



Republic of the Philippines  
Department of Finance  
**Securities and Exchange Commission**  
SEC Bldg. EDSA, Greenhills, Mandaluyong City

OFFICE OF THE GENERAL COUNSEL

08 May 2009

SEC-OGC Opinion No. 09-11

For: Power of a Corporation to  
Purchase Its Own Shares

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Attention: Atty. Santiago T. Gabionza, Jr., et al.

Gentlemen:

We reply to your request for opinion on whether Victorias Milling Corporation ("VMC"), despite its negative equity, can reacquire its own shares as a consequence of dation or offsetting agreement.

The pertinent facts of your query are as follows:

1. On 04 July 1997, VMC filed with the Commission a Petition for the (a) Declaration of Suspension of Payment to Creditors, (b) Approval of a Rehabilitation Plan, and (c) Appointment of a Management Committee. On 08 July 1997, the Commission issued an Order suspending all actions or claims against VMC pending before any court, tribunal, office, board, body and/or the Commission. On 08 August 1997, the Commission created a Management Committee to oversee VMC's operations and rehabilitation.<sup>1</sup>
2. One of the stockholders of VMC is Miguel J. Ossorio Pension Foundation, Inc. ("MJOPFI"). VMC has been advancing funds to MJOPFI to answer for the latter's commitment to its beneficiaries. VMC has been offered payment for the advances in favor of MJOPFI, shares which the latter had with VMC.

VMC would like now to acquire its own shares held by MJOPFI despite the former's negative retained earnings based on its Audited Financial Statements for the period ended 31 August 2006.

This Office is of the opinion that the proposed transaction cannot be undertaken. Pertinent to the instant query is the provision of Section 41 of the Corporation Code (B.P. Blg. 68), which is quoted below for easy reference:

<sup>1</sup> Note 2, Audited Financial Statements for the period ended 31 August 2006, p. 1.

"Sec. 41. *Power to acquire own shares.*- A stock corporation shall have the power to purchase or acquire its own shares for a legitimate corporate purpose or purposes, including but not limited to the following cases: Provided, That the corporation has unrestricted retained earnings in its books to cover the shares to be purchased or acquired:

1. To eliminate fractional shares arising out of stock dividends;
2. To collect or compromise an indebtedness to the corporation, arising out of unpaid subscription, in a delinquency sale, and to purchase delinquent shares sold during said sale; and
3. To pay dissenting or withdrawing stockholders entitled to payment for their shares under the provisions of this Code. (n)"

For a corporation to exercise its power to acquire its own shares, the following conditions must be present:

1. It is for a legitimate and proper corporate purpose;
2. There shall be an unrestricted retained earnings to purchase the same and its capital is not thereby impaired;
3. The corporation acts in good faith and without prejudice to the rights of creditors and stockholders; and
4. The conditions of corporate affairs warrant it.<sup>2</sup>

Before a corporation may acquire its own shares, it is required that it must have an unrestricted retained earnings based on the trust fund doctrine, which means that the capital stock, property and other assets of a corporation are regarded as equity in trust for the payment of corporate creditors.<sup>3</sup> The rationale behind this is that the creditors of a corporation have rightful preference over the stockholders in the distribution of corporate assets.<sup>4</sup> In other words, the claims of the creditors must first be satisfied before that of the stockholders. Thus, creditors have the right to assume that so long as there are outstanding debts and liabilities, the board of directors will not use the assets of the corporation to purchase its own stock.<sup>5</sup> Any disposition in violation of such doctrine is considered void.

Of significance in the instant query also is that corporate affairs must warrant the exercise of such right to purchase its own shares. This is in essence connected with the trust fund doctrine in which a corporation must provide sufficient funds to pay its creditors or that there must be sufficient assets that will remain after such purchase of its own shares.

From the foregoing, a corporation generally has no power to purchase its own shares of stock. Such rule, however, is subject to exceptions, namely:

1. Elimination of fractional shares;
2. Satisfaction of indebtedness to corporations;
3. Payment of shares of dissenting or withdrawing stockholders.<sup>6</sup>

<sup>2</sup> De Leon, Hector S. THE CORPORATION CODE OF THE PHILIPPINES 319 (1993).

<sup>3</sup> Boman Environmental Development Corporation v. Hon. Court of Appeals, et al. G.R. No. 77860, 22 November 1988.

<sup>4</sup> Ibid.

<sup>5</sup> Ibid, citing Steinberg vs. Velasco, 52 Phil. 953.

<sup>6</sup> Section 41 of the Corporation Code.

The above list is by no means exclusive according to one author and enumerated several instances where a corporation can purchase its own shares regardless of the existence of unrestricted retained earnings, viz:<sup>7</sup>

1. It may be exercised under Section 9 (treasury shares).
2. The corporation may purchase redeemable shares regardless of the existence of unrestricted retained earnings (Section 8).
3. Shares may be reacquired to effect a decrease in the capital stock of a corporation (Section 38).
4. In close corporation, where there is a deadlock respecting the management of its business, the Commission may order the purchase at their fair value of shares of any stockholder by the corporation regardless of the availability of unrestricted retained earnings in its books (Sec. 104, par. 1[4]).<sup>8</sup>

In one case, the Supreme Court held that redemption may not be made where the corporation is insolvent or if such redemption will cause insolvency or inability of the corporation to meet its debts as they mature, thus:

“This is a new provision which in effect qualifies the general rule that the corporation cannot purchase its own shares except out of current retained earnings. However, while redeemable shares may be redeemed regardless of the existence of unrestricted retained earnings, this is subject to the condition that the corporation has, after such redemption, assets in its books to cover debts and liabilities inclusive of capital stock. Redemption, therefore, may not be made where the corporation is insolvent or if such redemption will cause insolvency or inability of the corporation to meet its debts as they mature.”<sup>9</sup>

In the instant query, we are of the opinion that an unrestricted retained earning is an essential requisite before a corporation may purchase its own shares. Since VMC has negative unrestricted retained earnings as borne by its Audited Financial Statement for the period ended August 2006, the proposed purchase may not be undertaken. The contemplated transaction likewise does not fall under the exception where purchase of a corporation's shares may be undertaken regardless of the existence of unrestricted retained earnings. It is also worthy of note that VMC is under rehabilitation. At this point, it would be more prudent for VMC to conserve its assets in order to meet its obligations as they become due. As observed by the Officer-in-Charge of the Office of the General Accountant of this Commission, the proposed acquisition of shares through *dation* in payment does not appear to be consistent with the intention of the rehabilitation proceeding to facilitate the recovery of the company. The derecognition of receivables (if this is not yet fully impaired) without receiving any cash from the debtor would further aggravate the negative liquidity position of the company. Finally, the corresponding recognition of treasury shares would further increase the amount of negative equity of the company.

It shall be understood that the foregoing opinion is rendered based solely on the facts and circumstances disclosed and relevant solely to the particular issues raised therein and shall not be used in the nature of a standing rule binding upon the Commission in other cases

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<sup>7</sup> De Leon, Hector S. *supra*, p. 318.

<sup>8</sup> *Ibid*, p. 318.

<sup>9</sup> Republic Planters Bank v. Hon. Enrique A. Agana, Sr. et al., G.R. No. 51765, 03 March 1997.

whether of similar or dissimilar circumstances. If, upon investigation, it will be disclosed that the facts relied upon are different, this opinion shall be rendered null and void.

Very truly yours,



**VERNETTE G. UMALI-PACO**  
General Counsel

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