Republic of the Philippines
Department of Finance
Securities and Exchange Commission

OFFICE OF THE GENERAL COUNSEL

21 September 2021

SEC-OGC Opinion No. 21-10
Re: Redemption and retirement of Preferred Shares; Reduction of Capital Stock

TIU LATONIO & ASSOCIATES LAW OFFICE
2F Arcada 5 Building City, Highway Tipolo
Mandaue City, Cebu 6014

Attention: Atty. Emery Joy Tiu
Partner

Dear Atty. Tiu:

This refers to your letter dated 12 November 2020 requesting for opinion on the redemption of preferred shares, the retirement thereof, and the subsequent decrease in the capital stock of Mehitabel Incorporated ("Mehitabel" or the "Company").

In relation to your request, you disclosed the following facts for the consideration of the Commission:

1. Mehitabel was incorporated and registered with the Securities and Exchange Commission ("SEC" or "Commission") on 18 December 1987 with principal office address at Tac-An Road, Talamban, Cebu City. Pursuant to its amended Articles of Incorporation, Mehitabel has an *authorized capital stock* of One Hundred Thirty-Five Million Pesos (PhP135,000,000.00) divided into: a) *Common Shares*: Twenty-Five Million (25,000,000) with par value of One Peso (Php 1.00) per share; and b) *Preferred Shares*: One-Hundred Ten Million (110,000,000) with par value of One Peso (Php 1.00) per share.

2. The preferred shares are non-voting, non-participating, non-convertible and *redeemable at the option* of Mehitabel within five (5) years from the date of issue at par value of One Peso (Php 1.00) per share. The holders of preferred shares are entitled to receive cumulative cash dividends of not more than twenty-five percent (25%) per annum out of the unrestricted retained earnings and payable before any cash dividends are declared for distribution to holders of common shares.

3. As of 31 December 2019, Mehitabel's *outstanding capital stock* has a total par value of One Hundred Thirty-One Million Pesos (PhP131,000,000.00) divided into: a) *Common Shares*: Twenty-One Million (21,000,000) with par value of One Peso (Php 1.00) per share; and b) *Preferred Shares*: One-Hundred Ten Million (110,000,000) with par value of One Peso (Php 1.00) per share.

4. Mehitabel intends to redeem, at par value, all of the One-Hundred Ten Million (110,000,000.00) preferred shares it has issued.

5. As of 31 December 2019, the Audited Financial Statements of Mehitabel reflect a *retained earnings deficit* of Seventy-Nine Million Three Hundred Forty-Five Thousand Eight Hundred Forty-Three Pesos (79,345,843.00). However, you stated that Mehitabel has sufficient assets to cover its debts and liabilities prior to and after the proposed redemption. You also stated that the proposed redemption will not cause insolvency or result in the inability of the Company to meet its debts as they mature.

6. Further, you stated that should there be inadequate cash at the time the redemption is to be made, the Company plans to raise the funds needed to fulfill the par value redemption price of the preferred shares, either by disposal of an asset or assets of equivalent value or receive advances from common shareholders. This notwithstanding, you also represented that the Company will still have sufficient assets consisting of real and personal properties to cover its debts and liabilities both prior to and after the proposed redemption.

7. Lastly, you stated that subsequent to the proposed redemption, the preferred shares reacquired will be considered retired and will no longer be reissued. The Company will remove these redeemed preferred shares from the treasury by applying for a decrease in its authorized capital stock.

Based on the aforementioned facts and proposed courses of action, you raised the following issues:

1. Whether Mehitabel can redeem the preferred shares at par value even without unrestricted retained earnings, and without violating existing laws as well as the trust fund doctrine;

2. Whether Mehitabel is allowed to raise funds for the purpose of redeeming the preferred shares, either through the disposal of an asset or assets of equivalent value or receive advances from common shareholders, and all the while maintaining sufficient assets to cover its debts and liabilities, inclusive of the capital stock;

3. Whether interim Financial Statements (FS) are sufficient proof to provide interim balances after infusion of cash, if not otherwise appearing in the latest Audited FS, and whether such interim FS need to be audited by an external auditor;

4. Whether Mehitabel can retire the preferred shares after redemption and remove the same from the treasury by applying for the amendment of its Articles of Incorporation for the decrease of its authorized capital stock, from One Hundred Thirty-Five Million Pesos (PhP135,000,000.00) to Twenty-Five Million Pesos (PhP25,000,000.00); and

5. Whether or not the application for retirement of preferred shares and decrease in authorized capital stock can be applied and processed at the SEC Cebu Extension Office.

DISCUSSION

First Query: Redemption of Preferred Shares

Section 40 of the Revised Corporation Code (RCC)[1] states the *general rule* that there must be unrestricted retained earnings before a corporation can redeem, repurchase, repurchase or reacquire its own shares, to wit:

> "Section 40. Power to Acquire Own Shares. — **Provided that the corporation has unrestricted retained earnings in its books to cover the shares to be purchased or acquired, a stock corporation shall have the power to purchase or acquire its own shares for a legitimate corporate purpose or purposes**, including the following cases:
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> (a) To eliminate fractional shares arising out of stock dividends;
> (b) 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
> (c) To pay dissenting or withdrawing stockholders entitled to payment for their shares under the provisions of this Code." (*Emphasis supplied*)

An *exception* to this general rule is Section 8 of the RCC which defines *redeemable shares* and provides that such shares may be purchased by the corporation from the holders thereof upon the expiration of a fixed period, *regardless of the existence of unrestricted retained earnings in the books of the corporation*, to wit:

> "Section 8. Redeemable shares – Redeemable shares may be issued by the corporation ***when expressly provided in the articles of incorporation. They are shares which may be purchased by the corporation from the holders of such shares upon the expiration of a fixed period, regardless of the existence of unrestricted retained earnings in the books of the corporation, and upon such other terms and conditions stated in the articles of incorporation and the certificate of stock representing said shares***, subject to the rules and regulations issued by the Commission."

The abovementioned general rule and exception are stated in Sections 3 and 5 of the Rules Governing Redeemable and Treasury Shares issued by the Commission on 26 April 1982 ("1982 Rules")[2]:

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[1] Republic Act No. 11232, An Act Providing for the Revised Corporation code of the Philippines, February 20, 2019

[2] Rules Governing Redeemable and Treasury Shares, SEC Rules and Regulations, April 26, 1982; The rules are based on Section 8 (*Redeemable Shares, now Section 8 of the RCC*) and Sections 9 and 41 (*Treasury shares and Power of the*

"Section 3. Redeemable Treasury Shares. —

1. **No corporation shall redeem, repurchase or reacquire its own shares, of whatever class, unless it has an adequate amount of unrestricted retained earnings to support the cost of the said shares, <u>except</u>**:

a. **<u>When the shares are reacquired in the redemption of redeemable shares of the corporation</u>** or pursuant to the conversion right of convertible shares of the corporation, **<u>in accordance with the provision expressly provided for in its articles of incorporation and certificates of stock representing said shares of the corporation</u>**;

x x x

Section 5. Other Provisions. —

x x x

5. **Redeemable shares may be redeemed, <u>regardless of the existence of unrestricted retained earnings, provided that the corporation has, after such redemption, sufficient assets in its books to cover debts and liabilities inclusive of capital stock</u>"**.

Meanwhile, "*Unrestricted Retained Earnings*" is defined by SEC Memorandum Circular No. 11-08[3] as follows:

"Section 2. – Definition of Terms. — x x x

Unrestricted Retained Earnings - the amount of accumulated profits and gains realized out of the normal and continuous operations of the company after deducting therefrom distributions to stockholders and transfers to capital stock or other accounts, and which is: (1) not appropriated by its Board of Directors for corporate expansion projects or programs: (2) not covered by a restriction for dividend declaration under a loan agreement; and (3) not required to be retained under special circumstances obtaining in the corporation such as when there is a need for a special reserve for probable contingencies."

In the case of ***Republic v. Agana***[4], the Supreme Court held:

"Redeemable shares, on the other hand, are shares usually preferred, which by their terms are redeemable at a fixed date, or at the option of either issuing corporation, or the stockholder, or both at a certain redemption price. A redemption by the corporation of its stock is, in a sense, a repurchase of it for cancellation. The present Code allows

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Corporation to Acquire Own Shares, now Sections 9 and 40 of the RCC) of the Corporation Code of the Philippines (Batas Pambansa Blg. 68, May 1, 1980)

[3] Guidelines on the Determination of Retained Earnings Available for Dividend Declaration, SEC Memorandum Circular No. 11-08, December 5, 2008

[4] Republic Planters Bank v. Agana, Sr., G.R. No. 51765, March 3, 1997, 336 PHIL 1-14

redemption of shares even if there are no unrestricted retained earnings on the books of the corporation. 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**."

The condition that the corporation must have, after such redemption, assets in its books to cover debts and liabilities inclusive of capital stock, is consistent with the *trust fund doctrine* which was explained by the Supreme Court in *Halley vs. Printwell, Inc.*[5] in this wise:

> "The trust fund doctrine enunciates a — . . . rule **that property of a corporation is a trust fund for the payment of creditors**, but such property can be called a trust fund 'only by way of analogy or metaphor.' As between the corporation itself and its creditors it is a simple debtor, and as between its creditors and stockholders its assets are in equity a fund for the payment of its debts.
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> The trust fund doctrine, first enunciated in the *American case of Wood vs. Dummer*, was adopted in our jurisdiction in *Philippine Trust Co. vs. Rivera*, where this Court declared that:
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>> It is an established doctrine that **subscriptions to the capital of corporation constitute a fund to which creditors have a right to look for satisfaction of their claims** and that the assignee in insolvency can maintain an action upon any unpaid stock subscription in order to realize assets for the payment of its debts. (*Velasco vs. Poizat, 37 Phil., 802)*
>>
>> We clarify that the trust fund doctrine is not limited to reaching the stockholder's unpaid subscriptions. **The scope of the doctrine when the corporation is insolvent encompasses not only the capital stock, but also other property and assets generally regarded in equity as a trust fund for the payment of corporate debts**. All assets and property belonging to the corporation held in trust for the benefit of creditors that were distributed or in the possession of the stockholders, regardless of full payment of their subscriptions, may be reached by the creditor in satisfaction of its claim."

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[5] Donnina C. Halley v. Printwell, Inc., G.R. No. 157549, May 30, 2011, 664 PHIL 361-389

In short, although the general rule is that there must be unrestricted retained earnings before a corporation can redeem, repurchase, or reacquire its own shares, the exception is when the shares to be redeemed are *redeemable* as provided in the articles of incorporation and certificates of stock of the corporation. However, for any redemption of said shares to be valid, there must be sufficient assets to cover the debts and liabilities of the corporation[6].

Based on the foregoing, Mehitabel may purchase its redeemable shares from the holders thereof upon the expiration of a fixed period, as provided in its articles of incorporation and certificates of stock representing the said shares, *regardless of the existence of unrestricted retained earnings in its books*, considering that, based on its representation, it has, *after such redemption, sufficient assets in its books to cover debts and liabilities inclusive of capital stock.*

Second Query: Whether Mehitabel is allowed to raise funds for the purpose of redeeming the preferred shares

As to your second query, please be advised that as a matter of policy, the Commission refrains from or does not render an opinion on matters which (1) require determination of factual issues;[7] or (2) involve the exercise of business judgment or discretion that falls within the competence of the management of the entities concerned[8].

The issue of whether Mehitabel is allowed to raise funds for the purpose of redeeming the preferred shares, either through the disposal of an asset or assets of equivalent value or receive advances from common shareholders, while maintaining sufficient assets to cover its debts and liabilities inclusive of the capital stock, as represented in your letter, is one which requires determination of factual issues and/or the implementation of corporate acts that falls within the competence of, and/or calls for the exercise of the business judgment/discretion of the management of Mehitabel.

Third Query: Whether interim FS are sufficient proof to provide interim balances after infusion of cash, if the same does not yet appear in the latest audited FS; Whether such interim FS need to be audited by an external auditor.

In case the Commission's Company Registration and Monitoring Department (CRMD) or the Cebu Extension Office will require the Company to submit an *interim* FS in relation to the proposed decrease in authorized capital stock, as will be discussed below, it is recommended that the said interim FS be audited. Audited FS can provide reasonable basis for obtaining high, but not absolute, level of assurance or comfort to users that the FS are not materially misstated.

Fourth Query: Whether Mehitabel can retire the preferred shares after redemption and remove the same from the treasury by applying for the amendment of its Articles of Incorporation and decrease its authorized capital stock

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[6] Re: Redemption of Preferred Shares; Subscribed Capital Stock, SEC-OGC Opinion No. 20-19, May 27, 2019
[7] SEC Memorandum Circular No. 15, series of 2003, Section 5.8
[8] *Ibid.*, Section 5.9

Once redeemed, a corporation's redeemable preferred shares become part of the corporation's treasury shares, as specifically provided in Section 9 of the RCC, to wit:

> "Section 9. Treasury Shares. — **Treasury shares are shares of stock which have been issued and fully paid for, but subsequently reacquired by the issuing corporation through** purchase, **redemption**, donation, or some other lawful means. Such shares may again be disposed of for a reasonable price fixed by the board of directors."

Section 3, Paragraph 2 of the 1982 Rules states that:

> "Section 3. Redeemable Treasury Shares. —
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> x x x
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> 2. ***Treasury shares*** do not revert to the unissued shares of the corporation but are regarded as property acquired by the corporation which may be reissued or sold by the corporation at a price to be fixed by the Board of Directors; ***provided, however, that in the case of redeemable shares reacquired, the same shall be considered retired and no longer issuable, unless otherwise provided in the Articles of Incorporation***."

Meanwhile, Section 4, Paragraph 2 of the 1982 Rules states that while redeemed preferred shares are considered retired, the same remains in treasury until removed from their treasury status by decreasing the authorized capital stock of the corporation in accordance with Section 37 of the RCC[9].

In the case of Mehitabel, its amended Articles of Incorporation[10] is silent on the "reissuable" nature of its redeemable preferred shares. As such, once its shares are redeemed, the same shall be considered retired and may no longer be reissued. To eliminate the treasury shares, Mehitabel must file an application for decrease of authorized capital stock with the Commission and comply with all the requirements set forth in Section 37[11] of the RCC which states among others, that **no decrease of**

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[9] "Section 4. Retained Earnings. — x x x
2. The dividend restriction on retained earnings on account of the treasury shares being held shall be lifted only after the treasury shares causing the restriction are reissued or retained. **Retirement of treasury shares shall be effected by decreasing the capital stock of the corporation in accordance with Section 38 of the Corporation Code of the Philippines for the purpose of eliminating the treasury shares." (Now Section 37 of the RCC)**

[10] Submitted along with its Letter Request

[11] RCC, "Section 37. Power to Increase or Decrease Capital Stock; Incur, Create or Increase Bonded Indebtedness. — No corporation shall increase or **decrease its capital stock** or incur, create or increase any bonded indebtedness **unless approved by a majority vote of the board of directors and by two-thirds (2/3) of the outstanding capital stock at a stockholders' meeting duly called for the purpose. Written notice of the time and place of the stockholders' meeting and the purpose for said meeting must be sent to the stockholders at their places of residence as shown in the books of the corporation and served on the stockholders personally, or through electronic means recognized in the corporation's bylaws and/or the Commission's rules as a valid mode for service of notices.**

A **certificate must be signed by a majority of the directors of the corporation and countersigned by the chairperson and secretary of the stockholders' meeting**, setting forth:

authorized capital stock shall be approved by the Commission if its effect shall prejudice the rights of corporate creditors.

Fifth Query: Filing of application for decrease in authorized capital stock with SEC Cebu Extension Office

Regarding your final query, the 2020 SEC Citizen's Charter (2nd Edition) on Extension Offices[12] provides that an application for decrease in authorized capital stock can be filed in the SEC Cebu Extension Office.

It shall be understood that the foregoing opinion is rendered solely on the basis of the facts, circumstances and documents disclosed/submitted, and should be considered relevant solely to the particular issue raised therein. It shall not be used in the nature of a standing rule binding upon the Commission in other cases or upon the courts whether of similar or dissimilar circumstances[13]. If, upon further inquiry or investigation, it will be disclosed that the facts relied upon are different, this opinion shall be rendered void.

Please be guided accordingly.

Respectfully yours,

ROMUALD C. PADILLA
General Counsel

(a) That the requirements of this section have been complied with;
(b) The amount of the increase or decrease of the capital stock;
x x x
(e) The amount of stock represented at the meeting; and
(f) The vote authorizing the increase or decrease of the capital stock, or the incurring, creating or increasing of any bonded indebtedness.

Any increase or decrease in the capital stock or the incurring, creating or increasing of any bonded indebtedness shall require prior approval of the Commission, and where appropriate, of the Philippine Competition Commission. The application with the Commission shall be made within six (6) months from the date of approval of the board of directors and stockholders, which period may be extended for justifiable reasons.

Copies of the certificate shall be kept on file in the office of the corporation and filed with the Commission and attached to the original articles of incorporation. After approval by the Commission and the issuance by the Commission of its certificate of filing, the capital stock shall be deemed increased or decreased and the incurring, creating or increasing of any bonded indebtedness authorized, as the certificate of filing may declare: Provided, That the Commission shall not accept for filing any certificate of increase of capital stock unless accompanied by a sworn statement of the treasurer of the corporation lawfully holding office at the time of the filing of the certificate, showing that at least twenty-five percent (25%) of the increase in capital stock has been subscribed and that at least twenty-five percent (25%) of the amount subscribed has been paid in actual cash to the corporation or that property, the valuation of which is equal to twenty-five percent (25%) of the subscription, has been transferred to the corporation: **Provided, further, That no decrease in capital stock shall be approved by the Commission if its effect shall prejudice the rights of corporate creditors**. x x x

[12] 2020 Citizen's Charter (2nd Edition) – Extension Office; https://www.sec.gov.ph/wp-content/uploads/2020/12/2020CC_2nd-Edition-Extension-Office.pdf
[13] *Ibid.*, Footnote no. 5