Securities and Exchange Commission
PHILIPPINES

OFFICE OF THE GENERAL COUNSEL

SEC OGC Opinion No. 22-13
Re: Additional Paid In Capital

30 September 2022

COMMVERGE SOLUTIONS PHILIPPINES, INC.
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Attn: MS. MERCY SALVAN
Financial Director

Madam:

This refers to your letter dated 18 May 2021[1] requesting for opinion on the proposed actions of CommVerge Solutions Philippines, Inc. ("CommVerge Philippines") in returning its capital to its parent company CommVerge Solutions Holdings (Asia) Inc. ("CommVerge Holdings"), a company registered in the British Virgin Islands.

CommVerge Philippines is a company registered with the Securities and Exchange Commission (SEC) on 9 July 1999 with an authorized capital stock (ACS) of Ten Million Pesos (PhP10M) divided into 100,000 shares at a par value of PhP100.00 each.

You stated that from the years 1999-2001, CommVerge Philippines suffered recurring losses and incurred a cumulative deficit of Two Hundred Twenty Million Pesos (PhP220M). To help CommVerge Philippines, its parent company CommVerge Holdings made advances in the amount of Two Hundred Thirty Six Million Pesos (PhP236M) ("advances") to support the former's operations.

On 29 May 2002, the Commission approved an increase of CommVerge Philippines' ACS from its initial 100,000 shares to 2.5 million shares at par value of PhP100.00 each, or Two Hundred Fifty Million Pesos (PhP250M). Subsequently, CommVerge Philippines converted the advances equivalent to PhP236M to equity.

By 2006, CommVerge Philippines continued to suffer operating losses and incurred an annual deficit which reached a total of Four Hundred Twenty One Million Pesos (PhP421M). By 2007, CommVerge Holdings made additional advances to CommVerge Philippines in the amount of One Hundred Forty Nine Million Six Hundred Thousand (PhP149.6M).

Meanwhile, CommVerge Philippines submitted to the Commission an application for equity restructuring and creation of additional paid-in capital ("APIC") to partially wipe out the existing deficit as of financial year 2007. The application was then approved on 18 June 2008 which resulted in the conversion of PhP149.6M (advances received from CommVerge Holdings) to APIC.

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[1] Received by our office on 1 June 2021

As of 31 December 2018, CommVerge Philippines has paid out the advances which accumulated to about Php157M to CommVerge Holdings.

CommVerge Holdings has expressed its intent to recover the PhP149.6M advances that was converted to APIC and CommVerge Philippines intends to return the same provided it can do so legally and without violating the Trust Fund Doctrine.

In particular, CommVerge seeks legal opinion on the following:

I. "Whether the nullification of APIC and its subsequent conversion into subscribed capital will violate the Trust Fund Doctrine";
II. "Under what circumstances/ condition APIC may be applied to an increase in par value of CommVerge Philippines' shares without violating the Trust Fund Doctrine";
III. "Whether it is permitted to execute a reverse stock split to cover deficit in the amount of subscribed capital following the increase in par value"; and
IV. "Whether the increase in Authorized Capital Stock as a result of the reverse stock split would be considered "original issuance" of stocks and thus subject to documentary stamp taxes."

Nature of APIC and the Trust Fund Doctrine

APIC is any contribution of stockholders ***over the par value*** of shares.[2] The Commission, in the last paragraph of Section 2 of Memorandum Circular No. 11 (MC No. 11)[3], also considers APIC as ***premium*** when it defines **paid-in capital** as "the amount of outstanding capital stock and **additional paid-in capital or premium** paid over the par value of shares".

The Commission allows a stockholder to infuse cash or property to be treated as APIC or premium[4].

On 24 February 2006, the Commission issued SEC Resolution No. 94, Series of 2006 which adopts the policy of allowing corporations, at their option, to apply for SEC approval of the creation of APIC, *subject to payment of the filing fees applicable* for such application. It must be noted however, that when the consideration involved is other than cash, the approval of the Commission is necessary. Provided further, that when the purpose for the creation of APIC is for equity restructuring, the Commission's approval is mandatory regardless of whether the consideration is in cash or not.

In SEC Memorandum Circular No. 11, Series of 2008[5], the Commission mandates that APIC shall neither be declared as dividend nor shall it be reclassified to absorb deficiency except through an organizational restructuring duly approved by the Commission.[6]

From the foregoing, it appears that there are no specific rules and regulations issued by the Commission on the ***nullification*** of APIC and its subsequent conversion into subscribed capital. However, based on the previous Opinions[7] issued, ***conversion*** of APIC involves the observance of the Trust Fund Doctrine.

In the case of *Enano-Bote v. Alvarez*[8], citing the case of *Donna C. Halley vs. Printwell, Inc.*, the Supreme Court explained the ***Trust Fund Doctrine*** as follows:

> "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

[2] SEC OGC Opinion No. 14-13 addressed to Isla Lipana & Co., 11 June 2014
[3] Memorandum Circular No. 11 s.2008, Re : Guidelines on the Determination of Retained Earnings Available for Dividend Declaration, 5 December 2008
[4] https://www.sec.gov.ph/company/other-applications/
[5] *Ibid.*, no. 3
[6] *Ibid.*, no. 2
[7] *Ibid.*, no. 2; SEC OGC Opinion No. 19-50 addressed to Tan, Venturanza and Valdez.
[8] Enano-Bote v. Alvarez, G.R. No. 223572, 10 November 2020.

> 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."

Further, the Court in the case of *Philippine Trust Co. v. Rivera*[9] explained the rationale of the Trust Fund Doctrine in this wise:

> "It is 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 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) . . .
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> **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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> x x x." (*Emphasis supplied*)

In *National Telecommunications Commission (NTC) v. Honorable Court of Appeals*[10], the Court defined ***capital*** as a composition of the Trust Fund, to wit:

> "xxx...Briefly, capital refers to the value of the property or assets of a corporation. **The capital subscribed is the total amount of the capital that persons (subscribers or shareholders) have agreed to take and pay for, which need not necessarily by, <u>and can be more than</u>, <u>the par value of the shares</u>.** In fine, **it is the amount that the corporation receives, <u>inclusive of the premiums if any</u>, in consideration of the original issuance of the shares.** x x x **The "Trust Fund" doctrine considers this subscribed capital as a trust fund for the payment of the debts of the corporation, to which the creditors may look for satisfaction. Until the liquidation of the corporation, no part of the subscribed capital may be returned or released to the stockholder (except in the redemption of redeemable shares) without violating this principle.** Thus, dividends must never impair the subscribed capital; subscription commitments cannot be condoned or remitted; nor can the corporation buy its own shares using the subscribed capital as the considerations therefor.

Meanwhile, ***equity*** is defined in the International Accounting Standards Board's Framework as the residual interest in the entity's assets after deducting all its liabilities.

Equity includes the entity's issued ordinary shares, and options and warrants held by external parties to purchase those shares. There are many types of share capital, including ordinary shares, preferred shares, non-voting shares, participating shares and redeemable shares. **The price of share capital is recorded at the amount that a corporation received in consideration for the issuance of shares, plus share premium or APIC, if any.**[11]

Summarizing the preceding discussion, subsequently infused APIC forms part of equity emanating from the original subscription agreement. APIC, as a premium, forms part of the capital of a corporation and therefore falls within the purview of the Trust Fund Doctrine.

In *Ong Yong, et al. vs. David S. Tiu, et al.*[12], the Supreme Court discussed when the distribution of corporate 'Trust Fund' is allowed, thus:

> "The Trust Fund Doctrine, first enunciated by this Court in the 1923 case of Philippine Trust Co. vs. Rivera , provides that: subscription 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. **This doctrine is the underlying principle in the procedure for the distribution of capital assets, embodied in the Corporation Code, which allows the distribution of corporate capital only in three instances: (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.** Furthermore, the doctrine is articulated in Section 41 on the power of a corporation to acquire its own shares and in Section 122 on the prohibition against the distribution of corporate assets and property unless the stringent requirements therefor are complied with." (*Emphasis supplied*)

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[9] Philippine Trust Company v. Rivera, G.R. No. 19761, January 29, 1923.
[10] National Telecommunications Commission (NTC) v. Honorable Court of Appeals, G.R. No. 127937, July 28, 1999.
[11] SEC OGC Opinion No. 13-14 addressed to Isla Lipana & Co., dated 11 June 2014.
[12] Ong Yong v. Tiu, G.R. Nos. 144476 & 144629, [April 8, 2003], 448 PHIL 860-894

"The distribution of corporate assets and property cannot be made to depend on the whims and caprices of the stockholders, officers or directors of the corporation, or even, for that matter, on the earnest desire of the court a quo "to prevent further squabbles and future litigations" unless the indispensable conditions and procedures for the protection of corporate creditors are followed. Otherwise, the "corporate peace" laudably hoped for by the court will remain nothing but a dream because this time, it will be the creditors' turn to engage in "squabbles and litigations" should the court order an unlawful distribution in blatant disregard of the Trust Fund Doctrine."[13]

In *Philip Turner, et al. vs. Lorenzo Shipping Corporation*[14], the Supreme Court reiterated Ong Yong when it held that:

"**There can be no distribution of assets among the stockholders without first paying corporate debts.** Thus, any disposition of corporate funds and assets to the prejudice of creditors is null and void." *(Emphasis supplied)*

Having determined that APIC is covered by the Trust Fund Doctrine, we now evaluate your proposed actions and determine whether such can be allowed given the nature of the APIC in relation to the Trust Fund Doctrine.

I. Nullification of APIC and its subsequent conversion into subscribed capital will violate the Trust Fund Doctrine.

When a corporate 'Trust Fund' will be used for purposes other than those enumerated in *Ong Yong* i.e., to pay for the stockholder's additional subscription to capital stock, it will effectively result in the *unauthorized* distribution of the corporate Trust Fund, thereby violating the Trust Fund Doctrine.

In *NTC*[15], it is clear that, "until the liquidation of the corporation, no part of the subscribed capital may be returned or released to the stockholder (except in the redemption of redeemable shares) without violating this principle." The corporate creditors, therefore, should have the first claim on the trust fund of the corporation, and the stockholders have no rights to it, until all the creditors are satisfied.

Based on the foregoing, it is opined that a corporation may not nullify its APIC and subsequently convert it into subscribed capital, as the same violates the Trust Fund Doctrine.

II. Circumstances/conditions where APIC may be applied to an increase in par value of CommVerge Philippines' shares without violating the Trust Fund Doctrine

Please be informed that as a matter of policy, this Office does not render an opinion on requests which will entail gathering of legal materials or writing abstract essay for the requesting party since the Commission should not function or resemble as legal counsel of private firms.[16]

III. Whether it is permitted to execute a reverse stock split to cover deficit in the amount of subscribed capital following the increase in par value

Reverse stock split is "just the opposite of stock split" and described as the pro rata combination of all the outstanding shares of a specified class into smaller number of shares of that class by an amendment to articles stating the effect on outstanding shares . A reverse stock split may be required to increase the market value per share of a corporation's shares or to restructure other outstanding debt or equity instruments issued by the corporation or it may be used to eliminate certain small minority stockholders. A stock split or reverse stock split, like a share dividend, readjusts corporation's capital structure. Either can therefore, be used as part of a recapitalization of a corporation. Correspondingly, in a reverse stock split, the outstanding shares are transformed into a smaller number of outstanding shares and again the effect is disguised unless the par or nominal value of the shares is changed as part of the transaction. **In the absence of some feature not associated with the typical stock split (such as an option to receive cash rather than shares or a split or reverse split which does not result in**

[13] *Ibid.*, no. 12
[14] Philip Turner, et al. vs. Lorenzo Shipping Corporation, G.R. No. 157479, November 24, 2010.
[15] *Ibid.*, Note 11
[16] SEC Memorandum Circular No. 15 Series of 2003, No. 5.10.

proportionate change in the shareholdings of all holders of the same class or series) the receipt of shares as a result of a split does not result in taxable income to either the stockholder or the corporation.[17]

As described in the Philippine Accounting Standards (PAS) 33, a share split refers to issuing ordinary shares to existing shareholders for no additional consideration. Therefore, the number of ordinary shares outstanding is increased without an increase in resources. A reverse split or consolidation of ordinary shares, on the other hand, reduces the number of ordinary shares without a corresponding reduction in resources.

As such, a reverse stock split will not create an APIC because the amount of the subscribed and paid-up capital will remain the same, considering that this will merely be a decrease in number of shares but with a proportionate increase in par value. Hence, to undergo a reverse stock split will not result to decrease of deficit.

IV. Whether a reverse stock split will result to an increase in ACS and whether the same would be considered "original issuance" of stocks and thus subject to documentary stamp taxes.[18]

Since there will be no changes in the balance of the Share Capital/Capital Stock after a reverse stock split, an increase or decrease in capital would not be possible as it simply increases the par value and decreases the number of shares proportionately. A reverse stock split will not result to an increase of ACS.

It shall be understood that the foregoing opinion is rendered based solely on the facts, circumstances and documents disclosed/submitted and 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.[19] 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

[17] Ballantine & Sterling, California Corporation Laws, p. 8-94, pp. 8-96 – 8-96.10.
[18] For tax consequences, we defer to the Bureau of Internal Revenue (BIR).