Securities and Exchange Commission
PHILIPPINES

BAGONG PILIPINAS

OFFICE OF THE GENERAL COUNSEL

14 November 2024

SEC OGC Opinion No. 24-35
Re: Appropriation of Retained Earnings for Contingencies

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Attention: Attys. Rowneylin SJ. Sia and Saben C. Loyola

Dear Sir/Madam:

This refers to your letter[1] requesting for the Commission's opinion on the propriety of appropriating **Odfjell Philippines, Inc.'s ("OPI")** retained earnings to answer for the liabilities of OPI under Republic Act (RA) No. 11199 or the *Social Security System Act of 2018* and RA No. 8042 or the *Migrant Workers and Overseas Filipino Act of 1995,* as amended by RA 10022.

As mentioned in your letter, OPI is a corporation duly organized and existing under Philippine laws that is primarily engaged in the business of recruitment and placement of seafarers for overseas employment.

You stated that as a manning agency, OPI is solidarily liable with its principal/ employer for any and all claims arising out of an employer-employee relationship or by virtue of any law or contract involving Filipino workers for overseas deployment including claims for actual, moral, exemplary and other forms of damage.[2] These claims include but are not limited to full cost of medical, serious dental, surgical, and hospital treatment until the seafarer is declared fit for work; sickness allowance; cost of medicines and travel/ accommodation expenses incurred by the seafarer during treatment; and death and disability benefits, the amounts of which depend on the degree of disability and existence of a Collective Bargaining Agreement. The seafarer claims for death and disability benefits range from US$50,000 to US$250,000 excluding claims for medical expenses.

Similarly, OPI is solidarily liable with its principal for civil liabilities incurred for any violation of the Social Security System Act of 2018 and, as employer[3], OPI has the obligation to deduct and remit SSS contributions.

Per OPI's 2018 Audited Financial Statement[4], its paid-up capital is at P 5,000,000.00 while its unappropriated retained earnings are at P 17,778,809.00.

You also mentioned that as of 30 April 2019, the total medical and disability expenses for 25 seafarers is estimated to be at US$551,086, as stated in the list of open cases attached as Annex "B" of your letter, broken down as follows:

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[1] Dated 9 July 2019.
[2] Section 7 of RA No. 10022.
[3] Section 9-B of Social Security System Act of 2018.
[4] Attached to your letter as Annex "A".

1. US$158,436 for expenses incurred for medical treatment; and
2. US$392,650 for disability benefits.

On the other hand, OPI must spend additional P436,000.00/month or P 5,200,000.00/year for SSS employer contribution because of the recent increase in the same, as supported by the New SSS Contribution Schedule attached as Annex "C" of your letter.

In view of the "sudden increase in SSS employer contribution and OPI's potential liability for disability benefits and medical/ hospitalization expenses", OPI contemplates to restrict *the entire or a portion of its retained earnings* for aforesaid reasonable needs. Hence, you seek opinion on the following:

> *"I. Whether or not "possible contingencies" under Section 42 (c) of the Revised Corporation Code includes liability, potential or otherwise, for seafarer claims on medical/ hospitalization expenses, sickness allowance, death, and disability benefits; and increase in SSS employer contribution;" and*
>
> *"II. Whether or not OPI may appropriate the entirety of its unrestricted retained earnings or a portion thereof (amounting to P 12,778,809.00) as a reserve to aid it in paying for above-mentioned contingencies."*

I. Section 42 of the Revised Corporation Code (RCC); Rationale

Section 42 of the RCC provides:

> "Section 42. Power to Declare Dividends. - The board of directors of a stock corporation may declare dividends out of the unrestricted retained earnings which shall be payable in cash, property or in stock to all stockholders on the basis of outstanding stock held by them: xxx.
>
> Stock corporations are prohibited from retaining surplus profits in excess of one hundred percent (100%) of their paid-in capital stock, except: (a) when justified by the definite corporate expansion projects or programs approved by the board of directors; or (b) when the corporation is prohibited under any loan agreement with financial institutions or creditors, whether local or foreign, from declaring dividends without their consent, and such consent has not yet been secured; or **(c) when it can be clearly shown that such retention is necessary under special circumstances obtaining in the corporation, such as when there is need for special reserve for probable contingencies"** (emphasis supplied)

The law upholds the importance of distributing dividends as a reward paid to the shareholders for their investment in a company. Dividends are the return on investment of, and a direct source of income for, shareholders, particularly those seeking regular cash flow.

It must be noted, however, that dividends are payable only when there are profits earned by the corporation and as a general rule, even if there are existing profits, the board has the discretion to determine whether or not dividends are declared.[5]

To ensure fair treatment of shareholders and to prevent potential misuse of company funds, Section 42 limits the discretion of the board to retain earnings for general corporate purposes by providing three (3) exceptions to the prohibition on retention of surplus profits, namely:

> (a) when justified by the definite corporate expansion projects or programs approved by the board of directors; or
> (b) when the corporation is prohibited under any loan agreement with financial institutions or creditors, whether local or foreign, from declaring dividends without their consent, and such consent has not yet been secured; or
> (c) when it can be clearly shown that such retention is necessary under special circumstances obtaining in the corporation, such as when there is need for special reserve for probable contingencies.

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[5] Republic Planters Bank vs. Agana, 269 SCRA 1 (1997).

Thus, unless special restriction is permitted, the board must distribute as dividends those earnings in excess of the corporation's "paid-in capital stock."[6]

Considering that the purpose of the provision is to ensure that stockholders are not deprived of dividend pay-outs, any invocation of an exception to the prohibition to retain surplus profits under Section 42 should be evaluated with prudence and circumspection, lest an unwarranted retention be permitted resulting in the decrease of the unrestricted retained earnings[7] that should otherwise be available for dividend declaration.

"When the statute itself enumerates the exceptions to the application of the general rule, the exceptions are strictly but reasonably construed. The exceptions extend only as far as their language fairly warrants, and all doubts should be resolved in favor of the general provision rather than the exceptions".[8] Thus, following the rule in statutory construction, any of the 3 exceptions under Section 42 must be strictly construed against the one invoking it.

Accordingly, a corporation may invoke the exceptions under Section 42 of the RCC for purposes of retaining surplus profits in excess of one hundred percent (100%) of paid-in capital **only** when the elements or conditions thereof are **strictly complied with.**

II. Section 42 (c) of the RCC; Elements

To reiterate, under Section 42 (c) of the RCC, a corporation is allowed to retain its surplus profits in excess 100% of its paid-in capital stock *"when it can be clearly shown that such retention is necessary under special circumstances obtaining in the corporation, such as when there is need for special reserve for probable contingencies."*

It is clear from the above that the applicability of the provision is conditioned on the existence of the following:

(1) There must be a contingency or contingent liability;
(2) The contingent liability must be probable, not merely possible; and
(3) Special circumstances obtaining in the corporation must be considered in determining the necessity for such retention.

Contingency or Contingent liability

According to the Philippine Accounting Standard (PAS) 37, *Contingent liability* refers to: 1) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or 2) a present obligation that arises from past events but is not recognized because: (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or (ii) the amount of the obligation cannot be measured with sufficient reliability.

Probable vs. Possible

It is worthy to stress that Section 24 (c) uses the term "probable", not "possible", when it refers to the contingency that would warrant the retention of surplus profits in excess of 100% of paid-in capital stock.

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[6] Herbosa, T.J., Recalde, E.R., The Revised Corporation Code of the Philippines (Its Theories and Applications), 2019.

[7] Section 2 (e) of SEC Memorandum Circular No. 16, Series of 2023- **Unappropriated/ Unrestricted Retained Earnings**- the amount of accumulated profits and gains realized out of the normal and continuous operations of the corporation after deducting therefrom distributions to stockholders and transfers to capital stock or other accounts, and which is: (1) not appropriated by the Board of Directors for definite 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.

[8] G,R. Nos. 179431-32, Lokin vs. Comelec, 22 June 2010.

Possible is defined as "capable of existing or happening; feasible". In another sense, the word denotes extreme improbability, without excluding the idea of feasibility.[9] It is also referred as "that might exist or happen but is not certain to."[10]

On the other hand, the term ***probable*** means "likely to happen, to exist or be true".[11] This is consistent with the concept of ***probable*** in accounting rules[12] which consider an event to be probable if it is "more likely to occur than not", i.e., the probability that the event will occur is greater that the probability that it will not. As such, ***probable*** implies that there is a high chance or likelihood that a certain event might occur.

Given its letter and spirit, Section 42 (c) must be limited to those contingencies that are more likely to occur than merely possible ones.

Special circumstances in the corporation

Section 42 (c) likewise requires that the special circumstances obtaining in the corporation must be considered to show that the retention of surplus profits is necessary. If such special circumstances cast doubt on the contingency or on the necessity to retain, then the exception should not be applied. This is because, to reiterate, the right to retain such profits must not be exercised arbitrarily, for the protection of the interests of shareholders.

Thus, in the evaluation of whether retention is necessary or whether a contingent liability would warrant an appropriation or retention under Section 42 (c), the following, among others, must be considered:

1) The nature of the event or circumstance is "special", uncommon or rare in the normal operating course of business over which the company has no control;
2) The outflow of resources is "probable"; and
3) A reliable estimate cannot be made.

III. Application of Section 42 (c) on the raised issues

A. Liability, potential or otherwise for seafarer claims on medical/ hospitalization expenses, sickness allowance, death and disability benefits

Based on your representation, the uncertainty that creates a contingent liability of OPI arises from the adverse outcome of the cases involving the employees' claims and/or the possible default of the Principal.

However, while there may be a contingency, the probability of the same happening or not happening is likely unexpected or uncertain. For one, it is not certain whether the Principal would default if the employee decides to go against him. More importantly, it is significant to note that winning, or losing, a case depends on many variables, especially whether one would be able to prove a relevant fact and/or to overcome the evidence of the other party. Further, cases would, more often than not, involve legal issues that have no clear-cut or settled answers, thereby requiring much room for different interpretation and argumentation. Simply put, the outcomes of cases are generally hard to predict.

Moreover, there is nothing in the records that indicates reasonable likelihood of the event(s) happening. In fact, the contingency is even described in your query as "possible".

Lastly, there exist special circumstances in the corporation that negate the absolute necessity to retain the funds contemplated to be retained. It is normal for OPI to be exposed to a lot of claims, considering

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[9] Black's Law Dictionary.
[10] Cambridge Dictionary, https://dictionary.cambridge.org/dictionary/english/possible, last accessed 13 November 2024.
[11] *Ibid.*
[12] PAS 37.

that it is a manning agency catering to overseas Filipino workers (OFWs), in this case, seafarers who, by the nature of their profession, are in turn prone to a lot of risks, accident or otherwise. Because of this, certain safeguards are required by law. For example, Section 7 of RA 10022, which you cited in your letter, mandates manning agencies to put up a bond to answer for the claims of these OFWs.[13] The existence of the bond implies that the appropriate amount has been, or should have already been, appropriated to answer for such claims. Another example is the practice in the industry to cover the claims by insurance, whereby the liability is transferred to the insurer. In both cases, the financial outflow from the company is viewed to be remote.

B. Increase in SSS employer contribution

The increase in the SSS employer contribution is a circumstance mandated by the law over which OPI has no control. Laws are expected to be amended when they no longer serve their purpose. Amendment is necessary in order to adapt to the changes brought about by external factors such as technology, environment and lifestyle.

It must be noted, however, that the increase in the SSS employer contribution is already pursuant to an existing law, not merely an impending piece of legislation virtually certain to be enacted. In short, there is no longer a contingent liability as the expense, i.e., the increase in employer contribution, is already certain by virtue of the existing law. This is a normal expense that should be settled in the ordinary course of business operations.

Moreover, the increase in SSS employer share applies to all private companies doing business in the Philippines. OPI cannot claim that the increase is unique to itself to classify the same as a special circumstance obtaining in the corporation.

Based on the discussion above, Section 42 (c) cannot apply to the increase in SSS employer share.

IV. Conclusion

From the foregoing, we answer your first query in the negative, i.e., Section 42 (c) cannot be availed of.

As to your second query, only such amount as may be justified pursuant to the exceptions under Section 42 of the RCC should be retained.

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. If, upon further inquiry or investigation, it will be disclosed that the facts relied upon are different, this opinion shall be rendered void.[14]

Please be guided accordingly.

Very truly yours,

Romuald C Padilla
General Counsel

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[13] Section 7 of RA No. 10022- "xxx....The performance bond to be filed by the recruitment/placement agency, as provided by law, shall be answerable for all money claims or damages that may be awarded to the workers...xxx"
[14] Paragraph 7, SEC Memorandum Circular No. 15, Series of 2003.