Chapter 34

Coastal Pacific Trading v. Southern Rolling Mills:*
Directors' Duty of Loyalty and Fidelity to Creditors

The Facts

Respondent Visayan Integrated Steel Corporation (VISCO), organized in 1959, was engaged in the steel-processing business. In 1961, it obtained a loan from the Development Bank of the Philippines (DBP), secured by a duly recorded real estate mortgage over three parcels of land, including all the machineries and equipment found there.[1]

In 1963, VISCO also obtained a loan from respondent banks, secured by an unrecorded second mortgage over the same land, machineries and equipment earlier mortgaged to DBP.[2]

Further, in 1964-1965, VISCO entered into a processing agreement with Petitioner Coastal Pacific Trading, Inc. ("Coastal"). By virtue of that agreement petitioner delivered 3,000 metric tons of steel coils to respondent for processing into block iron sheets. The latter was able to process and deliver to Coastal only 1,600 metric tons of those sheets, leaving 1,400 metric tons unaccounted for.[3]

VISCO eventually defaulted on its obligation to respondent banks. After negotiations, the parties agreed to convert the unpaid loan into equity in the steel

corporation.[4] As a result, the banks (which had grouped themselves into a consortium) gained control and management of VISCO starting in 1966, acquiring more than 90 percent of its equity.[5] Notwithstanding this equity conversion, it remained indebted to the consortium in the amount of P16 million.[6]

The account of VISCO with the Far East Bank and Trust Company (FEBTC), in the name of "Board of Trustees VISCO Consortium of Banks," was renamed "Board of Trustees Consortium of Banks" (without the word "VISCO") upon the suggestion of Vicente Garcia, vice-president of both corporations. The change in the account name was adopted as a "precautionary measure to protect the interest of the Consortium of Banks."[7]

In 1974, fearing DBP's foreclosure of its assets, VISCO – through its board of directors – decided to sell its generator sets. The proceeds of the sale were deposited with FEBTC in a special account held in trust for the consortium.[8] The proceeds were intended to be used in paying the DBP loan and to secure the release of the mortgage.[9]

A year later, Coastal sued VISCO (Civil Case No. 21272) for fraudulently misapplying or converting the steel sheets entrusted to the latter.[10] After a writ of preliminary attachment was issued, the sheriff attempted to garnish the steel corporation's FEBTC account, which the bank denied holding. The bank admitted, however, the existence of a deposit account in the name of "Board of Trustees-Consortium of Banks," which it agreed to hold subject to prior liens.[11]

Meanwhile, the officers of VISCO requested a cash advance of P1.3 million from FEBTC for the full settlement of the steel corporation's debt to DBP.[12] FEBTC issued a check for that amount, payable to "[DBP] for [the] account of VISCO." In consideration of the payment, DBP assigned its mortgage rights to the

consortium.[13] Thus did the latter obtain its recorded primary lien over the real and chattel properties of VISCO.

In 1980, the consortium initiated proceedings for the extrajudicial foreclosure of mortgage. Southern Industrial Projects, Inc. (SIP), another creditor of VISCO, entered into the picture and filed a Complaint (Civil Case No. 3383) to enjoin the foreclosure. According to SIP, the mortgage had already been extinguished when DBP was paid by respondent, which used the proceeds from the sale of the generator sets.[14] The foreclosure was initially restrained, but the court eventually decided in favor of the consortium.[15]

Thus, in 1985, the foreclosure sale of VISCO's mortgaged properties proceeded, with the consortium emerging as the highest bidder. It then sold the foreclosed properties to the National Steel Corporation (NSC).[16] At the same time, VISCO assigned its right of redemption to the NSC.[17]

Shortly after, Petitioner Coastal filed a Complaint (Civil Case No. 3929) against respondents for the rescission of sale, damages and injunction.[18] It alleged, *inter alia*, that the assignment of the DBP mortgage to the consortium was fraudulent, because the bank had been paid with the proceeds from the sale of VISCO's generator sets. The Consortium, on the other hand, insisted that it had used its own funds to pay the DBP.

Meanwhile, in 1986, Civil Case No. 21272 was finally decided in favor of petitioner, to which was awarded P851,316.19 with legal interest, attorney's fees and costs.[19] The judgment remains unsatisfied to date.[20]

On the other hand, Civil Case No. 3929 was decided by the trial court in 1992 against Coastal.[21] On appeal, the Court of Appeals affirmed the trial court's

Decision, ruling mainly that, under the principle of *res judicata,* the case was already barred by the judgment on the case earlier filed by SIP (Civil Case No. 3383).[22]

The Issues

Stripped of nonessentials, the two issues may be restated as follows:

1. Whether the present action was barred by *res judicata*

2. Whether respondent banks disposed of VISCO's assets in fraud of the other creditors

The Court's Ruling

In a unanimous Decision,[23] the Court resolved to grant the Petition.

First Issue:
Res Judicata

The Court held that the CA had erred in applying *Southern Industrial Projects v. United Coconut Planters Bank* as a bar by *res judicata,* with respect to the present case, because there was no identity of parties and causes of action between the two cases.

Substantial identity of parties is present when there is privity between the two parties, such as when they are successors-in-interest by title subsequent to the commencement of the action, litigating for the same thing, under the same title, and in the same capacity.[24]

In the instant case, Coastal Pacific was not acting in the same capacity as SIP.

VISCO was sued by petitioner as a creditor under a processing agreement between them; and by SIP, based on an alleged breach of their management contract. Very clearly, because the rights of these two creditors were entirely distinct and separate from each other, in no manner were they privies of each other.[25]

We noted that confusion occurred in the resolution of the issue of identity of parties, because the two creditors were assailing the same transactions of VISCO on the same grounds. Since both had presented similar legal issues, the appellate court held that its ruling against one creditor applied with equal force against the other.[26]

This was a common but palpable misconception of the doctrine of *res judicata*. Persons do not become privies by the mere fact that they are interested in the same question or in proving the same set of facts, or that one person is interested in the result of a litigation involving the other. Several creditors of one debtor cannot be considered as identical parties for the purpose of assailing its acts. They have distinct credits, rights, and interests, such that the failure of one to recover should not preclude the others from also pursuing their legal remedies.[27]

Moreover, to bind petitioner -- a non-party to *Southern Industrial Projects* -- to the Decision in that case would clearly violate its rights to due process. As a separate party, it had the right to have its arguments and evidence evaluated on their own merits.[28]

The causes of action in the two Complaints were also different. Causes of action arise from violations of rights. A single act or omission may violate several rights at the same time, as when it violates separate and distinct legal obligations. The violation of *each of these separate rights* is a separate cause of action in itself.[29] Hence, although these causes of action arise from the same state of facts, they are distinct and independent and may be litigated separately; recovery on one is not a bar to

subsequent actions on the others.[30]

In the present case, the right of SIP (arising from its management contract with VISCO) was totally distinct and separate from the right of Coastal (arising from the latter's processing contract with respondent). Both were asserting distinct rights arising from different legal obligations of the debtor corporation. Thus, VISCO's violation of those separate rights gave rise to separate causes of action.[31]

Second Issue:

Fraud of Creditors

Preliminarily, this Court noted that by totally focusing on the innate validity of the assailed Contracts, the CA overlooked the issue of fraud as a ground for rescission. The latter did not at all address the heart of petitioner's cause of action: whether the transactions had been undertaken by the consortium to defraud VISCO's other creditors.[32] Elementary is the principle that the validity of a contract does *not* preclude its rescission.[33] In fact, rescission implies the existence of a contract that, while initially valid, produces a lesion or pecuniary damage to someone.[34]

Going over the records of the case, the Court found that there was more than a preponderance of evidence showing the consortium's deliberate plan to defraud VISCO's other creditors.

It will be recalled that 90 percent of the equity of VISCO had been acquired by respondent consortium, which then took over the management and control of the former. Thus, 9 out of the 10 directors of the steel corporation were officials of the consortium, which may be said to have effectively occupied and/or controlled the board.

Because they had control and guidance over the corporate affairs and property of VISCO, the officials of the consortium were in a position of trust.[35] As trustees, they should have managed its assets with strict regard for all the creditors' interests. As directors, their duty should have become more stringent when the corporation became insolvent or without sufficient assets to meet its outstanding obligations as they arose.

These directors, who were likewise representatives of the creditor-banks, should not have permitted themselves to secure undue advantage over the other creditors.[36] Regrettably, the consortium miserably failed to observe its duty of fidelity towards the debtor corporation and the latter's other creditors.

The Court further observed that as early as 1966, through its directors on the board of VISCO, the consortium had already assumed management and control over the latter. Hence, respondent banks were at the helm of the steel corporation when it recognized its outstanding liability to Coastal and offered to enter into a compromise agreement. Despite their knowledge, however, they did not adopt any measure to protect petitioner's credit.

Quite the opposite, they even took steps to hide the corporation's unexpended funds. Vicente Garcia's 1972 letter to Arturo Samonte – representative of FEBTC and director of VISCO – revealed that the funds were kept in an account named "Board of Trustees VISCO Consortium of Banks." Respondent banks deemed it best, however, to drop the name "VISCO" to avoid a takeover by the government, which was also a creditor of the corporation. The express intent of VISCO was for the benefit of the consortium, which had management and control of the corporation. This fact corroborated petitioner's contention that the other creditors had thereby been defrauded.

Further, the assignment of the DBP mortgage in favor of the consortium bore the earmarks of fraud. The original plan of respondents was to pay the bank with the proceeds from the sale of the two generator sets. This plan would have extinguished the encumbrance in favor of DBP and freed up the properties of VISCO, to the satisfaction of the latter's other creditors. This procedure would have been fair to all, but it was not followed by the consortium.

Surprisingly, respondents laid down a different payment procedure. The proceeds from the sale of the generator sets would *first* be paid to the consortium. It would then pay DBP and be subrogated to the latter's rights as the first mortgagee. The question was, if the intention was to pay the bank from sales proceeds of the generator sets, why did the money have to pass through the consortium?

Apparently, the answer can be gleaned from the nature of respondent consortium's mortgage. Notably, this mortgage remained unrecorded and not legally binding on the other creditors.[37] The consortium then adopted a payment procedure, which entitled it to obtain DBP's primary lien through an assignment, without incurring additional expenses. This primary lien allowed it to foreclose the assets of VISCO, regardless of the former's inferior claims. This clever ruse would have worked, had it not been resorted to by creditors who -- as directors -- were duty-bound not to take clever advantage of other creditors.

The intention to defraud the other creditors was even more striking in the light of the consortium's knowledge that the assets of VISCO would not be enough to meet its obligations to several other creditors. Fraud is present when the debtor knows that its actions would cause injury.[38]

Thus, the assignment in favor of the consortium was considered a rescissible contract for having been undertaken in fraud of the other creditors.[39] When there is

no more possibility for mutual restitution, which is required in all cases involving rescission, an indemnity for damages operates as restitution.[40]

In the instant case, the Court held that it was no longer possible to order the return of VISCO's properties, which had already been sold to NSC, a buyer in good faith. The Court determined that there was insufficient evidence that NSC had participated in the design to defraud the other creditors. Sans competent proof of bad faith, purchasers are deemed to be in good faith, and their interest in the subject property must not be disturbed.

Pursuant to Article 1385[41] of the Civil Code, petitioner was deemed entitled to an award for damages instead.

While recognizing that the question of damages should normally call for a remand to the lower court for further proceedings, the Court deemed it in the best interest of substantial justice to decide the issue of damages on the basis of the available records.

The Court found that the unsatisfied judgment credit[42] in favor of petitioner in Civil Case No. 21272 defined the extent of the actual damage the latter had suffered as a result of respondent consortium's fraudulent disposition of VISCO's assets.

The Court also awarded exemplary damages in the amount of ₱250,000, to serve as a warning to other creditors not to abuse their rights.[43]

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* GR No. 118692, July 28, 2006, per Panganiban, *CJ.*

[1] CA Decision, p. 3; *rollo,* p. 37.

[2] Petition, p. 4; *rollo*, p. 13.

[3] Petitioner's Memorandum, p. 3; *rollo,* p. 260.

[4] Respondents' Memorandum, p. 4; *rollo,* p. 226.

[5] Records, Vol. I, p. 176.

[6] CA Decision, p. 4; *rollo,* p. 38.

[7] Annex "D" of the Petition; *rollo,* p. 66.

[8] CA *rollo,* p. 104.

[9] Decision, pp. 8-9.

[10] Documentary Evidence of Coastal Pacific; records, pp. 18-19.

[11] Exhibit "E-5," id. at 34-35.

[12] Id. at 176.

[13] Records, Vol. I, pp. 100-105.

[14] Id. at 119-123.

[15] Id. at 131.

[16] Id. at 146-155 and 156-165.

[17] Id. at 166-170.

[18] Id. at 1-14.

[19] Documentary Evidence of Coastal Pacific; records, pp. 150-158.

[20] Decision, p. 15.

[21] CA *rollo*, pp. 96-108.

[22] Decision, pp. 17-20.

[23] First Division. Penned by Chief Justice Panganiban; concurred in by Justices Santiago, Martinez, Callejo, and Nazario.

[24] *Taganas v. Emuslan,* 410 SCRA 237, September 2, 2003; *Cagayan de Oro Coliseum v. CA,* 320 SCRA 731, December 15, 1999.

[25] Decision, p. 26.

[26] Id. at 27-28.

[27] Id. at 28.

[28] Id.

[29] *Perez v. CA,* 464 SCRA 89, July 22, 2005.

[30] See *The City of Bacolod v. San Miguel Brewery, Inc.,* 140 Phil. 363, October 30, 1969.

[31] Decision, p. 27.

[32] Decision, pp. 29-30.

[33] CIVIL CODE, Arts. 1380 and 1381 (3).

[34] A. TOLENTINO, COMMENTARIES AND JURISPRUDENCE ON THE CIVIL CODE OF THE PHILIPPINES 571, Vol. IV (1991). See *Ong v. CA,* 310 SCRA 1, July 6, 1999.

[35] *Prime White Cement Corporation v. IAC,* GR No. 68555, March 19, 1993, 220 SCRA 103.

[36] J. CAMPOS, JR. AND M.C. CAMPOS, THE CORPORATION CODE: COMMENTS, NOTES AND SELECTED CASES 780, Vol. I. (1990) (citing *Mead v. McCullough*, 21 Phil. 95, December 26, 1911).

[37] *See* CIVIL CODE, Art. 2125.

[38] A. TOLENTINO, COMMENTARIES AND JURISPRUDENCE ON THE CIVIL CODE OF THE PHILIPPINES, Vol. IV, 580 (1991).

[39] CIVIL CODE, Art. 1381 (3).

[40] CIVIL CODE, Art. 1385.

[41] "Neither shall rescission take place when the things which are the object of the contract are legally in the possession of third persons who did not act in bad faith.

"In this case, indemnity for damages may be demanded from the person causing the loss."

[42] "WHEREFORE, the judgment is hereby rendered in favor of the plaintiffs ordering defendant VISCO/SRM to pay the plaintiffs the sum of ₱851,316.19 with interest thereon at the legal rate from the filing of this complaint, plus attorney's fees of ₱50,000.00 and to pay the costs."

[43] CIVIL CODE, Art. 2229.