation and appraisal of assets which may be more quickly determined by the Central Bank than by the courts.[38] Indeed, in cases of financial crisis precipitating bank "runs" and the closure of banks or placing of the same under conservatorship or receivership, the Central Bank is in a better position to react quickly than a court to safeguard the interests of the thousands of depositors and creditors who may be detrimentally affected.

Placing a bank under conservatorship, receivership or liquidation is undertaken even before any adversarial hearing is conducted. In fact, a mismanaged bank may find itself being handed a directive that it will be placed under conservatorship without prior notice and hearing from the Central Bank. A previous hearing is nowhere required, either expressly or impliedly, by the Central Bank Act.[39] The reason for this drastic procedure is obvious: any further delay in initiating corrective action can cause further irreparable damage to the bank's depositors and creditors. Significantly, reason and logic as well as judicial precedent dictate that due process does not

[37] 15 SCRA 66 (1965).

[38] *See* United Savings Bank v. Morgenthau, 85 F. 2d 811, 299 U.S. 605, 81 L.ed. 446 (1936).

[39] *See* Rural Bank of Lucena, Inc. v. Arca, 15 SCRA 66 (1965); Rural Bank of Bato v. IAC, G.R. No. L-65642 (October 15, 1984); Rural Bank of Buhi v. CA, 162 SCRA 288 (1988).

require notice and prior hearing when such are likely to precipitate a run on a major bank. The giving of notice and prior hearing in such cases would defeat the very purpose of notice which is to safeguard the interest of all parties.[40] The delicate nature of the institution and the impossibility of preserving credit during an investigation has made it an almost invariable custom to apply supervisory authority in such a summary manner.[41] It is a heavy responsibility to be exercised with disinterestedness and restraint, but in the light of the history and custom of banking, it has been held not to be violative of the due process clause of the Constitution.[42] There is even jurisprudence to the effect that banking measures like conservatorship and receivership should be liberally construed so as to implement their manifest purpose of expeditiously and justly winding up the affairs and paying the debts of such unfortunate institution.[43]

Understandably, great deference should be given to the decision of the Central Bank, or in particular, the Monetary Board in placing a bank under conservatorship or liquidation. In the United States, there is even jurisprudence to the effect that even if a bank under conservatorship consequently fails, the Comptroller of the Currency (the official United States government office that places an insolvent US bank under receivership) may not be held liable for such failure. A suit by the stockholders of the bank against such officer for, in effect, deprivation of property, cannot prosper. This has been eloquently stated in *Smith v. Witherow*,[44] thus,

> It is true that the Comptroller's action in appointing a conservator in the present case did not succeed in effecting the rehabilitation of the Bank, but on the contrary resulted in further loss. This was unfortunate but is not available to the defendants as a defense to the present action. Even at their best, men are subject to the frailties of their human nature. Their judgment is never perfect. Short of Utopia such imperfection will be found in those in whom governmental power is reposed and who administer the laws. Remedial measures undertaken by them with the best of intentions

[40] Slay v. Berry, 27 Mich. App. 271, 183 N.W. 2d 436 (1970).

[41] *See* Fahey v. Mallonee, 332 US 245, 67 S. Ct. 1554, 1556 (1947).

[42] *Id.*, 332 US 250-54.

[43] Korbly v. Springfield Inst. for Savings, 245 U.S. 330, 62 L.ed. 326, 38 S. Ct. 887 (1917).

[44] 102 F.2d 638, 642-43 (9th Cir. 1939).

> are frequently thwarted by an unforseen turn in the tide of human affairs. None but a seer could predict the course of future events with certainty. In the homely but expressive phrase, hindsight is better than foresight. Consequently, if a remedial measure is undertaken under a valid law, its failure to accomplish its purpose because of an unforeseen change in conditions or because of human errors in its administration, honestly committed, does not constitute a taking of property without due process. . . . To hold otherwise would be to paralyze public administration and to render government impotent. It follows that the action of the Comptroller in appointing a conservator in the case before us, although resulting in loss, did not deprive the defendant's decedent of his property without due process. On the contrary, the obligation which the law cast upon him as a stockholder was fixed by the statute, which admits of no exception, and was not affected by the subsequent vicissitudes of the Bank.

In the Philippines, the above jurisprudence is taken cared of by the various legal doctrines on liability of a public officer. Thus, if a particular public officer acts completely within the scope of his authority mandated by law and, in the process, some individuals are injured, such officer generally will not be held liable for the injury.[45] The damage is popularly known in legal parlance as *damnum absque injuria*. The reason for this rule is very much similar to the above-qouted doctrine in *Smith v. Witherow*. However, it must also be pointed out that a public officer who commits a tort or other wrongful act, done in excess or beyond the scope of his duty, is not protected by his office and is personally liable therefor like any private individual.[46]

III. Importance of Reserve Requirements

Another very important public-confidence-enhancing-authority of the Central Bank is its capability to control the credit operations or the money-making process of commercial banks by requiring them to set aside a fraction of their deposit liabilities as reserves.[47] The higher the cash reserves of banks deposited in the Central Bank, the more flexible is the bank's capability of creating credit.

[45] *See* Forbes v. Chuoco Tiaco, 16 Phil. 534, 643; Alzua v. Johnson, 21 Phil. 309 (1912); Zulueta v. Nicolas, G.R. No. L-8252 (January 31, 1959) *cited in* MARTIN AND MARTIN, LAW OF PUBLIC OFFICERS AND ELECTION 286-89, (1981).

[46] Carreon v. Province of Pampanga, 99 Phil. 808 (1956).

[47] *See* Republic Act No. 265 as amended, Sec. 100.

> In the absence of central bank and centralized reserves, each of the commercial banks would, for example have to carry more cash in order to cope with seasonal strains and possible emergencies than if there were a central bank from which the banks could, directly or indirectly and individually or collectively, obtain the necessary accommodations at such times. In short, with a central bank to fall back upon in case of need, the commercial banks can with safety conduct either a larger volume of business with the same reserve or with the same amount of business with a smaller reserve than if they have to depend only on their own individual resources and on such money-market facilities as are available. The important point about centralized cash reserves is, however, that they serve to increase the capacity of the central bank to rediscount or otherwise create credit for the purpose of meeting cash requirements of the commercial banks or of the money market generally.[48]

> Also, reserve requirements serve as a very useful tool to control the volume of money created by the credit operations of the banking system. If the monetary situation prevailing is inflationary, the central bank may increase the existing reserve ratios against deposits and deposit substitutes to mop up excess monetary liquidity in the system. However, in accordance with the Section 104 of the Central Bank Act, such increase should be made in a gradual manner not exceeding four percentage points in any 30-day period. So that banks could adjust to the new ratio, they should be notified reasonably in advance of the date on which such increase is to become effective.

IV. Purpose of Capital Requirement

Capital requirements can likewise be imposed by the Central Bank to assure that banking institutions will be able to sustain seasonal strain.

> Capital performs several very important functions in banking institutions. It absorbs fluctuations in income so that banking institutions can continue to operate in periods when losses are being sustained. It also provides a measure of assurance to the public that an institution will continue to provide financial services thereby helping to maintain confidence in individual entities and the banking system as a whole. It serves to support growth yet restrains

[48] M.H. DE KOCK, THE CUSTODIAN OF CASH RESERVES OF THE COMMERCIAL BANK p. 59, (4d).

unjustified or imprudent expansion of assets. Capital also provides protection to depositors in the event of a threatened insolvency.[49]

Specifically, Section 113 of the Central Bank Act empowers the Monetary Board "to prescribe minimum ratios which the capital and surplus of banks must bear to the volume of their assets, or to specific categories thereof, and may alter said ratios whenever it deems it convenient so to do."

Capital of any bank should be sufficient to maintain public confidence in the institution, support the volume, type and the character of the business conducted, provide for the possibilities of loss inherent therein, and permit banks to continue to meet the reasonable credit requirements of the area served. Pertinently, "capital stock of a bank is a trust fund for the benefit and protection of the depositors and creditors of the bank; therefore it is of the highest importance that the fund should be kept unimpaired."[50]

GENERAL BANKING ACT

Republic Act No. 337 as amended is the other basic banking law existing in the Philippines. It is known as the General Banking Act. It contains the basic and mandatory statutory provisions on the establishment of a commercial bank, a savings and mortgage bank, and a building and loan association. Also, it contains sections on the operation and establishment of branches and agencies of foreign banks. These legal requirements for setting up banks and branches of foreign banks seek to protect the public against actual and potential injury.[51]

I. Ownership Limitation

One notable feature of the law is the percentage limitation that nationals of the Philippines and of other countries can own in a particular domestic bank. Generally, foreigners, individually or collectively, can own only

[49] 44 WASHINGTON FINANCIAL REPORTS 482.

[50] *See* Shriver v. Woodbine Savings Bank, 285 U.S. 467, 76 L.Ed. 884 (1932); Toombs v. Citizen's Bank, 281 U.S. 643, 74 L.Ed. 1088 (1930); Delano v. Butler, 118 U.S. 634 (1886); Hudson v. Bank of Waldo, 83 A.L.R. 887 (Fla. Sup. Ct. 1932).

[51] Central Bank v. Morfe, 20 SCRA 507 (1967); Republic v. Security Corp., 19 SCRA 58 (1967).

up to thirty percent (30%) of the voting stock of a domestic bank[52] while Philippine nationals, also collectively, up to one hundred percent (100%).[53] Under certain exceptional circumstances and conditions, the Monetary Board, with the approval of the President of the Philippines , may approve foreign equity participation (voting stocks) up to forty (40%) percent.[54] The reason for this rule on percentages is quite obvious. Considering that banks are business entities vested with public interest, it is but imperative that their control be in the hands of Filipinos. Foreigners cannot be expected to be as concerned as Filipinos in the economy of the Philippines. Needless to state, these foreigners will put their own vested interest over and above anything else. More often than not, this interest is not necessarily compatible with the interest of the country.

No commercial bank shall be licensed to operate if the stockholdings of any person or persons related to each other within the third degree of consanguinity or affinity, constitute more than twenty (20%) percent of the voting stock of the bank. Corollarily and as a general rule, the total stocks which any corporation may own in a bank should not exceed thirty percent (30%) of the voting stock of the bank.[55] It is reduced to twenty percent (20%) if the investing corporation is wholly owned, or the majority of the voting stock of which is owned by any one person or by persons related to each other within the third degree of consanguinity or affinity.[56] These limitations were recommended by the Joint Bank Survey Commission which undertook a review of the Philippine financial system in 1972.

The objective of these rules is to prevent a single or a few related individuals or a family from totally controlling a bank. This will in turn prevent undue concentration of banking resources and possible abuses related to the control of commercial credit in the hands of a few. Also, the concentration of vast economic power in a person or in a few-related individuals or in a family frequently leads to their possessing vast political power. This situation, as history has taught us, is not conducive to a healthy competitive climate which should animate our economy. In fact, such a situation could lead to corruption and the regression of not only our political system but also our economy. In a letter dated February 27, 1989 addressed to Senator Alberto G. Romulo, Chairman of the Senate Committee on Banks, Currencies and Financial

[52] General Banking Act, Republic Act 337 as amended, Sec. 12-A.

[53] *Id.* Sec. 26.

[54] *Id.* Sec. 12-A.

[55] *Id.* Sec. 12-B.

[56] *Id.*

Institutions of the Senate, CB Deputy Governor Gabriel C. Singson, in commenting on the proposed legislative bill increasing the percentage of the voting stock owned by Filipino investors in local banks from 20% to 30%, pertinently stated:

> These limitations on individual and family stockholdings (Sec. 12- D) were prescribed with the end in view of achieving a broad based ownership of banks in the belief that there is less possibility of the commission of fraud in a bank whose ownership is dispersed and not concentrated within a family or business group.
>
> The findings of the said Commission indicated that while the major contribution of family- controlled banks towards the development of the financial system in the past cannot be denied, and that the overwhelming majority of present-day financial institutions had their beginnings as family undertakings, past experience in the Philippine banking system appears to indicate that while family-controlled banks are notably efficient and competitive where the first generation is actively involved, a number of case studies indicate that succeeding generations had not been able to maintain the quality of initiative and competence initially manifested. Furthermore, there seems to be a tendency for family-controlled banks to consider the bank not as independent economic unit to be developed as such; rather, in many instances it is treated simply as another unit in the family conglomerate, a predisposition the results of which can be disconcerting for the banking unit.
>
> As a general rule, corporate investors other than a closely held corporation are allowed a higher limit of 30% as against the 20% limit on individual/family investors for the reason that as a general rule, ownership of a corporation is broad based and therefore the objective of diffusing ownership is effectively served.
>
> A family corporation, however, as well as any corporation the majority of the voting stock of which is owned by a single individual, is further limited to holdings equivalent to twenty per cent of the voting stock of the bank, in keeping with the demand for effective safeguards to ensure the diffusion of bank ownership.
>
> Other than these limitations on investing corporations, a bank is not restricted in the number of total corporate stockholders which it may take in because of the facility with which corporations are able to generate funds for massive capital requirements.

Significantly, Senate Bill No. 900 has been filed by Senators John Osmena and Alberto Romulo. This bill seeks to increase, as previously stated, the percentage of voting stock owned by Filipino investors in local banks from 20% to 30% to erase the discriminatory treatment in favor of foreign investments apparently existing in the present law. The Central Bank, through the CB Deputy Governor commented that there is no discrimination considering that, under the present law, Filipino investors may own up to 100% while Foreign investors can go only up to 30% or 40% with the approval of the President. The corresponding bill in the House of Representatives is House Bill No. 19601 sponsored by Congressmen Isidro E. Real, Jr., Alawadin T. Bandon Jr., Artemio A. Adasa Jr., and Congresswoman Venecia B. Agana.

There is merit to the proposed bills. While it is true that Filipino investments can go as high as 100%, it should be remembered that this is on a strictly collective basis. No single Filipino individual or a corporation the majority of the voting stock of which is owned by one person or persons related to each other within the third degree of consanguinity or affinity, may own more than 20% of the voting stock of the bank. However, a foreigner may own individually up to 30% of the voting stock of the bank.

Also, as a general rule, corporations, including its subsidiaries, may own only a maximum of 30% of the voting stock of the bank. Section 12-B of the General Banking Act does not make any distinction. Hence, the requirement should apply both to domestic and foreign corporations. As a matter of fact, this limitation has been strictly applied to Filipino corporations. For instance, after the Aboitiz Group purchased from the Land Bank of the Philippines 1,585,988 common shares of the Union Bank of the Philippines worth ₱518.621 million representing 35.12152 percent of Union Bank's outstanding capital stock, the Central Bank directed the Aboitiz Group to immediately make plans for an appropriate divestment of such holdings to comply with the 30% limitation rule.

However, the Central Bank has construed , and indeed implemented, the proviso in Section 12-A of the General Banking Act as an exception to this 30% corporate limitation rule in so far as foreign corporations are concerned. The said proviso states that with the approval of the President of the Philippines, the Monetary Board may increase the percentage of foreign-owned voting stocks in any domestic bank from 30% to 40%. Significantly it does not specify whether the 40% foreign equity ownership can be owned by a single foreign person or corporate entity. Hence, it would indeed be more logical and consistent with the 30% corporate limitation rule under Section 12-B, to construe the 40% under Section 12-A as a collective foreign ownership arrangement whereby, after a single foreign entity acquires 30%, it cannot acquire the additional 10% but the same should be given to

another foreign entity. However, as previously stated, this is not the case. In recent implementations of the proviso, the Central Bank, with the approval of the President , has granted the whole 40% to a single foreign corporation. The acquisition by the First National Bank of Boston, a foreign bank with principal office in Massachusetts, USA, of 40% of the voting stock of the Commercial Bank of Manila (now Boston Bank of the Philippines), from the Government Service Insurance System via a Purchase and Sale Agreement dated November 27, 1987 is a case in point. In fact, by December 1989, the First National Bank of Boston transferred this 40% to the Boston World Holding Corporation, another foreign corporation.

The policy question now is why is it that, with the approval of the President of the Philippines, a single foreign corporation is allowed to acquire up to 40% of the voting stock of a domestic bank while a single Filipino corporation cannot have the same privilege in his own country even with the consent of the President of the Philippines. This incongruity must be corrected. The implementation of the proviso in Section 12-A of the General Banking Act must be re-evaluated, or better, clarificatory amendments on the said proviso must be legislated. There seems to be no public interest consideration for this unequal treatment. Even the justification that such favorable treatment in favor of foreign entities is needed to attract more foreign investment in the country does not seem to be of such paramount consideration to deprive a well-off Filipino corporation of the same privilege.

II. Universal Banking

Another provision in the law which is worth discussing is that contained in Section 21-B. This provision, in essence, permits commercial banks to operate as an investment house as the same is defined in Presidential Decree No. 129. As an "investment house", a commercial bank can engage in the purchase and sale, for its own account, of securities of other corporations. It can also act as a broker or dealer of securities. Section 21-B also authorizes commercial banks to own all of the equity of a non-allied undertaking, or own a majority or all of the equity in a financial intermediary other than a commercial bank. Hence, commercial banks can have "investment house" affiliates if they do not want to directly engage in securities transactions. This new expanded power given to commercial banks has been popularly known as universal banking or unibanking. It paves the way for the merger of commercial banking activities and of investment banking in one particular commercial bank.

While universal banking has its advantages, this banking structure should nevertheless be a matter of serious concern to our millions of depositors. The unforgettable experience in the late 1920's and the 1930's of

the United States banking system should teach us a lesson. During that time, US banks were allowed to simultaneously engage in commercial and investment banking. US banks got so deeply involved with securities transactions that when the stock market fell, it carried with it the inevitable closure of many banks seriously engaged in investment banking. Remedial legislative measures were immediately passed by the United States Congress. One of the laws enacted by the US legislature was the Glass-Steagall Act which is still effective today.

> The Glass-Steagall Act was passed in 1933, in response to the banking collapse that ushered in the Great Depression of the 1930's. The Act reflected the widely-held view that the depth of the nation's financial crisis was attributable in large measure to the extensive participation of commercial banks in speculative investment banking activities. In order to restore public confidence in commercial banks as depository institutions, and to prevent future financial disasters, Congress sought "through flat prohibitions . . . to separate as completely as possible commercial from investment banking." . . . The two principal prohibitions designed to effect such a separation are found in Sections 16 and 21 of the Act. Section 21 prevents persons or firms involved in investment banking activities from engaging in commercial banking by making it illegal for any person "engaged in the business of issuing, underwriting, selling or distribution . . . stocks, bonds, debentures, notes or other securities to engage . . . in the business of receiving deposits." (12 U.S.C. 378.) Section 16 enforces this prohibition from the other side of the equation. It provides that "the business of dealing in securities and stock by member banks shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of customers, and in no case for its own account . . . (12 U.S.C. 24.)
>
> . . . .
>
> Such a separation was necessary, Congress believed, not only to protect bank assets from imprudent securities investments, but also to forestall the more subtle hazards that arise when a bank is cast in the role of the sole promoter for specific securities. In Congress' view "the promotional incentives of investment banking and the investment banker's pecuniary stake in the success of particular investment opportunities was destructive of prudent and disinterested commercial banking and of public confidence in the commercial banking system." (Investment Company Institute vs. camp, 401 U.S. 617). Senator Burkley, one of the Act's principal sponsors, noted that the banker who has nothing to sell to his

depositors is much better qualified to advise disinterestedly and to regard diligently the safety of depositors than the banker who uses the list of depositors in his savings department to distribute circulars concerning the advantages of this, that, or the other investment on which the bank is to receive an originating profit or an underwriting profit or a distribution profit or a trading profit or any combination of such profits.

In addition to the conflicts of interest that result when a bank acts as both promoter of securities and investment adviser to its depositors, Congress feared the promotional pressures that might lead banks to misuse their credit facilities in order to advance their investment banking activities. Thus, Congress expressed concern that banks might extend credit to shore up a company for which they distribute securities; or that banks would be tempted to make imprudent loans either to companies in whose securities they have a promotional stake or to purchasers of those securities; or that banks might pressure companies to which they have made loans to issue securities through the bank's distribution system. In short, Congress viewed certain investment banking activities as "fundamentally incompatible with commercial banking" and therefore created a "broad structure . . . that would surround the banking business with sound rules which recognize the imperfection of human nature that our bankers may not be led into temptation, the evil effect of which is sometimes so subtle as not to be easily recognized by the most honorable men.[57]

Setting up an investment company affiliate has also been seen as not an adequate safeguard to insulate a commercial bank from the hazards attendant in investment banking.

Because the bank and its affiliate would be closely associated in the public mind, public confidence in the bank might be impaired if the affiliate performed poorly. Further, depositors of the bank might lose money on investment purchased in reliance on the relationship between the bank and its affiliate. The pressure on banks to prevent this loss of public confidence could induce the bank to make unsound loans to the affiliate or to companies on whose stock the affiliate has invested. Moreover, the association between the commercial and investment banks could result in the commercial bank's reputation for prudence and restraint being

[57] Securities Indus. Ass'n. v. Bd. of Governors, 627 F. Supp. 695 (D.C. Dist. of Ct. 1986).

attributed, without justification, to an enterprise selling stocks and securities. Furthermore, promotional considerations might induce banks to make loans to customers to be used for the purchase of stocks and might impair the ability of the commercial banker to render disinterested advice.[58]

Apparently, to protect a commercial bank from the hazards of investment banking, our Central Bank has originally required a minimum capitalization of ₱500,000,000[59] (now ₱1 billion) for all commercial banks engaged in universal banking. Failure to meet such requirement may mean the withdrawal of the bank's license to perform expanded banking functions. Also, the Central Bank has required that universal banks must offer their shares to the public to prevent undue control of said banks by few individuals. While these measures can neutralize, so to speak, the danger of a unibank's exposure to speculative transactions, the same may not be enough to adequately restrain them from imprudently engaging in the same. It may even give them some incentives or justification to deal heavily in high risk transactions. It must be noted that, unlike traditional commercial banking transactions like loans where a bank may require a client to post a security for said loan such as a real estate mortgage, a chattel mortgage, a hold-out deposit or a compensating balance, investment banking transactions are not accompanied by such securities or guarantees. In short, in the latter case, a bank does not have anything to fall back on if the investment turns sour. The depositors' money used by the bank in financing its speculative transactions totally goes to waste. The bank then suffers a financial crisis which does not have anything to do with its ability to attract depositors or to its undertaking normal commercial banking functions, though prudent they may be. Added safeguards therefore must be imposed on unibanks such as stricter supervision and examination without necessarily obstructing its flexibility and independence, higher bank reserves, higher amount of deposit insurance based on the riskiness of its transactions, and closer supervision on its affiliates whether engaged in allied or non-allied banking functions.

LIABILITY OF BANK DIRECTORS

Short of rampant dishonesty and incompetence on a scale almost defying imagination, it is virtually impossible for an

[58] Bd. of Governors v. Investment Co. Inst., 450 US 63 (1981).

[59] Central Bank Circular No. 739 (1980).

established bank to lose money.[60]

Like any other corporation, the corporate powers of a banking institution and all its business and properties are exercised, conducted and controlled, respectively , by its board of directors.

> Directors of a bank are entrusted with the absolute responsibility to maintain general supervision over the bank's affairs and cannot escape liability for losses resulting from mismanagement on the grounds that they delegated exclusive management and control of the bank to its officers.
>
> . . . .
>
> It is the right and duty of the board to maintain a supervision of the affairs of the bank; to have a general knowledge of the manner in which its business is conducted, and of the character of that business; and to have at least such a degree of intimacy with its affairs as to know to whom, and upon what security, its large line of credit are given; and generally to know of, and give direction with regard to, the important and general affairs of the bank, of which the cashier executes the details. They are not expected to watch the routine of everyday's business, or observe the particular state of the accounts, unless there are special reasons . . .[61]

Considering the delicate and special nature of a banking institution and in order to protect it from corporate institutional thieves and from highly-paid incompetents, the State must show a special concern on the character and managerial ability of the directors or officers entrusted with the management of a banking institution. Thus, "[i]n order to maintain the quality of bank management and afford better protection to depositors and the public in general, the Monetary Board may pass upon and review the qualifications of persons who are elected or appointed bank directors and officers and disqualify those found unfit."[62]

This serious concern is even highlighted by the fact that both the

[60] Shapiro, *Bank Charters: How We Got to Do It,* WASH. MONTHLY, July-Aug., 1973, at 41, *as contained in* E. SYMONS AND J. WHITE, BANKING LAW 89 (2d 1984).

[61] White v. Thomas, 37 F.2d 452 (9th Cir. 1929); Larimore v. Canover, 775 F.2d 775 (7th Cir. 1985).

[62] Republic Act 337, Sec. 9-A.

Central Bank Act and the General Banking Law contain special provisions which impose stiff penalties upon directors or officers of banking institutions in the event they abuse their privileges or commit acts in violation of banking laws, rules and regulations. Specifically, the Central Bank has been granted the power to suspend and even remove bank directors found, among others, to have committed irregularities or to have conducted unsafe and unsound banking transactions.[63] In order that the public and the banking system may be amply protected from these erring directors, our banking laws also provide that

> [a]ny director or officer who shall resign from or cease to be connected with the bank after having been found to have been involved in, and required to explain any of the acts hereinabove mentioned and before formal administrative proceedings are taken against him, or who shall resign from or cease to be connected with said institution during the pendency of administrative proceedings, may be declared by the Monetary Board as disqualified to become a director or officer, or to hold any position, whether elective, appointive or on a consultancy basis, in any financial institution subject to supervision or regulation by the Central Bank until such time, after appropriate proceedings, that said director or officer is declared by the Monetary Board to be qualified to hold any of said positions.[64]

There are even proscribed acts the commission of which will immediately render *vacant* the office of the director or officer who perpetuates them.[65]

The administrative sanctions imposable are all without prejudice to the criminal penalties provided by the Central Bank Act or the General Banking Act, as the case may be. Specifically, Section 34 of the Central Bank Act imposes a fine of not more than ₱20,000 and imprisonment of not more than 5 years on any person who is found to be responsible for the wilful violation of the Central Bank Act or any order, instruction, rule or regulation issued by the Monetary Board. The same penalty is also imposable on any bank which persists in carrying on its business in an unlawful or unsafe manner. The said section is so broad in terms that it was evidently designed to establish penal sanctions for any and all violations of the Central Bank Act as well as of the

[63] Republic Act 265, Sec. 34-A.

[64] *Id.* last paragraph.

[65] Republic Act 337 as amended, Sec. 23.

regulations legally issued by the Monetary Board.[66]

Under Section 34 of the Central Bank Act, it is specifically required that the violation be "wilful". Since this is a criminal provision, the said requirement must be construed strictly. It cannot be enlarged or extended by intendment, implication, or by any equitable considerations.[67] Accordingly, it is not enough to show a negligent violation of the Central Bank Act and the rules and regulations issued by the Monetary Board. Something more, in effect a wilful violation, must be convincingly proven for a successful prosecution of the offense, and a valid imposition of the penalties provided by law.[68] In *People v. Adela*[69], the Court of Appeals considered violations of the Central Bank Act as *mala prohibita*. This means that criminal intent is not necessary although it is essential that there be intent to perpetrate the act.[70] Also, penal sanctions under Sec. 34 of the Central Bank Act may be imposed only upon persons responsible for the violation. Hence, the directors of a bank are liable under Section 34 only if they wilfully participate in the violations charged. More often than not, however, directors are only able to know the infractions after their commissions by officers appointed by them.

Interestingly, there is banking jurisprudence in the United States to the effect that if a director deliberately refrained from investigating that which it was his duty to investigate, any resulting violation of the statute must be regarded as intentional or "wilful" on his part.[71] In this regard, it has also been held that, while negligent acts are not within the ambit of a statute providing that only "intentional" acts are penalized, it makes the directors liable for a series of connected acts of negligence continued for such length of time that it must be inferred that their acts of negligence were intentional.[72]

---

[66] Exconde, 101 Phil. 1128.

[67] 1 R. AQUINO, REVISED PENAL CODE 13 (1987) (citing U.S. v. Abad, 36 Phil. 243 (1917); Sudario v. Acro Taxi, 86 Phil. 1 (1914); People v. Elkanish, 90 Phil. 53 (1951).

[68] *See* Bowerman v. Hamner, 250 U.S. 504, 63 L.Ed. 1113 (1919).

[69] People v. Adela, CA-G.R. No. 22860 (Oct. 29, 1959) *cited in* 3 AGBAYANI, COMMENTARIES AND JURISPRUDENCE ON THE COMMERCIAL LAWS OF THE PHILIPPINES 797 (1980).

[70] United States v. Go Chico, 14 Phil. 128 (1909); United States v. Siy Cong Bieng, 30 Phil. 577 (1915); Padilla v. Dizon, 158 SCRA 127 (1988).

[71] Corsicana National Bank v. Johnson, 251 U.S. 60, 64 L.ed. 141 (1919).

[72] Bailey v. O'Neal, 122 S.W. 503 (Ark. Sup. Ct. 1909).

Similarly, Section 87 of the General Banking Act provides that the violation of any provision of the said law shall be punished by a fine of not more than ₱2,000 or imprisonment of not more than two years, or both. Unlike the Central Bank Act, the General Banking Act does not make any qualification that the violation must be "wilful". Hence the offenses are clearly *mala prohibita*. The mere commission of the act is penalized. Only the perpetrators, the persons who actually performed the act, are liable. Good faith is not a defense in this kind of offense. Aside from this all-encompassing penal provision, the General Banking Act contains specific sections providing for special criminal penalties. Thus, under Section 38 (investing funds despite inadequate reserve), the officers and directors who make or cause such an investment are liable. Under Section 83 (violation of DOSRI rule), only the directors or officers who, directly or indirectly, procured the prohibited loan, are liable. However, the officers or directors who allowed such loans contrary to the DOSRI limitation may be held liable under Section 87. Under Section 87-A, officers or directors are made liable for certain prohibited acts like falsification of entries in bank reports, fraudulent overvaluing of property offered as security, accepting gifts or commissions in connection with the approval of a loan from a bank, revealing information to third person regarding a particular person's funds in the bank without court approval and others.

The most important prohibition against bank directors and officers which directly affect the money entrusted to them by depositors is contained in Section 83 of the General Banking Act. This prohibition is known as the DOSRI rule. This rule prohibits a director or officer of any banking institution, directly or indirectly, to borrow deposits or funds of such bank, and to act as guarantor, indorser, or surety for loans granted by such bank to others, or in any manner, be an obligor for moneys borrowed from the bank or loaned by it, except with the written approval of the majority of the board of directors of the bank, excluding the director involved. Even with such an approval, the amount of credit accommodation which may be extended to these directors must strictly abide by the rules and regulations issued by the Monetary Board. However, the outstanding credit accommodations which a bank may extend to its stockholders owning two per cent or more of the subscribed capital stock, its directors, or its officers, shall be limited to an amount equivalent to the respective outstanding deposits and book value of the paid-in capital contribution in the bank. The object of the DOSRI rule,

as held in a host of American cases[73] which jurisprudence on the subject is applicable in our jurisdiction, is to prohibit persons entrusted with the management of banks from appropriating to their own use funds of the banks entrusted to their care, and in so doing, render the banks unsafe or insolvent, or at least unable to afford persons other than directors the advantages of bank accommodations to the extent desired.

> To permit officers of a banking corporation who are entrusted with the power to loan at will the moneys deposited by the public for safekeeping to themselves is to open wide the doors to fraud and embezzlement. And the experience of the past has shown that whenever the officers of a banking institution take advantage --- which is too often the case --- of the opportunities thus afforded them without restriction, for their own private uses, the funds entrusted to their care, it almost invariably results in the wreck and ruin of the institution itself. The legislature, in order to guard against such disastrous results, and to create confidence in and give stability to our banking system, has by the enactment of the foregoing statute, undertaken to control and regulate the question.[74]

Another law which is significantly relevant in determining liabilities of directors and officers of the bank is the Corporation Code of the Philippines. Pertinently, under Section 31 of this law,

> Directors or trustees who wilfully and knowingly vote for or assent to patently unlawful acts of the corporation or who are guilty of gross negligence or bad faith in directing the affairs of the corporation or acquire any personal or pecuniary interest in conflict with their duty as such directors or trustees shall be liable jointly and severally for all damages resulting therefrom suffered by the corporation, its stockholders or members and other persons.

What is more important to emphasize is the matter of gross negligence. The mere fact that the law makes gross negligence and not merely simple negligence as the standard of liability signifies that the duty of care

[73] Arizona *ex rel.* Stowell v. Litrell, 14 Ariz. App. 203; Browning v. State, 101 Fla. 1051; Albert v. Baltimore, 2 Md. 159; Lester v. Howard Bank, 33 Md. 558; People v. Lewis, 262 Mich. 308; Little v. New House, 164 Miss. 619; State v. Lindberg, 125 Wash. 51.

[74] Cupit v. Park City Bank, 20 Utah 292; Pemigewasset Bank v. Rogers, 18 N.H. 255.

which should be exhibited by directors of corporations, including banks, must be that which ordinarily diligent, reasonable and prudent men would exercise under the same or like circumstances. The care and due diligence required of a bank director is not the care expected of any businessman but the care expected or required of a bank director in the business of a bank.[75] Bank directors ought not to be held to the highest degree of care and diligence for that might prevent men, whose unspotted reputations and good business judgments would give character and stability to the institution, from accepting such positions. Neither should they be held to the slightest degree, for that would have a tendency to destroy public confidence, and few men would be willing to deposit their money with the banks.[76]

Thus, it has been held that if by reckless inattention to the duties confided to the directors by a bank, frauds and misconduct are perpetrated by officers, agents, and directors, which ordinary care on their part would have prevented, then the bank directors are personally liable for the resulting loss.[77] Indeed, while directors of a bank are entitled to commit the banking business to their duly authorized officers and, in the absence of grounds for distrust, to assume that such persons will be upright in the performance of their duties, such bank directors cannot claim immunity from liability because of want of knowledge of the officers' wrongdoing if that ignorance is the result of gross inattention.

Continuous absences in meetings, for example, have been considered as acts of gross negligence making absentee directors liable for losses shown to have resulted from their inattention.[78] Having accepted positions in the board, it is the bank directors' duty to attend board meetings and assist each other in supervising the business. Significantly, it has even been held that, if gross mismanagement by officers of banking institutions is within the knowledge of the directors, then the latter are culpable. On the other hand, if they did not know of such gross mismanagement due to, among others, habitual absences in board meetings, then they are grossly negligent and inattentive to their duties and are likewise liable for the losses or damages suffered.[79]

Significantly, there is jurisprudence in the United States stating that

[75] Swentzel v. Penn Bank, 15 L.R.A. 305.

[76] Warren v. Robison, 19 Utah 289, 57 P. 287 (1909).

[77] Trustees Mut. Bldg. Fund & Dollar Savings Bank v. Bosseiux, 4 Hughes 387, 3 F. 817 (Va. Dist. Ct. 1880).

[78] Murphy v. Penniman, 105 Md. 452, 66 A. 282.

[79] Gibson v. Andreson, 80 F. 245.

a higher standard of diligence is required of banking directors as compared with that of other corporations. The reason given is that bank directors are charged with the trust responsibility to see that depositors' funds are safely and providently invested in the form of loans or otherwise and that the bulk of the funds of a bank are usually spread out in the community to help the wheels of industry revolve.[80] In this regard, it has also been held that a director of a bank, who is also the president thereof, is expected to undertake a higher degree of diligence than an ordinary bank director.[81]

Another important duty of directors is that of loyalty to the banking institution.[82] In this regard, the general rule as to conflicts of interest in ordinary corporate law applies.

> Directors of a business corporation act in a strictly fiduciary capacity. *Straits v. Andreson*, 1926, (245 Mass. 536, 150 N.E. 832, 44 A.L.R. 567); *Hill v. Nisbet*, (1885 100 Ind. 341,363). When a director deals with his corporation, his acts will be closely scrutinized. *Bossert v. Geis*, (1914, 57 Ind. App. 384, 107 N.E. 95). Directors of a corporation are its agents, and they are governed by the rules of law applicable to other agents, and, as between themselves and their principal, the rules relating to honesty and fair dealing in the management in the affairs of their principal are applicable. They must not, in any degree, allow their official conduct to be swayed by their private interest, which must yield to official duty. *Lender Publishing Co. v. Grant Trust Co.*, (1915, 182 Ind. 651, 108 N.E. 121). In a transaction between a director and his corporation, where he acts for himself and his principal at the same time in a matter connected with the relation between them, it is presumed, where there is thus potential on both sides of the contract, that self-interest will overcome his fidelity to his principal, to his own benefit and to his principal's hurt . . . Absolute and most scrupulous good faith is the very essence of a director's obligation to his corporation. The first principal duty arising from his official relation is to act in all things of trust wholly for the benefit of his corporation.[83]

A director willfully violating his duty of care and loyalty may be held liable, also under the Corporation Code, for all the damages resulting

[80] Broderick v. Marcus, N.Y.S. 455.

[81] Brannin v. Loving, 82 Ky. 370.

[82] *White*, 37 F.2d 880; *Larimore*, 775 F.2d 904; Joy v. Norton, 692 F.2d 880, 75 L.Ed. 2d 930 (2d Cir. 1982).

[83] Perlman v. Fedman, 219 F.2d 173 (1955).

therefrom suffered by the banking institution.[84]

It must be pointed out, however, that not all losses suffered by banks should necessarily be attributed to their directors. If the loss is simply the result of bad judgment after the directors have taken all considerations that can be reasonably made, the directors may not be held liable. This doctrine is what is known as the business judgment rule. This rule exists to protect and promote the full and free exercise of the managerial power granted to directors.

> The principle itself is 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 taken was in the best interest of the company.[85]

> The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves prior to making a business decision, of all material information reasonably available to them.[86]

> By definition, responsibility for business judgment must rest with corporate directors, whose individual capabilities and experience peculiarly qualify them for discharge of that responsibility, and thus, absent evidence of bad faith or fraud, courts must and properly should respect their determinations under business judgment doctrine.[87]

Under Philippine laws, there are indeed enough statutory sanctions and penalties imposable against erring or negligent bank directors and officers. Also, stockholders, depositors and creditors are given by statute the right to go after these people for damages. However, there seems to be a lack of intensity and initiative specially on the part of bank regulators to enforce these statutory remedies. This lackadaisical attitude on the part of our "law enforcers" has not contributed at all in enhancing public confidence which the public should repose on the banking system. In fact, it has emboldened many bank directors and officers to be grossly careless and to evade the law.

[84] *See* Corporation Code of the Philippines, Batas Pambansa Bilang 68, Sec. 31, 34.

[85] Zapata Corp. v. Maldonado, 430 A. 2d 779 (Del. Sup. Ct. 1955).

[86] *Id.*

[87] Auerback v. Bennett, 393 N.E. 2d 994 (N.Y. Ct. App 1979).

DEPOSIT INSURANCE LAW

Another important law designed to protect depositors of banks is Republic Act No. 3591 as amended, otherwise known as the Deposit Insurance law. This law establishes the Philippine Deposit Insurance Corporation.[88] The deposit liabilities of any bank or banking institution, which is engaged in the business of receiving deposits, shall be insured with the PDIC to the extent of ₱40,000.00.[89] Hence depositors are assured that, in the event of bank failure, they can recover their deposits in such failed bank from the government-supported PDIC. For a bank to avail of the benefits of PDIC insurance, it has to pay a premium, just like any other insurance transaction, to the insurer which is the PDIC. Generally, the assessment rate is determined by the Board of Directors of the PDIC provided that such rate will not exceed one-twelfth of one per centum per annum. Lately, we have heard that there are legislative bills presented in Congress to improve the Deposit Insurance Law. There are proposals to increase the insurable amount from ₱40,000.00 to ₱100,000.00, the assessment rate against insured deposits from one-twelfth to one-fifth (1/5) of one percent of deposits to be paid by the banks to the PDIC, and the government equity contribution in the PDIC from ₱2 billion to ₱5 billion.[90] Also, proposals to grant additional powers to the PDIC such as the authority to issue cease and desist order and to terminate the insurance status of a bank have also been proposed.[91] These moves for legislative amendment highlight the need to improve our deposit insurance system.

There are, however, two basic concerns which should be addressed in the light of the emerging risk tendencies of banking institutions. First is the PDIC's flat rate insurance system. Second is the effect of deposit insurance on market discipline.

[88] Philippine Deposit Insurance Corporation Act, Republic Act 3591 as amended, Sec. 1.

[89] *Id.* Sec. 3(g).

[90] *PDIC - Protected Bank Deposits Set at ₱100,000.*, Manila Times, July 30, 1988, at 9.

[91] *See PDIC to be Strengthened,* Manila Bulletin, February 24, 1989, at 27.

I. Flat-Rate Premium System

While the proposed increase in the assessment rate is an ostensible improvement, this does not modify the basic concept of such assessment which is the charging of premium on the basis of the amount of assessable deposits without taking into consideration the riskiness of the business transactions of banks. In other words, there has been no change to our flat-rate premium system of deposit insurance. Deposit insurance are based solely on the volume of insured deposits regardless of any risk relative to the insurance agency.

> Under this system, insured institutions have an incentive to take on more risk than they would otherwise, either by making riskier loans or by increasing leverage. Doing so does not subject them to higher premiums, and they obtain the benefits of the higher yields that normally accompany the assumption of greater risk.[92]

In effect also, prudently managed banking institutions have been subsidizing progressively operated banks dealing in riskier transactions. The more solvent, prudent and viable bank pays the same premium rates as a seriously troubled or excessive-risk-taking bank, even though the former poses a much lesser risk than the latter for the insurance fund. Indeed, the probability of bank failure in the former is very much lower than that of the latter such that if the latter finally collapses, it benefits from the same insurance pool to which the conservatively managed bank is also entitled. Significantly, this system also encourages banks to engage in risky transactions at the expense of PDIC. There is therefore reason to change PDIC's flat premium system of deposit insurance to a risk-based system.

> If the premium paid to the insurer were actuarily fair, in the sense of covering the expected losses of the insurer given the risk and capital of the firm and the terms of the insurance contract, the incentive to take on additional risk at the expense of the insuring agency would disappear.[93]

In the United States, there are already moves to change to a risk-based premium system of deposit insurance. However, the following was what Mr. Paul A. Volcker, former Chairman, Board of Governors of the United States Federal Reserve System, had to say regarding this aspect before

[92] *Financial Market Deregulation,* in BANKING, FINANCIAL INTERMEDIARIES AND MONETARY POLICY SUPPLEMENTAL NOTES 97 (R. Taggart ed. 1896).

[93] *Id.* at 98.

the Committee on Banking, Housing and Urban Affairs of The United States Senate on September 11, 1985:

> In principle, the proposal appears logical and attractive. It seems undeniably fair to require those institutions exposing the insurance fund to greater risk to pay higher premiums to compensate for that risk, an approach long followed by private companies in all areas of insurance.
>
> But there is reason to question the practical benefits of such an approach. If differential insurance premiums are to effectively deter excessive risk-taking, the range between premiums charged institutions exposed to relatively great risk and those operating more conservatively would have to be fairly wide. But such a wide range for premiums implies more precision in gauging the risk exposure of different institutions or different types of lending than may be objectively possible, or that is widely perceived as fair. We do not, for instance, want to indiscriminately place a drag on commercial lending, or agricultural lending, or energy lending. The size of the insurance premiums might be interpreted as a kind of credit rating, but it would be too crude to bear that burden. And I do not see in practice, how the premiums could be "fine-tuned" before problems in fact emerge.

In essence, Volcker is saying that while risk-based insurance has a very good remedial theoretical appeal, the implementation of the system might be very difficult.

> There are problems with risk-related premiums however, stemming from the difficulties associated with measuring risk properly and determining an appropriate schedule of premiums. One important measurement problem arises from the role that diversification plays in reducing risk. The riskiness of a portfolio cannot be evaluated simply by examining the riskiness of individual assets. Portfolio risk depends more on the interrelationships among the assets and how they match up with the structure of liabilities.[94]

The observations of Volcker are definitely applicable to our local deposit insurance system. However, it cannot be denied also that banking institutions now engage in riskier transactions than they have ever dealt before, specially with the emergence of universal banks and other non-banking

[94] *Id.*

financial institutions which compete with banks in terms of getting funds from the public. It would therefore be a serious error if, in coming up with legislative proposals intended to reform our deposit insurance system, our legislators will disregard such risk factor just because it might be hard to implement. Risk factors definitely play a vital and useful role in designing an insurance package that qualitatively equalizes the amount of contributions by member-banks to the insurance pool with the end in view of eliminating the unjustified "subsidy" effectively made by prudent banks in favor of those vigorously taking excessively risky ventures.

II. Market Discipline

The second aspect that should be considered in deposit insurance is its effect on market discipline. Does the law, in insuring deposits of depositors to the extent of ₱40,000.00, really enhance genuine public confidence in our banking system or, in reality, eliminate the incentive on the depositors to evaluate the kind of bank they are lending their money to, thereby causing a gradual erosion of consumer-concern on the soundness of banks? It cannot be denied that while deposit insurance has the effect of minimizing bank runs in that it assures the depositors that their deposits are safe, at least, to the extent of ₱40,000.00, it also effectively "spares most depositors the cost of learning about the operation of banks."[95] And,

> as a consequence, deposit insurance frees banks from the discipline and cost of those depositors concern. Bankers need not pay depositors a premium (in interest, "free" services, or other concessions) to compensate them for the risk of investing in the bank.[96]

As a further consequence, this may encourage bank managers to be more daring and to continue to risk a person's deposit to the extent of ₱40,000. This managerial boldness is even given more impetus with the thought that the PDIC, the insurer, is a government insurance company financially backed by the Republic of the Philippines which, in turn, has always the available money, though minimal it may be, to support any financial shortfall in the PDIC for the sake of public interest.

[95] Benston, *Deposit Insurance and Bank Failure,* Economic Review, March 1983, at 8.

[96] *Id.*

Also, in the light of the foregoing, will an increase in the insurable deposit to P100,000 give incentive to bank managers to be more circumspect in their dealings and thus, assure the financial soundness of our banking system? Will it greatly encourage prudent banking? Or will it further embolden these people to take on added risks and thus, correspondingly increase the threat of bank failures? By such an increase in insurable deposit, will it further erode market discipline on the part of the depositing public? These are some of the policy questions which our legislators should address themselves to. Insuring bank deposit is a wise policy, but it should be pegged at a level that will not destroy or lessen the consumers' concern over the operations of the banks they put their money in. It should be packaged in such a way that depositors will be positively and constructively induced from time to time to make careful examination of or check on the condition, both financially and operationally, of the financial intermediary they patronize. In this way, bank managers will be "forced" to be always on guard and to always undertake prudent banking transactions so as not to lose scrutinizing but good clients.

CONCLUSION

The survival of our banking system depends on the degree of public confidence it enjoys. Banking laws are therefore designed to ensure its viability and trustworthiness by providing effective regulatory powers to the Central Bank and by strengthening safeguards against imprudent banking practices. These laws should be diligently enforced. Erring bank directors and officers must be immediately dealt with to ensure the integrity of the banking system. Efforts to amend our banking laws must not only consider the emerging boldness of banks to engage in more risky transactions but also the ways to enhance market discipline on the part of the depositing public. Significantly, if these considerations are adequately reflected in the law and implemented, the public will, in effect, be made to take active part in enhancing and assuring the stability of banking institutions. Consequently, the depositing public itself will serve as the catalyst in strengthening and nurturing the very public confidence which is supposed to be reposed by it in our banking system. Should this happen, our banking institutions will truly become efficient and effective financial intermediaries between the providers of funds and the users of the same. Definitely, this will greatly contribute to the needed improvement in our economy.

ASPECTS OF PHILIPPINE LAW AND JURISPRUDENCE ON SERVICE CONTRACTING ARRANGEMENTS

DENNIS G. SOLIVEN*

The present dissertation attempts to trace the evolution of the law and jurisprudence on that aspect of Philippine labor relations law called "service contracting." Traditionally the bane of many labor law practitioners, not owing merely to the ambiguous rules applicable thereto but likewise to their seeming amplification by the Supreme Court and pertinent regulatory agencies, the law on service contracting arrangements has evolved into a conundrum of sorts. The author does not profess to provide clear-cut answers and thereby disentangle the legal mesh attendant to the topic of discussion; although it is hoped that the reader will come out of this more informed, less confused, and better able to cope with the development of law and jurisprudence on this controversial aspect of Philippine labor relations law.

I. PRE-LABOR CODE SERVICE CONTRACTING ARRANGEMENTS

A traditional bone of contention in many labor standards and labor relations cases has been the existence or non-existence of an employer-employee relationship between the parties. For the existence of such a relation, the Supreme Court frequently adopted the four (4) criteria approach first enunciated in the case of *Viaña v. Al Lagadan*,[1] thus:

> In determining the existence of employer-employee relationship, the following elements are generally considered, namely: (1) the selection and engagement of the employee; (2) the payment of wages; (3) the power of dismissal; and (4) the power to control the employees' conduct - although the latter is the most important

* LL.B., Ateneo de Manila School of Law (1988); Associate Editor, ALJ (1988); Associate, Sycip, Salazar, Hernandez, and Gatmaitan Law Office.

[1] 99 Phil. 408 (1956).