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

17 April 2013

SEC OGC Opinion No. 13-03
Re: Previously incurred indebtedness as payment for subscription of shares by way of pre-emptive rights

Picazo Buyco Tan Fider & Santos
104 H.V. dela Costa Street
Salcedo Village, Makati City
Metro Manila, Philippines 1227

Attention: **Ms. Estrelita G. Gacutan**
Ms. Mahleene G. Go

Dear Mses. Gacutan and Go,

This refers to your *Letter* dated 16 November 2012 requesting an opinion about previously incurred indebtedness as payment for subscription shares by way of pre-emptive rights.

In your Letter, you provided the following details:

- Company B and Company C are existing shareholders in Company A.[1]
- Company A, a publicly listed company, will conclude separate loan transactions with Company B and Company C in the next few months denominated as "Term Loan Facilities".
- Company B and Company C will be extending the loans under the Term Loan Facilities to assist Company A in meeting its cash/funding requirements.[2]
- Company A is contemplating a stock rights offering ("SRO", for brevity) by way of pre-emptive rights sometime in the first half of 2013, and Company B and Company C will be offered rights shares pursuant to the SRO.
- Instead of shelling out additional money to pay for their respective subscriptions to the rights shares they will subscribe pursuant to the

[1] The total percentage shareholding of Company B and Company C in Company A is less than 50% of the latter's total outstanding capital stock.
[2] The proceeds of the loan will be remitted in cash to Company A.

SRO, Company B and Company C intend to convert the principal amount of the loans under the Term Loan Facilities as subscription payments for rights shares under the SRO

- While Company B and C will be allowed to pay through the conversion of liabilities into equity, the other stockholders participating in the SRO will pay in cash.
- Except for the form of payment, all other terms will be the same as to all stockholders.
- Company A intends to file with the Commission a request to confirm the valuation of the converted liabilities into subscription payments under the SRO and such request will be made simultaneously with the filing of the Registration Statement for the SRO; and it will be disclosed in the prospectus and other selling materials for the SRO.

In this regard, you are requesting the following:

(1) whether the previously incurred indebtedness can be used as subscription for shares and under what conditions; and
(2) whether the proposed structure of the SRO (e.g. wherein one bloc of stockholders is allowed to pay by conversion and others by cash) would violate the Corporation Code, Securities Regulation Code (SRC), etc.

As to your first query, Section 62 of the Corporation Code provides the following:

"**Section 62.** *Consideration for stocks.* - Stocks shall not be issued for a consideration less than the par or issued price thereof. **Consideration for the issuance of stock may be any** or a combination of any two or more **of the following:**

1. Actual cash paid to the corporation;

2. Property, tangible or intangible, actually received by the corporation and necessary or convenient for its use and lawful purposes at a fair valuation equal to the par or issued value of the stock issued;

3. Labor performed for or services actually rendered to the corporation;

4. Previously incurred indebtedness of the corporation;

5. Amounts transferred from unrestricted retained earnings to stated capital; and

6. Outstanding shares exchanged for stocks in the event of reclassification or conversion.

Where the consideration is other than actual cash, or consists of intangible property such as patents of copyrights, the valuation thereof shall initially be determined by the incorporators or the board of directors, subject to approval by the Securities and Exchange Commission. x x x"[3] (Emphasis supplied)

Clearly, Section 62 of the Corporation Code expressly allows a previously incurred indebtedness to be used as consideration for the issuance of stocks, provided that the valuation of the indebtedness be determined by the board of directors, subject to approval of the Commission, in order to prevent watering of stocks.[4] Watering of stocks is a situation wherein the consideration for subscription is not a fair valuation equal to the par or issue value of the stock.[5] The amount of the indebtedness or liabilities to be settled should be at least equal to the par value of the shares of stock which the corporation intends to issue.[6] However, there must first be an indebtedness incurred in order that a liability maybe converted into subscription payment.

In this connection, the following requirements are to be submitted to the Commission:

1. Detailed schedule of liabilities being offset, showing all debts and credit to such liability account, date, nature of account and amount.

2. Deed of assignment executed by the creditor[s] assigning the amount due to him in payment for the unpaid subscription[s].

3. Company's book of accounts must be kept up to date and be made available for examination by the Commission to determine that the liabilities represent valid and legitimate claims against the company.[7]

4. If the principal office of the corporation is located in the province, a report by an independent certified public accountant must be submitted.[8]

The foregoing, however, are without prejudice to the requirements of the Financial Analysis and Audit Division (FAAD) of our Company Registration and Monitoring Department (CRMD), considering that the request or application for approval

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[3] Batas Pambansa Blg. 68 (1980).
[4] SEC Opinion No. 06-08, 23 January 2008.
[5] *Id.*
[6] (SEC Opinion, 11 June 1982).
[7] SEC Opinion, 2 October 1992.
[8] SEC Opinion, 24 February 1988.

of the valuation of consideration for shares of stock other than cash is within the jurisdiction of that Department to decide.[9]

As to your second query, a pre-emptive right under Section 39 of the Corporation Code refers to the right of a stockholder of a stock corporation to subscribe to all issues or disposition of shares of any class, in proportion to their respective shareholdings,[10] and on equal terms with other holders of the original stocks, before subscriptions are received from the general public.[11] In this case, the payments of Company B and Company C for the subscriptions shall be in the form of conversion of the previously incurred indebtedness while the payments of the other stockholders for their subscriptions shall be in cash. However, even when payment of the debt is in terms required to be made by the corporation in money or cash, a set-off of the debt without going through this unnecessary formality is equivalent to a payment for the stock in cash.[12] Thus, it appears that the proposed structure of the SRO would not violate the requirement that the offer must be on the same terms to all stockholders.

It is understood though that the foregoing opinion is rendered based solely on the facts you disclosed and described in the query and relevant solely to the particular issue raised therein, and shall not be used in the nature of a standing rule binding upon the courts or the Commission in other cases whether of similar or dissimilar circumstances.[13] If upon investigation, it is disclosed that the facts relied upon are different, this opinion shall be rendered void.

Very truly yours,

CAMILO S. CORREA
General Counsel

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[9] SEC Opinion No. 06-08, 23 January 2008.
[10] Majority Stockholders of Ruby Industrial Corp. v. Lim, et al., G.R. No. 165887, 6 June 2011.
[11] De Leon, The Corporation Code of the Philippines Annotated, 2002 ed., p. 360
[12] *Id*, p. 543, citing 18 CJS 682-683.
[13] Par. 7, SEC Memorandum Circular No. 15, Series of 2003.