04 February 2008

SEC OGC Opinion No. 08-04

Decrease of Capital Stock,
Return of Capital

SYCIP SALAZAR HERNANDEZ & GATMAITAN
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Makati City
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Attention: Atty. Rose Marie M. King
Atty. Benedicto P. Panigbatan
Atty. Ma. Charizza B. Carlos

Gentlemen:

This refers to your letter dated 04 January 2007(sic) requesting confirmation that:

1. the contemplated decrease in capital stock of the Company for the purpose of partial return of capital to its shareholders is permissible; and

2. the return of capital can be implemented in the form of the Company's shares of stock in LandCo.

You likewise request the confirmation of the conditions required under Section 38 of the Corporation Code that the Company must observe for the purpose of implementing the contemplated decrease in capital stock and partial return of capital to its shareholders.

You disclosed in your letter that your client, hereinafter referred to as the “Company”, is a domestic corporation that is engaged in health care services. The Company owns a parcel of land on which its health care facilities are located. The Company intends to transfer its parcel of land to a new entity (the “LandCo”) in exchange for LandCo shares to streamline its corporate activities and asset ownership. After the shares are issued in the name of the Company, it will decrease its authorized capital stock for the purpose of returning the capital of its shareholders in the form of the Company's shares of stock in the LandCo. The value of the Company's shares of stock in LandCo will be the extent of the decrease in the authorized capital stock of the Company.
As a rule, a company cannot make a return of capital to its stockholders except upon lawful dissolution and after payment of all its debts and liabilities. The following, however, are the instances where distribution of capital assets are allowed, viz: (1) amendment of the Articles of Incorporation to reduce the authorized capital stock, (2) purchase of redeemable shares by the corporation, regardless of the existence of unrestricted retained earnings, and (3) dissolution and eventual liquidation of the corporation. However, a corporation cannot lawfully decrease its capital stock if the effect is to relieve the stockholders of the obligation to pay their respective subscription.

In one case, the Supreme Court stated that it is an established doctrine that subscriptions to the capital of a corporation constitute a fund to which creditors have a right to look for satisfaction of their claims. A corporation has no power to release an original subscriber to its capital stock from the obligation of paying for his shares, without a valuable consideration for such release; and as against creditors a reduction of the capital stock can take place only in the manner and under the conditions prescribed by the statute or the charter or the articles of incorporation.

The foregoing Supreme Court ruling embodies the Trust Fund Doctrine, which provides that subscriptions to the capital stock of a corporation constitute a fund to which the creditors have a right to look for the satisfaction of their claims. The assets of a dissolved corporation belong to the stockholders. However, the corporate debts must be paid and its obligations discharged before the proceeds obtained in liquidating the assets may be distributed among the stockholders. That is the underlying principle in the distribution of corporate assets.

Section 38 of the Corporation Code, however, grants a corporation the power to increase or decrease its capital stock. Though it is a management prerogative, strict compliance with the procedures and requirements for decreasing (increasing) a capital stock is necessary, to wit:

1. Amendment of the pertinent provisions of the articles of incorporation indicating the amount of decrease if:
   
   a. Approved in a board meeting by the majority vote of the board of directors;
   
   b. Approved in a regular or special stockholders' meeting, after prior written notice to the stockholders served personally or by mail in accordance with its by-laws, indicating (i) the proposed decrease and (ii) the time and place of the stockholders' meeting, by 2/3 of the outstanding capital stock;

1. Corporation Code, Section 122, last par.
3. Ibid.
c. The resolution approved by the required votes of directors and stockholders, which should be quoted in the certificate, should indicate the proportionate reduction in the number of shares each stockholder will receive in relation to the decreased capital stock and the deadline a stockholder shall surrender his certificate of stock in exchange for a new certificate indicating the reduced number of shares.

2. Evidenced by director's sworn certificate signed by majority of the directors and countersigned by the chairman and the secretary of the stockholders' meeting, to be submitted to this Commission.

The value of the decrease in the capital stock may be distributed to the stockholders, as contemplated by the Company, as long as the rights of the creditors are not affected. For this reason, the consent of the creditors of the Company need to be secured. It is also worthy to point out that the Commission will only allow a decrease in capital stock if the capital of the Company will not be impaired. The solvency of the Company must also be assured. Finally, the decrease in the authorized capital stock shall be published once in a newspaper of general circulation.

Based on the foregoing discussion, this Office thus opines that as long as the formalities laid down in Section 38 of the Corporation Code are complied with and the rights of all stockholders and creditors of the Company are not prejudiced, we see no infirmity to the proposed decrease in capital stock of the Company for the purpose of partial return of capital to its shareholders in the form of the Company's shares in LandCo.

The foregoing opinion is based solely on the facts disclosed in the query and it shall not be used in the nature of a standing rule binding upon the Commission in other cases.

Very truly yours,

VERNETTE G. UMALI-PACO
General Counsel