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

27 October 2011

SEC Opinion No. 11- 44
Re : Nationality Restrictions;
Control Test and Grandfather Rule;
Composition of the Board

ATTY. WILFREDO M. PENAFLOR
President
Northern Luzon UPC Asia Corporation
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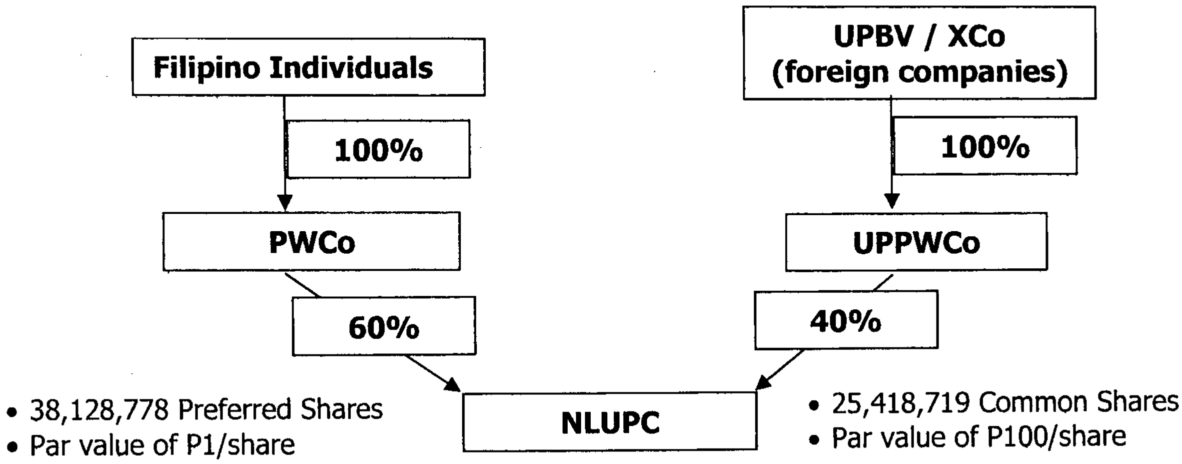
Gentlemen:

This refers to your letter dated 01 August 2011 requesting confirmation by the Commission of your position that the proposed ownership structure and composition of the Board of Northern Luzon UPC Asia Corporation ("NLUPC") is legal and valid, and does not violate the nationality restrictions prescribed by the Philippine Constitution and applicable laws.

As disclosed in your letter, NLUPC is a domestic corporation established to develop, construct and own the Caparispisan and Balaoi wind energy projects in Pagudpud, Ilocos Norte. It has secured from the Department of Energy Service Contracts for the exploration, development and utilization of wind resources. As a developer and owner of wind energy projects, NLUPC is subject to the nationality restriction imposed by the Philippine Constitution and other pertinent laws.

Under the proposed corporate structure of NLUPC, PWCo, an entity organized and existing under Philippine laws and 100% owned by Filipino individuals, shall own and hold 38,128,778 redeemable preferred shares with a par value of PhP1.00 per share, allegedly comprising sixty percent (60%) of the total outstanding capital stock of NLUPC. The remaining forty percent (40%) thereof, allegedly composed of 25,418,719 common shares with a par value of PhP100.00 per share, shall be owned and held by UPPWCo, a joint venture between two foreign companies, namely UPBV and XCo, that is likewise organized and existing under Philippine laws.

The foregoing proposed corporate structure is illustrated in your letter as follows:



Your letter also states that NLUPC's Articles of Incorporation are proposed to be amended to reflect the above-described corporate structure and the following features of the preferred shares:

(a) Each will be of equal rank, preference and priority and identical in all respects, regardless of its issuance;

(b) **Each shall have the same voting rights as common shares**;

(c) The preferred shares shall be entitled to 6% per annum non-cumulative, non-participating dividend out of the unrestricted earnings of NLUPC;

(d) The dividends owing to the holder of the preferred shares must first be paid before any dividends are paid to the holders of the common shares;

(e) In the event of the NLUPC's liquidation, voluntary or involuntary dissolution, distribution of assets or winding-up, if after paying debts and liabilities of NLUPC, there are insufficient assets to pay for and liquidate all the shares of the Corporation, the preferred shares will be paid the par value of the shares plus any and all unpaid dividends ahead of the common shares;

(f) The preferred shares shall not be convertible into common shares;

(g) The preferred shares shall be redeemable upon approval of the Board of Directors and at the redemption price equal to the issue price plus any accrued and undistributed dividends. Shareholders' vote shall not be required for redemption. However, the preferred shares shall be redeemable only if the redeemed shares are replaced with at least an equivalent amount of newly paid-in shares so as to maintain NLUPC's total paid-in equity at the same level immediately prior to redemption. Redeemed shares shall be retired and no longer issuable;

(h) Pre-emptive rights shall not be granted on the part of any stockholder of preferred shares; and

(i) The preferred shares must be held by Filipino citizens or corporations or associations of whose capital is 100% owned by Filipino citizens.

Your letter further states that as part of the proposed ownership structure, NLUPC's Board of Directors shall be composed of 10 members, four (4) of whom shall be Filipino citizens and shall be nominated by the preferred shareholders; another four (4) of whom, who may be Filipino or foreign citizens, shall be nominated by the common shareholders and the remaining two (2) shall be independent directors, who must be Filipino citizens, and shall be jointly nominated by preferred and common shareholders. All of the directors must be elected by the NLUPC shareholders at large. The independent directors will each hold one (1) preferred share to qualify for the NLUPC Board and shall, upon nomination and prior to the election, submit to the Corporate Secretary a letter of confirmation stating that he holds no interests affiliated with the Corporation, management or any shareholder of the Corporation at the time of his election or appointment and/or re-election as director.

Given the foregoing, NLUPC seeks confirmation on:

(1) Whether or not the proposed ownership structure and composition of the Board of NLUPC is legal and valid, and does not violate the nationality restrictions prescribed by the Philippine Constitution and applicable laws; and

(2) Whether or not the ownership of NLUPC prescribed by the Philippine Constitution and applicable laws is determined based on the shares of stock that can vote in the election of directors regardless of the classification, features and par value of such shares.

The legal capacity of a corporation to enter into co-production, joint venture and production-sharing agreements with the State for the exploration, development and utilization of natural resources including all forces of potential energy is regulated by Article XII, Section 2 of the 1987 Constitution, to wit:

> ***Section 2.*** *All lands of the public domain, waters, minerals, coal, petroleum, and other mineral oils,* ***all forces of potential energy****, fisheries, forests or timber, wildlife, flora and fauna, and other natural resources are owned by the State. With the exception of agricultural lands, all other natural resources shall not be alienated.* ***The exploration, development, and utilization of natural resources shall be under the full control and supervision of the State. The State*** *may directly undertake such activities, or it* ***may enter into co-production, joint venture, or production-sharing agreements with Filipino citizens, or corporations or associations at least 60 per centum of whose capital is owned by such citizens.*** *Such agreements may be for a*

> *period not exceeding twenty-five years, renewable for not more than twenty-five years, and under such terms and conditions as may provided by law. x x x*
> *x x x x x x [Emphasis supplied].*

Corollary thereto, Executive Order No. 858 (EO 858)[1] identifies the exploration, development and utilization of natural resources as one of the investment areas and/or activities reserved to Philippine nationals, thereby, allowing only up to forty percent (40%) foreign equity participation, to wit:

> ***Section 1. Only the investment areas and/or activities listed in the Annex hereof shall be reserved to Philippine nationals****, and hereafter shall be referred to as the Eight Regular Foreign Investment Negative List.* ***The extent of foreign equity in these areas shall be limited to the percentages indicated in the List.***
>
> *Annex A*
>
> *x x x x x x x x x*
>
> ***Up to Forty Percent (40%) Foreign Equity***
>
> ***17. Exploration, development and utilization of natural resources*** *x x x*
> *x x x x x x [Emphasis supplied]*

Section 3(a) of Republic Act No. 7042 (RA 7042), otherwise known as the Foreign Investment Act of 1991, as amended by Republic Act No. 8179, defines Philippine national as –

> *Section. 3. Definitions. - As used in this Act:*
>
> *a) the term* ***"Philippine National"*** *shall mean a citizen of the Philippines or a domestic partnership or association wholly owned by citizens of the Philippines; or* ***a corporation organized under the laws of the Philippines of which at least sixty percent (60%) of the capital stock outstanding and entitled to vote is owned and held by citizens of the Philippines*** *or a corporation organized abroad and registered as doing business in the Philippine under the Corporation Code of which one hundred percent (100%) of the capital stock outstanding and entitled to vote is wholly owned by Filipinos or a trustee of funds for pension or other employee retirement or separation benefits, where the trustee is a Philippine national and at least sixty percent (60%) of the fund will accrue to the benefit of Philippine nationals:* ***Provided, That where a corporation and its non-Filipino stockholders own stocks in a Securities and Exchange Commission (SEC) registered enterprise, at least sixty percent (60%) of the capital stock outstanding and entitled to vote of each of both corporations must be owned and held by citizens of the Philippines and at least sixty percent (60%) of the members of the Board of Directors of each of both corporations must be citizens of the Philippines, in order that the corporation shall be considered a Philippine national;***

Further, private sector participation in the exploration, development, utilization and commercialization of wind energy resources is reinforced in Executive

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[1] Promulgating the Eight Regular Foreign Investment Negative List (05 February 2010).

Order No. 462 (EO 462)[2] identifying those qualified to participate in such endeavor, to wit:

> *Section 1. Exploration, Development and Utilization of OSW Energy Resources. –* ***Subject to existing rights, the government, through the DOE, shall engage in the assessment, exploration, extraction, harnessing, development and utilization of ocean, solar and wind (OSW) energy resources, preferably with the participation of the private sector under a production-sharing contract awarded by the Secretary of the DOE,*** *after due consultation with the host community/ies and local government unit/s concerned, through public bidding or negotiation. The production sharing contractor must be technically and financially capable of undertaking the operations required in the contract.*
>
> *x x x x x x x x x*
>
> *Section 7. Qualification of Contractor. –* ***A contractor*** *under this Order* ***shall be a qualified natural or juridical person seeking to explore, develop, utilize and harness OSW energy resources in the Philippines for purposes of producing power and/or types of energy.*** *Details of financial, technical and other qualifications of a contractor shall be specified by the Secretary of the DOE in the implementing rules and regulations of this Order.*

The Implementing Rules and Regulations of EO 462 reiterate the constitutional requirement that the controlling interests of enterprises entering into co-production, joint venture or sharing agreements in the exploration, development, utilization and commercialization of natural resources should be held by Filipino citizens or by corporations or associations at least sixty percent (60%) of the capital of which is owned by Filipino citizens, to wit:

> ***Section 4 (w). "Qualified person"*** *– any citizen of the Philippines with capacity to contract, or* ***a corporation****, partnership, association, cooperative or any other business aggrupation,* ***organized under the laws of the Republic of the Philippines at least sixty percent (60%) of the capital of which is owned by citizens of the Philippines.***
>
> *x x x x x x x x x*
>
> ***Section 19. Renewable Energy Service/Operating Contract***
>
> *A. State Ownership of All Forces of Potential Energy – All forces of potential energy and other natural resources are owned by the State and shall not be alienated. These include potential energy sources such as kinetic energy from water, marine current and wind; thermal energy from solar, ocean, geothermal and biomass.*
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> *B. Parties to a Service/Operating Contract – The exploration, development, production and utilization of natural resources shall be under the full control and supervision of the State.*

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[2] Enabling Private Sector Participation in the Exploration, Development, Utilization and Commercialization of Ocean, Solar and Wind Energy Resources for Power Generation and Other Energy Uses.

> ***The State may directly undertake such activities, or it may enter into co-production, joint venture or co-production sharing agreements with Filipino citizens or corporations or associations at least sixty percent (60%) of whose capital is owned by Filipinos.*** *Foreign RE Developers may also be allowed to undertake RE development through an RE Service/Operating Contract with the government, subject to Article XII, Section 2 of the Philippine Constitution.*

In determining compliance with the nationality restrictions laid down in the Constitution and other pertinent laws, the Commission, in a plethora of opinions, has consistently applied the following manner of calculating the Filipino interest in a corporation:

> ***Shares belonging to corporations or partnerships at least 60% of the capital of which is owned by Filipino citizens shall be considered as of Philippine nationality, but if the percentage of Filipino ownership in the corporation or partnership is less than 60%, only the number of shares corresponding to such percentage shall be counted as of Philippine nationality.*** *Thus, if 100,000 shares are registered in the name of a corporation or partnership at least 60% of the capital stock or capital respectively, of which belong to a Filipino citizens, all of the said shares shall be recorded as owned by Filipinos. But if less than 60%, or, say, only 50% of the capital stock or capital of the corporation or partnership, respectively belongs to Filipino citizens, only 50,000 shares shall be counted as owned by Filipinos and the other 50,000 shares shall be recorded as belonging to aliens.*
>
> *x x x x x x x x x*
>
> ***Under the above-quoted SEC Rules, there are two cases in determining the nationality of the Investee Corporation. The first case is the 'liberal rule,' later coined by the SEC as the Control Test in its 30 May 1990 Opinion, and pertains to the portion in said Paragraph 7 of the 1967 SEC Rules which states, '(s)hares belonging to corporations or partnerships at least 60% of the capital of which is owned by Filipino citizens shall be considered as of Philippine nationality.'*** *Under the liberal Control Test, there is no need to further trace the ownership of the 60% (or more) Filipino stockholdings of the Investing Corporation since a corporation which is at least 60% Filipino-owned is considered as Filipino.*
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> ***The second case is the Strict Rule or the Grandfather Rule Proper and pertains to the portion in said Paragraph 7 of the 1967 SEC Rules which states, "but if the percentage of Filipino ownership in the corporation or partnership is less than 60%, only the number of shares corresponding to such percentage shall be counted as of Philippine nationality."*** *Under the Strict Rule or Grandfather Rule Proper, the combined totals in the Investing Corporation and the Investee Corporation must be traced (i.e., "grandfathered") to determine the total percentage of Filipino ownership.*
>
> ***Moreover, the ultimate Filipino ownership of the shares must first be traced to the level of the Investing Corporation and added to the shares directly owned in the Investee Corporation.*** *x x x*
>
> *x x x x x x x x x*

In other words, based on the said SEC Rule and DOJ Opinion, the ***Grandfather Rule*** *or the second part of the SEC Rule* ***applies only when the 60-40 Filipino-foreign equity ownership is in doubt*** *(i.e. in cases where the joint venture corporation with Filipino and foreign stockholders with less than 60% Filipino stockholdings [or 59%] invests in other joint venture corporation which is either 60-40% Filipino-alien or 59% less Filipino). Stated differently, where the 60-40 Filipino-foreign equity ownership is not in doubt, the Grandfather Rule will not apply." (Emphasis supplied).*[3]

Further, the Commission has consistently opined that the ownership of the shares of stock of a corporation is based on the total outstanding or subscribed/issued capital stock regardless of whether they are classified as common voting shares or preferred shares without voting rights.[4] It is further said that the test for compliance with the nationality requirement is based on the total outstanding capital stock irrespective of the amount of the par value of shares,[5] and likewise without regard to whether or not such shares have been fully or partially paid.[6] This is, thus, the general rule, such that when the provision merely uses the term "capital" without qualification (as in Section 11, Article XII of the 1987 Constitution, which deals with equity structure in a public utility company), the same should be interpreted to refer to the sum total of the outstanding capital stock, irrespective of the nomenclature or classification as common, preferred, voting or non-voting.[7]

However, the Supreme Court in the case of Gamboa v. Finance Secretary (*Gamboa case*),[8] construed the term "capital" in Section 11, Article XII of the Constitution as shares of stock that can vote in the election of directors, to wit:

Indisputably, one of the rights of a stockholder is the right to participate in the control or management of the corporation. This is exercised through his vote in the election of directors because it is the board of directors that controls or manages the corporation. In the absence of provisions in the articles of incorporation denying voting rights to preferred shares, preferred shares have the same voting rights as common shares. However, preferred shareholders are often excluded from any control, that is, deprived of the right to vote in the election of directors and on other matters, on the theory that the preferred shareholders are merely investors in the corporation for income in the same manner as bondholders. In fact, under the Corporation Code only preferred or redeemable shares can be deprived of the right to vote. Common shares cannot be deprived of the right to vote in any corporate meeting, and any provision in

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[3] SEC-OGC Opinion No. 11-26 dated 19 April 2011 citing Department of Justice Opinion No. 020, series of 2005, addressed to then Secretary of the Department of Finance, the Honorable Cesar Purisima; SEC-OGC Opinion No. 10-20 dated 27 May 2010; SEC-OGC Opinion No. 10-08 dated 08 February 2010; SEC Opinion dated 02 January 1990; DOJ Opinion No. 018 series of 1989, dated 19 January 1989.
[4] SEC Opinion No. 04-30 dated 28 April 2004 addressed to Marlene Caluya.
[5] SEC Opinion No. 04-49 dated 22 December 2004 addressed to Atty. Priscilla B. Valer of Romulo Mabanta Buenaventura Sayoc & De Los Angeles.
[6] SEC Opinion No. 06-36 dated 21 September 2006 addressed to Atty. Tadeo F. Hilado of Angara Abello Concepcion Regala & Cruz Law Offices.
[7] SEC-OGC Opinion No. 09-10 dated 19 May 2009 addressed to Congchingyan & Peralta Law Offices, citing SEC-OGC Opinion No. 18-07 dated 28 November 2007 addressed to Rafael C. Bueno, Jr.
[8] G.R. No. 176579, 28 June 2011.

the articles of incorporation restricting the right of common shareholders to vote is invalid.

Considering that common shares have voting rights which translate to control, as opposed to preferred shares which usually have no voting rights, the term "capital" in Section 11, Article XII of the Constitution refers only to common shares. However, if the preferred shares also have the right to vote in the election of directors, then the term "capital" shall include such preferred shares because the right to participate in the control or management of the corporation is exercised through the right to vote in the election of directors. ***In short, the term "capital" in Section 11, Article XII of the Constitution refers only to shares of stock that can vote in the election of directors.***

This interpretation is consistent with the intent of the framers of the Constitution to place in the hands of Filipino citizens the control and management of public utilities.

x x x x x x x x x

Mere legal title is insufficient to meet the 60 percent Filipino-owned "capital" required in the Constitution. Full beneficial ownership of 60 percent of the outstanding capital stock, coupled with 60 percent of the voting rights, is required. The legal and beneficial ownership of 60 percent of the outstanding capital stock must rest in the hands of Filipino nationals in accordance with the constitutional mandate. Otherwise, the corporation is "considered as non-Philippine national[s]."

x x x x x x x x x

To construe broadly the term "capital" as the total outstanding capital stock, including both common and non-voting preferred shares, grossly contravenes the intent and letter of the Constitution that the "State shall develop a self-reliant and independent national economy ***effectively controlled*** *by Filipinos." A broad definition unjustifiably disregards who owns the all-important voting stock, which necessarily equates to control of the public utility.*

It must be emphasized that the foregoing Supreme Court decision is subject of a pending Motion for Reconsideration.

Considering that under the proposed corporate structure, 60% of NLUPC's shares of stock will be owned legally and beneficially by PWCo, a domestic corporation 100% owned by Filipino individuals, and the same 60% are voting preferred shares under the proposed Amendment to its Articles of Incorporation, the Commission, notwithstanding the pending Motion for Reconsideration in the Gamboa case, confirms that NLUPC's proposed corporate structure complies with the aforementioned nationality restrictions and is therefore legal and valid.

However, it must be emphasized that no transfer of stock or interest [including redemption of shares by NLUPC] which shall reduce the ownership of Filipino citizens to less than the required percentage of the capital stock as provided by existing laws shall be allowed or permitted to be recorded in the proper books of the corporation and this restriction shall be indicated in all stock certificates issued by the corporation,[9] and in the Articles of Incorporation. Thus, any redemption of NLUPC's redeemable preferred shares owned and held by PWCo that will in effect reduce Filipino ownership to less than that required by the Constitution and existing laws violates the aforementioned nationality restrictions. Hence, we suggest that item (g) in the proposed Amendment to the Articles of Incorporation be modified to the effect that "the preferred shares shall be redeemable only if the redeemed shares are replaced with at least an equivalent amount of newly paid-in shares so as to maintain NLUPC's total paid-in equity at the same level immediately prior to redemption **and as to ensure compliance with the nationality requirements.**"

Similarly, issuance of shares by NLUPC that will alter Filipino ownership to less than that required by the Constitution and other existing laws also violates aforementioned nationality restrictions.

With regard to the proposed composition of NLUPC's Board of Directors, Section 2-A of Commonwealth Act No. 108, as amended by Presidential Decree No. 715, otherwise known as the "The Anti Dummy Law," allows foreigners to be elected as members of the Board of Directors of corporations engaging in partially nationalized activities including exploration, development, utilization and commercialization of natural resources, to the extent of their allowable participation or share in capital in such entities, viz –

> *Section 2-A. Unlawful Use, Exploitation or Enjoyment. xxx xxx xxx And provided, finally, that the election of aliens as members of the board of directors or governing body of corporations or associations engaging in partially nationalized activities* ***shall be allowed in proportion to their allowable participation or share in the capital of such entities.***

Since NLUPC is engaged in a partially nationalized activity with forty percent (40%) foreign equity participation and its Board of Directors shall be composed of ten (10) members, the Commission opines that four (4) foreigners may be elected as members of NLUPC's Board of Directors.

However, the Commission has reservations on the proposed manner of nominating and electing members of NLUPC's Board of Directors as such arrangement dilutes the participation of a Philippine national, i.e. PWCo, in the election of the Board of Directors of NLUPC as required in Section 2-A of the Anti-Dummy Law.

Well settled is the rule that corporations act through their respective Boards of Directors and unless otherwise provided in its by-laws, it is the prerogative of the Board of Directors of a corporation to appoint nominees in the Board of Directors of other corporations of which it is a stockholder, whose acts shall be under the ultimate direction of the Board of Directors of the appointing corporation.[10] It is for these reasons that the nominating power of a corporate stockholder must be considered in determining compliance with the allowable foreign participation prescribed by the

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[9] Section 15 of the Corporation Code of the Philippines.

[10] SEC Opinion dated 10 July 1995 addressed to Mr. Jerome M. Tang of Intercon Diagnostic Laboratory.

Constitution and other pertinent laws in a corporation engaged in a partially nationalized activity.

As disclosed in your letter, NLUPC's stockholders under the proposed corporate structure consist of two corporations, namely PWCo and UPPWCo, which shall respectively own 60% and 40% of NLUPC's shares. The total number of directors to be nominated by said corporate stockholders is the same as the total number of members of NLUPC's Board, i.e. ten (10). The preferred stockholder, i.e. PWCo, will nominate four (4) directors who shall be Filipino citizens, while the common stockholder, i.e. UPPWCo, which is the foreign corporate stockholder, will nominate four (4) directors who may be a Filipino or a foreigner. The preferred and common stockholders will jointly nominate two (2) independent directors, who must be Filipino citizens. Thus, those who will be nominated by PWCo and UPPWCo will essentially be those who will be voted for and elected to become directors of NLUPC.

Under the Anti-Dummy Law, and consistent with the inherent right of stockholders, aliens may be elected in proportion to their allowable participation or share in the capital. Corollarily, the other side of the equation, that is, the Filipino component, should also be allowed representation in the Board in proportion to the Filipino share or participation in the capital.

In the proposed arrangement, UPPWCo, the foreign corporate shareholder, is absolutely allowed to nominate four (4) alien directors in NLUPC because of its forty percent (40%) share therein. However, PWCo, the Filipino corporate stockholder, is not similarly given the absolute power to nominate six (6) directors in NLUPC, by virtue, and despite of, its sixty percent (60%) interest therein. Worse, the foreign corporate stockholder has an equal say in the nomination of the two (2) independent directors. It defeats the mandate of the Anti-Dummy Law and violates the inherent right of PWCo to vote in proportion to the number of shares it owns, thus giving undue advantage to UPPWCo. It should be pointed out that under the proposed arrangement, PWCo and UPPWCo will practically have the same right to nominate and eventually vote for five (5) directors each.

Accordingly, the proposed manner of nominating and electing members of NLUPC's Board creates an unfair and anomalous situation wherein a Philippine national is placed on equal footing with a foreigner in terms of participation in the governing board of NLUPC, a corporation engaged in a partially nationalized activity, thereby, providing a means to circumvent our nationalization laws.

Thus, the Commission holds that the procedure for the nomination and election of members of NLUPC's Board should not permit the circumvention of the rules on allowable foreign participation as prescribed under the Constitution and pertinent laws.

Lastly, considering that under the proposed ownership structure, all NLUPC shares shall have voting rights and the Filipino stockholders, through PWCo, shall own and hold redeemable preferred shares with a par value of PhP1.00, and the foreign stockholders shall own and hold common shares with a par value of Php 100.00, the Commission believes that the said proposed ownership structure is determined regardless of the par value of such shares.

The foregoing opinion is rendered based solely on the facts disclosed in the query 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 whether of similar or dissimilar circumstances.[11] If, upon investigation, it will be disclosed that the facts relied upon are different, this opinion shall be rendered void.

For the Commission En Banc,

Vesper Julius B. Garcia
Officer-in-Charge
Office of the General Counsel

[11] SEC Memorandum Circular No. 15, series of 2003.