COMPARATIVE RESPONSES TO SELF-DEALING TRANSACTIONS: *THE UNITED STATES AND THE PHILIPPINES*

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I. INTRODUCTION

Section 23 of the Corporation Code of the Philippines (hereinafter "Corporation Code' or "Code") states:

> Unless otherwise provided in this Code, the corporate powers of all corporations formed under this Code shall be exercised, all business conducted, and all property of such corporations controlled and held by the board of directors.[1]

But the board's exercise of corporate powers is not unlimited. Directors and officers should, collectively and individually, have the interest of the corporation they serve paramount in mind. For them, the fundamental question is always: will the transaction serve the best interests of the corporation? Essentially subjective, this question can be a difficult one to resolve. Thus, when directors and officers fail to optimize for their corporation or even honestly err, they remain immune from liability because of the *business judgment rule*. This rule

> sustains corporate transactions and immunizes management from liability where the transaction is within the powers of the

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1. Philippine Corporation Code, B.P. BLG. 68, § 32 (May 1, 1980). This supplants Act No. 1459, as amended, known as the Corporation Law, which was enacted on March 1, 1906 by the Philippine Commission, the then legislative body of the Philippines, and took effect on April 1, 1906.

corporation (*intra vires*) and the authority of management, and involves the exercise of *due care and compliance with applicable fiduciary duties*.[2]

Where, however, a director or officer breaches his fiduciary duties of "good faith and fair dealing,"[3] as by profiting at the expense of the corporation, then the *business judgment rule* ceases to operate.[4] For this reason, transactions apparently between two or more decision-makers but actually involving only one, *i.e.*, self-dealing transactions, will not only subject these transactions to severe judicial scrutiny but also exclude interested directors or officers from protection.[5]

A self-dealing transaction exists where the following elements occur:

(1) there is a transaction between the referent corporation (corporation or shareholders whose interest may be prejudiced) and some person;

(2) a certain individual (either a director, officer, or controlling shareholder, or group of them) has decision-making influence with respect to actions taken by the referent corporation; and

(3) this influential individual or group has a greater personal interest in the welfare of the other person involved in the transaction, or in certain collateral consequences of the transaction, than in the welfare of the referent corporation.[6]

In the Philippines, Section 32 of the Corporation Code provides the statutory response to self-dealing transactions. It reads:

> 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 the following conditions are present:

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2. HENN & ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 661 (1983) (italics supplied).
3. *Id.* at 625.
4. *Id.* at 628, 661.
5. International Insurance Co. v. Johns, 874 F.2d 1447 (11th Cir. 1989).
6. R. CLARK, CORPORATE LAW 147 (1986). A fourth condition, Clark states, makes a transaction unfair and abusive: where the transaction is in fact unfair to the referent corporation.

> (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;
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> (2) That the vote of such director or trustee was not necessary for the approval of the contract;
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> (3) That the contract is fair and reasonable under the circumstances; and
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> (4) That in the case of an officer, the contract with the officer has been previously authorized by the board of directors.
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> Where any of the first two conditions set forth in the preceding 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-thirds (2/3) of the outstanding capital stock or two-thirds (2/3) of the members of the 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.[7]

Whether Section 32 effectively polices self-dealing transactions largely depends upon whether it shields the corporation and, correspondingly, the investment of stockholders, especially the minority stockholders, from detrimental contracts while jointly allowing the corporation, acting through its directors and officers, enough latitude to exercise its business options in the manner it sees profitable. Must Section 32 necessarily limit the options of the corporation by policing the behavior of its directors and officers? After comparing Section 32 to the response of the United States to self-dealing transactions, this paper will comment on whether Section 32 strikes a happy balance between these two concerns. Since Section 32 derives from statute and case law in the United States, an inquiry into the historical shifts in American attitude toward self-dealing transactions is most useful at this point.

7. Philippine Corporation Code, § 32.

II. SOME HISTORICAL INSIGHTS

A. *Attitudinal Shifts in the American Experience*

In the United States, self-dealing transactions, also known as interested-director transactions, have elicited different viewpoints through the years. Judicial response to these transactions has evolved from a rigid, though "certain,"[8] rule to one that is increasingly becoming practical,[9] "open-ended and spongy."[10]

1. The Traditional View: A Rule of Absolute Voidability

During the 19th century, the United States deemed self-dealing transactions voidable at the insistence of stockholders without regard to questions of fairness or unfairness. The stubbornness and inflexibility of the rule were its chief selling points. It deterred self-dealing from arising by not giving the interested director the opportunity to prove special circumstances which might otherwise exempt the transaction from the indiscriminate sweep of the prohibition.[11]

This conservative attitude flowed from the popular notion that man's behavior and judgment were determined by his basic desire for self-preservation and personal development.[12] It was also born of the "difficulty [and undesirability] of judicial second guessing of director's relationships and actions . . . articulated in their opinions."[13] Case rulings in the 1860s and 1870s further revealed the strong influence of English common law, which viewed directors as trustees.[14]

In *Munson v. Syracuse*,[15] the Court denied a petition by Munson for specific performance. There, Munson entered into a contract with a new railroad company where he was a director. Although he had complied with his obligation to purchase properties of a defunct railroad company in his capacity as mortgagee, the company refused to perform its obligation to issue bonds to Munson. It contended that Munson had breached his

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8. N. LATTIN, THE LAW OF CORPORATIONS 291 (1971).
9. *Id.*
10. CLARK, *supra* note 6, at 163.
11. Munson v. Syracuse, G & C Ry. Co., 8 N.E. 355, 358 (N.Y. 1886).
12. Cagampang, *The Fiduciary Duties of Corporate Directors under Philippine Law*, 46 PHIL.L.J. 513, 541(1971).
13. CLARK, *supra* note 6, at 164.
14. Cagampang, *supra* note 12, at 519, *citing* GOWER, MODERN COMPANY LAW 471.
15. *Munson*, 8 N.E. at 355.

fiduciary duties as director by dealing with the company. Mr. Justice Andrews found the contract wholly "repugnant to that great rule of law which invalidates *all* contracts made by a trustee of fiduciary, in which he is personally interested, at the election of the party he represents."[16] The ruling in *Munson* specifically precluded any inquiry whatever into the fairness of the contract.

Similarly, *Wardell v. Union Pacific R.R. Co.*[17] found a challenged contract voidable at the stockholder's insistence. In *Wardell*, the directors of the railroad company knowingly entered into a one-sided lease contract with Wardell. Intending to benefit from the same somehow, they later formed a coal company, to which Wardell assigned his interest in the contract. But after working amicably and jointly with Wardell, who was, in fact, even made an officer of the coal company, the directors appropriated the contract by forcibly taking possession of the mines, books, papers, tools and other personal property of the coal company to Wardell's exclusion. Finding the directors' interest in the transaction inconsistent with their fiduciary duties toward stockholders and creditors, Mr. Justice Field held:

> [A]ll arrangements by directors of a railroad company, to secure an undue advantage to themselves at its expense, by the formation of a new company as an auxiliary to the original one, with an understanding that they or some of them shall take stock in it, and then, that valuable contracts shall be given to it, in the profits of which they, as stockholders in the new company, are to share, are so many unlawful devices to enrich themselves to the detriment of the stockholders and creditors of the original company, and will be condemned whenever properly brought before the courts for consideration.[18]

The English rule, moreover, did not distinguish whether the self-dealing contract was approved by a disinterested majority of the directors, *i.e.*, by directors other than the one interested in the transaction. Applying this rule, the Munson court stated:

16. *Id.* at 358 (italics supplied).
17. 193 U.S. 651 (1880).
18. *Id.* at 658.

> It can make no difference in the application of the rule in this case that Munson's associates were not themselves disabled from contracting with the corporation, or that Munson was only one of ten directors who voted in favor of the contract . . . . [Conversely,] a corporation, in order to defeat a contract entered into by directors, in which one or more of them had a private interest, is not bound to show that the influence of the director or directors having the private interest determined the action of the board.[19]

Cumberland Coal and Iron Co. v. Parish[20] argued for a flat prohibition against self-dealing. The Maryland Supreme Court stated that when a director deals with his company,

> the remaining directors are placed in the embarrassing and invidious position of having to pass upon, scrutinize and check the transactions and accounts of their own body, with whom they are associated on terms of equality in the general management of all the affairs of the corporation.[21]

In other words, *Cumberland* implicitly recognized the extreme difficulty, if not impossibility, of maintaining independence in the boardroom.[22]

2. The Interim View: Rule of Qualified Voidability

At the turn of the century, Court dockets teemed with cases involving self-dealing. But unlike earlier cases which concerned mostly railroad frauds in public corporations, these controversies involved self-dealing within closed corporations.

With the proliferation of corporations, it was soon realized that "certain contracts with directors may be highly advantageous to the

19. *Munson*, 8 N.E. at 358.
20. 42 Md. 598 (1875).
21. *Id.* at 606.
22. *See* Brudley, *The Independent Director--Heavenly City or Potemkin Village*? 95 HARV. L. REV. 597, 610, 612 (1982) (noting the many factors that affect a director's independence and doubting if it is possible for a director to be truly independent at all).

corporation."[23] Courts then began to reevaluate whether the uncompromising rule of the late 1800s had to be relaxed to adapt to the changing milieu. By 1910, the rule of strict voidability yielded to a flexible rule:

> [A] contract between a director and his corporation was valid if it was approved by a disinterested majority of his fellow directors and was not found to be unfair or fraudulent by the court if challenged; but that a contract in which a majority of the board was interested was voidable at the instance of the corporation or its shareholders without regard to any question of fairness.[24]

The positive values of self-dealing, especially in the context of a close corporation, began to surface. One such advantage presented by a self-dealing transaction which justified its regulation rather than absolute prohibition was the accessibility of directors to the corporation. An insider may, for instance, offer better terms than outsiders for a particular transaction.[25] Transaction costs may also be reduced to a minimum considering that insiders need not establish continuity or reliability, acquire information, and assess risks.[26]

But the only explanation proffered to justify the shift from uncompromising rigidity to permissiveness - and, perhaps, to accommodate the growing number of close corporations - came by way of analogy drawn between a director and a trustee:

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23. R. STEVENS, PRIVATE CORPORATIONS 683-684 (2d ed. 1949). *See also* G. HORNSTEIN, CORPORATE LAW AND PRACTICE 542 (1959); LATTIN, *supra* note 8, at 290-291 (recognizing "the practical fact of corporate life that such transactions are frequent and often to the advantage of the corporation. Then, too, there is the surprising discovery that directors for the most part are not bent on skulduggery").

24. Marsh, *Are Directors Trustees?* 22 BUS. LAW. 35, 39-40 (1966).

25. Brudley, *supra* note 22, at 624.

26. *Id. See also* CLARK, *supra* note 6, at 164-165. Under Clark's "Judicial Enlightenment Theory," the courts' growing leniency toward basic self-dealing springs from the realization that certain self-dealing transactions have positive values. Since basic self-dealing is more prevalent in closed corporations than in public corporations, the theory proposes that (a) the strict voidability rule suits public corporations more than it does closed corporations; (b) since the American Civil War, state judges have adopted rules which are socially efficient; and (c) judges, in resolving controversies, are greatly influenced by the facts and circumstances of a case, more than any other consideration. To conclude, it suggests that the liberalization in the attitude of the courts is explained by the upsurge in self-dealing controversies involving closed corporations. The theory is supported by a study cited by Clark - John C. Dugan, The Decline and Fall of the Corporate Prophylactic Rule: An Empirical Inquiry (1981) (unpublished manuscript on file at Harvard Law School Library).

> ... a trustee, while forbidden to deal with himself in connection with the trust property, could [nonetheless] deal directly with the cestui que trust if he made full disclosure and took no unfair advantage; and that the case of a director who abstained from representing the corporation but dealt in his capacity with a majority of disinterested directors was properly analogized to a trustee dealing with the cestui que trust.[27]

This attitude was liberal insofar as it allowed courts to examine the circumstances in a given case and to adopt the two tests that ought to be met for a legitimate self-dealing transaction, namely, the approval test and the fairness test.

The adoption of the approval test superseded *sub selentio* the earlier holding in *Munson* which severely limited judicial inquiry to determining whether there was, in the controversy, a self-dealing transaction and that determination conclusively resolved the validity of the transaction. The approval test constrained courts to inquire further into the circumstances surrounding the approval of the self-dealing transaction. Was it approved by a disinterested majority of the directors, *i.e.*, by directors who have only the interest of the company in mind? It is well-settled in all jurisdictions in the United States that, in a legitimate self-dealing transaction, the vote of the interested director must not have been necessary to approve the transaction. However, authorities differ on whether the independence sought to be ensured procedurally applies to whether a quorum exists. That is to say, can an interested director be counted for purposes of determining a quorum? "Virtually all cases held that the interested director could not be counted for quorum purposes [disinterested quorum]."[28]

The adoption of the "fairness test" also abrogated *sub selentio* the ruling in *Munson*. "Fairness" became a legitimate area of judicial inquiry. The courts began to determine whether the self-dealing transaction "carries

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27. Marsh, *supra* note 24, at 40.

28. *Id.* at 42. *See* Revised Model Business Corporation Act (RMBCA),§ 8.62 (c), which likewise excludes interested directors in determining the presence of a quorum. *See, however,* California Corporations Code, § 210(c), Delaware General Corporation Law, sec. 144(b), and New York Business Corporation Law, § 713(c), all of which allow the inclusion of the common or interested director for quorum purposes. *See also* Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968); Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107, 38 ALR 2d 425 (Sup. Ct. 1952); Everett v. Phillips, 43 N.E. 2d 18 (N.Y. 1942), where interested directors were counted for quorum purposes by virtue of charter provisions allowing the same.

the earmarks of an arm's length bargain."[29] Would disinterested directors have, under like circumstances, endorsed the same?

Globe Woolen Co. v. Utica Gas & Electric Co.[30] pioneered judicial inquiry into the fairness of a self-dealing contract. Until then, self-dealing was downright voidable at the election of the corporation. In that case, a manufacturing company and an electric company entered into a contract for the supply of electricity. Maynard, a nominal director and the chairman of the executive committee of the electric company desisted from voting when the contact was presented to the board. He was concurrently the chief stockholder, president and a director of the manufacturing company. The contract proved to be a losing venture for the electric company for which reason it sought to rescind the contract on the ground that it was unfair and made under the dominating influence of Maynard, the common director. Plaintiff company sued for specific performance. The Court, speaking through Mr. Justice Cardozo, annulled the contract. It held:

> One does not divest oneself so readily of one's duty as trustee. The refusal to vote . . . gives to the transaction the form and presumption of propriety, and requires one who would invalidate it to probe beneath the surface. . . . A beneficiary, about to plunge into a ruinous course of dealing, may be betrayed by silence as well as by the spoken word.
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> . . . He cannot rid himself of the duty to warn and to denounce, if there is improvidence or oppression, either apparent on the surface or lurking beneath the surface, but visible to his practiced eye. . . .
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> There was an influence here, dominating perhaps, and surely potent and persuasive. . . . [H]e dealt with a subordinate, who looked up to him as to a superior, and was alert to serve his pleasure.[31]

More important, it found the contract "startling[ly]" unfair. It said that a "[t]here was, then, a relation of trust reposed, of influence exerted, of superior knowledge on the one side and legitimate dependence on the other. . . *A trustee may not cling to contracts thus won, unless their terms are fair and just.*"[32]

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29. Pepper v. Litton, 308 U.S. 295, 306-307 (1939)
30. 121 N.E. 378 (N.Y. 1918).
31. *Id.* at 379-380.
32. *Id.* at 380 (italics supplied).

American case law thence vacillated between the stringent rule laid down in *Munson* and the more liberal one in *Globe*.

3. The Modern View: A Rule of Fairness

Munson was not expressly overturned until much later. In *Piccard v. Sperry*,[33] the Court ruled that "[t]o the extent that [*Munson*] may be said to impose a more rigid standard, it yields to the more moderate view expressed by both prevailing and dissenting opinions expressed in *Everett v. Phillips*."[34]

In *Everett v. Phillips*,[35] directors of the Empire Power Corporation and their families owned almost all the stocks of the corporation. Concurrently, they owned a majority of the common stock of Long Island Lighting Company. The power company loaned to the lighting company huge sums of money. As the debts fell due, the power company, through the board of directors, continually extended deadline for payment. Plaintiff Everett contended that the directors, "in seeking benefit for themselves and for the Long Island Lighting Company, which they controlled through stock ownership. . . caused Empire Power Corporation, which [they] also controlled through stock ownership, to make a loan, which might work harm to the Empire Power Corporation."[36] Mr. Chief Judge Lehman, in upholding the loan contract, ruled that "[t]he dual position of the directors making the unprejudiced exercise of judgment by them more difficult, should [only] lead the courts to scrutinize these transactions with care. It does not, however, alone suffice to render the transactions void . . . ."[37] While setting aside the contract, the dissenting opinion agreed with the majority holding to the extent that it, contrary to *Munson*, found the self-dealing element not necessarily fatal to the contract. The difference between the majority and minority opinions stemmed from irreconcilable

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33. 48 F. Supp. 465 (S.D.N.Y. 1943), *aff'd*, 152 F.2d 462 (2d Cir. 1946), *cert. denied*, 328 U.S. 845 (1946).

34. *Id.* at 467. *See* Note, *The Status of the Fairness Test under Section 713 of the New York Business Corporation Law*, 76 COLUM. L. REV. 1156, 1168 (1976): "Section 713 [of the New York Business Corporation Law] was thus 'designed to eliminate the inconsistent positions taken in *Munson v. Syracuse, Geneva, & Corning R.R. Co.*.. and *Everett v. Phillips*' and to abrogate the holding in *Munson* that a transaction could be void or voidable merely because of the director's conflict of interest." (quoting *Explanatory Memorandum* in JOINT LEGISLATIVE COMM. TO STUDY REVISION OF CORP. LAWS, SIXTH INTERIM REPORT TO 1962 SESSION OF N.Y.S. LEGISLATURE, 1962 N.Y.S. LEGIS. DOC. NO. 30 at 104-41) (alteration in original).

35. 43 N.E.2d 18 (N.Y. 1942).

36. *Id.* at 23.

37. *Id.* at 22.

impressions as to the fairness of the contract. Mr. Judge Desmond, in dissent, stated:

> To make a case for the invalidation of such a contract, there must be shown circumstances tending to prove that the contract was made in bad faith, fraud or other breach of trust, including a biased exercise of judgment . . . . [T]he burden is then upon those who would maintain the contract to establish its fairness, particularly when they themselves are shown to have exercised the dominating influence in effecting the contract.[38]

In *Shlensky v. South Parkway Building Corporation*,[39] the South Parkway Building Corporation leased space in its commercial building to the South Center Department Store, a corporation wholly owned by Englestein, one of its directors. This and other transactions were challenged by plaintiff minority stockholders of the building corporation, in a suit for damages. The other transactions involved the purchase of old furniture from the department store wholly owned by its director Englestein; the condonation of backrentals due from the store; purchase by the corporation of a lot owned by Englestein shortly before transaction; grant of executive compensation to Englestein; an income-sharing agreement approved by the board, under which the store would vacate premises in favor of another company but would share in the net increase in rentals; and a similar income-sharing agreement under which an amusement company, again, wholly owned by Englestein, would share in the net rentals otherwise exclusively accruing to the building corporation from the State of Illinois — with deduction allowed only for remodeling expenses. Mr. Justice Bristow, citing *Geddes v. Anaconda Copper Mining Co.*,[40] held that "in view of the lack of approval by a disinterested majority [of the directors], it was incumbent upon defendants to sustain the burden of establishing the fairness of these transactions."[41] The board of directors, completely dominated as it was by director Englestein, failed to prove the fairness of the contracts questioned. In sum, the *onus* of proof was held by the Illinois Supreme Court to rest on the shoulders of those defending the validity of the transaction.

38. *Id.* at 24.
39. 166 N.E.2d 793 (Ill. 1960).
40. 254 U.S. 590 (1921).
41. *Shlensky*, 166 N.E.2d at 802.

By 1960, self-dealing contracts were no longer presumed voidable whether or not they had been approved by a disinterested majority of the board. Instead, the courts would subject such contracts to "rigid and careful scrutiny" and would invalidate them if found unfair to the corporation.[42]

B. The Philippine Experience

In the Philippines, *Mead v. McCullough*[43] is one of the few cases on self-dealing to reach the Philippine Supreme Court. The Supreme Court there ruled that "[t]he general doctrine, however, in regard to contracts of this class, is not that they are absolutely void, but that they are voidable at the election of the party whose interest has been so represented by the party claiming under it."[44] The challenged transaction involved in the sale of the company's assets and rights to a wrecking contract to one of its directors. However, in view of the approval by a *disinterested majority of the directors*, this was treated as an exception to the rule. Unanimity in consent among the other directors foreclosed any opportunity for McCullough, as company director and president, as well as the interested party, to vote. Nor was his presence necessary to constitute quorum. The Court, in sustaining the transaction, said:

> [A] director or officer may in good faith and for *adequate consideration* purchase from a majority of directors or stockholders the property even of an insolvent corporation, and

42. Marsh, *supra* note 24, at 43. *See* CLARK, *supra* note 6, at 160, where Clark detects a trend towards an "even more lenient" attitude. Clark states that "in 1975 California adopted a comprehensive new corporate code containing a provision that can be read to exclude the need for an interested director transaction to pass a judicial test of fairness. Section 310 of that code requires a transaction to be 'just and reasonable' for it to stand alone or be approved by the Board of Directors but omits that requirement with respect to *shareholder ratification*. In context, the omission suggests that a transaction properly ratified by shareholders is immune to a judicial inquiry into the fairness of its terms." (emphasis in original). *See also* Moody, *Statutory Solutions to Conflict of Interest in Close Corporations*, 35 CLEV. ST. L. REV. 95, 102 (1987). There, Moody observes that "'[s]afe harbor' statutes of the California type have been adopted in thirty-nine jurisdictions." In contrast, see Campos, *Conflict of Interest Transactions in Corporate Management*, 51 PHIL. L. J. 485, 497 (1976), where Campos, *citing* sec. 40 of the Proposed Corporation Code of the Philippines, surmised that "the better side of caution must have prompted the proposal in the CORPORATION CODE to follow the stricter rule that a *participating* interested director's contract with his corporation is voidable [unless ratified by stockholders], regardless of fairness." (emphasis in original).

43. 21 Phil. 95 (1911).

44. *Id.* at 115. In other words, the corporation whose interest, as principal, was represented by its directors, has the option of seeking the annulment of the self-dealing transaction.

> the sale thus made to him is valid and binding upon the minority.[45]

It added, however, that

> The acts of [the directors] in view of the relations which they bore to the corporation, are subject to the most severe scrutiny. *They are obliged to establish that they acted with the utmost candor and fair dealing for the interest of the corporation, and without taint of selfish motives.*[46]

As such, *Mead* departed from the restrictive policy embodied in the old Civil Code of the Philippines.[47] According to Article 1459 of the Code, agents "cannot acquire by purchase even at a public auction or judicial auction, whether in person or through the mediation of another . . . the property whose administration or sale may have been entrusted to them."[48] *Mead* tempered this restriction by pointing out that "an officer or director of a corporation, being an agent of an artificial person and having a joint interest in the corporate property, is not such an agent . . . ."[49] Article 1491 of the current Civil Code of the Philippines[50] upholds the *ratio decidendi* in *Mead* by allowing agents to acquire by purchase property entrusted to them for administration or sale *provided* that "the consent of the principal has been given."[51]

In sum, *Mead* holds that a self-dealing transaction is voidable at the option of the corporation, with the burden of proof upon the proponents of the contract to show otherwise by establishing (1) that the transaction had been approved by a disinterested majority of the board and (2) that the transaction was fair and reasonable. In that case, the fairness standard consisted in the adequacy of the consideration.

The ruling in *Mead* was reiterated in a Philippine Court of Appeals (CA) case. In *Abaya Lumber Company, Inc. v. H.J. Detrick*,[52] the appellate

45. *Id.* at 113-114 (italics supplied).
46. *Id.* at 122 (italics supplied).
47. Spanish Civil Code of 1889. The Code was extended to the Philippines by the Royal Decree of July 31, 1889 and was published on the Gaceta de Manila on November 17, 1889. It took effect on December 7, 1889.
48. *Id.* art. 1459.
49. Mead v. McCullough, 21 Phil. 95, 122 (1911).
50. Philippine Civil Code, R.A. No. 386 (August 30, 1950).
51. *Id.* art. 1491 (2).
52. G.R. No. 44918, 7 LAWYERS J. 678 (June 23, 1939).

Court sustained two self-dealing transactions. In the first transaction, the lumber company, unable to source funding elsewhere, borrowed money from defendant director's wife to pay overdue salaries of laborers. To secure the obligation, defendant director executed a mortgage on company property with the consent of the board of directors. The interest rate on the loan was notably lower than the prevailing interest rate in the market. In the second transaction, the company ceded lumber to defendant's wife in payment of the loan. The board resolution fixed the price at which the sale was to be made and, in case there were no other buyers with better offers, authorized the sale to defendant's wife. Mr. Justice Bengzon affirmed the decision of the court *a quo* because "[the loan] cannot be held voidable nor void merely because of this [self-dealing] circumstance, for the transaction was not unfair to the corporation and the officers acted in good faith and for its benefit."[53] He laid down the rule concerning loans to a corporation by directors as follows:

> Directors or other officers may loan money to the corporation, where they act in good faith, the money is needed for its benefit and the transaction is open and otherwise free from blame, although they are not in duty bound to do so, and they may also take and enforce security therefor, and they may make such loans not only where the company is solvent, but also where it is in failing circumstances . . . .[54]

Concerning the sale of lumber, he opined that

> where a director purchases from the corporation (this transaction may be considered a purchase by Detrick from the corporation), the transaction will be carefully scrutinized . . . . [W]e could discover no indication either of bad faith of the defendant Detrick or of trick or of undue advantage gained by him.[55]

Abaya thus holds that a director need not personally engage in a self-dealing transaction with the corporation. Having a familial interest in a party transacting with the corporation will render him interested as a director or officer. It also suggests, as factors to consider when gauging "fairness," the "need" for the contract, the contract interest rate as against

53. *Id.* at 679, *citing* Fletcher Cyc. Corp. § 931 (Perm. Ed) [hereinafter Fletcher].
54. *Id.*, *citing* Fletcher, *supra* note 53, § 952.
55. *Id.*

the market interest rate, and whether there was undue advantage to the director or officer.

Steinberg v. Velasco[56] also likened a director to a "mandatory" who is, as such, expected to exercise proper care and diligence, and ordinary skill and judgment over corporate assets.[57] In that case, a financially distressed corporation purchased shares from defendant stockholders. *These stockholders were erstwhile company directors who were schemingly allowed to resign by defendant board of directors in order to sell to the corporation. Subsequently, the incumbent directors individually purchased shares*[58] *from the corporation and, on the same occasion, declared dividends.* The stock purchase by the corporation and the dividend declaration were, however, undertaken without first ascertaining the actual value of surplus. These transactions, being tantamount to a withdrawal of capital, proved detrimental to creditors. The *Steinberg* court found defendant board liable for breach of their fiduciary duty "to care for [the property of the corporation] and manage its affairs in good faith . . . resulting in waste of its assets and injury to the property[.]"[59] More important, it held the resigned directors *primarily* liable, as self-dealing directors, to account for the consideration received for their shares. The incumbent directors, on the other hand, were held *secondarily* liable for the same amount, for the breach of their duty to care for corporate assets and for bad faith, and were held jointly and severally liable for the dividends.

Therefore, *Steinberg* laid down the liability of self-dealing directors: they are primarily liable for the entire consideration received from the challenged transaction. Disinterested directors — those other than self-dealing directors — privy to the unfair self-dealing transaction are secondarily liable for the same amount. Furthermore, it states that courts will thwart any scheme adopted by a self-dealing director to skirt liability.

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56. 52 Phil. 953 (1929).

57. *Id.* at 961.

58. *See* Fletcher, note 54, § 958 ("The rules that apply to transactions between the directors or managing officers of a corporation and the corporation itself apply equally well when directors or officers issue stock to themselves.") *See also* Pappas v. Moss, 393 F.2d 865 (3d Cir. 1968), where the New Jersey court held that, notwithstanding the provision in the certificate of incorporation allowing transactions between interested directors and the board, the directors selling the corporation's stock to themselves must nonetheless show by clear and convincing proof that the transaction was honest, fair and reasonable. *Steinberg* was silent on the liability of the directors' purchasing shares from the corporation.

59. *Steinberg*, 52 Phil. at 960.

In another Philippine Court of Appeals case,[60] plaintiff stockholders sued defendant Carameng, the company president, treasurer, and general manager, for recovery of the salaries illegally received by him and his wife, also a company director, and for recovery of the company farm project which he appropriated. The Court, through Mr. Justice J.B.L. Reyes, overturned the ruling of the lower court dismissing the suit, on the ground that, since a director of a corporation presumptively serves without compensation, he may not fix, increase, or vote compensation to himself unless expressly authorized by the charter or by the stockholders. Here, defendant was not so authorized; but even assuming he were,

> if he [was] necessary to make up the quorum; or if his vote [was] necessary to the result, the resolutions [would] be void or voidable; but where his vote [was] not necessary to the adoption of the resolution, it [would] not necessarily be void, although he may have voted for it or although he may have been present when the vote was taken.[61]

No approval was, however, possible. Of the five directors who composed the board, only two were qualified to vote in favor of the compensation. The other three were disqualified because one of them was abroad and the other two were related to defendant Carameng. Besides, Carameng's action was "so grossly selfish as to amount to consecutive fraud on the corporation and its minority."[62]

The Court also ordered defendant to account for the operations of the farm project. Defendant director, being

> in control of the corporation, occup[ied] a fiduciary relation towards the corporation and its stockholders, in respect to [sic] the business or the property of the corporation, and cannot deal with its property for their own personal benefit and advantage .... *[He] could not gratuitously convey it to himself unless the other directors, not under his control, voted in favor of the conveyance.*[63]

60. Camera Exchange Inc. v. Carameng, G.R. No. 10093-R, 50 O.G. 2650 (December 9, 1953).
61. *Id.* at 2656, *citing* 19 C.J.S. §§199-200.
62. *Id.*
63. *Id.* at 2658 (italics supplied).

Thus, Philippine jurisprudence upholds as legitimate some self-dealing transactions. Nonetheless, its attitude toward this subject remains conservative *vis-a-vis* American standards. For instance, while in the United States, articles of incorporation may recognize transactions between a director or an officer and the corporation,[64] in the Philippines, the same still provokes controversy. *Palting v. San Jose Petroleum*[65] decided against the legality of a charter provision immunizing self-dealing directors or officers from liability. The provision read in part:

> . . . all and any of the person who may become director or officer of the corporation shall be relieved from all responsibility for which they may otherwise be liable by reason of any contract entered into with the corporation, whether it be for his benefit or for the benefit of any other person, firm association or partnership in which he may be interested.[66]

The Supreme Court annulled the liability-limitation provision as contrary to public policy.

It is clear from the foregoing that, in the Philippines, self-dealing transactions are voidable at the option the corporation unless the proponents of the contract prove that (1) the contract was approved by disinterested directors (or in a situation where the presence of the interested director was unnecessary for quorum purposes, and his vote unnecessary to approve the contract), and (2) the contract was fair and reasonable. Moreover, directors may deal directly or indirectly with the corporation. Where a relative of a director énters into a contract with the corporation, then the director will be considered an interested director. Such a contract must also pass the disinterested approval and fairness tests. Otherwise, the interested director shall be held accountable for profits or gain resulting from the transaction. Any attempt by the self-dealing director to circumvent liability, whether by resigning shortly before the transaction or on the strength of exculpatory provisions in the articles of incorporation, shall not prosper.

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64. *See* 18B AM.JUR. 2D CORPORATIONS, § 1739 (1985) ("The provision in articles of incorporation may recognize the validity of a contract between an officer or director and the corporation but require that the officer's or director's interest be disclosed to the board of directors").

65. 18 SCRA 924 (1966).

66. *Id.* at 942.

Some factors to consider in determining the fairness of the contract are, according to *Mead*, adequacy of the consideration; and according to *Abaya*, the need for the contract, the particular loan interest rate compared to the market rate, and whether there was undue advantage to the director.

III. ANALYSIS OF SECTION 32 AND RELEVANT U.S. LAW

Although considered a major breakthrough in Philippine legislation,[67] Section 32 of the Philippine Corporation Code merely codifies the view on self-dealing transactions at the turn of the century enunciated in *Mead v. McCullough.*

A. *Some Preliminary Observations*

Section 32 of the Code reveals that the Philippine rule is one of qualified voidability. Under Section 32, a transaction is voidable at the option of the corporation if an officer or director had dealt with the corporation. The corporation may opt to brush aside the fact that one or more of its directors or officers had self-dealt or it may challenge the contract by proving the adverse interest of one or more of its directors or officers in the contract. Section 32, however, permits the proponents of the contract to defend the same by proving the presence of "all" conditions listed in Section 32.[68]

Transactions between corporations with interlocking or common directors also present a conflict-of-interest situation. Section 33 of the Code reads:

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67. There was no provision on self-dealing transactions in the old Corporation Law, Act No. 1459.

68. Philippine Corporation Code, §32. *To illustrate:*

	Disinterested Director Approval (Vote and Quorum)	**Interested Director Approval (Vote and/or Quorum)**
FAIR	NOT VOIDABLE	VOIDABLE [CAN BE RATIFIED BY 2/3 VOTE OF FULLY-INFORMED STOCKHOLDERS]
UNFAIR	VOIDABLE [CANNOT BE RATIFIED]	VOIDABLE [CANNOT BE RATIFIED]

> Except in cases of fraud, and provided the contract is fair and reasonable under the circumstances, a contract between two or more corporations with interlocking directors shall not be invalidated on that ground alone: *Provided That if the interest of the interlocking director in one corporation or corporations is merely nominal, he shall be subject to the provisions of the preceding section (Section 32) 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 interlocking directors.*[69]

Clearly, Section 33 proceeds from the premise that "a contract between two or more corporations with interlocking directors shall not be invalidated on that ground alone." The wording of this provision parallels interested-director provisions in the United States which immediately dispels the notion that evidence of a director's personal interest in a contract with the corporation conclusively annuls the same.[70]

Section 32 is phrased in a contrary context. It states that "[a] contract of the corporation with one or more of its directors or trustees or officers is voidable upon the option of the corporation."[71] Section 33 presumes the legitimacy of contracts between corporations with common directors, while Section 32 presumes the voidability of a self-dealing transaction. Interestingly, most jurisdictions in the United States police both self-dealing director contracts and interlocking-director contracts under a rule of presumed legitimacy.

What then accounts for the stricter rule in the Philippines *vis-a-vis* self-dealing transactions? Apparently, the framers of the Corporation Code, in particular, Sections 32 and 33, presumed that self-dealing transactions under Section 32 involved a more severe form of conflict-of-interest than interlocking-directors transactions. While in dealings between corporations with common directors, the common directors are placed in a dilemma as to which corporation to serve with undivided loyalty, in self-dealing

69. *Id.* §33 (italics supplied).

70. Del. Gen. Corp. Law, §144: "(a) No contract... between a corporation and one or more of its directors, or between a corporation and any other corporation... in which one or more of its directors are directors or officers or have a financial interest, shall be void or voidable solely for this reason . . .." *See also* N.Y. Bus. Corp. Law, §713 (a) and Cal. Corp. Code, §310 (a) which are similarly worded.

71. Philippine Corporation Code, §32.

transactions, the corporation's interest is pitted immediately against the self-dealing director's personal interest. Where, however, the interlocking director's interest is substantial (more than 20% of the outstanding capital stock) in one corporation and nominal (less than or equal to 20% of the outstanding capital stock) in the other, the law will pierce the veil of corporate fiction and treat the former corporation as his alter ego. In that case, Section 32 will apply as to the corporation where his interest is nominal. Where the interlocking director's holdings in the corporations are both nominal or both substantial, though one be greater than the other, Section 33 presumes parity in director interest and loyalty. Hence, Section 32 will *not* apply.

B. *The Self-Dealing Parties*

Section 32 does not apply to a situation where there is no contract entered into by the corporation. There must be a contract either directly or indirectly entered into by directors or officers with their corporation; or by a business entity, in which the directors or officers have a significant direct or indirect financial interest, with the corporation; or by a partially owned subsidiary corporation with its parent corporation; or by corporations with common or interlocking directors.[72]

In the United States, an "interested" director need not personally deal with the corporation. Under the Revised Model Business Corporation Act (RMBCA), a director is deemed "interested" in a transaction when he

> knows at the time of commitment that he or a related person is a party to the transaction or has a beneficial financial interest in or so closely linked to the transaction and of such financial significance to the director or a related person that the interest would reasonably be expected to exert an influence on the director's judgment if he were called upon to vote on the matter.[73]

For this purpose, "related person" means

> (1) the spouse (or a parent or sibling thereof) of the director, or a child, grandchild, sibling, parent (or spouse of any thereof) of

72. CLARK, *supra* note 6, at 159.

73. RMBCA, *supra* note 28, §8.60(1)(i). *See also* A.L.I. PRINCIPLES OF CORPORATE GOVERNANCE, §1.23 (1994).

> the director, or an individual having the same home as the director, or a trust or estate of which an individual specified in . . . (i) is a substantial beneficiary; or (ii) a trust, estate, incompetent, conservativee, or minor of which the director is a fiduciary.[74]

C. *The Approval Procedure*

Section 32 of the Code notably scrutinizes the behavior of the interested director in a self-dealing contract by prescribing an approval procedure to sustain its validity. This procedure consists of (1) the approval by a disinterested majority of the board, *i.e.*, one in which an interested director's presence and vote is unnecessary OR if not, (2) by ratification by the vote of stockholders representing two-thirds (2/3) of the outstanding capital stock.

The mere participation of the director by his presence or vote does not *per se* render the contract vulnerable. However, his vote, if necessary for the approval of the contract, or his presence, if necessary to constitute quorum, renders the contract voidable. In the United States, the RMBCA proposes which directors may effectively endorse an interested-director transaction.

> (a) Director's action respecting a transaction is effective . . . if the transaction received the affirmative vote of majority (but not fewer than two) of those qualified directors on the board of directors or a duly empowered committee of the board who voted on the transaction . . . provided that action by a committee is so effective only if (1) all its members are qualified directors, and (2) its members are either all the qualified directors on the board or are appointed by the affirmative vote of a majority of the qualified directors on the board. . . .
>
> (d) . . . "qualified director" means . . . any director who does not have either (1) a conflicting interest respecting the transaction, or (2) a familial, financial, professional, or employment relationship with a second director who does have a conflicting interest respecting the transaction, which

74. RMBCA, *supra* note 28, §8.60(3).

> relationship would, in the circumstances, reasonably be expected to exert influence on the first director's judgment when voting in the transaction.[75]

Strict compliance with the procedure laid down in Section 32 of the Code will not, however, ensure the fidelity of the board to the corporation it serves. An interested director may still dominate the board by other means such as those which tend to impair the objectivity of the other directors. A look into the minutes of the board meeting will disclose whether there was disinterested quorum and vote. It may not disclose whether the other directors actually acted under the subtle influence of an interested director. Hence, a good test is *whether circumstances tend to prove that the interested director dominated the board.*[76]

An interested director may also feign compliance with the test by employing dummies to represent him - and also the corporation concurrently.[77] In *Globe,* the assailed contract was annulled although the interested director refrained from voting and from lobbying for its approval. The Court noted that the interested director by dealing with a "subordinate, who looked up to him as a superior and was alert to serve his pleasure," exerted dominating influence on the board.[78] In at least one case, a director was disallowed from pleading his non-participation in the board meeting to validate the self-dealing transaction. The Court there said:

> The very words in which he asserts his right declare his wrong; he ought to have participated, and in the interests of the stockholders, and if he did not, and they have thereby suffered loss, of which they shall be the judges, he must restore the shares he has obtained - he must hold against them no advantage that he has got through neglect of his duty towards them.[79]

For this reason, the Philippines disallows cross-voting, a scheme whereby an interested director deliberately misses a board meeting to lend a semblance of objectivity to board proceedings but is nonetheless assured

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75. *Id.* §8.62.
76. Globe Woolen Co. v. Utica Gas & Electric Co., 121 N.E. 378 (N.Y. 1918).
77. J. SALONGA, PHILIPPINE LAW ON PRIVATE CORPORATIONS 238 (1968).
78. *Globe,* 121 N.E. at 380.
79. STEVENS, *supra* note 23, at 684, *citing* Stewart v. Lehigh Valley R. Co., 38 N.J. L. 505, 523 (E. & A. 1875)

the favorable vote of attending directors, who are reciprocally entitled to such accommodation.[80]

1. Relevance of Shareholder Ratification

Section 32 also covers a situation where the approval of a disinterested majority of the directors was not secured. This may occur in any or a combination of the following circumstances: where the vote cast by interested director was necessary for the approval of the contract; where his presence was counted for quorum purposes; or where he dominates the board in any other way. In any of these cases, stockholders representing two-thirds (2/3) of the outstanding capital stock must ratify the contract after proper disclosure by the interested director.

Shareholder ratification has been criticized as a poor substitute for director approval. For while directors have the opportunity to deliberate fully on the merits of the contract, shareholders ratifying the contract can but superficially study the contract and cannot bargain for better terms.[81]

In the United States, "the courts seemed to have a great deal of latitude in deciding how much weight to give to shareholder ratification and what effect it will have on the outcome of a particular case."[82] Generally, American case law has found ratification relevant to self-dealing contracts in either of three ways: (1) it "immunize[s] the transaction from shareholder attack on the ground that it was not properly authorized;"[83] (2) it "shift[s] the burden of proof on the issue of the fairness of the transaction to a plaintiff who attacks it;"[84] or (3) it "immunize[s] the transaction against attack on the grounds that it was unfair.[85]

In the Philippines, "[r]atification by stockholders makes possible a contract beneficial to the corporation in a situation where a majority of the directors or trustees may have some interest in such contract. Otherwise, there will be no one competent to act for the corporation even in a case where the corporation would be obviously benefitted by the contract."[86]

2. The Burden of Proof

It is well-settled in the Philippines that the burden of proof on the issue of fairness lies upon the interested director where he represents both

80. Legarda v. La Previsora Filipina, 66 Phil. 723 (1938).
81. Marsh, *supra* note 24, at 49.
82. CLARK, *supra* note 6, at 178-179.
83. *Id.* at 178.
84. *Id.*
85. *Id.* Since Section 32 requires that a legitimate interested director transaction be fair and reasonable, disinterested director approval or shareholder ratification does not foreclose attack based on unfairness.

himself and the corporation.[87] While, in the United States, the burden shifts from the interested director and the proponents of the contract to the dissenting stockholder upon director approval or stockholder ratification, no such authority can be found in the Philippines. Pursuant to *Mead* and Section 32, the burden of proof on the issue of fairness *never leaves* the approving directors, although the participation of the interested director may have been unnecessary to pass the contract.

Section 32 lays down the general rule that "[a] contract of the corporation with one or more of its directors or trustees or officers is voidable, at the option of such corporation."[88] Where, therefore, a dissenting stockholder establishes in court that one or more of the corporation's directors or officers has an interest in a contract with the corporation, it behooves the proponents of the contract to rebut this presumption of voidability by proving the presence of *all* the conditions enumerated in Section 32, namely, disinterested director quorum and vote and that the contract was "fair and reasonable under the circumstances."[89] If unable to prove disinterested director quorum and vote, they must prove that the contract, in addition to being fair and reasonable, was ratified by fully-informed stockholders, representing two-thirds of the outstanding capital stock. By imposing a "fairness and reasonableness" standard, Section 32 conforms with the majority view in the United States that, at least initially, the interested director bears the burden of proving the fairness of the contract.[90]

In the United States, however, opinions clash as to whether the burden of proof on the issue of fairness shifts upon stockholder ratification and, if so, what kind of ratification is adequate for that purpose. Interestingly, most cases which shifted the burden of proof on the issue of fairness to the challenging shareholder involved self-dealing provisions imposing a fairness test as an alternative to the approval procedure.

In *Cohen v. Ayers*,[91] the Court, construing Section 713 of the New York Business Corporation Law,[92] held that ratification or director

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87. Mead v. McCullough, 21 Phil. 95, 116-117 (1911), *citing* Hancock v. Holbrook, 40 La. Ann. 53, 62, 3 So. 351, 356 (1888).

88. Philippine Corporation Code, § 32.

89. *Id.*

90. Comments, *"Interested Director's" Contracts--section 713 of the New York Business Corporation Law & the Fairness Test*, 41 FORDHAM L. REV. 639, 664 (1974), *citing* Geddes v. Anaconda Copper Mining Co., 254 U.S. 590 (1921). *See also* Fletcher, *supra* note 53, § 921.

91. 596 F.2d 733, 741 (7th Cir. 1979).

92. "Sec. 713. Interested Directors:

(a) No contract or other transaction between a corporation and one or more of its director, or between a corporation and any other corporation, firm, association, or other entity in which one or more of its directors are directors or officers, or have a substantial approval revives the business judgment rule and shifts the burden of proving unfairness onto the contesting shareholders.[93] In *Pappas v.*

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for such purpose:

(1) If the material facts as to such director's interest in such contract or transaction and as to any such common directorship, officership or financial interest are disclosed in good faith or known to the board or committee, and the board or committee approves such contract or transaction by a vote sufficient for such purpose without counting the vote of such interested director or, constitute an act of the board as defined in Section 708 (Action by the board), by unanimous vote of the disinterested directors; or

(2) If the material facts as to such director's interest in such contract or transaction and as to any such common directorship, officership or financial interest are disclosed in good faith or known to the shareholders entitled to vote thereon, and such contract or transaction is approved by vote of such shareholders.

(b) If such good faith disclosure of the material facts as to the director's interest in the contract or transaction as to any such common directorship, officership or financial interest is made to the directors or shareholders, or known to the board or committee or shareholders approving such contract or transaction, as provided in paragraph (a) the contract or transaction may not be avoided by the corporation for reasons set forth in paragraph (a). *If there was no such disclosure or knowledge, or if the vote of such interested director was necessary for the approval of such contract or transaction at a meeting of the board or committee at which it was approved, the corporation may avoid the contract or transaction unless the party or parties thereto shall establish affirmatively that the contract or transaction was fair and reasonable as to the corporation at the time it was approved by the board, a committee or the shareholders.* . . ."

New York Business Corporation Law, § 713 (italics supplied).

93. *See also* Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979) ("[S]hareholder ratification shifted the burden of proof of want or inadequacy of consideration for the grant of the options from defendants to plaintiffs."); Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) ("[A]pproval by fully-informed disinterested directors or disinterested stockholders ... permits the invocation of the business judgment rule and limits judicial review to issues of gift or waste of corporate assets with the burden of proof upon the party attacking the transaction."); Puma v. Marriott, 283 A.2d 693, 695 (Del. Ch. 1971) ("[I]t cannot be said that the Marriott group stood on both sides of the transaction [absent any showing that they dominated the board]. Therefore, the test here applicable is that of business judgment, there being no showing of fraud," [with the burden of establishing the entire fairness of the transaction shifting to the challenging stockholders.]); Warshaw v. Calhoun, 221 A.2d 487, 492 (Del. Sup. Ct. 1966) ("In the absence of a showing of bad faith on the part of the directors or of a gross abuse of discretion, the business judgment of the directors will not be interfered with by the courts."); Gottlieb v. Heyden Chemical Corp., 91 A.2d 57, 59 (Del. Ch. 1962) ("[T]he entire atmosphere is freshened and a new set of rules invoked where formal approval has been given by a majority of independent, fully-informed shareholders."); Clatterbuck, *Section 21-2040.01: Interested Director Transactions and Considerations of Fairness*, 59 NEB. L. REV. 909, 919 (1979) (Compliance with the statute's approval procedures fully shifts the burden of proving unfairness to those challenging the transaction.); Comments, *The Interested Director in Texas*, 21 SW. L.J. 794, 803 (1967) (Even if the interested director did vote, the board's approval will shift the burden of proof to the corporation if his vote was not necessary to pass the resolution). *See, however,* Scott v. Multi-Amp Corp., 386 F. Supp. 44, 67-68 (D.N.J. 1974) (There, the court deferred to *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66 (Cal. 1952) by ruling that interested-director transactions must "pass muster under each subdivision" of the New Jersey self-dealing provision, although the provision merely required an approval procedure and a fairness requirement in the alternative. The court held that compliance with the approval procedure did not shift the burden on the issue of fairness to the challenging stockholders, but only lowered the quantum of evidence

Moss,[94] however, ratification did not shift the burden of proof because it was *ineffective*. The Court said:

> [W]here, as here, a majority of the shares are held by those "interested" in effectuating the merger, there can be no ratification, at least in the sense that it transfers to the attacking party the burden of showing fraud. And this was the holding even though a substantial majority of the shares held by independent minority stockholders were voted in favor of ratification.[95]

Pappas was reiterated in *Fliegler v. Lawrence*.[96] The Delaware Supreme Court there held that

> [t]he purported ratification by Agau shareholders would not affect the burden of proof . . . because the majority of shares voted in favor of exercising the option were cast by defendants in their capacity as Agau shareholders. Only about 1/3 of the disinterested shareholders voted and we cannot assume that such non-voting shareholders either approved or disapproved . . . . [W]e cannot say that the entire atmosphere has been freshened . . . .[97]

Implicit in both *Pappas* and *Fliegler* is the recognition that, the stockholder ratification must be effective or devoid of self-interest to shift the burden of proof on the fairness issue to dissenting stockholders. There is, however, authority that "adverse interest [in a self-dealing contract] does not disqualify a stockholder from voting as a shareholder."[98] *Kirwan v. Parkway Distillery*[99] may have well provided the reason why:

> *When voting as a stockholder he has the legal right to vote with a view of his own benefits and is representing himself only;* but, a director represents all the stockholders in the capacity of trustee for them and cannot use his office as director for his personal benefit at the expense of stockholders.[100]

94. 393 F.2d 865 (3d Cir. 1968).
95. *Id.* at 868.
96. 361 A.2d 218 (Del. 1976).
97. *Id.* at 221.
98. SALONGA, *supra* note 77, at 297. *See also* Jimenez, *Corporate Watchdogs*, 27 ATENEO

There are current efforts in the United States to disqualify the interested director from voting his shares. Under the RMBCA, only qualified shares may be voted to ratify the contract. "Qualified shares" refers to:

> [S]hares entitled to vote . . . except shares that, to the knowledge, before the vote, of the secretary (or the officer or agent of the corporation authorized to tabulate votes) . . . are beneficially owned (or the voting of which is controlled) by a director who has a conflicting interest respecting the transaction or by a related person of the director, or both.[101]

In the Philippines, Section 32 does not distinguish whether or not interested directors are proscribed from voting their shares. Therefore, in the absence of any stipulation to that effect, interested directors may exercise their right as stockholders to do so.

3. Adequacy of Disclosure

Whether approved by a majority of disinterested directors or by shareholders representing 2/3 of the outstanding capital stock, the contract must always, in addition to satisfying the fairness test, be accompanied by proper disclosure. Although Section 32 does not expressly require disclosure in the case of director approval, Article 1339 of the Philippine Civil Code states that "[f]ailure to disclose facts, when there is a duty to reveal them, as when the parties are bound by confidential relations, constitutes fraud."[102] American jurisprudence has likewise required disclosure as an element of fairness.[103]

The disclosure contemplated in Section 32 must contain certain information. Otherwise, disclosure, as well as the ensuing approval either by disinterested directors or stockholders, will not be effective. Section 32 thus requires "full" disclosure but does not define this catch-all word.

Practically all self-dealing provisions in the United States require disclosure of material facts as to the conflict of interest and the transaction. The interested director should reveal

> (i) the existence and nature of the conflict of interest and (ii) all facts known to him respecting the subject matter of the transaction that an ordinarily prudent man would reasonably

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101. RMBCA, *supra* note 28, §8.63(b).
102. Philippine Civil Code, art. 1339.

believe to be material to a judgment about whether or not to proceed with the transaction.[104]

In addition, *Globe* enjoins the interested director to give "a word of warning"[105] to the other directors about the risks and one-sidedness of the transaction.

D. *The Fairness Test*

A self-dealing transaction, in addition to meeting the approval procedure prescribed in Section 32, must also be "fair and reasonable under the circumstances." This directive contradicts jurisprudence in the United States to the effect that compliance with the approval procedure, whether by director approval or shareholder ratification, revives the business judgment rule and insulates the transaction from attack based on unfairness. Courts, nonetheless, have allowed dissenting stockholders to challenge the contract on grounds of "fraud,"[106] "overreaching,"[107] or "waste or gift of corporate assets."[108] To the extent fairness was deemed essential to a legitimate self-dealing transaction, Section 32 conforms with the rulings in *Remillard Brick Co. v. Remillard-Dandini Co.*[109] and *Scott v. Multi-Amp Corp.*.[110]

In *Remillard*, the California appellate court said that "[e]ven though the requirements of Section 820 are technically met, transactions that are unfair and unreasonable to the corporation may be avoided."[111] This, in

104. RMBCA, *supra* note 28, §8.60(4).

105. Globe Woolen Co. v. Utica Gas & Electric Co., 121 N.E. 378, 380 (NY 1918).

106. Villanueva, *The Fiduciary Duties of Directors and Officers Representing the Creditor Pursuant to a Loan Workout Arrangement: Parameters under the Philippine Corporate Setting*, 35 ATENEO L.J. 11, 40 (*citing* Continental Sec. Co. v. Belmont, 99 N.E. 138 (N.Y. 1912); American Timber and Trading Co. v. Niedermeyer, 558 P.2d 1211 (Or. 1976); *contra* Claman v. Robertson, 128 N.E. 2d 429 (Ohio 1955)).

107. *Id.* (*citing* Chambers v. Beaver-Advance Corp., 140 A.2d 808 (Pa. 1958)).

108. *Id.* (*citing* 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)).

109. 241 P.2d 66 (Cal. 1952).

110. 386 F.Supp. 44 (D.N.J. 1974).

111. Remillard Brick Co. v. Remillard-Dandini Co., 241 P.2d 66, 74 (Cal. 1952). Section 820 of the California Corporation Code, as cited by the court, provided:

> No contract or other transaction between a corporation and ... any corporation ... in which one or more of its directors are directors or are financially interested, is either void or voidable because such director or directors are present at the meeting of the board of directors or a committee thereof which authorizes or approves the contract or transaction, or because his or their votes are counted for such purpose, if the circumstances specified in any of the following subdivisions exist:
>
> (a) The fact of the common directorship or financial interest is disclosed or known to the board of directors or committee and noted in the minutes, and the board or

effect, requires transactions to pass both the approval procedure and the fairness test. In *Scott*, the New Jersey Court read a *Remillard* gloss onto the New Jersey interested-director provision. Since transactions now had to "pass muster under each subdivision,"[112] notwithstanding the disjunctive "or" between the approval procedure and the fairness test, compliance with the former did not shift the burden of proof on the fairness issue from the proponents of the transaction to the corporation. It merely lowered the quantum of proof required to establish fairness. *Scott* thus reinforces the proposition that, under Section 32, no shifting in the burden of proof results.

Whether a contract is fair and reasonable depends upon the circumstances of the case as perceived and weighed by the judge. In this sense, resolution of this issue is a highly subjective process. It is not however an arbitrary one, as *Pepper v. Litton*[113] provides the applicable test: whether the transaction carries the earmarks of an arm's length bargain – arm's length bargaining test.[114] Would disinterested directors have entered into the transaction themselves? "Did the directors place the interests of the corporation first?"[115] In answering these questions, the court does not determine for itself what terms and conditions are fair and should, therefore, be embodied in the contract. Rather, it merely determines whether the terms of the contract fall within a range of reasonableness under the circumstances.[116] In other words, fairness is more of a range than a point.

The fairness test, furthermore, does not sanction *post hoc* reviews by courts. Otherwise, fairness would turn on the outcome of the transaction. At all times, the fairness or unfairness of a contract is tested at the time it was approved by the directors or ratified by stockholders – or at the time of commitment[117] — based on circumstances then obtaining. For until the approval procedure is met, the corporation is not party to the contract. In

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(b) The fact of the common directorship or financial interest is disclosed or known to the shareholders, and they approve or ratify the contract or transaction in good faith by a majority vote or written consent of shareholders entitled to vote.

(c) The contract or transaction is just and reasonable as to the corporation at the time it is authorized or approved.

112. Scott v. Multi-Amp Corp., 386 F.Supp. 44, 67 (D.N.J. 1974)

113. 308 U.S. 295 (1939).

114. *Id.* at 306-307.

115. Topping, *Corporations - Interested Directors Dealing with the Corporation - The Fairness Doctrine*, 37 MO. L. REV. 531, 536 (1972) (arguing that this should be the true test of fairness).

116. EISENBERG, CORPORATIONS AND BUSINESS ASSOCIATIONS 417 (1996) ("Note on Fair Transactions" under RMBCA, *supra* note 28, §8.61(b)(3)).

117. RMBCA, *supra* note 28, §8.60(5). "Time of commitment" respecting a transaction means the time when a transaction is consummated or, if made pursuant to contract, the time when the

sum, terms of a contract are deemed fair if they are within the range that might have been entered into at arm's length by disinterested persons.

Certain standards, however, have aided courts in determining the fairness of a challenged contract. One standard culled from United States case law by the RMBCA is the "Benefit to the Corporation." Under this standard, the court, looking into the substantive fairness of the transaction,

> will be . . . required to consider not only the *market fairness* of the terms of the deal, but also, as the board would have been required to do, *whether the transaction was one reasonably likely to yield favorable results (or reduce detrimental results)* from the perspective of furthering the corporation's business activities.[118]

In *Shlensky v. South Parkway Bldg. Corp.*,[119] the Illinois court listed factors for courts to consider in determining fairness. These factors are whether the corporation received full value for the commodities purchased; the corporation's need for the property; the corporation's ability to finance the purchase; whether the transaction was at market price, or below, or constituted a better bargain than what the corporation could have obtained; whether any detriment to the corporation existed; whether there was a possibility that corporate gain was siphoned off directly or indirectly; and whether full disclosure was done.

In *Mead*, the Court looked into the adequacy of the consideration to determine the fairness. It further required the interested director to show candor and fair dealing. In *Abaya*, the appellate Court inquired into the need for the contract, compared the interest rate on the loan to the market rate, and examined whether the interested director secured undue advantage to himself.

Another standard is the "Process of Decision"[120] under which the court observes the demeanor of the interested director to find out, for instance, whether there was proper disclosure of material information or whether he exerted improper pressure upon other directors; and whether there was duress or fraud. In determining the same, the inquiry is whether the procedural unfairness deprived other directors of their ability to exercise a meaningful choice.[121]

Other considerations showing the presence or absence of undue influence are the number of directors interested, their presence in the meeting at which the contract was adopted, whether the plan was initiated

118. EISENBERG, *supra* note 116, at 417-418 (italics supplied).
119. 166 N.E.2d 793 (Ill. 1960).

by the interested director or by the corporation, and the dominance exerted, if any, by the interested director.[122]

While the arm's length bargaining test is the "most pervasive test"[123] in the United States, some jurisdictions have applied other tests to self-dealing transactions. Delaware, the "mother of corporations,"[124] has used a variation of the fairness test: it asks "whether the proposition would have commended itself to a wholly independent board of directors."[125]

New York has shifted back and forth between the fairness test and the "good faith" test. In one case involving a parent company and its subsidiary, the Court considered fairness from the point of view of parties to the transaction as "receiving what they bargained for."[126]

Thus, it is clear that courts possess wide discretion to determine whether a challenged contract suffers from unfairness. Critics of the fairness test charge that it makes "ideal directors" of judges. They thus suggest the formulation of objective or less arbitrary standards so as to avert abuse of discretion. But can fairness be truly legislated without taxing its flexibility and without hamstringing the courts?

E. Remedies and Liabilities

Section 32 of the Corporation Code entitles the corporation to have a self-dealing contract annulled where the interested director fails to establish all the conditions for a valid self-dealing contract. Upon annulment of the contract, Article 1398 of the Philippine Civil Code directs the parties to restore to each other "the things which have been the subject matter of the contract, with their fruits, and the price with its interest, except in cases provided by law."[127] In the United States, restitution is likewise available in actions for rescission of self-dealing contracts.[128]

Section 31 of the Corporation Code, however, imposes a more stringent liability on self-dealing directors and officers upon annulment of the challenged contract: they are jointly and severally liable for *all damages* suffered by the corporation, its stockholders or members and

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122. Note, *The Fairness Test of Corporate Contracts with Interested Directors*, 61 HARV. L. REV. 335, 340 (1948). The article suggests a rephrasing of the fairness test in terms of the conduct of directors thus: "would reasonable and disinterested directors have conducted themselves as did the particular directors?" *See also* 18B AM.JUR. 2D CORPORATIONS, § 1755 (1985).

123. Clatterbuck, *supra* note 93, at 921.

124. HENN, *supra* note 2, at 32.

125. Clatterbuck, *supra* note 93, at 921 (quoting E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 75 (1972)).

126. Case v. New York Central Railroad, 204 N.E.2d 643 (N.Y. 1965).

127. Philippine Civil Code, art. 1398.

128. CARY AND EISENBERG, CASES AND MATERIALS ON CORPORATIONS 662 (1995).

other persons, as a result of their disloyalty.[129] Thus, in *Steinberg*, the resigned directors, who sold their shares to the corporation they had served, were deemed self-dealing directors and were held principally liable for the entire consideration received without any corresponding return of the subject matter. The incumbent directors who were privy to the fraudulent scheme were held secondarily liable for the same amount.

Although United States courts have awarded punitive damages against self-dealing directors or officers, especially where there is proof of fraud, recovery is traditionally limited to the gain or the difference between the contract price and the fair price.[130]

IV. CONCLUSION

Section 32 clearly sets too stringent a test for self-dealing transactions. It severely polices the behavior of corporate fiduciaries, thereby limiting business options available to them, at the expense of corporate gain.

Under Section 32, self-dealing transactions, although not necessarily voidable, are presumed voidable upon the *mere* showing that a director or officer had dealt with the corporation he serves. For this reason, it is susceptible to misuse by disgruntled shareholders who may want to frustrate legitimate board action by filing frivolous suits.

That the presumption of voidability is merely disputable is hardly consoling, given the fact that Section 32 imposes a *heavy* burden upon proponents of the contract to establish the presence of *all* the conditions enumerated therein. Thus, even if proponents of the contract prove faithful compliance with the approval procedure, the section still presumes the self-dealing contract to be voidable unless the proponents further prove its fairness and reasonableness. Until then, the corporation, through the challenging stockholder, benefits from the presumption of voidability. There is, therefore, *no shift in the burden of proof* on the issue of fairness even after proof of compliance with the approval procedure and upon further proof that truly independent directors approved the contract. Thus, Section 32 encourages litigation on the (un)fairness of a challenged contract. Since this issue is inherently contentious, presumptive benefits to the corporation arising from the challenged contract may well end up becoming casualties of protracted litigation.

Courts may, nonetheless, defer to the sound business judgment of directors or officers in cases where unfairness is not patent. But this will transpire only upon a court's refusal to intervene in a business transaction,

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129. It pertinently states: "Directors or trustees who . . . acquire any personal and 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." Philippine Corporation Code, art. 31 (italics supplied).

130. CARY AND EISENBERG, *supra* note 128, at 662-663.

whereby the court prudently refrains from substituting its own judgment of what is fair or unfair for the directors' own perception of the same.

There is, therefore, a need to recognize the business judgment of disinterested directors, officers, or trustees in instances where it may be reasonably presumed. In this regard, Section 32 should be amended to rule out any inference therefrom that completely devalues the business judgment rule. For instance, the burden of proof on the issue of fairness should shift to the corporation once the approval procedure is met.

This will allow corporations wider latitude to exercise its business options and endow business transactions and commitments greater stability. In any case, nothing precludes the court from annulling the contract on the same grounds relied upon in *Globe*: that compliance with the approval procedure was merely *ceremonial* and that the self-dealing director or officer had, in fact, dominated the board or influenced its decision.

While Article 1398 of the Philippine Civil Code provides for mutual restitution of "the subject matter of the contract, with their fruits, and the price with its interest"[131] by parties, Article 31 of the Philippine Corporation Code and *Steinberg* imposes a heavier sanction upon self-dealing directors in annulled contracts by holding them primarily liable for the entire consideration — actual damages — without any corresponding return of the subject matter. Restitution is withheld to penalize fiduciaries for disloyalty. Disinterested directors, on the other hand, are secondarily liable insofar as they may have been privy to the abusive self-dealing contract.

Although Section 32 seems biased against the interested director, it would be hasty to conclude from that alone that United States law on self-dealing transactions is more sophisticated in that it better enables the court to dispense justice *both* to the interested director and the referent corporation. Perhaps, the severity of Section 32 on the side of caution merely reflects the existing narrow base of ownership in almost all Philippine corporations.[132] This is a situation replete with great temptation and opportunity to engage in self-dealing transactions. With this specific point in mind, Section 32 may still be an appropriate response at this time. Of course, it will take another study to test that proposition.

131. Philippine Civil Code, art. 1398.

132. *See* John F. Doherty, A Preliminary Study of Interlocking Directorates Among Financial, Commercial, Manufacturing and Service Enterprises in the Philippines (1978) (available at the Rizal Library of the Ateneo de Manila University School of Arts & Sciences, Quezon City, Metro Manila, Philippines)(as of 1977, some 60 families in the Philippines control at least 305 of the top 1,000 corporations nationwide through an intricate web of interlocking directorates and dummy corporations); Edita Tan, Interlocking Directorates, Commercial Banks, Other Financial Institutions and Nonfinancial Corporations (Sept. 1991) (a discussion paper on file at the University of the Philippines School of Economics, Quezon City, Philippines)("control by Manila's 40 families over the country's economic wealth is not without an empirical basis").