Republic of the Philippines
Department of Finance
Securities and Exchange Commission
OFFICE OF THE GENERAL COUNSEL

02 February 2022

SEC-OGC Opinion No. 22-01
Re: Redemption of Preferred Shares

ROMULO MABANTA BUENAVENTURA
SAYOC & DE LOS ANGELES
21st Floor Philamlife Tower
8767 Paseo De Roxas St.
Makati City

Attn: ATTY. AGUSTIN MONTILLA IV
Agustin.Montilla@romulo.com

Dear Atty. Montilla,

This is in response to your electronic mail dated 15 June 2021[1] requesting for guidance from the Commission as regards the rules on the effect of redeemed preferred shares on the unrestricted retained earnings in view of Sections 3(1) and 4(1) of the Commission's 1982 Rules Governing Redeemable and Treasury Shares ("1982 Rules")[2].

You stated that your client has redeemable preferred shares in its outstanding capital stock, whose articles of incorporation (AOI) and certificates of stock provide for such redemption. You are requesting for confirmation that the exception in Section 4(1) of the 1982 Rules will apply once the said preferred shares are redeemed, such that the amount of your client's retained earnings equivalent to the cost of the said redeemable shares will not be restricted.

Section 40 of the Revised Corporation Code (RCC)[3] states the *general rule* that there must be unrestricted retained earnings before a corporation can redeem, 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*)

[1] Forwarded to this Office by the Office of the General Accountant on 16 June 2021
[2] SEC Rules Governing Redeemable and Treasury Shares (1982)
[3] Republic Act No. 11232, An Act Providing for the Revised Corporation Code of the Philippines, February 20, 2019

"Unrestricted Retained Earnings" is defined under *SEC Memorandum Circular No. 11-08*[4], 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."

An exception to the general rule provided in the afore-quoted provision is found in Section 8 of the RCC which defines and provides for the issuance of ***redeemable shares***. These are shares that may be issued by the corporation when expressly provided in the AOI and which 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 1982 Rules. As cited in your letter, Section 3(1) of the 1982 Rules provides:

"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, **except**:

   a. **When the shares are reacquired in the redemption of redeemable shares of the corporation** or pursuant to the conversion right of convertible shares of the corporation, **in accordance with the provision expressly provided for in its articles of incorporation and certificates of stock representing said shares of the corporation.**" *(Underscoring supplied)*

Meanwhile, Section 5(5) of the 1982 Rules states that "redeemable shares may be redeemed, 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***

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

liabilities inclusive of capital stock." 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***[5] that the property of a corporation is a trust fund for the payment of its creditors.

Once redeemed, the said redeemable preferred shares become part of the corporation's ***treasury shares*** which are defined under the RCC as follows:

> "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 4 (1) of the 1982 Rules states that "the ***amount of unrestricted retained earnings equivalent to the cost of the treasury shares being held***, **other than those acquired in accordance with the exceptions provided in Section 3(1) of these rules,** ***shall be restricted from being declared and issued as dividends.***" *(Underscoring supplied)*

In ***SEC-OGC Opinion No. 19-03***[6], the Commission opined that Section 4(1) of the 1982 Rules explicitly provides that generally, **treasury shares shall be deducted from the unrestricted retained earnings to arrive at the 'Retained Earnings Available for Dividend Declaration'**. The reason for this is that such amount of earnings equivalent to the cost of treasury shares is *not* considered part of the earned or surplus profits that is distributable as dividends. The exception to this general rule is provided in Section 3(1) of the 1982 Rules which states that ***redeemed*** redeemable shares, ***although part of the treasury shares***, is **not** subtracted from the unrestricted retained earnings to arrive at the 'Retained Earning Available for Dividend Declaration.'

The 1982 Rules continue to apply in the computation of unrestricted retained earnings for dividend declaration and remain significant insofar as the exemption of the particular items is concerned. Section 3(1) thereof recognizes the ***special nature of treasury shares in the form of redeemed redeemable shares,*** upon which the exception (or non-deduction) is based[7]. It was further explained:

> "x x x Given such, a corporation may not redeem its shares unless there is adequate retained earnings. "However, due to the special nature of a redeemable share as provided for in the AOI, **adequate amount of unrestricted retained earnings is not necessary for its redemption provided that corporation has, after such redemption *sufficient assets in its books to cover debts and liabilities inclusive of capital stock*." Hence the**

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[5] Explained by the Supreme Court in *Donnina C. Halley v. Printwell, Inc.*, G.R. No. 157549, May 30, 2011, 664 PHIL 361-389: "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.

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:

"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)"* x x x

[6] SEC-OGC Opinion No. 19-03 dated 14 February 2019 addressed to Atty. Benedicto Panigbatan

[7] *Ibid.*

exception should be read with Section 5 (5) of the same 1982 Rules. "The present Code allows 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."[8]

Thus, the exception provided in Section 3(1) of the 1982 Rules will only apply **subject to the sufficiency of assets in its books to cover debts and liabilities inclusive of capital stock.**[9] Considering that the exception under the 1982 Rules under Section 4(1) in relation to Section 3(1) thereof presupposes that the corporation has sufficient assets to cover its debts and liabilities inclusive of capital stock, consistent with the *trust fund doctrine*, there is no need to deduct the treasury shares acquired pursuant to such exception from the unrestricted retained earnings, as the redemption of said redeemable preferred shares will not prejudice or be detrimental to the creditors of the said corporation.

In view of the foregoing, it is our well-considered opinion, and thus confirm that the exception in Section 4(1) of the 1982 Rules will apply once preferred shares are redeemed, such that the amount of the retained earnings equivalent to the cost of the redeemable shares will not be restricted (i.e. non-deductibility of the cost of the treasury shares arising from such redemption from the unrestricted retained earnings), provided there are sufficient assets in the books of the corporation to cover its debts and liabilities inclusive of capital stock.

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[10]. 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.

Very truly yours,

ROMUALD C. PADILLA
General Counsel

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[8] *Ibid.*, quoting the Corporation Code (now RCC), 1982 Rules and *Republic Planters Bank v. Agana, Sr.*, G.R. No. 51765, March 3, 1997, 336 PHIL 1-14
[9] *Ibid.*
[10] *Ibid.*, Footnote no. 5