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THE FIDUCIARY DUTIES OF DIRECTORS AND OFFICERS REPRESENTING THE CREDITOR PURSUANT TO A LOAN WORKOUT ARRANGEMENT: PARAMETERS UNDER PHILIPPINE CORPORATE SETTING*

CESAR L. VILLANUEVA**

I. INTRODUCTION

Philippine corporation law is fundamentally a transplant of American corporation law. Prior to the transfer in 1898 of sovereignty over the Philippines to the United States, the Spanish laws did not provide for an entity exactly corresponding to the notion of the corporation in English and American law. The Spanish *sociedades anonimas*[1] governed by the Spanish Code of Commerce, however, were likened to the English joint stock company, with features resembling those of both the partnership and the corporation.[2] In 1906,the United States Philippine Commission enacted the Corporation Law,[3] a general law authorizing the creation of corporations in the Philippines, and which was a sort of codification of American corporation law.[4] The evident purpose of the Commission was to introduce the American corporation into the Philippine business setting as the standard commercial entity and hasten the day when the *sociedades anonimas* of the Spanish law would be obsolete.[5] "For a period of about fifty years, from the enactment of the Corporation Law of 1906, both '*sociedad anonima*' and corporation,

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* A paper submitted in satisfaction of the written work requirement in the seminar on Corporate Planning and Counseling, Harvard Law School, April, 1989.

** Professor of Law, Ateneo de Manila School of Law; LL.B., Ateneo de Manila School of Law (1981); LL.M. Harvard Law School (1989); Partner, Villanueva & Bernardo Law Offices.

[1] The pertinent provisions governing *sociedades anonimas* were Articles 151 to 159 of the Code of Commerce of Spain which, on August 6, 1888, was extended to the Philippines and became effective as law on December of that year.

[2] 3 A. AGBAYANI, COMMERCIAL LAWS OF THE PHILIPPINES 5-8 (1980).

[3] Act No. 1459 (1906).

[4] *See* Harden v. Benguet Consolidated Mining Co., 58 Phil. 141, 145-147 (1933).

[5] *Id.*

co-existed in the Philippine legal system. It is no wonder, therefore, that the development of the principles and jurisprudence regarding internal management and fiduciary relations of directors, stockholders, and the corporation should have something of both the civil law and common law.[6] In 1980, the Philippine legislature enacted the Corporation Code of the Philippines[7] to supplant the Corporation Law. The Corporation Code sets down explicit provisions on the fiduciary duties and obligations of directors and officers, many of which are really a codification of principles established from judicial decisions decided under the old Corporation Law.

As in American corporation law, Philippine statutory and jurisprudential principles vest in the board of directors the management and control of corporate affairs.[8] Necessary corollaries of the powers vested in the directors are the fiduciary duties of care, obedience,[9] and loyalty. The general principles that have evolved in Philippine jurisprudence on the fiduciary obligations of directors do not squarely address the precarious role of directors and officers who are elected or appointed to corporations to represent the interests of particular groups, namely, major corporate creditors resulting from loan workout arrangements.

In the Philippines, the usual arrangement entered into by a financially distressed corporation and its major creditor, usually a bank, to avoid foreclosure proceedings is to authorize the creditor to elect its representatives to the board of directors, and appoint key officers of the corporation. Conflict of interests considerations are very much apparent in such situations. The nominees of the corporate creditor have, by reason of their positions as directors and officers, fiduciary obligations to the corporation and its stockholders; on the other hand, they are specifically appointed to oversee the interest of their appointing principal-creditor, as delineated in the loan workout agreement. What are the limits of the powers and the extent of the liabilities of such directors and officers? A situation where corporate directors and officers are serving two masters is tenuous at best, and although such arrangements are sanctioned by law and business practice, there seems to be no governing principles or rules other than the general principles of

[6] Cagampang, *The Fiduciary Duties of Corporate Directors under Philippine Law*, 46 PHIL. L. J. 513, 517 (1971).

[7] Batas Pambansa Bilang 68 (1980).

[8] *See* Corporation Code, Sec. 23.

[9] This is the equivalent to the American concept of the duty "to act lawfully". *See* CARY & EISENBERG, CASES AND MATERIALS ON CORPORATIONS 549 (1988). Other Commentators treat the duty to act lawfully as an aspect of the duty of care. *See* CLARK, CORPORATE LAW 138-139 (1986).

corporation law on directors' fiduciary duties which are premised on the theory that directors and officers should serve only the interests of the corporation and its stockholders.

In the American setting, a detailed discussion of the obligations of nominee directors and officers appointed to protect the creditor's interests would lead to the broader and relatively new legal field of "lender liability." The theory that is evolving from various federal and state rulings is that whenever a creditor has anything other than an arm's length relationship with its borrower, the potential for liability exists.[10] Under this control theory, when a creditor has control of the affairs of a borrowing corporation and *improperly participates* in its management, the creditor may be held responsible to the corporation and affected third parties for losses suffered or liabilities incurred on account of such participation.[11] And although control may arise legitimately out of a valid interest of the creditor to protect its interests, it may have serious legal repercussions.[12]

The paper will examine the parameters of a loan workout arrangement under the Philippine setting, with comparison of developments in American jurisprudence, but will be limited to the fiduciary role of the nominee directors and officers as shaped by the conflict of interests situation that exists in discharging their obligations to all parties affected: the appointing creditor, the corporation and its stockholders, and other corporate creditors. The underlying theme of this paper, therefore, is that the nominee directors and officers, although elected to, or appointed by or on behalf of a corporate creditor, seek to discharge their functions to the appointing creditor consistent with the legal demands of their fiduciary duties and obligations.[13]

[10] *See* CAPELLO, LENDER LIABILITY 148 (First ed. 1987).

[11] Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor*, 31 BUS. LAW 343 (1975).

[12] *See generally* CAPPELLO *supra* note 10. The other common law theories supporting the principle of lender liability are: (a) fraud theory; (b) bad faith breach theory; (c) duress theory; (d) negligence theory; (e) conversion theory; (f) defamation theory; (g) *prima facie* tort theory; and (h) infliction of emotional distress theory. *Id.*

[13] The discussions in this paper are applicable not only to the situation where the creditor elects the majority or all of the members of the board of directors of a corporation pursuant to a voting trust agreement executed by the controlling stockholders, but also any other arrangement where the members of the board of directors and other key corporate officers are meant to represent the creditor, as when the stockholders voluntarily elect the nominees of the creditor pursuant to a restructuring or a loan workout agreement.

II. THE PHILIPPINE PARADIGM OF A LOAN WORKOUT ARRANGEMENT

In considering the paradigm of the Philippine loan workout arrangement, it may be illuminating to consider two such arrangements that have been described in decisions of the Philippine Supreme Court.[14]

In the early case of *Everett v. Asia Banking Corporation*,[15] the plaintiff's complaint described the arrangement as follows: The Bank, through its manager, represented to the Company that for the mutual protection of the Bank and the Company, it was advisable that the Bank should temporarily obtain control of the management and affairs of the Company without interference or hindrance from outsiders, and to this end that it would be necessary for the stockholders of the Company to place their shares in a Voting Trust to be held by the Bank or one of its officers for the benefit of the Company. It was represented that if this were done, the Bank would then finance the Company under its own supervision, and that if and when the same were successful and in a position to resume independent operation, the said trust would be terminated and the stock returned to its true owners, or in case at any time the Bank decided to discontinue operation under the said trust then the stock would also be so returned.[16]

It was further represented by the Bank that in order to protect the mutual interests of the Bank and the Company, it was necessary to carry into effect the said proposed voting trust without the knowledge of other corporate creditors and thereby place the Bank in an advantageous position with regard to them. Relying upon the promise and representations of the Bank and to further finance the Company, the stockholders executed a voting trust agreement.[17]

Shortly after the Bank had control of the Company through installation of its own directors and officers, the Bank caused the Company to: (a) grant new mortgages upon its properties to the Bank "without regard to the interest of the Company and looking solely to the advantage of the

[14] Only decisions of the Supreme Court establish jurisprudence or doctrines in Philippine jurisdiction. *See* Miranda v. Imperial, 77 Phil. 1066, 1073 (1947); Albert v. Court of First Instance of Manila, 23 SCRA 948, 961 (1968); Insular Life Assurance Co. Employees Assn. v. Insular Life Assurance Co., 37 SCRA 244, 279 (1971); Tugade v. Court of Appeals, 85 SCRA 226, 230 (1978).

[15] 49 Phil. 512 (1926).

[16] *Id.* at 516-18.

[17] *Id.*

Bank;"[18] (b) permit "the Bank to foreclose the same and to sell the property of the Company at such times and in such manner as to be solely to the interests of the Bank or of themselves, and wholly without regard to the best interests of the Company itself, in disregard to the duties and obligations of a trustee;"[19] (c) permit " the Bank to bring suits against the Company, in which the Company was not represented by anyone having its interest at heart;"[20] and (d) cause the transfer of the assets of the Company to another entity organized by the Bank.[21]

Unfortunately, *Everett* was decided by the Philippine Supreme Court on the procedural issue of whether it was proper for the trial court to have sustained a demurrer to the complaint. The merits of the allegations of the complaint were not touched upon by the Court, and the case was remanded to the trial court for hearing on the merits.

Another more recent trend is the situation presented in the case of *Development Bank of the Philippines v. Ilustre, Jr.*,[22] where a large bank creditor as part of the financial reorganization of a large company, while extending needed additional loans, would convert some of the old outstanding obligations to equity holdings. In *Ilustre*, pursuant to a memorandum of agreement to rehabilitate the Isarog Pulp and Paper Co., Inc. ("Isarog"), the Development Bank of the Philippines ("DBP"), in addition to extending new loans totalling several millions of dollars and restructuring part of outstanding loans, converted past due obligations into common and preferred shareholdings in the Isarog. The transactions resulted in DBP obtaining approximately 91% of the total outstanding shares of Isarog, thereby enabling it to elect a substantial majority of the board of directors. The private owners of Isarog continued to be the President and Executive Vice-President of the company. After a few months, the board of directors, in order to prevent the continuing financial losses of the Isarog arising from alleged incompetence of the old management, created an executive committee to assume direct management of the company and contracted a professional management company to act as management consultant for the company. The private stockholders then filed an action seeking to rescind the memorandum of agreement to reacquire management of Isarog.

Ilustre reached the Philippine Supreme Court not on the merits of the

[18] *Id.* at 519.

[19] *Id.*

[20] *Id.* at 519-20.

[21] *Id.* at 520.

[22] 138 SCRA 11 (1985).

issue but rather on the question of whether jurisdiction over the case was with the regular courts or with the Securities and Exchange Commission ("SEC") which had original jurisdiction over all matters pertaining to intra-corporate disputes.

The situations described in *Everett* and *Ilustre* are typical of the arrangements that have flourished in the Philippine business setting covering situations when creditors agree to restructure the loans of financially distressed corporations in lieu of foreclosure proceedings. Despite these cases covering loan workout arrangements, the Supreme Court has never ruled on the obligations and fiduciary duties of such nominee directors and officers appointed by creditors to the borrowing corporations.

In discussing therefore the fiduciary duties of such nominee directors and officers, and the rules that should govern their acts, we shall consider the following features of a loan workout as the paradigm under Philippine setting:

First, a loan workout between the creditor and a distressed corporation would be covered by an agreement, whether in the form of a single memorandum of agreement, or with a separate voting trust agreement, that would authorize or empower the creditor to appoint at least a majority of the members of the board of directors of the corporation, and some of its key officers. This would authorize the creditor to take-over management of the corporation through the majority of the board of directors appointed by it, and the appointment by the nominee board of key officers of the corporation.

Second, although in certain situations the creditor may convert some of the obligations to equity investments in the corporation, nevertheless, the payment by the distressed corporation of the existing or remaining debt exposure remains the primary concern of the creditor in the loan workout arrangement.

Third, the arrangement is often intended to be an interim measure while the corporate debtor is experiencing financial difficulties. As soon as the corporate debtor "gets back on its feet," control is intended to revert to the stockholders under the terms provided for in the loan workout agreement.

Fourth, the transfer of management to the creditor is intended to promote the mutual interests of the creditor and the corporation.

The paradigm raises several issues for discussion. Are the terms of such a loan workout agreement transferring management or control of the corporation to the creditor valid under Philippine law? In the absence of detailed contractual stipulations, what is the extent of the powers of the nominee directors and officers in promoting the interest of the appointing creditor? If the parties do stipulate, how far can the stipulation extend to promote the interest of the creditor? The arrangement always involves the situation of self-dealing on the part of nominee directors and officers. A self-dealing situation arises when a transaction appears to be between two or more parties but actually involves only one decision-maker.[23]

In appointing the nominee directors and officers, the corporate creditor usually appoints its own directors or officers. The situation is equivalent to the appointing creditor itself sitting on the board of the borrowing corporation. The situation parallels that arising from basic self-dealing situations, since it can be expected that the primordial loyalty of such nominee directors and officers would be to their appointing principal.

The nominating creditor may decide to appoint outsiders to the board and officers of the corporation. In such a case, the nominating creditor is likely to be appointing an overseer board equivalent to an "outsider" board that would be more objective in enforcing the terms of the loan workout agreement, as compared to directors and officers who are elected by the stockholders of the corporation. In the case where the nominating creditor appoints an "outside" board, the focal issue is the board's mandated obligation to the appointing creditor, i.e., the extent of its duties as a watch-dog for the creditor of the corporation. This situation can be likened to that of interlocking directorship.

The voting trust device involving the complete surrender by the shareholder of his voting rights to a trustee or trustees is recognized in Philippine jurisdiction as the effective means employed by parties in the rehabilitation of insolvent corporations, as well as in irrevocably committing groups of shareholders to the continuation of fixed business policies.[24] Under the prevailing view, a voting trust should have a legitimate business purpose to promote the best interest of the corporation.[25] It is therefore not considered valid if it exists only for the benefit of the trustees without any

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[23] CLARK, CORPORATE LAW 144 (Little, Brown and Co., 1986). Clark states three conditions for the existence of self-dealing: (1) a transaction between the referent corporation (i.e., entity whose interests may be in jeopardy) and some other persons; (2) certain individuals (or a group of them) have decision-making influence with respect to the actions taken by the referent corporation; (3) the influential individual or group has a greater personal interest in the welfare of the other person involved in the transaction than the welfare of the referent corporation. A fourth condition makes the self-dealing transaction unfair or abusive: the transaction is in fact unfair to the referent corporation. *Id.* at 147.

[24] Ferrer, *Varying a Shareholder's Statutory Participation in Management by the Use of Non-Statutory Devices: Is It Possible under our Corporation Statute?*, 9 ATENEO L.J. 9, 10 (1959).

[25] Nicolas, *Devices Affecting Control under the Corporation Code*, 58 PHIL. L.J. 95, 109-110 (1983) (citing BALLANTINE, CORPORATION 427-28 (1946)).

obligation to perform any useful service for the protection of the stockholders or creditors of the corporation, or if it unduly restricts the power of the directors.[26] Among the legitimate purposes listed to be served by voting trusts is "to aid in reorganization plans and adjustments with creditors in bankruptcy or financial difficulty."[27]

In the case of distressed banks, the Central Bank of the Philippines ("CB"), as one of the conditions to extending financial assistance, often requires the execution of voting trust agreements by the private controlling stockholders, to allow the CB to elect its nominee directors to the distressed bank and take over operations during the period of rehabilitation. In *Ramos v. Central Bank of the Philippines*,[28] the controlling stockholders of the Overseas Bank of Manila ("OBM") executed a voting trust agreement pursuant to the agreement of the CB to provide adequate funds for "the rehabilitation, normalization and stabilization" of OBM. The CB then appointed its nominee board of directors and key officers of OBM, but it failed to provide adequate funds, and later placed the bank under liquidation. The Philippine Supreme Court found the CB liable and directed it to comply fully with the terms of the voting trust agreement to rehabilitate OBM. The case was decided on principles relating to obligations and contracts, primarily the doctrine of promissory estoppel.

The enforcement by the Court of the terms of the voting trust agreement in the loan workout arrangement can be taken as an imprimatur that such arrangements, even when there is included a transfer of control to the creditor, are generally valid and do not violate any public policy. Although it has been held that it would be a wastage of corporate assets to appoint directors and officers whose primary task is to serve the private interests of a stockholder and no benefit is expected to flow to the corporation,[29] in the case of a loan workout, the appointment of the directors and officers by the creditor is not only for the sole benefit of the latter but also of the corporation borrower since it is a measure adopted to avoid it being plunged into bankruptcy.

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[26] *Id.* (citing Marvin v. Solventol Chemical Products, Inc., 298 N.W. 782 (1941)).

[27] *Id.* (citing BALLANTINE, CORPORATION 429 (1946)).

[28] 41 SCRA 565 (1971).

[29] In *Republic Bank v. Cuaderno*, 19 SCRA 671 (1967), it was held that "[i]t may be considered wastage or diversion of corporate funds to hire officers and appoint directors whose main purpose is to shield the chairman from criminal prosecution" since the corporation would have no interest in shielding the directors. The corporation could sue to nullify the appointments, and recover those paid out for the purpose.

The Corporation Code itself contains certain provisions that recognize, perhaps in an oblique way, the power of the corporations to be bound by certain stipulations in loan agreements that contract around corporation law principles. Section 59 restricts the life of voting trusts to a period not exceeding five (5) years at any one time, yet by way of excepting, it provides that "in the care of a voting trust specifically required as a condition a condition in a loan agreement, said voting trust may be for a period exceeding five (5) years but shall automatically expire upon full payment of the loan." Section 39, in affirming that in the absence of a contrary provision in the articles of incorporation, stockholders enjoys preemptive rights to subscribe to all issues or disposition of shares, nevertheless exempts the issuance of shares "in payment of previously contracted debt." Also, Section 43, which prohibits stock corporations from retaining surplus profits in excess of 100% of their paid-in capital stock, provides as an exception thereto the situation "when the corporation is prohibited under any loan agreement with any financial institution or creditor, whether local or foreign, from declaring dividends without its/his consent, and such consent has not yet been secured."

The principle of granting to the creditor management control of the borrowing corporation pursuant to a loan workout agreement therefore seems to be a non-issue in Philippine jurisdiction. There is no public policy offended with the appointment by the corporate creditor of the majority or the entire composition of the board of directors of the corporation.[30] Also, it seems clear that the creditor and the corporation can validly enter into other stipulations in the loan workout agreement that are consistent with the transfer of management control to the creditor. What really remains in issue is the <u>nature</u> and <u>extent</u> of the tasks vested upon the nominee directors and officers pursuant to the loan workout agreement. Despite the validity of the proposition that loan workout agreements create, by the principle of autonomy of contracts, certain rights, privileges, and powers in the appointing creditors, well-established principles of corporation law impose certain fiduciary duties on corporate directors and officers. How far can contractual stipulations suppress general corporation principles on fiduciary obligations of directors and officers to promote the interest of the creditor?

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[30] Under the second paragraph of Section 23 of the Corporate Code, "[e]very director must own at least one (1) share of the capital stock of the corporation of which he is a director, which share shall stand in his name on the books of the corporation." Such a requirement as to stockholding is satisfied if the director has naked legal title to the share, although the beneficial ownership may be in another. All that is necessary is that the stock shall stand in the name of the director in the corporate books. SALONGA, PHILIPPINE LAW ON PRIVATE CORPORATIONS 257 (1968). *See also* Jimenez, *Corporate Watch-Dogs*, 27 ATENEO L.J. 15, 17 (1982).

III. STAGE ONE: NEGOTIATING THE FINANCIAL CRISIS

When a corporation is in serious financial condition, often the only way to avoid insolvency proceedings is to come to terms with its major creditor and work out a loan restructuring agreement. Even as the corporation may bargain the holders of its seat of power, how much more can be bargained away by the corporation is limited by the public policy placed on the nature of the functions of directorship and officership.

Section 23 of the Corporation Code provides that "[u]nless otherwise provided in [the] Code, the corporate powers of all corporations formed under [the] Code shall be exercised, all business conducted and all property of such corporations controlled and held by the board of directors or trustees."[31] Although the Philippine Supreme Court had earlier held that "[t]he board of directors of a corporation is a creation of the stockholders and controls and directs the affairs of the corporation by delegation of the stockholders,"[32] it is now generally accepted that the directors are not ordinary agents in the immediate control of the stockholders, but their powers are, in the very important sense, original and undelegated, and that the stockholders do not confer, nor can they revoke, those powers or create a sterilized board of directors.[33] In *Ramirez v. Orientalist Co.*,[34] the Philippine Supreme Court held void a resolution adopted at a meeting of stockholders refusing to recognize a contract entered into by the board of directors, reasoning that the powers of management reside in the board and not with the stockholders.[35] In *Barretto v. La Previsora Filipina*,[36] the Court held that "contracts between the corporation and third persons must be made by or under the authority of its board of directors and not by its stockholders; hence, the action of the stockholders in such matters is only advisory and not in any wise binding on the corporation.[37]

The rule in Philippine law, like that in American law, is that contracts which seek to limit the directors' free exercise of their discretion, or which

[31] This is the same language of section 28 of the old Corporation Law.

[32] Angeles v. Santos, 64 Phil. 697, 706 (1937).

[33] SALONGA, PHILIPPINE LAW ON PRIVATE CORPORATIONS 238 (1968).

[34] 38 Phil. 634 (1918).

[35] *Id.* at 654. *See also* Wolfson v. Manila Stock Exchange, 72 Phil. 492, 499 (1941).

[36] 57 Phil. 649 (1932).

[37] *Id.* at 655 (citing 5 W. FLETCHER, CYCLOPEDIA OF THE LAW OF CORPORATIONS 2097 (First ed.)).

tempt directors to disregard their fiduciary obligations to the shareholders,[38] or which seek to make directors and officers only nominal and passive,[39] have generally been held to be void.[40] Such contracts call for conduct which is inconsistent with directors' obligation to the entire body of shareholders.[41] However, where the directors so contracting are the only shareholders or where all other shareholders have approved such a contract, the contract is not considered against public policy,[42] simply because no third party to the contract is really adversely affected.

In a loan workout agreement, the creditor and the corporation, even as they stipulate to grant the former power to appoint the controlling board, cannot authorize the nominee board to act merely as dummies for the creditor. Any stipulation to the contrary would be void as against public policy. The nominee board must itself act as *sui generis*, an independent body which must decide for itself the best welfare of all the parties involved. This principle is understandable only from the point of view that even with the majority of the stockholders agreeing to the loan workout agreement, they cannot bind minority stockholders, nor can they prefer the appointing creditor to the detriment of other corporate creditors. There have been cases when the court has declared invalid contracts entered into by the controlling directors which were deemed to be so unconscionable and oppressive as to amount to wanton destruction of the rights of the minority shareholders.[43]

In *Steinberg v. Velasco*,[44] the Court likened the position of a director to a "mandatory" who "is bound not only to exercise proper care and diligence, but ordinary skill and judgment."[45] In *Mead v. McCullough*,[46] the Court held that "[a] corporation is essentially a partnership, except in form. The directors are the trustees or managing partners, and the stockholders are the *cestui que*

[38] West v. Camdem, 135 U.S. 507, 10 S.Ct. 838, 34 L.Ed. 254 (1890).

[39] Manson v. Curtis, 223 N.Y. 313, 119 N.E. 559.

[40] *See* SALONGA, *supra* note 33, at 239.

[41] West v. Camdem, *supra* note 38.

[42] Harris v. Magrill, 131 MISC. 380, 226 N.Y.S. 621 (1928). *See also* 28 COL. L. REV. 378.

[43] Ingersoll v. Malabon Sugar Co., 53 Phil. 745, 749 (1929) Marsman Investments, Ltd. v. Abaca Development Co., 9 SCRA 783, 785-86; and Gamboa v. Victoriano, 90 SCRA 40, 47 (1979).

[44] 52 Phil. 953 (1929).

[45] *Id.* at 960-61 (citing Section 458 Ruling Case Law, Vol. 7).

[46] 21 Phil. 95 (1911).

trust and have a joint interest in all the property and effects of the corporation."[47]

In the celebrated case of *Strong v. Repide*,[48] the Philippine Supreme Court held that directors or managers of corporations (here a *sociedad anonima*) are agents of the shareholders as well as of the corporation only as to the property in their immediate charge and not as to the stocks in the hands of the members. In the absence of any statement by them or request for information on the part of a member, they may acquire his stock by purchase through an agent or broker, without disclosing the identity of the purchasers or their plans for the corporation. In a dissenting opinion, Justice Johnson insisted that when the stockholders of a corporation elect a board of directors for the purpose of managing the business affairs of said corporation, they thereby become the agents and stand in a fiduciary relation with the stockholders in the management of such corporation and will not be permitted, during the continuance of such relation, to deal with the property of said corporation in a way which will result to their individual benefit as against the rights and interests of the stockholders. If they do, such special advantage will be for the benefit of the particular stockholders injured.[49]

The United States Supreme Court overturned the majority ruling[50] holding that a purchase of stock in a corporation by a director and owner of three-fourths of the entire capital stock, who was also administrator general of the company, and engaged in the negotiations which finally led to the sale of the company's lands to the Philippine Islands Government at a price which greatly enhanced the value of the stocks, was fraudulent as procured by "insidious machinations" inducing the execution of the contract of sale, within the meaning of Article 1269 of the Civil Code defining deceit, where he employed an agent to make the purchase, concealing both his own identity as the purchaser, and his knowledge of the state of the negotiations and their probable successful result.[51]

In the case of *Gokongwei, Jr. v. Securities and Exchange Commission*,[52] the Philippine Supreme Court, in upholding the validity of a by-law provision that disqualified competitors from being elected to the board

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[47] *Id.* at 121 (citing Per Walworth, Ch., in Robinson v. Smith, 3 Paige, 222, 232; 5 *idem*, 607; Slee v. Bloom, 19 Johns., 479; Hoyt v. Thompson, 1 Seld., 320).

[48] 6 Phil. 680 (1906).

[49] *Id.* at 715.

[50] Strong v. Repide, 213 U.S. 417; 43 L.Ed. 853 (1909).

[51] *Id.* at 958.

[52] 89 SCRA 336 (1979).

of directors, held:

> Although in the strict and technical sense, directors of a private corporation are not regarded as trustees, there cannot be any doubt that their character is that of a fiduciary insofar as the corporation and the stockholders as a body are concerned. As agents entrusted with the management of the corporation for the collective benefit of the stockholders, "they occupy a fiduciary relation, and in this sense the relation is one of trust."[53] "The ordinary trust relationship of directors of a corporation and stockholders", according to *Ashaman v. Miller*,[54] "is not a matter of statutory or technical law. It springs from the fact that directors have the control and guidance of corporate affairs and property and hence of the property interests of the stockholders. Equity recognizes that stockholders are proprietors of the corporate interests and are ultimately the only beneficiaries thereof * * * ."[55]

The Corporation Code now provides explicit rules on the duties and liabilities of directors and officers not only in their relation to the corporation and the stockholders, but also "to other persons."

> Sec. 31. Liability of directors, trustees or officers.--Directors or trustees who willfully and knowingly vote for or assent to patently unlawful acts of the corporation or who are guilty of gross negligence or bad faith in directing the affairs of the corporation or acquire any personal or pecuniary interest in conflict with their duty as such directors or trustees *shall be liable jointly and severally for all damages resulting therefrom suffered by the corporation, its stockholders or members and other persons.* When a director, trustee or officer attempts to acquire or acquires, in violation of his duty, any interest adverse to the corporation in respect of any matter which has been reposed in him in confidence, as to which equity imposes a disability upon him to deal on 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. (Underscoring supplied.)

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[53] *Citing* 3 FLETCHER, CYCLOPEDIA CORPORATIONS 144 (1975). (underscoring supplied).

[54] 101 F.2d 85, *cited in* 2 ALECK, MODERN CORPORATION LAW § 959.

[55] Gokongwei, Jr. v. Securities and Exchange Commission, 89 SCRA 336, 367-68 (1979).

Section 31 codifies the three-fold duties of directors and officers.[56] It is a new provision with no counterpart in the old Corporation Law. While it reaffirms the general fiduciary duties of directors and officers to the corporation and its stockholders, the imposition of fiduciary duties "to other persons" seems to expand the established normal scope of the fiduciary duties. Before the enactment of the Corporation Code, there was little dispute to the proposition that directors and officers are fiduciaries only to the corporation and its stockholders, and beyond that they are considered to owe no fiduciaries duties to other persons under corporate law principles. It is true that directors and officers may, by clearly unlawful act, make themselves personally liable to third parties; but such liabilities stem not from their fiduciary duties under corporate law, but by other legal sources such as tort, bankruptcy, or violation of criminal laws. But the use of the phrase "to other persons" in Section 31 may imply that the three-fold fiduciary duties of directors and officers arising from the very nature of their office in the realm of corporation law is owed beyond the corporation and stockholders.

Do directors and officers now owe fiduciary duties to corporate creditors? Under the old Corporation Law, it was clear that normally directors and officers owed no fiduciary duties to corporate creditors, and the latter may not sue them for mismanagement,[57] and that their remedy is only indirectly through bankruptcy or receivership proceedings, or by creditor's suit to enforce the liability as a corporate asset.[58] The only time the Philippine Supreme Court talked of a fiduciary duty being owed by directors and officers to corporate creditors is when there is a state of insolvency. In *Mead v. McCullough*,[59] the Court held:

> While a corporation remains solvent, we can see no reason why a director or officer, by the authority of a majority of the stockholders or board of managers, may not deal with the corporation, loan it money or buy property from it, in like manner as a stranger. *So long as a purely private corporation remains solvent, it directors are agents or trustees for the stockholders. They owe no duties or obligations to others. But the moment such a corporation becomes insolvent, its directors are trustees of all the creditors, whether they are members of*

[56] 3 A. AGBAYANI, COMMERCIAL LAWS OF THE PHILIPPINES 267 (1988).

[57] SALONGA, *supra* note 33 (citing Allen v. Cochran, 160 La.125,107 So. 292 (1926)).

[58] *Id.*

[59] 21 Phil. 95 (1911).

> *the corporation or not, and must manage its property and assets with strict regard to their interest;* and if they are themselves creditors while the insolvent corporation is under their management, they will not be permitted to secure to themselves by purchasing the corporate property or otherwise any personal advantage over the other creditors. * * * . (Underscoring supplied.)[60]

It must be noted that Mead talked of the fiduciary duty of directors and officers not under the auspices of judicial insolvency or bankruptcy proceedings; rather, the use of the term "insolvency" in the aforequoted portion of the decision referred to a state of financial condition of the corporation, for indeed the case did not cover a situation where the corporation was under bankruptcy proceedings.

In *Steinberg v. Velasco*,[61] where a receiver of an insolvent corporation brought suit against directors and officer for unlawful repurchase of shares and declaration of dividends at the time the corporation was already insolvent, the Philippine Supreme Court, in discussing the duty of care and diligence of directors and officers, held that "[c]reditors of a corporation have the right to assume that so long as there are outstanding debts and liabilities, the board of directors will not use the assets of the corporation to purchase its own stock, and that it will not declare dividends to stockholders when the corporation is insolvent." What seems to be implied from the juxtaposition of the Court's reasoning is that the fiduciary duties of directors and officers extend to corporate creditors as a principle of corporate law, rather than a precept under the law on bankruptcy.

In *Ramos v. Central Bank of the Philippines*,[62] the Court held that certain acts of a controlling creditor that adversely affect the corporation, its stockholders, and creditors would make it liable for damages.

> We are constrained to agree with petitioners that the conduct of the CB from and after January, 1968, reveals a calculated attempt to evade rehabilitating OBM despite its promises. What is more aggravating is that by the ordered liquidation, depositors and *other creditors* would have to share in the assets of the OBM, while the CB's own credits for advances were secured by the new mortgages it had obtained from the petitioners, thereby gaining for it what amounts to an illegal preference. To cap it all, the CB disregarded its representations and promises to rehabilitate and normalize the

[60] *Id.* at 113.

[61] 52 Phil. 953 (1929).

[62] 41 SCRA 565 (1971).

financial conditions of OBM, as it had previously done with the Republic Bank, without even offering to discharge the mortgages, given by petitioners in consideration for its promises, or notifying petitioners that it desired to rescind its contract, or bringing action in court of the purpose. And all the while CB knew that the situation of the OBM was deteriorating daily, with penalties at 3% per month continually accumulating, while its creditors, depositors and stockholders awaited the promised aid that never came, and which apparently CB never intended to give. (Underscoring supplied).

A close reading of *Ramos* shows that it was not really decided on principles of corporation law. In pinning the liabilities of the CB, the Court referred to Articles 1159 and 1315 of the law on obligations and contracts of the Civil Code.[63] The workout arrangement in *Ramos* was entered into essentially between the CB and OBM, and no indication that the creditors' consent was obtained for the arrangement. Yet in deciding the issues, the decisions lumped the interests of corporate workout arrangement in Ramos was entered into essentially between the CB and OBM, and no indication that the creditors' consent was obtained for the arrangement. Yet in deciding the issues, the decisions lumped the interests of corporate creditors with the protection of the rights of the stockholders, thus: "The petitioners having complied with these conditions and parted with value to the profit of the CB (which thus acquired additional security for its own advances), the CB may not now renege on its representations and liquidate OBM, to the detriment of its stockholders, depositors and other creditors, under the rule of promissory estoppel."[64] Since the creditors were not parties to the agreement, it is difficult to see how the CB would have contractual obligations towards them.

In essence, in a loan workout arrangement situation, the nominee directors and officers cannot be authorized, even with the consent of the corporation, to be relieved of their fiduciary duties to the corporation, its stockholders, and perhaps to other corporate creditors. Other provisions of the Corporation Code would indicate that even under extraordinary

[63] ART. 1159. Obligations arising from contracts have the force of the law between the contracting parties and should be complied with in good faith.

ART. 1315. Contracts are perfected by mere consent, and from that moment the parties are bound not only to the fulfillment of what has been expressly stipulated but also to all the consequences which, according to their nature, may be in keeping with good faith, usage and law.

[64] *Ramos*, 41 SCRA at 588.

circumstances the fiduciary roles of decision-makers is maintained. Section 97, on close corporation,[65] provides that when the articles of incorporation provides that the business of the corporation shall be managed by the stockholders rather than by a board of directors, then "the stockholders of the corporation shall be deemed to be directors for the purpose of applying the provisions of this Code and shall be subject to all liabilities of directors." Under Section 100(5), to the extent that stockholders are actively engaged in the management or operation of the business and affairs of a close corporation, the stockholders are held to strict fiduciary duties to each other. Said stockholders shall also be personally liable for corporate tort unless the corporation has obtained reasonably adequate liability insurance.

The process of negotiating a loan workout agreement that envisions a shift of control to the creditor does not represent an arm's length transaction. Often, it is in a desperate situation that the corporation bargains from to stave off liquidation. The threat of foreclosure by the creditor on the major assets places the corporation under the gun during the whole negotiating process. In a situation where the appointing creditor appoints an "outside board" to the corporation, the rules on inter-locking directors should be applied by analogy. Section 33 of the Corporation Code now governs the situations pertaining to transactions between corporations with inter-locking directors.

> Sec. 33. Contracts between corporations with inter-locking directors. --Except is cases of fraud, and *provided the contract is fair and reasonable under the circumstances,* a contract between two or more corporations having inter-locking directors shall not be invalidated on that ground alone: *Provided, that if the interest of the inter-locking director in one corporation is merely nominal, he shall be subject to the provisions of the preceding section insofar as the latter corporation or corporations are concerned.*
>
> Stockholdings exceeding twenty (20%) percent of the outstanding capital stock shall be considered substantial for purposes of inter-locking directors. (Underscoring supplied.)

The rule embodied in Section 33 is that contracts between

[65] Close corporation is defined under Section 98 as that where: (a) all of the corporation's issued stock of all classes, exclusive of treasury shares, shall be held of record by not more than a specified number of persons, not exceeding twenty (20); (b) all of the issued stock shall be subject to one or more specified restrictions on transfer; (b) the corporation shall not list in any stock exchange or make any public offering of any of its stock of any class.

corporations with inter-locking directors are valid as long as there is no fraud and the contracts are fair and reasonable under the existing facts. Nevertheless, if the interest of directors is considered nominal (not exceeding 20%), the rules of Section 32 on self-dealings will apply.

Section 44 of the Corporation Code provides that when a corporation enters into a management contract, the approval of the board of directors is itself not enough; in addition, the vote of stockholders representing a majority of the outstanding capital stock is required. In case a stockholder representing the interests of both the managing and the managed corporations owns or controls more than one-third (1/3) of the outstanding capital stock entitled to vote of the managing corporation, or where a majority of the members of the board of directors of the managing corporation also constitute a majority of the members of the board of directors of the managed corporation owning at least two thirds (2/3) of the total outstanding stock entitled to vote.[66]

If the entering of a management contract requires the approval of the stockholders, in the same manner a loan workout agreement that envisages a transfer of control of the corporation to the creditor should be subject to the qualifying vote of stockholders owning at least two-thirds (2/3) of the outstanding capital stock of the corporation. This recommended requirement would often be fulfilled in the paradigm of a loan workout arrangements because the only way that the creditor would be able to obtain control of the board is when the controlling stockholders execute voting trust agreements. However, installing a new board does not always have to be with stockholder

[66] *Sec. 44. Power to enter into management contract. --No corporation shall conclude a management contract with another corporation unless such contract shall have been approved by the board of directors and by stockholders owning at least a majority of the outstanding capital stock, or by at least a majority of the members in the case of non-stock corporation, of both the managing and the managed corporation, at a meeting duly called for the purpose: Provided, That (1) where a stockholder or stockholders representing the same interest of both the managing and the managed corporation own or control more than one-third (1/3) of the total outstanding capital stock entitled to vote of the managing corporation; or (2) where a majority of the members of the board of directors of the managing corporation also constitute a majority of the members of the board of directors of the managed corporation, then the management contract must be approved by the stockholders of the managed owning at least two-thirds (2/3) of the total outstanding capital stock entitled to vote, or by at least two-thirds (2/3) of the members in the case of a non-stock corporation. No management contract shall be entered into for a period longer than five years for any one term.*

The provisions of the next preceding paragraph shall apply to any contract whereby a corporation undertakes to manage or operate all or substantially all of the business of another corporation, whereby such contracts are called service contracts, operating agreements or otherwise: Provided, however,that such service contract or operating agreements which relate to the exploration, development, exploitation or utilization of natural resources may be entered into for such period as may be provided by the pertinent laws or regulations.

action, since a current board may resign *in seriatim* to install the representatives of the creditor.[67] But more importantly, not only the general proposal or rehabilitation by the creditor's management, but also the very details of the enabling terms and conditions of the creditor's regime, should receive stockholder scrutiny.

The weakness of stockholders' approval or ratification has, however, been pointed out. When stockholders are asked to ratify a transaction with interested directors they are often not in position to *negotiate* for the corporation since they are limited to accepting or rejecting the proposed transaction[68] "Even if it be assumed that the deal is fair, that is not what shareholders are entitled to. They are entitled to have someone negotiate the best deal obtainable for the corporation."[69] Thus, the qualifying vote of the stockholders to a loan workout agreement does not assure that the terms thereof would not be onerous as to gravely prejudice the interests not only of the approving stockholders, but also those of the minority stockholders and corporate creditors. The major stockholders of the corporation often have little bargaining powers themselves since often their personal guarantee of the corporate loans make them vulnerable to the threats of foreclosure. To obtain the approval of the minority stockholders and all corporate creditors to the loan workout agreements, especially in large public corporations, may prove unwieldy and may not result in reaching a loan workout agreement at all, especially when the time cost of money compels the major creditor to make early decisive moves on delinquent accounts. The corporation and its stockholders and other corporate creditors need the protective role of a party who can bargain from a strong position. A famous American article[70] has suggested prior administrative approval of transactions involving conflict of interest situations;[71] so does a leading American corporate author.[72]

[67] *Under Section 29 of the Corporation Code, any vacancy occurring in the board of directors other than by removal by stockholders or members or by expiration of term, may be filled by the vote of at least a majority of the remaining directors, if still constituting a quorum.*

[68] *See* Marsh, *Are Directors Trustee?*, 22 BUS. LAW 35, 49 (1966).

[69] *Id.*

[70] *Id.*

[71] *Id.* at 51, 73-76.

[72] CLARK, *supra* note 23, at 188-89: "Many of the major opportunities for realizing self-dealing surpluses could be exploited in a legal system that (1) basically adopted a flatly prohibited rule against basic self-dealing but (2) provided for administrative approval, through class exemptions and specific variances, of transactions that meet appropriate standards of justification. For a variety of reasons, the Securities and

(continued...)

This is the role that the Philippine SEC is probably already equipped to handle. Already, the SEC, pursuant to the powers granted by its enabling law,[73] undertakes or supervises the management of entities in appropriate cases when there is imminent danger of dissipation, loss, wastage or destruction of assets, or paralyzation of business operations of such corporations on entities which may be prejudicial to the interest of minority stockholders, or the general public. As a necessary requirement for the adoption and implementation of a loan workout agreement, it may be required that the same be first submitted by the parties to the SEC for approval.

The requirement of a prior approval by the SEC would and should serve the following purposes: (a) to ensure that the terms of the loan workout agreement would promote the best interests of all affected parties, including the minority stockholders and other corporate creditors; (b) to serve also as a "stamp of approval" of the extent of involvement of the creditor in the affairs of the corporation, and the faithful implementation of which would not constitute "overreaching" as to make the appointing creditor liable for the obligations of the corporation to third parties under the various theories of "lender liability." Would such a system bind minority stockholders and corporate creditors? It is unlikely, since a rule of law cannot and should not work to deprive nonparticipating parties of their day in court in what is perceived to be a violation of their rights.

IV. STAGE TWO: MANAGING THE FINANCIAL CRISIS

The focal point of the whole arrangement must fall within the ambit of the role of the nominee directors and officers, for it is in their implementation that life is given to the loan workout agreement.

A. General Standard of Management

The case of *Steinberg v. Velasco*,[74] describes the nature of the duty of care that must be exercised by directors and officers in general:

> [D]irectors are not liable for losses resulting to the corporation

[72](...continued)
Exchange Commission may be the best regulatory agency to administer this proposed exemption-making process."

[73] Pres. Decree 902-A, Sec. 5 (1976), as amended.

[74] 52 Phil. 953 (1929).

> from want of knowledge on their part; or for mistakes of judgment, provided they were honest, and provided they are fairly within the scope of the powers and discretion confined to the managing body. But the acceptance of the office of a director of a corporation implies a competent knowledge of the duties assumed, and directors cannot excuse imprudence on the ground of their ignorance or inexperience; and if they commit an error of judgment through mere recklessness or want of ordinary prudence or skill, they may be held liable for the consequences. Like mandatory, to whom he has been likened, a director is bound not only to exercise proper care and diligence, but ordinary skill and judgment. As he is bound to exercise ordinary skill and judgment, he cannot set up that he did not possess them.[75]

The concept of "bad faith" in corporation law, as it pertains to directors and officers, has received definition from the Philippine Supreme Court. In *Board of Liquidators v. Kalaw*,[76] it was held that "bad faith does not simply connote bad judgment or negligence; it imports a dishonest purpose or some moral obliquity and conscious doing of wrong; it means breach of a known duty through some motive or interest or ill will; it partakes of the nature of fraud * * * bad faith contemplates a state of mind affirmatively operating with furtive design or with some motive of self- interest or ill will or for ulterior purposes."[77]

A board of directors which fails, in spite of knowledge or by virtue of business imprudence, to prevent the officers of the corporation from committing illegal acts would be acting in fraud, and would entitle the stockholders to bring a derivative suit in behalf of the corporation, and may seek to have the corporation's operations placed under receivership.[78] As an alternative to removing an abusive majority stockholder from management, the court may grant to the minority stockholder a veto right, appealable to the court, on all decisions of management.[79] When the corporation is virtually immobilized from commencing suit against its abusive directors, laches does not even begin to attach against the corporation until such abusive directors

[75] *Id.* at 960-61 (citing Section 458 Ruling Case Law, Vol. 7).

[76] 20 SCRA 987 (1967).

[77] *Id.* at 1006-1007.

[78] Reyes v. Tan, 3 SCRA 198, 202 (1961). *See also* Angeles v. Santos, 64 Phil. 697, 706 (1937).

[79] Chase v. Buencamino, Sr., 136 SCRA 365 (1985).

are removed from office.[80]

In the situation where the creditor appoints its own directors or officers to the board of the corporation, a basic self-dealing situation arises. Under Philippine law, a party participates not only if he votes personally or is present, but even when absent, if all the other board members are his relatives or if the board is dominated in some other way by him, as when he employs dummies.[81] In cases of director's contract with the corporation, by the weight of authority, the burden of proof of fairness in fiduciary contracts is on the director or the one claiming under his contract to show that the transaction is fair and honest, even though the corporation is represented by a disinterested voting majority of directors.[82]

Although an "outside" board may be deemed to be more objective than a board composed of the creditor's own officers, nevertheless since they are appointed by virtue of the mandate of the loan workout agreement, how much of the interests of the appointing creditor is to be pressed upon the exercise of the business judgment is largely affected by the terms thereof. The agenda set out for the "outside" board will determine their responsibilities, and if the agenda is one-sided in favor of the creditor, then the provisions of Section 31 of the Corporation Code will apply.

Section 32 of the Corporation Code presently governs situations pertaining to self-dealing situations.

> Sec. 32. Dealings of directors, trustees or officers with the corporation.--A contract of the corporation with one or more of its directors or trustees or officers is voidable, at the option of such corporation, unless all the following conditions are present:
>
> 1. That the presence of such director or trustee in the board meeting in which the contract was approved was not necessary to constitute a quorum for such meeting;
> 2. That the vote of such director or trustee was not necessary for the approval of the contract;
> 3. That the contract is fair and reasonable under the circumstances; and
> 4. That in the case of an officer, the contract with the officer has been previously authorized by the board of directors.
>
> Where any of the first two conditions set forth in the preceding

[80] Central Cooperative Exchange Inc. v. Tibe, Sr., 33 SCRA 593, 598 (1970).

[81] SALONGA, *supra* note 33, at 296.

[82] *Id.*

> paragraph is absent, in the case of a contract with a director or trustee, such contract may be ratified by the vote of the stockholders representing at least two-third (2/3) of the outstanding capital stock or of two-thirds (2/3) of the members in a meeting called for the purpose: *Provided,* That full disclosure of the adverse interest of the directors or trustees involved is made at such meeting: *Provided, however,* That the contract is fair and reasonable under the circumstances.

The basic premise of Section 32 is that self-dealing transactions are not void *per se* nor are they automatically voidable. The condition of a self-dealing contract would need only to satisfy any of the two tests provided in Section 32:

> First Test: (a) the contract is fair and reasonable under the circumstances; and (b) there is approval by disinterested directors.[83]
> Second Test: (a) the contract is fair and reasonable under the circumstances; and (b) disclosure and shareholder ratification by a qualified majority vote of two-thirds of the outstanding capital stock.

Section 32 adopts the rule that the interested directors could not be counted for quorum purposes. Although it does not provide for full disclosure when it comes to the approval of the contract by the disinterested directors, the same is deemed to be a requisite, for otherwise it would amount to fraud or "insidious machination" as held in *Strong*. The rules on unauthorized contracts may be used by analogy. Philippine jurisprudence has held that before unauthorized contracts may be ratified, its terms and conditions must be brought to the full knowledge of the board of directors,[84] and the ratification cannot be made by the same officers who entered into it.[85] Where the contract does not comply with the requisite of being "fair and reasonable under the circumstances," and yet it receives the approval of the required disinterested board, or is ratified by stockholders representing two-thirds of the outstanding capital stock, the contract is voidable at the option of the corporation. In this case, it is likely that only the non-approving

[83] Unlike 144 of the Delaware General Corporation Law, and MBCA 8.31, the disinterested directors must constitute a quorum.

[84] Yui Chuck v. Kong Li Po, 46 Phil. 608, 615 (1924); *See also* Montague v. Artesian Water Co., 32 Phil. 468, 474 (1915).

[85] Vicente v. Geraldez, 52 SCRA 210, 228 (1973).

minority stockholders could bring a derivative action on behalf of the corporation to have the contract annulled. The personal liability of the directors for knowingly approving such a contract is governed by Section 31.

Section 32 does not also indicate whether in determining the stockholders' vote ratifying a self-dealing transaction, the adverse interest of a shareholder does not disqualify him from voting as a shareholder to ratify such contract. The opinion has been expressed that such adverse interest does not disqualify a stockholder from voting his shares.[86] Nevertheless, in *Walter E. Olsen & Co. v. Olsen*,[87] the Philippine Supreme Court, determining the legal effect of the ratification by stockholders of the activities of the director, held:

> Having, as he had, absolute and almost exclusive control over the function of the corporation * * * [t]he approval of his account at the first meeting of the stockholders cannot be considered a justification of his conduct, nor does it remove every suspicion of bad faith, because the corporation was constituted exclusively by the defendant-appellant himself and his co-speculator, Mark, and nothing else could be expected from it. * * * .[88]

In *Olsen* a controlling stockholder, who had almost exclusive control over the functions of the corporation and its funds on account of his three-fold capacity as president, treasurer and general manager, was held to the duties of "trustee" of the corporation, which included his obligation to see by all legal means possible that the interest of the stockholders were protected, and that he should not abuse the extraordinary opportunity which his multiple positions offered him to dispose of the funds of the corporation. "Ordinary delicacy required that in the disposition of the funds of the corporation for his personal use, he should be very careful, so as to do it in such a way as would be compatible with the interests of the [minority] stockholders and his fiduciary character."[89] In a loan workout arrangement, in spite of the execution of the voting trust, the vote of the stockholders would be one counted for ratification, otherwise the requirement would prove useless since the appointing creditor holds the controlling vote by virtue of the

[86] SALONGA, *supra* note 33, at 297; *see also* Jimenez, *Corporate Watch-Dogs*, 27 ATENEO L. J. 15, at 37 (1982). However, in sustaining this position, authors or commentators cite American jurisprudence.

[87] 48 Phil. 238 (1925).

[88] *Id.* at 242-43.

[89] *Id.* at 242.

voting trust.

When faced with the enforcement of the terms of the loan workout agreement in situations where the creditor and the corporation would have conflicting interests, the norm that should govern the nominee directors is dictated by Section 31 of the Corporation Code.[90] It should be noticed that under Section 31, no ratification by stockholders of the unlawful act of the directors and officers is provided. Whereas, when it comes to Sections 32 and 33, on self- dealings and interlocking directorship, and Section 34, on usurpation of corporate opportunity,[91] stockholder ratification is allowed. The clear inference of the statutory language is that when directors willfully and knowingly vote or assent to patently unlawful acts of the corporation (a violation of the duty of obedience), they are liable, and such liability cannot be contracted away.

B. Providing a General Insulation for Nominee Directors and Officers for Acts Under Loan Workout Agreement.

Under the old Corporation Law, the Supreme Court adopted the strict rule which disallowed provisions in the corporate charter or by-laws exempting in advance directors and officers from liabilities on self-dealing with the corporation. In the case of *Palting v. San Jose Petroleum, Inc.*,[92] the articles of incorporation provided that: (a) no contract or transaction between the company and any other association or corporation shall be affected except in case of fraud, by the fact that any of the directors or officers of the company may be interested in or are directors or officers of such other associations or

[90] Sec. 31. Liability of Directors, Trustees or Officers. --Directors or trustees who willfully and knowingly vote for or assent to patently unlawful acts of the corporation or who are guilty of gross negligence or bad faith in directing the affairs of the corporation or acquire any personal or pecuniary interest in conflict with their duty as such directors or trustees shall be liable jointly and severally for all the damages resulting therefrom suffered by the corporation, or its stockholders or members and other persons.

[91] Sec. 34. Disloyalty of a Director. --Where a director, by virtue of his office, acquires for himself a business opportunity which should belong to the corporation, thereby obtaining profits to the prejudice of such corporation, he must account to the latter for all such profits by refunding the same, unless his acts has been ratified by a vote of the stockholders owning or representing at least two-thirds (2/3) of the outstanding capital stock. This provision shall be applicable, notwithstanding the fact that the director risked his own funds in the venture.

[92] 18 SCRA 924 (1966).

corporations; (b) none of such contracts or transactions of the company with any person or persons, firms, associations or corporations shall be affected by the fact that any director or officer of the company is a party to or has an interest in such contract or transaction or has any connection with such person or persons, firms, associations or corporations; and (c) any and all persons who may become directors or officers of the company are thereby relieved of all responsibilities which they would otherwise incur by reason of any contract entered into with the company either for their own benefit, or for the benefit of any person, firm, association or corporation in which they may be interested.

In striking down such provisions, the Philippine Supreme Court held:

> These provisions are in direct opposition to our corporation law and corporate practices in this country. These provisions alone would outlaw any corporation locally organized or doing business in this jurisdiction. The impact of these provisions upon the traditional fiduciary relationship between the directors and the stockholders of a corporation is too obvious to escape notice by those who are called upon to protect the interest of investors. The directors and officers of the company can do anything, short of actual fraud, with the affairs of the corporation even to benefit themselves directly or other persons or entities in which they are interested, and with immunity because of the advance condonation or relief from responsibility by reason of such acts. This and the other provision which authorizes the election of non-stockholders as directors, completely disassociate the stockholders from the government and management of the business in which they have invested.[93]

Palting therefore renders void any blanket condonation for future wrongs to be committed by directors and officers. It does not prohibit actual dealings between the corporations and its directors and officers. This same premise has been maintained in Section 32 of the Corporation Code since its requirements of fairness and disclosure of the particular transaction would prevent advance and broad condonation of self-dealing contracts. In an opinion rendered by the SEC, it held that directors cannot evade liability under Section 31 through a by-law amendment shifting the liability to the managing director or the executive vice president.[94]

[93] *Id.* at 942-43 (1966).

[94] Opinion, dated Jan. 22, 1982; *see* Jimenez, *Corporate Watch-Dogs*, 27 ATENEO L.J. 15, 28 (1982).

But even if a blanket authority is not authorized, nevertheless, the Philippine Supreme Court has allowed self-dealing transactions. In *Mead v. McCullough*,[95] the Supreme Court held: "May officers or directors of the corporation purchase the corporate property? The authorities are not uniform on this question, but on the general proposition whether a director or an officer may deal with the corporation, we think the weight of authority is that he may."[96] It was further held that an officer or director of a corporation, who is a stockholder, being an agent merely of an artificial person, and having a joint interest in the corporate property, is not such an agent as that treated of in Article 1713 of the old Civil Code as to disqualify him from buying corporate properties.[97]

C. How Far Can the Contractual Stipulations in the Loan Workout Agreement Go in Allowing the Corporate Creditor to Prefer Its Interest?

Although a stipulation that preempts or stifles the *exercise* of discretion (i.e., business judgment) of directors and officers or that seeks to hold them to a lesser standard of loyalty is void as being against public policy, nevertheless, directors and officers, being merely agents of the corporation, are bound by the valid and binding contracts of the corporation. A loan workout agreement must certainly belong to such category. What can be the extent of power that can therefore be granted to the creditor in a loan workout agreement that becomes the guide by which the nominee directors and officers may discharge their obligations to all parties?

It is simple to propose that when the "rights" conferred to the creditor under the loan workout agreement are consistent with the "interests" of the corporation, then the enforcement thereof by the nominee directors and officers would not be a violation of their fiduciary duties to the other parties to the arrangement. But it is hard to imagine a situation when the "creditor's rights" would ever be consistent with the "corporate interests," for the former often, if not always, conflicts with the latter. It probably, therefore, is a question of degree. When the exercise of the creditor rights "adversely affect" the interests of the corporation, its stockholders, and perhaps even other

[95] 21 Phil. 95 (1911).

[96] *Id.* (citing Merrick v. Peru Coal Co., 61 Ill. 472; Harts v. Brown, 77 Ill. 226; Twin-Lick Oil Co. v. Marbury, 91 U.S. 587; Whitwell v. Warner, 20 Vt. 425; Smith v. Lansing, 22 N.Y. 520; City of St. Louis v. Alexander, 23 Mo. 483; Beach v. Miller, 130 Ill. 162).

[97] *Id.* at 121-22.

creditors, then despite the contractual stipulations in the loan workout agreement, the nominee directors and officers have no obligation to enforce such provisions; otherwise, they may be held personally liable, and the questioned transactions may be enjoined. What is the degree to which one can judge whether the "adverse effect" would warrant such defiance by the nominee directors and officers of the contractually indicated duties?

As mentioned previously, Philippine jurisprudence has not resolved to what extent the creditor may, through its nominee directors and officers, interfere into the affairs of the corporation, and still be within legal bounds. For this we turn for guidance to American jurisprudence.

V. COMPARISON WITH DEVELOPMENTS IN AMERICAN JURISPRUDENCE

The general principle of the fiduciary duty of loyalty is said to be a residual concept that can include factual situations that no one has foreseen and categorized and thus contribute to the continuous evolution of corporation law.[98] The fiduciary duties of a creditor who assumes control of the management of a borrowing corporation is one of the fields where such principle has extended to.

The controlling motivation for a creditor seeking control of a corporation is to obtain a benefit which may take the form of the successful rehabilitation of the corporation, the enhancement of the collateral, or the avoidance of deterioration thereof.[99] Control by the creditor may exist when the power to select a majority of the directors of a corporation may be exercised by virtue of a voting trust, or as holder of an irrevocable proxy, or as pledgee of shares with power to vote a controlling block of a debtor's stocks.[100]

Control may arise with no malevolent intent on the creditor's part, and would not be reprehensible when viewed in the light of the creditor's legitimate right not only to protect its interest in terms of the funds it has loaned, but also to ensure the borrower's survival so that the loan can be repaid.[101] Under certain circumstances, such a move on the part of the

[98] CLARK, *supra* note 23, at 141; *see also* CLARK, AGENCY COSTS VERSUS FIDUCIARY DUTIES 55, 71-79 (1985).

[99] Schecter, *The Principal Principle: Controlling Creditors Should be Held Liable for their Debtors' Obligations*, 19 U.C. DAVIS L. REV. 875, 882 (1986).

[100] Douglas-Hamilton, *supra* note 11, at 344.

[101] CAPELLO, *supra* note 11, at 148.

major creditor may be beneficial to all concerned, including the junior creditors. But when control is employed by the creditor primarily for its own interest at the expense of other parties, any action it takes pursuant thereto becomes a violation of its fiduciary duties. It is at that point when the creditor "oversteps the imaginary boundary which transforms it into managing and controlling the borrower as to make itself liable."[102]

In discussing the fiduciary duties of loyalty of nominee directors and officers appointed by the creditor, perhaps the best place to start is the case of *Pepper v. Litton*,[103] to which the Philippine Supreme Court frequently alludes in discussing the fiduciary obligations of directors and officers. In *Pepper*, the United States Supreme Court held that the powers of a director and a dominant controlling stockholder or group of stockholders, are "powers in trust" and that "[t]heir dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation are challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein."[104] The Court also laid down the fiduciary standards of conduct of a controlling stockholder in relation to the corporation, its other stockholders, and creditors:

> He who is in such a fiduciary position cannot serve himself first and his cestuis second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. He cannot by the use of the corporate device avail himself of privileges normally permitted outsiders in a race of creditors. He cannot utilize his inside information and his strategic position for his own preferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. *He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements.*[105] (Emphasis supplied.)

[102] *Id.*

[103] 308 U.S. 295, 60 S. Ct. 238, 84 L.Ed. 281 (1939).

[104] *Id.* at 306 (citing Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 599).

[105] *Id.*, at 247, 311.

Both statutory and case law suggest two approaches to deal with conflict-of-interests cases: (a) The parties may arrange to have provisions in the charter or by-laws that authorize and insulate self-dealing transactions to a greater extent than that provided under general corporation law; or (b) they may also seek shareholder approval or ratification of particular self-dealing transactions.[106] American decisional law has established that such provisions merely indicated the shift from the voidability rule to the present fairness rule about self-dealing transactions.[107] There is no indication that charter provisions may generally substitute for clearly established rules governing conflicts of interest; and such provisions are not seen as foreclosing judicial scrutiny of the transactions.[108] Doubt has been expressed as to the effectiveness of such a principle since courts would not carefully and vigorously scrutinize all such transactions unless one presents the issue.[109]

Shareholder ratification simply immunizes the transaction from attack on the ground that it was not properly authorized; that it will shift the burden of proof on the issue of the fairness of the transaction to whoever interposes the voidability of the transaction. But even courts that clearly give substantial weight to ratification often leave an out for the plaintiff who can prove something worse than unfairness, such as "fraud,"[110] "overreaching,"[111] or a "waste or gift of corporate assets."[112] "To a large extent, the difference between these forms of misconduct and ordinary unfairness is just a matter of degree. In practice, the courts seem to have a great deal of latitude in deciding how much weight to give to shareholder ratification and what effect

[106] CLARK, *supra* note 23, at 175.

[107] "By 1960 it could be said with some assurance that the general rule was that no transaction of a corporation with any or all of its directors was automatically voidable at the suit of a shareholder, whether there was a disinterested majority of the board or not; but that courts would review such a contract or subject it to rigid and careful scrutiny, and would invalidate the contract if it was found to be unfair to the corporation." Marsh, *supra* note 70, at 43.

[108] CLARK, *supra* note 23, at 176-178.

[109] Marsh, *supra* note 70, at 54-55.

[110] Continental Sec. Co. v. Belmont, 99 N.E. 138 (N.Y. 1912); American Timber and Trading Co. v. Niedermeyer, P.2d. 1211 (or 1976); Contra Claman v. Robertson, 128 N.E. 2d. 429 (Ohio 1956).

[111] Chambers v. Beaver-Advance Corp., 140 A.2d 808 (Pa. 1958).

[112] Schreiber v. Bryan, 396 A.2d 512 (Del. Ch. 1978); Eliasberg v. Standard Oil Co., 92 A.2d 862 (N.J. Super. 1952), *aff'd mem* 97 A.2d 437 (N.J. 1953).

it will have on the outcome of a particular case."[113]

In *Globe Woolen Co. v. Utica Gas & Electric Co.*,[114] the New York Court of Appeals, through Judge Cardozo, laid down the rule that the obligation of a director in a conflict-of-interests situation requires of him not only to disclose his own interest in the contract to the approving directors and to abstain from voting, but he also has an affirmative duty to disclose the risks and one-sidedness of the proposed transaction itself.[115] In *Commons v. Schine*,[116] the California Court of Appeals held that one who dominates and controls an insolvent corporation may not use his power to secure to himself an advantage over other creditors and he shall be "treated in the same manner as a director of an insolvent corporation and thus occupies a fiduciary relationship to its creditors."[117]

Control alone is almost never sufficient to justify imposing liability on the creditor; proof of some form of tortious conduct is also required to hold the controlling creditor liable.[118] What would constitute egregious conduct on the part of the creditor depends largely on the attending circumstances in each case.[119] For example, it is not uncommon or unlawful for creditors to insist that borrowers, particularly financially troubled ones, meet certain requirements initially to obtain a loan or as a condition for continued financing. "The lender may require that debt-to-equity ratios be maintained, accounts receivables be assigned, or other conditions be met to ensure that the borrower maintains financial health and is able to repay its loan. If the terms are freely agreed upon by the borrower and the conditions are fairly and consistently applied, liability is unlikely."[120] Where the bank merely made suggestions to the borrower, but the borrower had no obligation to follow them, and in addition, the bank merely monitored the borrower's finances but did not mandate how they should be managed, the Court found

[113] CLARK, *supra* note 23, at 178-179.

[114] 121 N.E. 378 (N.Y. 1918).

[115] *Id.* at 381.

[116] 35 Cal.App.3d 141, 110 Cal.Rptr. 606 (1973).

[117] 35 Cal.App.3d 141, 144; 110 Cal.Rptr. 606, 608-609.

[118] Schechter, *supra* note 69, at 888.

[119] The court should scrutinize the creditor's actual use of its control over debtor-borrower's operations to determine whether its control constituted inequitable conduct. In Re T.E. Mercer Trucking Co., 16 B.R. 176, 190 (Bankr.N.D. Tex. 1981); In Re American Lumber Co., 5 B.R. 470 , 478 (D. Minn. 1980).

[120] CAPELLO, *supra* note 10, at 148.

it reasonable to conclude that transfers made by the debtor to the bank were not voidable preferential transfers.[121] The monitoring of operations and proffering of advice to a debtor, even when coupled with a decision to withhold credit, does not rise to the level of control for purposes of equitable subordination.[122]

But the creditor oversteps the imaginary boundary when it takes control of the borrower, as when it insists that its own management be installed, that voting rights be exercised to allow the borrower to be dominated by the creditor, and that restrictive clauses be included in the loan agreements to protect the creditor's interests.[123] The creditor may install key personnel on the borrowers's premises.[124] So also, when the creditor interferes unduly in the day-to-day management of the borrower's business, as when the actual marketing and financing activities of the borrower are made only with the concurrence and open approval of the representative of the creditor, this would be an improper entanglement, as to make the creditor be considered the principal of the borrower, and therefore jointly liable to other corporate creditors.[125] It may be the same result if the creditor induces the borrower to hire a "management" or "consultant" of the creditor's choosing, when it turns out that the management or consultant is more the agent of the creditor.[126] In *Credit Managers Association of Southern California v. Superior Court*,[127] the creditor's compelling the borrower to hire a business consulting company selected by the creditor that was able to overrule and supplant the borrower's board of directors, made the creditor liable to the borrower for the losses resulting from the mismanagement of the consultant.

A series of massive transfers that strip the debtor of vital assets surely

[121] In Re Ludwig Honold Manufacturing Co., Inc., 46 B.R. 125 (Bankr. E.D. Pa. 1985).

[122] W.T. Grant, 699 F.2d 599 (2d Cir. 1983).

[123] *Id.*

[124] Chicago Mill & Lumber Co. v. Boatmen's Bank, 234 F. 41, 43-44 (8th Cir. 1916); Krivo Indus. Supply Co. v. National Distillers & Chem. Corp.; 483 F.2d 1098, at 1110-1112 (5th Cir. 1916); Credit Manager's Ass'n. v. Superior Court, 51 Cal. App. 3d 352, 124 Cal.Rptr. 242 (1975).

[125] A. Gay Jenson Farms Co. v. Cargill, Inc. (Minn. 1981) 309 N.W. 2d 285.

[126] Technology Exchange Corporation of America, Inc. v. Grant County State Bank (D. Colo. 1986) 646 F.Supp. 179.

[127] 51 Cal. App. 3d 352, 124 Cal. Rptr. 242 (1975).

must be sufficient to trigger liability.[128] The controlling creditor may affect the borrower's income by affecting prices, marketing policies, or asset management, such as when the borrower is compelled to sell its product for cash at a lower price rather than on credit in order to build up bank accounts instead of receivables, at the expense of long-term revenues; or when it is forced to sell-off assets to raise cash.[129] The same principle is also applicable to the creditor's influence on the debtor's production procedures.[130]

Other objected intrusions of the creditor include: (a) compelling the corporation to obtain additional infusions of investment or credit, with the aim of generating new assets that become part of the senior creditor's collateral;[131] (b) causing corporation to delay payments to other creditors;[132] (c) vetoing necessary expenditures so that debtor's cash position is enhanced;[133] and (d) causing the debtor to dispose of unencumbered but vitally productive assets and to transmute the proceeds into a possibly less productive, but encumbered form.[134]

When a creditor, whose main motive is to protect its own interests at the expense of other creditors, unduly interferes with a financially troubled

[128] In Re Process-Manz Press, Inc., 236 F.Supp. 333, 336-344 (N.D. Ill. 1964), rev'd on other grounds, 369 F.2d 513 (7th Cir. 1966), *cert. denied* 386 U.S. 957 (1967); In Re Rego Crescent Corp. 9 B.C.D. 867, 872, 23 B.R. 958 (Bankr. E.D.N.Y. 1982).

[129] State National Bank of El Paso, 628 S.W.2d. 661; *see also* Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098, at 1112 (5th Cir. 1974).

[130] Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098, at 1110-1114 (5th Cir. 1974).

[131] *E.g.* Central States Stamping Co. v. Terminal Equip. Co., 727 F.2d 1405, 1409 (6th Cir. 1984), involving direct misrepresentation to junior creditors by senior creditor; In Re Osborne, 42 Bankr. 988, 999-1000 (Bankr. W.D. Wis. 1984) (same); *see also* In Re Falstaff Brewing Corp. Antitrust Litig., 441 F.Supp. 62, 65 (E.D. Mo. 1977), involving allegations that a dominant lender forced the debtor to procure new equity investment.

[132] In Re American Lumber, 5 Bankr. 470, 474 (Bankr. D. Minn. 1980).

[133] Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098, at 1111 (5th Cir. 1973), modified and reh'g denied, 490 f.2d 916 (5th Cir. 1974).

[134] In Re Ludwig Honold Mfg., 46 BAnkr. 125, 127-129 (Bankr. E.D. 1985); *see also* State Nat'l Bank of El Paso v. Farah Mfg., 678 S.W.2d 661, at 677-678, 691 (tex. Civ. Appl. 1984), senior creditors influenced selection of debtor's chief executive officer, who then sold off some of the debtor's productive assets to repay the debtor's obligations to the senior creditor.

borrower, its claim may be made subject to equitable subordination.[135] Thus, when a creditor, whose credit was originally unsecured, compelled the borrower to subsequently convey a security prior to liquidating the credit and taking over its operation, it was penalized by having its credit subordinated to other corporate liabilities.[136] A controlling corporate creditor may be held liable to the corporation entitling the latter to equitable adjustment of a creditor's rights in bankruptcy or reorganization proceedings, upon the claim that the bankrupt corporation has suffered losses through the mismanagement of the controlling corporate creditor.[137] In *Taylor v. Standard Gas Co.*,[138] the controlling stockholder and only debtor of the company was made liable to the latter when it caused the latter to pay preferred dividends in large amounts in order to prevent the preferred stockholders from having a vote and a voice in its management, and that such dividends were paid by the company when it was nearly in bankruptcy and in dire need of working capital. In *In Re Process-Manza Press, Inc.*,[139] the corporate creditor was held liable for participating in the wrongful manipulation of the credit of the parent corporation on its subsidiary.

Admittedly, most of the afore-discussed authorities cover situations when the lender, who directly owes no fiduciary duties to the borrowing corporation or the stockholders, participates directly in or dominates the running of the debtor's operations. However, the instances covered therein would be good indications of what particular acts and circumstances may be considered egregious or oppressive provisions in the loan workout agreement, and the enforcement of which the nominee directors or officers, or even the nominating creditor itself, may be held liable.

If a guiding principle can be extracted from the various cases decided on the matter, it is that the conduct of a creditor which has the power to control the operations of a corporation would become egregious or oppressive when either: (a) control is employed to achieve transactions the sole purpose of which is to benefit the creditor; or (b) the creditor disregards the separate corporate personality of the corporation as to treat the latter its mere

[135] In Re American Lumber Co. 5 B.R. 470 (Bankr. D. Minn. 1980).

[136] *Id.*

[137] *See* Douglas-Hamilton, *supra* note 11, at 348. *See also* In Re prima Company, 98 F.2d (7th Cir. 1938) *cert. denied* 305 U.S. 658 (1939), the corporate borrower suffered damages through the mismanagement of the creditor's agent.

[138] 306 U.S. 307 (1939).

[139] 236 F.Supp. 333 (N.D. Ill. 1964), rev'd on other grounds 369 F.2d 513 (7th Cir. 1966) *cert. denied* 386 U.S. 957 (1967).

instrumentality, regardless of its motive.

In a loan workout arrangement, what seems to be the controlling factor in the determination of the reasonableness of the terms thereof is whether the transactions are of such nature as would have been undertaken by the corporation where it not under the control of the creditor. Ordinarily, the nominee directors and officers appointed by the creditor would not be in a position to make such an unbiased judgment. The demarcation line delineating the extent of the fiduciary obligations of the nominee board in determining whether they would be breaching their duties to any party, would demand that in spite of the origin of their appointment, the nominee board must see itself as fiduciary of all contending interests in a loan workout arrangement, and not set themselves out as dummies at the will of the appointing creditor. Their transactions involving the appointing creditor would be subject to rigorous scrutiny; and the burden is on the creditor, acting through the nominee board, to prove good faith and fairness to the corporation and its beneficiaries in any transaction with the corporation in which such creditor is involved. "The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain."[140] Violation of the fiduciary roles would not only subject the appointing creditor to liability and likely subordination of its claims against the borrowing corporation, but may also subject the nominee directors and officers to personal liability as well. A director or officer who violates the duty of fair dealing may be required to repay the corporation any salary he earned during the relevant period in addition to making restitution of his wrongful gain.[141] Punitive damages may also be awarded against directors and officers who have breached their duty of loyalty.[142]

VI. STAGE THREE: PULLING THE PLUG

The underlying motivation in the loan workout arrangement for the cooperating stockholders is for the creditor's representatives to use all reasonable means to save their investments by managing the corporation out of financial crisis. Although miracles are not within the contractual scope, still the parties contract with the expectation that best efforts would be expended.

[140] Pepper v. Litton, 308 U.S. 295, at 306, 307 (1939).

[141] American Timber & Trading Co. v. Niedermeyer, 276 Or. 1135, 558 P.2d 1211 (1976); Lawson v. Balitomore Paint & Chem. Corp. v. Gover, 303 Mass. 1, (20 N.E.2d 482 (1939).

[142] Rowen v. Le Mars Mutual Insurance Co. of Iowa, 282 N.W.2d 639, 662 (Iowa 1979).

However, even as the creditor contracts to help rehabilitate the corporation, it is with implied understanding that the creditor, in seeking control of the corporation, has a cropped agenda: first, to seek to rehabilitate the corporation since it would also be to creditor's benefit that the corporation be brought back to a financial position to be able to fully pay its obligations; second, that in the event that the rescue operation does not succeed, the appointing creditor would be in the best position to ensure that it gets the maximum realization of its exposure. Certainly then, the creditor seeks control of the corporation in the hope of bettering its position on the whole gambit. In the first stage, its motivation is compatible with the interests of the stockholders and even other corporate creditors; in the second stage, a clear conflict of interest arises.

A loan workout arrangement is premised on the expressed or implied contractual commitment on the part of the creditor, acting through its nominee board and officers, that it will give its best efforts to rehabilitate and normalize the financial conditions of the borrowing corporation, and only when it is clear that the financial collapse is irreversible will the creditor commence any action that would liquidate its exposure to the corporation. At the point of insolvency, the proprietary interests of the stockholders in the corporation is actually nil, since the corporate assets are not even enough to cover the prior claims of the corporate obligations. The proposition is that at the point of insolvency, the fiduciary obligations of the nominee directors and officers to the stockholders is at best at its minimal; and their fiduciary obligations to the appointing creditors pursuant to the terms of the loan workout agreement become primordial.

The determination of when the corporation has reached that point which allows the nominee directors and officers to take measures to protect the best interests of the appointing creditors is an exercise of business judgment. The nominee directors and officers stand at the center of the controversy when the plug is pulled. Often it is never clear whether it has become a "lost cause" for the corporation. But certainly when the tell-tale signs are showing, then it is best to prepare for the inevitable. Who is to make the call? This is the situation that presents the most difficult case of divided loyalty for the nominee directors and officers. Directors and officers of a corporation elected by the stockholders would have no reluctance in taking decisive and full measures for the continued survival of the corporation. But with nominee directors and officers, their divided loyalty would put them in a situation where pushing a course of action to save the corporation would not be in the best interests of the appointing creditor. This is best exemplified in decisions of whether it is time to liquify the assets of the corporation or maintain or even enhance its production capabilities, which would require continued investment in inventory and maintenance of the availability of suppliers credit by the upkeeping of schedule of payments.

When the nominee directors and officers start taking half measures with the desire of minimizing the losses of the appointing creditor, then they could be accused of disloyalty under the terms of the loan workout arrangement, because "best efforts" have not been given to ensuring the rehabilitation of the corporation. And who is to say that it is precisely such half measures that precipitated the fall?

A carefully worded loan workout agreement that details the formula or conditions under which the creditor may, at its discretion, give it the legal option to pull the plug on the corporation should cover such a situation. Nevertheless, the contractual solution will not cover two areas. Firstly, the accusation that half measures have in fact brought about the stipulated conditions, especially with a board and management appointed by the creditor. Secondly, the contractual solution would not bind non-contracting parties, like the minority stockholders and perhaps other corporate creditors.

The problem that nominee directors and officers may be held personally liable for charges of disloyalty may be resolved with the appointing creditor taking out D & O insurance, which however is a type of insurance yet to be made available in the Philippine setting. However, the appointing creditor remains exposed to contingent liabilities for taking control of the borrowing corporation under the loan workout arrangement.

VII. CONCLUSION

Philippine statutory and case law indicate that a loan workout arrangement granting to a creditor control of the affairs of a corporation through the appointment of the board and key officers is itself legally permissible. But the legal consequences of such an arrangement as against the creditor and the nominee representatives have not clearly been settled in Philippine jurisprudence. At the very least, there is shaping up an expansive principle that control granted to the creditor pursuant to a loan workout arrangement does not authorize the controlling creditor to run the affairs for its exclusive benefit. It is an accepted proposition therefore that a controlling creditor, through the nominee board and officers, has assumed a fiduciary role in relation to the corporation and its stockholders. Whether there is an absolute fiduciary obligation to other corporate creditors is not clear under Philippine statutory and case law; but at the point of insolvency it would seem that such a fiduciary obligation arises.

There is likewise a clear jurisprudential indication that the parties to a loan workout agreement can contract around some of the principles of corporation, but the extent to which this can be done is not clear. To insist that the corporate affairs under the loan workout arrangement should be

judged by what is an arm's length transaction is to begin only to construct the framework of the principle that should govern the fiduciary role of nominee directors and officers. In fact, such a premise may miss the whole point. In a desperate financial situation, are not the borrowing corporation and the major creditor allowed to adopt a situation that is less than arm's length? The extraordinary demands of the circumstances that have led to a loan workout arrangement shows that the relationship between the creditor and the corporation have ceased to be one that is at arm's length.

On the other hand, to remove all fiduciary standards would certainly lead to much abuse, especially when the position of one of the parties, the corporation, has made it so vulnerable as not to be able to effectively fend for its interests. The teachings of American case law show that without proper legal check, creditor control leads to abuse and that by the time the effects of the creditor's actions have been unravelled, it is too late, and the corporation has reached the point beyond financial rehabilitation.

The pivotal role of the nominee directors and officers determines the viability of any unifying theory underlying loan workout agreements. The role of nominee directors, therefore, becomes a delicate balancing of the contending interests of the corporate creditor, the borrowing corporation and its stockholders, and perhaps the other corporate creditors. For, as has been shown by a study of American cases, a nominee board that tends to be over-protective of the interests of the appointing creditor, may in fact run the risk of making the latter liable for damages caused to the corporation or its stockholders, or for the obligations of the corporation to other corporate creditors.

Under this theory, nominee directors and officers, even though not acting directly for their personal benefit, are held to be in a self-dealing situation *vis-a-vis* the corporation. Despite the extraordinary setting which necessitated the adoption of the loan workout agreement, the nominee board and directors are to be held a high standard of loyalty to the corporation. This would include an application to them of the liability principles of Section 31 of the Corporation Code for willfully and knowingly voting for or assenting to patently unlawful acts of the corporation or for directing the affairs of the corporation in bad faith. Only by the maintenance of this high fiduciary standard would the nominee board be induced to work closely with the other officers of the corporation to reach a justifiable end. Often the threat of personal liability engenders closer working relations between nominee directors and the officers and corporation's own officers since such a close working relationship tends to ward off any imputation that the transactions prejudice the borrowing corporations and its stockholder. But the nominee directors and officers should not be paralyzed into immobility because of fear for personal liability. Despite the high fiduciary standards placed upon

nominee directors and officers, the approval by the SEC of the terms and conditions of a loan workout agreement should provide them "safe harbors" within which they can pursue the interests of their appointing creditor.

At the stage of negotiation and adoption of the loan workout agreement, the recommended SEC procedure would allow flexibility and perhaps even bold innovativeness to the contracting parties, but at the same time provide the best available protection to all interests affected by the arrangement through the overseeing authority of the SEC. And the maintenance of the high fiduciary standards on the role of the nominee directors and officers encourages an even-handed implementation of the terms of the loan workout agreement.