



Institute of Corporate Directors

THE ROLE OF THE BOARD OF DIRECTORS:
*PHILIPPINE LEGAL & REGULATORY
FRAMEWORK, AND PRACTICE*

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THIRD ASIAN ROUNDTABLE ON CORPORATE GOVERNANCE

Singapore, 4th-6th April 2001

Executive Summary

Corporate governance practice in the Philippines has been shaped by various laws and by the prevailing business structure.

The laws are broadly consistent with the core principles of modern corporate governance. The Corporate Code, the newly revised General Banking Act, and the recently enacted Securities Regulation Code draw most of their inspiration from principles on corporate governance that are fundamentally the same as those proposed by the OECD. Indeed, in the Philippines, most problems of corporate governance do not arise from the laws themselves, but generally from the spirit of compliance with them.

The spirit of compliance is affected by the prevailing business structure. Family-owned corporations are predominant. Financing comes mainly from banks, and capital markets have remained undeveloped. Standards of disclosure and accountability have in practice not been at par with those observed in, and demanded by, more developed financial markets.

Thus, any corporate governance reforms can not be focused on laws, although regulatory regimes need to be considerably strengthened. Regulatory agencies such as the SEC, the BSP (the central bank), the Insurance Commission, and the Department of Finance can and should be at the forefront of reforms.

But reform initiatives from government regulators need to be strongly complemented by reforms with far-reaching impact on the prevailing business structure and the professional practice of reputational agents, particularly of accountants, auditors, corporate secretaries, corporate lawyers, and above all of corporate directors. In this regard, a strong competition policy, further liberalization of the economy, and adoption of international standards and global best practices can speed up reforms in corporate governance practices in the Philippines.

Education of corporate directors, who need to internalize the principles of corporate governance, and who have to live up to their fiduciary duties, imposed upon them by law, is a good first step. But for this step to lead anywhere in the direction of genuine reforms, it has to be complemented by strong initiatives from the regulators and other structural reforms in the economy.

Manila, March 2001

I. The General Legal Framework in the Philippines

A. Qualifications of Directors

In the Philippines, the legal provisions pertaining to the board of directors are the Corporation Code (*Batas Pambansa 8*) for non-bank corporations, the General Banking Act of 2000 for banks and parts of the Securities Regulation Code and the Constitution. The Corporation Code prescribes the number of directors to be not less than five nor more than 15. Banks have the same limits in the number of directors except that two of the directors must be independent directors.

The Corporation Code prescribes the minimum qualifications of a director as follows:

1. A director must own at least one share
2. A majority of the directors must be residents of the Philippines
3. A director must not have been convicted by final judgment of an offense punishable by imprisonment for a period exceeding six years, or a violation of the Corporation Code, committed within five years prior to the date of his election
4. The by-laws of the corporation can require a director to have other qualifications and prescribe disqualifications. As an example of the latter, the by-laws can prohibit a stockholder who holds a substantial interest in a competing corporation from being elected as director.

Under the “fit and proper rule” under the General Banking Law of 2000, the Monetary Board of the Central Bank (*Bangko Sentral ng Pilipinas* or “BSP”) has the authority to prescribe, review, and pass upon the qualifications and disqualifications of individuals elected or appointed as bank directors or officers in order to maintain the quality of bank management and better protect depositors and the public.

In addition to the requirements under the Corporation Code of the Philippines, the minimum qualifications for bank directors required under the Manual of Regulations for Banks are:

1. A director must be at least 25 years old at the time of his election, and
2. A director must be at least a college graduate or have at least five years of experience in business, or have undergone training in banking acceptable to the appropriate supervising and examining department of the BSP.

B. Election of Directors

In stock corporations, the stockholders elect directors. Every director must own at least one share of the capital stock of the corporation. Directors hold office for a term of one year although the law allows them to hold over in the absence of an election. At all elections of directors, there must be present, either in person or by written proxy, a number of stockholders sufficient to represent a majority of the outstanding capital stock entitled to vote. The Corporation Code does not allow employees to vote unless they also own shares. Only natural persons may be members of the board because being an artificial being, a corporation acts only

through its officers and agents. Corporations and other legal entities or juridical persons are not qualified to occupy the position of director.

Cumulative voting is mandatory under Philippine law. This means that a stockholder may either vote such number of shares in favor of specific directors or he may cumulate said shares and give one or more candidates a total of votes equal to the number of directors to be elected multiplied by the number of his shares.

Philippine law does not provide for, much less require, any classification of directors. The Corporation Code does not classify directors into non-executive or executive directors. Directors are elected for a term of one year and every director voted upon in the same election has the same term as the others unless he is elected to a specific vacancy caused by death, resignation or incapacity of an elected director, in which case, he is to serve the remaining term only. Where the law requires independent directors, as in banking and publicly listed companies, the independent directors, by definition represents the minimum number of non-executive directors.

II. Composition of the Board

A survey of corporate governance practices conducted by Asian Development Bank for publicly listed Philippine companies in 1999,¹ could provide some insights on the actual qualifications of members of boards in Philippine corporate practice. The survey found that the three most important bases for electing a director into the board are: relationship with the large (dominant) shareholder, size of shareholding of the director and professional expertise, in that order. It suggests that direct or indirect shareholdings are the more important criteria than professional expertise. It suggests that the Corporation Code may need to be strengthened to improve the capacity and skills of directors to govern the corporation rather than relying on the power of their shareholdings.

The Philippine Constitution and some special laws impose a limit on the number of foreign directors in certain cases. As a rule, the Constitution does not allow the election of foreign directors in fully nationalized industries (e.g., mass media, educational, institutions, advertising). In partially nationalized industries (e.g., public utilities, mining), the number of foreigners that can sit in the board is in proportion to their shareholdings. In industries that are not nationalized, there is no limit on the number of foreign directors.

The Securities Regulation Code (“SRC”) requires that listed companies have at least two independent directors. Similarly, the General Banking Law of 2000 also requires at least two independent directors for banks. Both define an independent director as a person other than an officer or employee of the corporation or bank, its parent or subsidiaries, or any other individual having a relationship with the corporation or bank that would interfere with the exercise of his independent judgment in carrying out his responsibilities as a director.

¹ See “Philippine Corporate Governance Environment and Policy and Their Impact on Corporate Performance”, by Cesar G. Saldana, Asian Development Bank, Manila, October 1999

III. Responsibilities of the Board

A. Powers of the Board of Directors

Under the Corporation Code, the board of directors conduct the business of the corporation and control all of its property. The Corporation Code entrusts the board of directors with the general control and management of the business of the corporation with authority to transact businesses within the scope of its charter powers. Thus, the directors, subject to any express restrictions in the charter or valid by-laws of the corporation, or the general law, possess the power to bind the corporation and its stockholders by any contract which is within its powers, and which in their judgment is necessary in order to carry out the objectives of the corporation.

B. Fiduciary Duties of a Director

The following are the fiduciary duties of directors:²

1. To exercise utmost good faith in all transactions relating to their duties to the corporation and its property, and in their dealings with and for the corporation they are held to the same strict rule of honesty and fair dealing between themselves and their principal as other agents.
2. To act for the benefit of the corporation and not for their own benefit.
3. Not to profit as individuals by virtue of their position.
4. To ensure that profits received by them from the company's property or business revert to the company and to hold the same as trustees for the benefit of the corporation and its stockholders.
5. Not to acquire an interest adverse to that of the corporation, while acting for the corporation or when dealing individually with third persons.

The Corporation Code provides that a director is liable for damages for certain acts that constitute a violation of its fiduciary duties, such as voting for or assenting to patently unlawful acts of the corporation or for gross negligence or bad faith in directing the affairs of the corporation or acquiring any personal or pecuniary interest in conflict with their duty as such directors.³ Any act or omission of a director that constitutes a violation of his fiduciary duties, can be a ground for removal for cause, and cause of action for damages.

The fiduciary role of the board has not changed since passage of the Corporation Code, except for the introduction of the requirement of two independent directors under the Securities Regulation Code affecting publicly listed companies. For banks, The changes are the requirements for independent directors and for the BSP to apply the "fit and proper" test on nominees for directors. These are major changes that occurred in response to the Asian crisis of

² Lopez, *The Corporation Code of the Philippines: Annotated* at 472-473.

³ Sec. 31 of the Corporation Code provides: Liability of directors, trustees or officers. — Directors or trustees who wilfully and knowingly vote for or assent to patently unlawful acts of the corporation or who are guilty of gross negligence or bad faith in directing the affairs of the corporation or acquire any personal or pecuniary interest in conflict with their duty as such directors or trustees shall be liable jointly and severally for all damages resulting therefrom suffered by the corporation, its stockholders or members and other persons.

1997. The regulation of appointments of directors by the BSP is an especially major change in response to the problems BSP had with self dealing directors of banks that failed during the wake of the Asian crisis.

The 1999 ADB Survey identified the responsibilities of the board in actual practice and the relative importance given to them by top management. Survey responses indicated that the board's role is to make strategic decisions for the company. Among the many possible roles of the board, respondents identified two other most important responsibilities as shown in the next table are protecting the shareholders' interest and appointment of senior management. Protection of shareholders' interest clearly refers to majority (rather than minority) shareholders and their prerogative to appoint key managers and formulate strategies for the business.

| Responsibilities of the Board | Ranking According to Importance | | | | | |
|--|---------------------------------|--------------|-----------|--------------|-----------|--------------|
| | 1st | % | 2nd | % | 3rd | % |
| Make strategic decisions on company | 23 | 38.3 | 9 | 19.1 | 0 | 0.0 |
| Protect shareholder interest | 21 | 35.0 | 6 | 12.8 | 1 | 3.4 |
| Appoint senior management | 6 | 10.0 | 13 | 27.7 | 8 | 27.6 |
| Ensure company follows legal and accounting requirements | 3 | 5.0 | 11 | 23.4 | 5 | 17.2 |
| Determine remuneration of senior management | 3 | 5.0 | 5 | 10.6 | 5 | 17.2 |
| Determine remuneration of board directors | 2 | 3.3 | 2 | 4.3 | 8 | 27.6 |
| Make day-to-day decisions | 0 | 0.0 | 1 | 2.1 | 2 | 6.9 |
| Others | 2 | 3.3 | 0 | 0.0 | 0 | 0.0 |
| TOTAL | 60 | 100.0 | 47 | 100.0 | 29 | 100.0 |

IV. The Decision Making Process of the Board

A. Decision and Policymaking Role of the Board

The Corporation Code grants the board of directors the sole power and responsibility to exercise all the corporate powers and to control or manage all the business and properties of the corporation except in certain instances where the law requires the concurrence or consent of the stockholders. The following acts require prior action or subsequent ratification of stockholders:

1. Amendment of articles of incorporation and amendment of articles of incorporation of close corporation
2. Sale, lease, exchange, mortgage, pledge or other disposition of all or substantially all of its property and assets
3. Investment of corporate funds in another corporation or business or for any other purpose other than the primary purpose
4. Increase or decrease of capital stock; incurring, creating or increasing bonded indebtedness
5. Adoption of by-laws
6. Amendments, repeal to by-laws or adoption of new by-laws

7. Merger or consolidation of the corporation with another corporation or other corporations
8. Approval of stock dividends
9. Execution of management contract with another corporation
10. Voluntary dissolution of corporation or by shortening the corporate term

Management consists of the officers who execute and implement the policies and programs laid down by the board of directors/trustees. It comprises the third level of corporate authority, the stockholders being one level and the board the other level. The powers and authorities of corporate officers are merely derived from and generally subject to the powers of the board.

B. Control by the Board Over Company Management

The board retains effective control over the company and the executive management through its power and authority to select, appoint and remove corporate officers; authority to determine executive compensation; to set strategic directions and policies; to delegate authority to management; and to exercise control and supervision over management.

The Corporation Code provides that meetings of directors may be regular or special. The regular meeting of the board is required to be held monthly unless there is a contrary provision in the by-laws. On the other hand, special meetings may be held anytime upon the call of the President or as provided in the by-laws. The board has the discretion to require management to report to the board, including the content and frequency of the reports.

The Corporation Code does not provide for the role of the stakeholders in the board. Nevertheless, the board in its discretion may allow any other stakeholders, e.g., employees, and creditors, to attend board meetings. Unless the stakeholder is a shareholder, the information available to him/her is the same as those available to the general public, e.g, information filed with government regulatory agencies such as the Securities and Exchange Commission or for listed companies, the Philippine Stock Exchange.

C. Collective Liability of Directors

Board members are generally not personally liable when they act in good faith in behalf of the corporation. However, there are cases where the directors or other corporate officers may be held liable jointly with the corporation. There are cases where corporate directors may be held personally liable for damages especially when a director exceeds the scope of his functions or duties. A director may be held personally liable in the following cases:

1. Unlawful Act, Gross Negligence or Bad Faith and Conflict of Interest.

Directors who “willfully and knowingly vote for or assent to patently unlawful acts of the corporation”⁴ may be held liable for damages suffered by the corporation, its stockholders or members and other persons. In order for liability to attach under this provision, the unlawful act of the corporation must be patent and that the directors have agreed thereto voluntarily despite the knowledge that the corporate act is in violation of the law.

⁴ Sec. 31, Corporation Code.

Second, directors who are guilty of gross negligence or bad faith in directing the affairs of the corporation⁵ may also be held liable for damages suffered by the corporation or by third persons. In cases of negligent acts, the negligence involved must be “gross” as to amount to bad faith for the directors to be liable. Moreover, according to established Philippine jurisprudence, the gross negligence or bad faith of a director cannot be presumed. The burden is upon the complaint to prove the alleged losses and to show that they were the consequence of the negligence and mismanagement of the director concerned.⁶ This simply means that the relationship between the negligent act of the director and the damages caused thereby must be clearly established for liability to attach.

Finally, directors are prohibited from acquiring any pecuniary interest in conflict with their duties. Whenever such conflicting interests are acquired by them, they are “liable as trustees for the corporation and must account for the profits which otherwise would have accrued to the corporation.”⁷

2. Liability for “Watered Stock”

Directors may also be held liable for the so-called “watered stocks”, i.e., shares issued at less than par value. Any director or officer of a corporation consenting to the issuance of such watered stocks and who does not object in writing to its issuance is liable, solidarily with the stockholder concerned, to the corporation and its creditors.

3. Contractual Stipulation

Directors may be held liable when the director, trustee or officer has contractually agreed or stipulated to hold himself personally and solidarily liable with the Corporation.

4. Disloyalty

A director of a corporation may be held liable for “disloyalty”. There is disloyalty “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.”⁸ Such director must account by refunding the corporation with the profits he obtained unless his act has been ratified by a vote of the stockholders owning or representing at least two-thirds (2/3) of the outstanding capital stock. The director must account for profits even if he risked his own funds.

5. Insider Trading and Other Manipulative Practices

For listed companies, under the SRC, a director can be held liable for damages for insider trading and other manipulative practices.

6. Filing False Statement

Furthermore, the SRC also provides for the possible civil liability of a director for filing false registration statements with the SEC. This rule specifically outlines that a director is liable for damages incurred by investors who incurred damages due to the untruthful statements or omission in registration statements filed with the SEC.

⁵ *Ibid.*

⁶ Manila Press Inc., v. Ben Gan, SEC-AC CASE NO. 440, October 29, 1998.

⁷ *Ibid.*

⁸ Sec. 34, Corporation Code.

7. Access to Information by a Director, Especially Non-executive Director

The Corporation Code requires that records of all business transactions of the corporation and the minutes of any meetings to be open to inspection by any director, trustee, stockholder or member of the corporation at reasonable hours on business days and he may demand a copy of excerpts from said records or minutes.⁹ Furthermore, the Code requires, the corporation to furnish him, within ten days from receipt of a written request of any stockholder, its most recent financial statements, which include a balance sheet as of the end of the last taxable year and a corresponding profit or loss statement for the same period, showing in reasonable detail its assets and liabilities and the result of its operations.¹⁰ Any officer or agent of the corporation who shall refuse to allow any director, trustees, stockholder or member of the corporation to examine and copy excerpts from its records or minutes shall be liable to such director, trustee, stockholder or member for damages. The Code allows as the corporation to refuse provision of information to a shareholder that will improperly use the information or was not acting for a legitimate purpose in making his demand.

At the regular meeting of stockholders or members, the board of directors or trustees are required under the Code to present to the stockholders a financial report of the operations of the corporation for the preceding year, which shall include financial statements, duly signed and certified by an independent certified public accountant.

V. The Relationships among Board Members and Between the Board and Other Bodies

In practice, the functions of the chairman pertain to the Board while those of the Chief Executive Officer (CEO) pertain to management. However, there is no law that prohibits the chairman from being the CEO and in fact there have been instances where the chairman is concurrently the CEO. The by-laws of a corporation may provide for the position of the chairman of the board of directors where he is made the chief executive officer or given distinct duties.¹¹ In the absence of such a provision in the by-laws, the Corporation Code directs that the chairman merely preside at all meetings of the directors/trustees and the stockholders/members.¹²

1. Board Committees

Except for the Executive Committee, the Corporation Code does not have any other provision regarding board committees. The Executive Committee may act on such specific matters within the competence of the Board as maybe delegated to it by the Board. The Board may however create other committees for the performance of certain functions. The Board may delegate such powers to such committees, and provide adequate resources for the same, as the board may deem necessary and appropriate.

⁹ Section 74.

¹⁰ Section 75.

¹¹ Lopez at 425.

¹² *Ibid.*

Committee members have access to information of the company only by reason of their being directors and stockholders. The Corporation Code does not provide for special access to information for board committees.

The ADB Corporate Governance Survey of 1999 found that only 35 percent of respondent companies have board sub-committees. Companies with sub-committees have an average of only 1.5 committees. The sub-committees are audit committees and nomination committees. The audit committee recommends the selection of the independent external auditors and evaluates its report. The nomination committee is involved in the search and review of suitable candidates for top management positions in the corporation.

2. Conflicts of Interest at the Board Level

The Corporation Code sets the rules on conflicts of interest in the cases of self-dealing directors, contracts between corporation with interlocking directors and acquisition of business opportunity for the benefit of a particular director. Under the Corporation Code, any contract entered into by a director and the corporation is voidable unless the contract is at arms-length or is otherwise ratified by the stockholders. On the other hand, contracts entered into by two corporations with interlocking directors are required to be fair and reasonable and not fraudulent. Finally, a director cannot acquire for himself a business opportunity which should belong to the Corporation otherwise he is liable to account for and refund the corporation with any profits he gained from that opportunity.

Because of the inherent conflict-of-interest of an interlocking director, certain special laws and regulations have been promulgated and issued to prevent interlocking directorates between certain corporations.¹³ Thus, the Insurance Code prohibits a director of an insurance company to be concurrently a director of an insurance adjustment company (Sec. 187, Insurance Code). Further, the Investment House Law also prohibits a person from being concurrently a director of an investment house and a bank. (Sec. 6, P.D. No. 129, as amended).

Section X145 of the Manual of Regulations prohibits concurrent directorship of banks or between bank and a non-bank financial intermediary, except as may be authorized by the Monetary Board. In determining concurrent directorship, a husband and his wife are considered as one person.

VI. Directors' Remuneration and Training

The Corporation Code specifically provides that in the absence of any provision in the by-laws fixing their compensation, the directors shall not receive any compensation, as such directors, except for reasonable per diems.¹⁴ However, such compensation other than per diems may be granted to directors by the vote of majority of the stockholders, provided that the total

¹³ Lopez at 485.

¹⁴ Sec. 30, Corporation Code.

yearly compensation of directors, as such directors, shall not exceed ten percent of the net income before income tax of the corporation during the preceding year.¹⁵ The directors may receive their compensation in the form of stock option or other similar instruments subject to the stockholders' approval and to said limitation as to the amount or value of up to 10% of the preceding year's net income before tax.

The ADB Survey revealed that companies compensate their chairman of the board by fixed salary (52 percent of respondents), fixed salary plus performance related bonus (30 percent) or per diem for meetings (18 percent). The compensation of the chairman of the board is determined directly by the board (54 percent of respondents), by the parent company or by company by-laws (21 percent) and by recommendation of management (15 percent).

The Corporation Code does not specifically provide for the training of directors. However, in the case of directors of banks, the "fit and proper" rule indirectly requires that only directors who are aware of their fiduciary duties and responsibilities be nominated for the position. This implicitly requires some internal or external training of directors of banks.

¹⁵ *Ibid.*