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

OFFICE OF THE GENERAL COUNSEL

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SEC Opinion No. 14-13
Reversal of APIC and Reinvestment as Capital or as Loan

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Attention: **Aimee Rose D. G. Dela Cruz**
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Re: **TOENEC PHILIPPINE, INC.**

Gentlemen:

We received your letter dated November 18, 2013, requesting for our opinion on whether the Additional Paid-In Capital (APIC) contributed by a foreign stockholder can be nullified and subsequently reinvested as capital stock or as loan.

Background

You mentioned that your client, Toenec Philippines Inc. (Toenec), is a domestic corporation engaged in general and specialty construction services and other allied business. It was registered with the Commission on 26 October 1995 through SEC Certificate of Registration No. AS95010770. By the nature of its business, Toenec is required to secure and maintain a regular constructor's license issued by the Philippine Contractors Accreditation Board (PCAB). Thus, it is required by PCAB to maintain its status as a Filipino corporation, that is, at least sixty percent (60%) of the company's capital stock must be owned by Filipinos and that any foreign equity should be limited to forty percent (40%) thereof.

You further declared that Toenec has consistently maintained a 60-40 Filipino-foreign equity structure and has regularly obtained a PCAB license for a number of years. However, for construction fiscal year (CFY) 2010-2011, it was unable to renew its license mainly because it incurred capital deficit for the period ended 31 December 2009. The PCAB requires an applicant to maintain good financial standing, otherwise, it will not further renew the latter's license. Thus, the foreign stockholders of Toenec decided to infuse through APIC the amount of Php 50,000,000.00 purposely to eliminate Toenec's deficit and eventually to secure the renewal of its PCAB license. The infusion did not involve any issuance of Toenec's shares of stock and, as such, it was recorded in the books as APIC. More importantly, the transaction wiped out the deficit.

Despite the elimination of the deficit, PCAB still declined to approve Toenec's application for renewal of license and informed the company that the infusion of APIC resulted in increasing the foreign ownership in Toenec beyond the forty percent (40%) limit. According to PCAB, the capital requirement is computed on the actual peso value of the investment of each stockholder, thus, the foreign equity of Toenec breached the 40% limit when the foreign stockholders infused capital in the form of APIC.

Toenec's Proposed Action

You likewise stated that Toenec will comply with the ruling of PCAB. To do this, it is planning to nullify its previous APIC contribution of Php 50 Million on the ground that the condition for which the said contribution was made did not materialize. In line with the objective of securing a renewed PCAB license renewed, the foreign stockholder would instead invest the Php 50 Million in Toenec by:

1. Subscribing to the unissued shares of stock

   Toenec will take steps to increase its authorized capital stock to accommodate the issuance of new shares. At all times, the company shall maintain a 60-40 Filipino-foreign equity structure. Thus, both the foreign and Filipino stockholders of Tonec will contribute proportionate amounts to maintain their respective shareholding in the company. Insofar as the Php 50 Million previously booked as APIC, the same shall now be invested as part of the subscribed capital stock. In this case, Toenec would have sufficient assets to cover its liabilities, hence, no creditors will be prejudiced.

2. Extending a loan agreement.

   Alternatively, the Php 50 Million APIC may be invested in the form of loan. Similarly, Toenec would have adequate assets to answer for all liabilities and therefore no creditors shall be prejudiced.

You therefore ask whether the regulatory laws, rules and regulations being implemented by the Commission allow the nullification of the APIC account for the purpose of reinvesting the same, either in payment for the subscription of the corporation's unissued shares of stock, or in a form of loan to the corporation.

OPINION

The Commission, in several guidelines, allows a stockholder to infuse cash or property, to be treated as APIC, whenever no additional shares are issued in consideration thereof. In SEC **Resolution No. 27, Series of 2006**[1], the Commission initially deleted the filing fees for the creation of APIC, on the ground that APIC is created simply to wipe out deficits and when a corporation has a deficit it has financial problems and could not afford to pay for the fees. Subsequently, on February 24, 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. In MC **No. 11, Series of 2008**[2] (MC No. 11), 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.[3]

From the foregoing, it appears that there are currently no express, specific rules and regulations issued by the Commission on the nullification of APIC and its subsequent conversion into a loan or subscribed capital. There are, however, fundamental doctrines that should be observed in this kind of transaction, one of which is the Trust Fund Doctrine.

The Supreme Court, in *Donna C. Halley vs. Printwell, Inc.*[4] , explained the Trust Fund Doctrine in this wise:

> "The trust fund doctrine enunciates a –
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> xxx 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 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)

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[1] January 17, 2006
[2] Re: Guidelines on the determination of retained earnings available for dividend declaration.
[3] Last paragraph, Section 6.
[4] G.R. No. 157549, May 30, 2011

> We clarify that the trust find 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."[5]

According to *Halley*, the Trust Fund pertains to the subscription to the capital stock of the corporation. However, when the corporation is insolvent, the Trust Fund encompasses not only the subscription to the capital stock, but also other property and assets of the corporation.

The Supreme Court, in *National Telecommunications Commission v. Honorable Court of Appeals*[6], defined "capital" as a composition of the Trust Fund, to wit:

> "The term "capital" and other terms used to describe the capital structure of a corporation are of universal acceptance and their usages have long been established in jurisprudence. 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, and can be more than, the par value of the shares. **In fine, it is the amount that the corporation receives, inclusive of the premiums if any, in consideration of the original issuance of the shares.** In the case of stock dividends, it is the amount that the corporation transfers from its surplus profit account to its capital account. It is the same amount that can be loosely termed as the "trust fund" of the corporation. 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."[7]

In other words, when the corporation is solvent the corporate Trust Fund consists only of the "Subscribed Capital" which is the amount that the corporation receives in consideration of the issuance of shares, plus share premiums, if any.

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[5] Underlining ours.
[6] G.R. No. 127937, July 28, 1999, 311 SCRA 508, 514
[7] Underlining ours.

The Commission, in the last paragraph of Section 2 of MC No. 11, also considered APIC as premium when it defined Paid-in Capital as:

> "*Paid-in Capital* - the amount of outstanding capital stock and additional paid-in capital or premium paid over the par value of shares"

In other words, APIC is any contribution of stockholders over the par value of shares. Incidentally, "share premium" is also defined as the amount received by a firm over the par value of its share. Share premium is also called paid-in surplus.[8]

"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. Corporate entity may refer to it as owner's equity, shareholders' equity or capital and reserves. The term "equity" is often used to encompass an entity's Equity Instruments and Reserves. Equity Instruments is defined in paragraph 11 of the International Accounting Standards (IAS) No. 32 as:

> "An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all its liabilities."[9]

Equity Instrument includes an 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.

APIC or share premium cannot be classified as Reserves, since the former is a premium on subscription contributed by stockholders while the latter should include only retained earnings, and other reserves. Indeed, paragraph 78(e) of IAS No 1 disaggregated equity capital and reserves into various classes, such as, paid-in capital, share premium and reserves.

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.

Having established that the corporate Trust Fund Doctrine encompasses APIC, the same should be governed by the pronouncement of the Supreme Court in *Ong*

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[8] http://www.businessdictionary.com/definition/share-premium.html#ixzz32syIPIBj
[9] Underlining ours.

Yong et al. vs. David S. Tiu, et al.[10] as to 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.
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> 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.
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> In the instant case, the rescission of the Pre-Subscription Agreement will effectively result in the unauthorized distribution of the capital assets and property of the corporation, thereby violating the Trust Fund Doctrine and the Corporation Code, since rescission of a subscription agreement is not one of the instances when distribution of capital assets and property of the corporation is allowed.
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> Contrary to the Tius' allegation, rescission will, in the final analysis, result in the premature liquidation of the corporation without the benefit of prior dissolution in accordance with Sections 117, 118, 119 and 120 of the Corporation Code.[23] The Tius maintain that rescinding the subscription contract is not synonymous to corporate liquidation because all rescission will entail would be the simple restoration of the *status quo ante* and a return to the two groups of their cash and property contributions. We wish it were that simple. Very noticeable is the fact that the Tius do not explain why rescission in the instant case will not effectively result in liquidation. The Tius merely refer in cavalier fashion to the end-result of rescission (which incidentally is 100% favorable to them) but turn a blind eye to its unfair, inequitable and disastrous effect on the corporation, its creditors and the Ongs."[11]

[10] G.R. No. 144476, April 8, 2003, 401 SCRA 1,14
[11] Underlining ours.

In *Philip Turner et al. vs. Lorenzo Shipping Corporation*[12], 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."[13]

Having determined that APIC is encompassed by the Trust Fund Doctrine, we can now evaluate your proposed options and determine whether such can be allowed given the requisites of the Trust Fund Doctrine.

I] Reversal of APIC and its Subsequent Conversion into Loan

The nullification of APIC and its subsequent conversion into a loan violates the Trust Fund Doctrine. This is because the APIC is considered a contribution of a stockholder over and above the par value of shares and falls under the concept of corporate Trust Fund upon its recording in the books of the corporation.

It is clear from *Ong Yong* and *Turner* that the Trust Fund Doctrine prohibits Toenec from distributing its capital to the stockholders other than those instances provided for by the Corporation Code. The reason for the prohibition is that Toenec's creditors have the right to assume that, so long as there are outstanding debts and liabilities, Toenec will not liquidate its capital to their prejudice.

Moreover, the nullification of APIC and its subsequent conversion into a loan can be considered as a reduction of the corporate Trust Fund as the same will be transferred from the Equity Account to the corporate Liability Account. In other words, upon APIC's conversion into a loan, it is as if there will be advance payment to the stockholder/creditor of his investment which equates to a distribution of corporate assets to said stockholder in preference over the other creditors of the corporation. This is what has been prohibited by *Ong Yong* and *Turner*.

II] Reversal of APIC and Conversion into Subscribed Capital

You represented that Toenec infused APIC purposely to eliminate the Company's deficit and eventually to secure the renewal of its PCAB License.[14] You also stated that such transaction wiped out the deficit but PCAB declined to approve Teonec's application for renewal of license. However, we noticed that paragraph 14.3 of Toenec's Notes to the Financial Statements as of December 31, 2011 and 2012 ("Notes") merely disclose that this APIC was contributed "to support the Company's operations." Stated otherwise, the disclosure in the Notes does not make the infusion subject to a suspensive condition that the PCAB license would be renewed. Thus, ownership over the funds has already been transferred to the corporation. Its

[12] G.R. No. 157479, November 24, 2010.
[13] Underlining ours.
[14] Paragraph 5, page 1 of the Request for Opinion dated November 18, 2013.

nullification, despite its subsequent conversion into subscribe capital, equally violates the Trust Fund Doctrine.

When corporate Trust Fund will be used for purposes other than those enumerated in *Ong Yong*, i.e. to pay for the stockholders additional subscription to capital stock, it will effectively result in the unauthorized distribution of the corporate Trust Fund, thereby violating the Trust Funds Doctrine. In the instant case, if the reversal of the APIC and its conversion into subscribed capital are allowed, the same would be tantamount to the corporation using its corporate Trust Fund to pay for the subscription of its stockholder for the issuance of its own shares.

In *NTC*, 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.

Finally, in *Ong Yong*, it was declared that "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, xxx 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."

Based on the foregoing, it is opined that Toenec may not reverse its APIC and, subsequently, convert it into a loan or pay additional subscription to capital stock, as the same violates the Trust Fund Doctrine.

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 Courts or upon the Commission whether of similar or dissimilar circumstances.[15] If, upon investigation, it is disclosed that the facts relied upon are different, this opinion shall be rendered void.

CAMILO S. CORREA
General Counsel

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[15] SEC Memorandum Circular No. 15, Series of 2003