UNBUNDELED SHARES: CIRCUMVENTING CORPORATE NATIONALITY RULES THROUGH SWAPS, OPTIONS AND OTHER DEVICES

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Abstract

Corporate nationality clauses have a simple and seemingly innocuous language: “corporations at least X per centum of whose capital is owned by Filipino citizens”. This presupposes that “capital” is a unified bundle of economic and control rights. However, modern finance and contract law can “unbundle” economic rights from control rights through the use of options, swaps, forwards, hybrid instruments, variable interests, and a vast catalogue of contractual arrangements. Unbundled economic rights allow foreign investors to have economic interest without ownership of shares, and unbundled control rights allow foreign minority stockholders to have effective control without majority of voting rights. Does this circumvent foreign equity limitations? Do the control test, beneficial ownership doctrine and other corporate nationality rules render them illegal?

Key words

Corporate nationality rules; unbundled shares.

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Introduction

“The law has not kept pace with financial market reality.”
(Waddell et al, 2010)

Corporate nationality clauses have a simple and seemingly innocuous language: corporations at least X per centum of whose capital is owned by Filipino citizens. This presupposes that “capital” is a unified bundle of rights (Micheler, 2014). These rights include economic and control rights (Hu et al., 2008). Economic rights pertain to the ability of a share of stock to produce monetary gains for the stockholder. Control rights pertain to the power of a stockholder to influence corporate policy. Ownership of one share of stock means holding economic rights in conjunction with control rights (Geens et al., 2010). We shall call this the Bundle Theory of Shares (Hayden, 2008), illustrated as follows:

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1 See, e.g., Section 11, Article XII of the 1987 Constitution (“No franchise, certificate, or any other form of authorization for the operation of a public utility shall be granted except to citizens of the Philippines or to corporations or associations organized under the laws of the Philippines, at least sixty per centum of whose capital is owned by such citizens”).


3 Control rights are also called “voting rights”, since it is through the exercise of formal voting power that stockholders can pass shareholder resolutions. See Dong, Liping and Uchida, Konari and Hou, Xiaohong, How Do Corporate Control Rights Transactions Create Shareholder Value? Evidence from China (2014), available at SSRN: http://ssrn.com/abstract=2396514
This theory is based on the One Share – One Vote Principle, or the idea that the number of shares owned by a stockholder must be in direct proportion to the number of his votes (Wong, 2013). Corporate governance scholars articulate the rationale behind this principle as follows:

“Shareholders have […] appropriate incentives to make discretionary decisions because they ‘receive most of the marginal gains and incur most of the marginal costs’ attributable to those decisions.” (Martin, 2005)

In short, since shareholders absorb the risks and rewards of stock ownership, they must also be given the power to direct the activities of the corporation to manage those risks and rewards (Burkart et al, 2007). In reality, however, advances in finance and contract law are eroding the Bundle Theory of Shares (Sercu, 2004). It is possible to “unbundle” stockholder rights through the use of options, swaps, forwards, hybrid instruments, variable interests, and a vast catalogue of other contractual arrangements (Hu, 2006).

These devices can unbundle a share of stock in two ways: either by unbundling economic rights or by unbundling control rights (Black at al., 2012). Unbundled economic rights lead to a Separation of Legal Ownership and Economic Interest over the shares (Hu, 2006). Unbundled control rights lead to a Separation of Control in Law and Control in Fact (Studniberg, 2013). These two modes of de-packaging or decoupling stockholder rights produce Unbundled Shares, or shares divested of some economic rights and shares divested of some control rights (Burkart et al., 2007).

Unbundled shares circumvent foreign equity limits because the general language of corporate nationality clauses presupposes the Bundle Theory of Shares. Through the Separation of Legal Ownership and Economic Interest, a Filipino stockholder retains title to majority of the total capital stock and majority of the voting stock, but transfers the economic features or cash flow characteristics of stock ownership to a foreign investor (De Luca, 2007). In short, there is economic interest without ownership. On the other hand, through the Separation of Control in Law and Control in Fact, a Filipino stockholder holds majority of the voting rights in the election of directors, in fundamental matters, and in submitted matters, but a foreign investor holds actual or effective control of the Filipino corporation (Studniberg, 2013). In short, there is power without majority of voting rights.

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4 The main issue in Gamboa vs. Teves (G.R. No. 176579, October 9, 2012), for instance, is the interpretation of “capital” in Section 11, Article XII of the Constitution.
Chapter 1. Theory of Unbundled Shares

The early history of corporation law shows that the Bundle Theory of Shares has never been the general norm. By default, economic rights were separate from control rights. There was no One Share – One Vote Principle. The number of shares was not directly proportional to the amount of voting rights.

In Ancient Rome, the ownership structure of the publicani was designed through the issuance of one class of shares to the wealthy and another class to the general public (Burkart et al, 2007). This is similar to the modern-day multi-class equity structure, which involves the issuance of dual or multiple series of shares, with each series having a different set of control rights (Bebchuk et al, 2000). In the Middle Ages, corporations adopted a per capita voting scheme, where each member of the corporation was entitled to one vote, regardless of the amount of his capital contribution (Burkart et al, 2007). This is similar to the design of control rights in a non-stock corporation, where one member is entitled to exactly one vote5.

In the same period, some corporations also adopted differential voting rights, where one group of stockholders is entitled to a disproportional number of votes compared to another group. This is not very different from the Roman publicani’s multi-class equity structure (Burkart, 2007).

In early 19th century America, corporations adopted a per capita voting scheme. This was the default rule in the common law of corporations, which was similar to the default voting scheme in partnerships (Hayden et al, 2008). In the same period, some corporations observed a prudent mean rule. Under this rule, the “votes-per-share would decrease as the individual shareholder got more and more shares; a shareholder with five shares might get five votes, but a shareholder with 100 shares might only get ten votes.” (Hayden et al, 2008)

In the creation of the first Bank of the United States, Alexander Hamilton proposed the adoption of the prudent mean rule and a rejection of the One Share – One Vote Principle. According to Hamilton, the One Share – One Vote Principle allowed a dominant stockholder to “monopolize the power and benefits of the bank.” (Hayden et al, 2008)

5 “In nonstock corporations, the voting rights attach to membership. Members vote as persons, in accordance with the law and the bylaws of the corporation. Each member shall be entitled to one vote unless so limited, broadened, or denied in the articles of incorporation or bylaws.” (Tan vs. Sycip, G.R. No. 153468, August 17, 2006)
In late 19th century America, the use of cumulative voting became prevalent in upholding minority stockholder rights (Hayden et al, 2008). In early 20th century America, corporations started to issue non-voting shares, but dominant stockholders retained voting shares. This is similar to the issuance of preferred shares today (Sec. 6, B.P. 68, “The Corporation Code of the Philippines”). In the same period, corporations responded to the prevalence of non-voting shares by moving toward the One Share – One Vote Principle (Hayden et al, 2008). In 1926, the New York Stock Exchange (NYSE) prohibited the listing of corporations with non-voting shares (Burkart et al, 2007).

In late 20th century America and Europe, the prevalence of corporate takeovers incentivized corporations to issue shares with inferior voting rights. The reason is that corporate takeovers took place by purchasing a controlling block of voting shares. In 1986, the NYSE discarded its One Share – One Vote Principle because both the American Stock Exchange and NASDAQ allowed the listing of corporations with multi-class equity structure. In the same period, European countries introduced legislation allowing deviations from the One Share – One Vote Principle. However, subsequent legislation again prohibited such deviations (Burkart et al, 2007).

In 1988, the U.S. Securities and Exchange Commission introduced Rule 19c-4. This rule prohibited multiple classes of shares with disproportionate voting rights. However, this rule was subsequently invalidated by the D.C. Circuit. At present, stock exchanges no longer prohibit corporations to deviate from the one share – one vote principle (Hayden et al., 2008).

In summary, the history of corporation law shows the prevalence of deviation from the One Share – One Vote Principle, in the following forms: (1) multi-class equity structure, (2) per capita voting scheme, (3) differential voting rights, (4) prudent mean rule, (5) cumulative voting, and (6) non-voting shares.

In the next section, some of these forms of deviation from the One Share – One Vote Principle are, in fact, devices that circumvent corporate nationality rules and foreign equity limitations.

**Chapter 2. Analysis of Unbundling Devices**

Unbundling devices are classified according to their effects: (1) devices that create economic interest in a corporation, without legal ownership of shares by
the foreign investor, and (2) devices that create de facto control over the corporation, without majority of voting rights held by the foreign stockholder.

**Subchapter 1. Economic Interest Without Ownership**

The following are devices that create economic interest in a corporation, without legal ownership of shares by the foreign investor: (1) put-call parity transactions, (2) total return swaps, (3) synthetic leases, (4) forward contracts, (5) subordinated debt, (6) equity default swaps, (7) equity-linked notes, (8) depositary receipts, (9) surplus notes, and (10) supply contracts with fixed-price forward. The enumeration is not exclusive.

**Put-Call Parity**

Under the concept of put-call parity, a foreign investor enjoys the economic characteristics of owning shares of stock in a Filipino corporation, without having legal title over the said shares (Knoll, 2005). A set of contractual arrangements can transfer the cash flow pattern associated with stock ownership from the Filipino stockholder to the foreign investor, allowing the latter to replicate or simulate economic interest in equity (Knoll, 2008). This can occur with the use of four financial instruments: a stock, a bond, a call option (giving the foreign investor a right, but not an obligation, to purchase the stock), and a put option (giving the Filipino stockholder a right, but not an obligation, to sell the stock).

**Illustration:** a Filipino corporation operates a TV broadcasting station. A Filipino stockholder owns all the stocks of the broadcasting corporation as of 01 January 2010. Assume the value of the stock on this date is P1 billion. The foreign investor wants to purchase the shares of stock in the corporation, but is unable to do so because of foreign equity restrictions. Instead, he lends P1 billion (i.e. equivalent to the value of the stock as of 01 January 2010) to the Filipino stockholder. Assume that the Filipino stockholder does not expect an interest payment on the loan. The foreign investor holds a call option over the stock, to be exercised at a future

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6 In theory, this element can be any equity interest or any asset that provides variable returns, such as land.

7 This element can be any debt instrument that guarantees protection of the principal amount, with or without interest payment.

8 See Executive Order No. 858 dated 05 February 2010 for foreign equity restrictions in various industries.

9 An example of this kind of debt instrument is a zero-coupon bond, where the principal amount is delivered to the borrower at a discount. Upon maturity, the borrower pays off the entire principal amount without interest. See, e.g., BDO vs. Republic, G.R. No. 198756, January 13, 2015.
date, 01 January 2015, and at the exercise price of P1 billion. On the other hand, the Filipino stockholder holds a put option over the stock, to be exercised at the same future date as the call option (i.e. 01 January 2015), and at the same exercise price of P1 billion (Knoll, 2008).

How does this transaction allow the foreign investor to replicate the economic characteristics of equity ownership? When future date 01 January 2015 arrives, two scenarios can happen: either the value of the stock will increase or decrease. If the stock is worth P1.1 billion (i.e. P100 million increase in value), the foreign investor will exercise the call option, because it will allow him to purchase the stock at P1 billion, giving him a gain of P100 million. On the other hand, if the stock is worth P900 million (i.e. P100 million decrease in value), the Filipino stockholder will exercise the put option, because it will allow him to sell the stock at P1 billion, protecting him from incurring a loss of P100 million (Knoll, 2008).

Under both scenarios, the Filipino stockholder does not care whether the fair value of the stock will increase or decrease. Even though the Filipino stockholder holds full equity ownership, it is as if he is only holding a zero-coupon bond payable at the principal of P1 billion. On the other hand, the foreign stockholder is exposed to the variability in the value of the stock. It is as if he holds full beneficial ownership over the stock (Yermack, 2010).

Is the foreign investor legally allowed to exercise the call option, or can the Filipino stockholder legally exercise the put option, if the sale of stock breaches foreign equity limits? This question is premised on the assumption that the call and put options can only be settled by delivering the shares. However, the call and put options can also be settled in cash through a netting arrangement. At future date 01 January 2015, if the value of the stock is P1.1 billion, and the foreign investor exercises the call option at the strike price of P1 billion, the Filipino stockholder will have the obligation to deliver the stock valued at P1.1 billion, and the foreign investor will have the obligation to pay at P1 billion. Under cash settlement, the Filipino stockholder will pay P100 million to the foreign investor, because the foreign investor can apply the Filipino stockholder’s debt of P1 billion to the monetary value of the shares. On the other hand, if the value of the stock as of 01 January 2015 is P900 million, and the Filipino stockholder exercises the put option at the strike price of P1 billion, the foreign investor has the obligation to pay P1 billion, while the Filipino stockholder has the obligation to deliver the shares valued at P900 million. Under the same netting arrangement, the foreign investor will pay P100 million to the Filipino stockholder, because the foreign
investor can apply the Filipino stockholder’s debt of P1 billion to the monetary value of the shares (De Nardis et al, 2010).

With these conditions, the risks and rewards of stock ownership are effectively transferred from the Filipino stockholder to the foreign investor. The foreign investor virtually holds the stock while the Filipino stockholder virtually holds a bond10 (Knoll, 2008).

If the loan extended by the foreign investor pays interest, the concept of put-call parity still holds by adding the amount of interest to the strike prices of the put and call options.

Total Return Swap

Through a total return swap, a Filipino stockholder enters into an agreement with a foreign bondholder to exchange the cash flows of their respective financial instruments (Wehn, 2010). The Filipino stockholder pays the foreign bondholder an amount equivalent to the gains on the stock, in the form of positive changes in fair value relative to the original price. On the other hand, the foreign bondholder pays the Filipino stockholder an amount equivalent to the loss on the stock, in the form of negative changes in the stock's fair value. Meanwhile, the foreign bondholder periodically pays the Filipino stockholder a stipulated amount, equal to the fixed return of the bond. This periodic payment is guaranteed by the foreign bondholder, which means that it is not dependent on the performance of the stock11.

Illustration: Company X is engaged in nationalized or partially nationalized economic activities, like mining. A Filipino stockholder owns shares in Company X worth P1 billion on 01 January 2010. A foreign investor is prohibited from acquiring any additional shares in Company X due to foreign equity limitations at 40% of total capital stock and 40% of total voting shares12. However, the foreigner holds a bond with a par value of P2 billion at 3% interest per annum. The Filipino stockholder and foreign bondholder enter into a total return swap, with a term of five (5) years. Every year, the foreign bondholder remits the interest income

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10 The put-call parity theorem formally states, “[G]iven any three of the four following financial instruments—a riskless zero-coupon bond, a share of stock, a call option on the stock and a put option on the stock—the fourth instrument can be replicated.”


12 See Executive Order No. 858 dated 05 February 2010 for foreign equity restrictions in various industries.
on the bond to the Filipino stockholder, which is P60 million per year (3% of P2 billion).

On 01 January 2015, which is the expiration of the swap, the shares in Company X are worth P1.4 billion, so the Filipino stockholder remits P400 million (the difference of the current value of the shares at P1.4 billion and the original value of said shares at P1 billion) to the foreign bondholder. On the other hand, if the shares in Company X are worth P900 million on 01 January 2015, the foreign bondholder will remit P100 million (the difference of the original value of the shares at P1 billion and the current value of the shares at P900 million) to the Filipino stockholder.

During the five-year term of the swap, the Filipino stockholder becomes indifferent to changes in the fair value of the stock. The swap transfers the economic characteristics of equity, without transferring legal title over the stock. Legally, the foreigner holds a bond while the Filipino owns a stock. Financially, the foreigner is virtually the owner of the stock while the Filipino is virtually the holder of a bond (Waddell et al, 2010).

Forwards

Under a forward contract, a Filipino stockholder owning shares of stock in a Filipino corporation enters into an agreement with a foreign investor to sell the shares at a fixed price to be paid in the future, called the forward price (Commodity Futures v. Erskine, 512 F.3d 309, 322, 6th Cir. 2008; Planters Bank Trust Co. v. Sklar, 555 So.2d 1024, 1031, Miss. 1990). Since the fair value of the shares is variable over time, a rise in fair value over the forward price provides gains to the foreign investor. On the other hand, a drop in the fair value below the forward price is a loss to the foreign investor (Kline vs. First W. Government Securities, Inc., 24 F.3d 480, 482, 3d Cir. 1994).

Since the forward price is already certain, the foreign investor can provide an upfront payment to a Filipino investor who is a non-holder of stock, so that the latter can use the proceeds to purchase the subject shares of stock. In this case, the agreement is called a prepaid forward.

The forward contract appears to be an ordinary stock purchase agreement. However, what makes it special is the manner of settlement between the parties.

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Under an ordinary stock purchase agreement, there is an obligation to deliver the shares from the seller to the purchaser. Under a forward contract, there is a standard stipulation allowing the parties to set off their respective obligations so that only the difference in cash is delivered to the other party.

The Filipino stockholder is indifferent to any changes in the fair value of the stock during the life of the forward contract because he is guaranteed to receive the forward price. The parties can even stipulate that the profit of the Filipino stockholder on the forward price is equivalent to the returns on a benchmark bond having the same maturity as the forward contract. In this sense, the Filipino stockholder hedges his position by transferring the risks and returns of equity ownership to the foreign investor. The Filipino stockholder receives returns mimicking the fixed income of a benchmark bond, while the foreign investor receives returns or losses mimicking the risk-return profile of the stock. This mimicking effect is called a “synthetic position”. Under a synthetic position, there is an economic simulation of the cash flow behavior of one asset class (such as stock), even though one has legal title to another asset class (such as a bond). Agreements that create synthetic positions are called “synthetic transactions”. Forward contracts are one of the most common devices in structuring a synthetic transaction14.

The difference between the total return swap and the forward contract is that the former entails an exchange of cash flows of equity and of debt, respectively, while the latter contemplates a sale with the stipulation of a fixed price to be paid in the future.

The difference between a call option agreement and a forward contract, on the other hand, is that the former gives the holder of the option the right, but not the obligation, to purchase the shares, while in the latter, the buyer in the forward contract has the obligation to purchase the shares.

Illustration: a Filipino stockholder owns shares in Company X, which is engaged in public utilities. The foreign ownership limitation is 40% total capital stock and 40% total voting stock. Assume that the foreign investor intends to purchase shares in Company X beyond the foreign ownership limitation, at an additional 20% of the total capital stock. Assume that the current fair value of the shares

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representing the 20% of total capital stock is P5 billion. Assume also that the forward contract has a life of five (5) years. The forward price is P5.2 billion. The parties determined the forward price by replicating the possible returns on a 10-year government security with indicative yield of 4%. The indicative return is P200 million (P5 billion multiplied by 4%). If at the end of the 5-year contract, the fair value of 20% of the total capital stock in Company X is P7 billion, the foreign investor profits from the transaction by P1.8 billion (the difference of the fair value of P7 billion at the end of the 5-year contract and the forward price of P5.2 billion). On the other hand, if the fair value is P4.9 billion, the foreign investor suffers loss from the transaction by P300 million (the difference of the forward price of P5.2 billion and the fair value of P4.9 billion at the end of the 5-year contract). Meanwhile, regardless of whether the fair value of the stock rises or falls, the Filipino stockholder is guaranteed to make a gain of P200 million, which is the indicative gain on a government security15.

Note that the forward contract per se is not void just because delivering the shares to the foreign purchaser results to a breach in foreign equity limits. Since the foreign investor is precluded from purchasing the shares under the forward contract, he can assign his rights to a third party who is qualified to make the purchase, or he can settle the marginal difference between the forward price and the fair value of the shares. Thus, if the fair value increases above the forward price, the Filipino stockholder will pay the foreign investor the marginal difference of P1.8 billion. If the fair value decreases below the forward price, the foreign investor will pay the Filipino stockholder P300 million.

Subordinated Debt

A subordinated debt is an obligation whereby the repayment of principal and interest is prohibited for as long as the debtor is obligated to a senior creditor, or “so long as a specifically identified senior debt remains unpaid.” It is created through a subordination agreement, whereby the creditor usually waives his priority lien, if any (Aviel v. Ng, 161 Cal.App.4th 809, Cal. Ct. App. 2008). If the Filipino corporation cannot operate through its own capital and through other unsubordinated debt, a significant amount of subordinated debt can be a badge of disguised ownership. A subordinated debt is akin to equity holding, which means that it has

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15 For other examples of forward contracts, see Duke Energy Trading and Marketing v. Davis, 267 F.3d 1042 (9th Cir. 2001); Top of Iowa Cooperative v. Sime Farms, Inc., 608 N.W.2d 454 (Iowa 2000); Lachmund v. Adm. Investor Services, Inc., 191 F.3d 777 (7th Cir. 1999).
almost the same risk as ownership of stock. If the borrower fails to repay the subordinated debt, the lender absorbs the losses of the borrower.

Equity Default Swap

An equity default swap is a misnomer because equity does not default. Equity default swaps are so named because the features of this contract are analogous to a credit default derivative. A credit default derivative has two parties: a debt-holder who is in need of protection from defaulting creditors, and a party who insures the debt-holder’s loss from default should it actually occur. The consideration for this protection from default risk is a periodic payment of premiums. By analogy, the equity default swap also has two parties: an owner of stock who is in need of protection from a drastic decline in stock price, and a party who insures the stockowner’s loss from such decline should it actually occur. The consideration is also a periodic payment of premiums (Logie at al, 2006).

Are equity default swaps insurance contracts, subject to the jurisdiction of the Insurance Commission? The similarities between an equity default swap and an insurance contract are as follows:

1. **Premiums serve as consideration.** – Under an insurance contract, the insured remits periodic payments to the insurer, called insurance premiums, as consideration for entering into an insurance contract. Under an equity default swap, the protection buyer also remits periodic payments to the protection seller (Gulf Resorts, Inc. vs. Philippine Charter Insurance Corp., G.R. No. 156167, May 16, 2005).

2. **A contingent event triggers liability.** – Under an insurance contract, the happening of a contingent event triggers the liability of the insurer to indemnify the insured for the loss caused by the event. Under an equity default swap, the contingent event is a drastic decrease in the price of an underlying stock, which triggers the liability of the protection seller to pay the protection buyer for the amount of the loss (Philippine Health Care Providers, Inc. vs. CIR, G.R. No. 167330, June 12, 2008).

The similarity ends here. They differ as follows:

1. **Loss need not be realized.** – Under an insurance contract, the loss that triggers the insurer’s liability for indemnity must be actual or realized. Under an equity default swap, the protection buyer’s loss is unrealized. To illustrate: if the protection buyer holds a stock that drops in price by more than 30%
in one day, the protection seller will indemnify the protection buyer in cash for the amount represented by the 30% difference. Meanwhile, the protection buyer may continue to hold the stock until the price returns to a level before the 30% decline, and he may thereafter sell the stock without realizing the 30% loss (PwC, Tax Accounting for Insurance Companies, 2012).

2. No insurable interest. – Under an insurance contract, the insured must hold an insurable interest. For example: an insured must own, lease or have some other property interest over a piece of equipment in order to insure against its loss. Under an equity default swap, the protection buyer does not need to hold the reference stock.

In this case, either the protection buyer is hedging or speculating. Under a hedging transaction, the protection buyer is exposed to a pre-existing financial risk that bears some relation to the price of the reference stock. Under a speculative transaction, the protection buyer creates financial risk for himself where none existed before (Culp, 2011).

3. *Equity interest as object.* – An insurance contract may have for its object the life of a person or property. On the other hand, the reference asset in an equity default swap is any equity interest (Hinnerich, 2010).

**Equity-Linked Notes**

A Filipino debtor corporation issues a note, which represents an unsecured and unsubordinated obligation. The note is a zero coupon bond which obligates the Filipino issuer to pay back to the foreign note-holder the principal amount of the bond at maturity. The note is linked to a reference asset, such as an index of securities, a basket of assets, or one share of stock. The Filipino issuer may or may not own the underlying assets. If the value of the underlying assets increases with reference to the principal amount of the note, the Filipino issuer will deliver the gains on the underlying assets to the foreign note-holder. This gives the foreign note-holder participation in the changes in the fair value of a share of stock, but only to the extent of the gains. If the value of the underlying assets decreases with reference to the principal amount of the note, the Filipino debtor will still deliver the principal amount of the zero coupon bond, and nothing else. Hence, in case of negative changes in the fair value of the underlying assets, the foreign note-holder is still guaranteed to receive back the principal amount of the zero coupon bond (Collins et al, 2008).
An equity-linked note, therefore, is primarily a debt instrument. However, it provides equity exposure to the foreign note-holder over the underlying shares of stock.

Illustration: A foreign investor who wishes to purchase shares of stock in a corporation, but is unable to do so because of foreign investment restriction, may instead purchase an equity-linked note from a Filipino issuer. Assume that the value of the shares today is P1 billion. The foreign investor lends P1 billion to a Filipino issuer, but only delivers P950 million. The P50 million difference represents the discount on the note. The Filipino issues the note with principal amount at P1 billion; hence, the Filipino issuer is obligated to pay back P1 billion at maturity date, effectively paying the P50 million discount, which—under a zero coupon bond—is the economic equivalent of an interest payment.

The Filipino issuer enters a call option over the shares of stock, with strike price at P1 billion, with the same maturity date as the zero coupon bond. At maturity date, assume that the shares of stock are worth P1.1 billion. The Filipino stockholder exercises the call option. He then pays back P1 billion under the zero coupon bond to the foreign investor, and also pays him P100 million, representing the positive changes in the fair value of the shares of stock.

On the other hand, if at maturity date, the shares of stock are worth P900 million, the Filipino stockholder does not exercise the call option. He pays back P1 billion under the zero coupon bond to the foreign investor, and nothing else. The Filipino issuer bears the cost of discounting the zero coupon bond, and the cost of entering the call option.

Depositary Receipts

A Deposit Agreement is an agreement among three parties: a Filipino corporation whose shares are subject of deposit, a depositary of the deposited shares, and foreign holders of depositary receipts. Depositary receipts evidence interests in the deposited shares (COMPAQ Computer Corp. Subs. v. Commissioner, 113 T.C. 214, T.C. 1999). The Deposit Agreement allows the Filipino corporation to deposit shares, and the depositary to issue receipts representing interests in the deposited shares to foreign investors. If the Filipino corporation declares dividends on the shares, the depositary is obligated to distribute the cash proceeds to the foreign holders of depositary receipts, in proportion to the number of receipts representing the deposited shares (Pinker v. Roche Holdings Ltd., 292 F.3d 361, 3d Cir. 2002).
Only the depositary has the power to exercise votes on the deposited shares (Saunders, 1993). This is because the depositary maintains legal title over the shares (Hannah, 1929). Hence, the depositary must be of Philippine nationality.

Surplus Notes

A Filipino corporation issues a surplus note to a foreign investor to fund its operations. The Filipino corporation repays the surplus note from funds in its surplus profits, or the amount by which the assets exceed liabilities (Life Ins., 76 P.3d 366, Alaska 2003). “A surplus note is a specialized type of promissory note by which the promisor agrees to pay the agreed principal amount and interest only if and when the promisor’s financial condition is such that it has capital and surplus in excess of a stated amount.” (Buffo v. Graddick, 742 F.2d 592, 11th Cir. 1984). The surplus note has a stated maturity date, but the expiration of the maturity will not trigger an obligation to repay the note if the capital and surplus do not exceed the stipulated amount (Buffo v. Graddick, 742 F.2d 592, 11th Cir. 1984).

In this sense, the surplus note is a hybrid instrument that behaves simultaneously like equity and debt. Therefore, a significant foreign holder of surplus notes may in reality be a disguised equity holder. Substantial foreign investments in surplus notes in excess of the foreign equity limitations may be a badge of economic interest without stock ownership.

Supply Contract with Fixed-Price Forward

Under a supply contract, the Filipino corporation acts as the purchaser and the foreign corporation acts as the seller over goods. Supply contracts that create ‘variable interests’ transfer the economic risks and rewards of the purchaser’s business to the foreign supplier. An example is an arrangement that inserts a fixed-price forward agreement over the price of the goods (PwC, Guide to Accounting for Variable Interest Entities, 2003).

Under the fixed-price forward agreement, the foreign supplier agrees to sell the goods to the Filipino purchaser at a fixed price during the period of the contract. Since the price is fixed, the foreign supplier absorbs the fluctuation in the cost of producing or procuring these goods. The foreign supplier suffers losses for selling goods at a cost beyond the fixed price in the supply contract, and enjoys gains if the cost of goods is below the fixed price (Jarrow et al., 1981).
A supply contract with fixed-price forward agreement does not automatically lead to a conclusion of disguised ownership. If the Filipino corporation depends on the foreign supplier for its profitability, and its profitability is guaranteed but limited, the supply agreement effectively puts the Filipino corporation in the position of a holder of a fixed income asset, rather than a holder of equity. On the other hand, the foreign supplier is exposed to the risks and rewards of holding equity in the Filipino corporation (Nenova, 2003).

Subchapter 2. Power without Majority of Voting Rights

The following are devices that create or indicate de facto control in a corporation, without majority of voting rights held by the foreign stockholder: (1) super-majority provisions, (2) veto rights, (3) loan covenants, (4) non-arm’s length transactions, (5) call options, (6) stock transfer restrictions, (7) passive institutional investments, (8) voting caps, (9) minority blockholding, and (10) redeemable preferred shares. The enumeration is not exclusive.

Super-Majority Provisions

Where a simple majority would ordinarily suffice, super-majority voting requirements impose a higher-than-majority threshold to pass shareholder resolutions (Easterbrook, 1983). The threshold requirement is usually two-thirds or 66.7% of outstanding shares, but it can be increased to as high as 80%, 90%, or to a unanimous vote. Super-majority voting requirements can be interpreted in three ways: (1) an implied dilution of voting control by Filipino majority shareholders, (2) an implied increase of voting control by foreign minority shareholders, or (3) an implied veto right from a bloc of foreign minority shareholders.16

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16 Illustration: assume that Filipino shareholders have 51% voting rights, foreign shareholders have 49% voting rights, and the super-majority voting requirement is at least 66.7% or two-thirds of outstanding voting shares. This can be interpreted as follows:

1. Proportional dilution of voting rights. – The 66.7% super-majority voting requirement is mathematically equivalent to a simple majority requiring 50% plus one vote, with a proportional dilution of voting rights of Filipino shareholders or, in the alternative, a proportional increase of voting rights of foreign shareholders.

2. Implied dilution of voting control by Filipino majority shareholders. – If the Filipino majority stockholders exercise the entire 51% of voting rights, they are still short of 15.67% (66.67% – 51%) plus one vote to pass the shareholder resolution requiring super-majority votes. Hence, the voting control of Filipino majority stockholders is impliedly diluted to 35.33% (51% – 15.67%) voting rights had the voting requirement been simple majority.

3. Implied increase of voting control by foreign minority shareholders. – The implied dilution of voting rights of Filipino majority stockholders by 15.67% is effectively added to the voting rights of foreign minority stockholders, making the latter’s...
Veto Rights

A shareholders agreement can create express or implied veto rights in favor of one or some stockholders (O’Neal, 1953). Veto rights are express when the agreement states that the approval or consent of the foreign stockholder is necessary to pass a resolution (O’Neal, 1960). The foreign stockholders may withhold their consent or express their disapproval to a proposed stockholder resolution.

Veto rights are implied when the shareholders agreement imposes a super-majority voting requirement to pass a resolution, and the total Filipino voting rights are less than the amount of votes required. The foreign stockholders have implied veto rights equal to the amount of the balance between the threshold of votes and the total Filipino voting rights.

Illustration: assume that the Filipino majority stockholders hold 51% voting rights, the foreign minority stockholders hold 49%, and the voting threshold is a super-majority requirement of 66.7%. Under the concept of implied veto rights, the foreign minority stockholders can veto only to the extent that they can muster 15.7% (66.7% – 51%) votes.

Under the concept of express veto rights, assume that there are two coalitions of foreign minority stockholders. Even if Filipino majority stockholders and one coalition of foreign minority stockholders muster 66.7% plus one vote, the other coalition of foreign minority stockholders can choose to withhold its consent or approval. This effectively disregards the weight of stockholders’ voting rights.

Veto rights can therefore be interpreted in two ways: (1) they are implied voting rights equivalent to an effective majority voting control by the foreign stockholder, regardless of the actual weight of his voting rights; or (2) they are an implied dilution of voting control held by Filipino majority stockholders, and a divestment of majority voting control status, regardless of the fact that he holds majority of voting shares.

voting rights equal to 64.67% (41% + 15.67%) had the voting requirement been simple majority.

4. Implied veto right from a bloc of foreign minority shareholders. – Under a simple majority voting requirement, the 49% voting rights of foreign shareholders is not sufficient to block 51% votes from Filipino shareholders. However, under a super-majority voting requirement of 66.7%, foreign minority shareholders can veto the Filipino majority shareholders by exercising 33.33% (100% – 66.6%) plus one vote, which is well within the 49% voting rights of foreign minority shareholders. This implied veto right is more obvious and potent if there is only one foreign minority shareholder.
Loan Covenants

Corporate control is allocated between Filipino shareholders and foreign creditors. Filipino shareholders exercise control through formal voting rights, while foreign creditors exercise control through loan covenants. These covenants are embedded in loan agreements. The greater is the amount of foreign loan relative to the equity held by Filipino stockholders, the greater is the credit risk assumed by the foreign creditor, and the greater is the credit risk, the greater is the restrictiveness imposed by the foreign creditor in the loan covenants. Corporate control is allocated between Filipino shareholders and foreign creditors. Filipino shareholders exercise control through formal voting rights, while foreign creditors exercise control through loan covenants. These covenants are embedded in loan agreements. The greater is the amount of foreign loan relative to the equity held by Filipino stockholders, the greater is the credit risk assumed by the foreign creditor, and the greater is the credit risk, the greater is the restrictiveness imposed by the foreign creditor in the loan covenants (Wang, 2013).

In case of breach in loan covenants, the foreign creditor can either terminate the loan agreement, or allow the Filipino borrower-corporation to re-negotiate the covenants. It is during such re-negotiation that the foreign creditor can impose undertakings and restrictions on the Filipino borrower-corporation’s business policy (Wang, 2013).

The greater is the restrictiveness of loan covenants imposed during loan origination, the greater is the probability of covenant violations during the life of the loan. The occurrence of covenant violations, in turn, triggers covenant re-negotiations. The alternative to covenant re-negotiation is loan default, acceleration, and termination of loan agreement. Because of this, the Filipino borrower-corporation is compelled to make substantial concessions to the foreign creditor during covenant re-negotiation (Wang, 2013).

Non-Arm’s Length Transaction

The foreign corporation may exert indirect control over a Filipino corporation if the nature of business relationship is such that there are unequal negotiating advantages between the two parties. The foreign corporation may be the sole customer of the Filipino corporation, or there exists other important and exclusive contractual arrangements between them, such as supply, marketing, leasing or franchising agreements. Two factors generally indicate the existence of a non-arm’s length transaction: (1) the Filipino corporation is economically dependent
on the foreign corporation, and (2) as a result of this dependence, the Filipino corporation is forced to deal with only one party, i.e. the foreign corporation (Studniberg, 2013).

Call Options

A call option gives the foreign minority stockholder a right, but not an obligation, to purchase the shares of the Filipino majority stockholder (Allaire Corp. v. Okumus, 433 F.3d 248, 2d Cir. 2006). To exercise the call option means that the foreign minority stockholder will elect to purchase the shares (Glass v. Commissioner of Internal Revenue, 87 T.C. 1087, T.C. 1986). The exercise date of the call option indicates the period within which the option can be exercised (Progressive Corp. and Subsidiaries v. U.S., 970 F.2d 188, 6th Cir. 1992). The strike price of the option is the price at which the foreign minority stockholder will purchase the shares, if he elects to exercise the option (Dewees v. C.I.R., 870 F.2d 21, 1st Cir. 1989). The underlying shares refer to the shares subject to purchase, if the foreign minority stockholder exercises the call option (Board of Trade of City of Chicago vs. SEC, 883 F.2d 525, 7th Cir. 1989).

The fair value of the underlying shares is different from the strike price of the call option. If at exercise date, the fair value is greater than the strike price, the foreign minority stockholder makes a gain. The call option is said to be in-the-money\textsuperscript{17}. If the fair value is lesser than the strike price, he suffers a loss. The call option is said to be out-of-the-money\textsuperscript{18}.

Exercising the call option will remove the equity interest of the Filipino majority stockholder from the corporation. This is regardless of whether the call option is in-the-money or out-of-the-money. This is also regardless of whether the foreign minority stockholder exercises the option or sells it to a third party\textsuperscript{19}.

The foreign minority stockholder can legally exercise the call option, even if it will breach foreign equity limitations (J.G. Summit Holdings, Inc. vs. CA, G.R. No. 124293, January 31, 2005). The consequence of exercising the call option is the disqualification of the Filipino corporation from engaging in partially nationalized activities, or from holding land (J.G. Summit Holdings, Inc. vs. CA, G.R. No. 124293, January 31, 2005). In this way, foreign holders of call options

\textsuperscript{17} See, e.g., Comrie v. Enterasys Networks, Inc., 837 A.2d 1 (Del. Ch. 2003).

\textsuperscript{18} See, e.g., In re Digital Island Securities Litigation, 357 F.3d 322 (3d Cir. 2004).

\textsuperscript{19} For an example of selling call options to a third party, see, e.g. U.S. v. Nacchio, 573 F.3d 1062 (10th Cir. 2009).
over majority of the shares in a Filipino corporation have the potential to destroy stockholder value.

Stock Transfer Restrictions

Under a stock transfer restriction, a Filipino majority stockholder cannot assign, encumber, sell or transfer his equity interest without the approval or consent of the foreign minority stockholder. The stock transfer restriction is embodied in a shareholder agreement between the Filipino majority stockholder and the foreign minority stockholder (Gray v. Bicknell, 86 F.3d 1472, 8th Cir. 1996). The purpose is to preserve the strategic alliance between the foreign and Filipino investors as co-stockholders.

Passive Institutional Co-Investors

Institutional investors are entities managing a pool of funds for buying and holding investment assets, including shares of stock. Examples are insurance companies, mutual funds, and pensions (Rosen v. Brookhaven Capital Management Co., Ltd., 113 F. Supp.2d 615, S.D.N.Y. 2000). There are two types of institutional investors: (1) active and (2) passive fund managers. In terms of sensitivity to managerial performance, active fund managers accumulate or divest their holdings in the corporation to improve managerial performance, while passive fund managers are often unwilling to accumulate or divest holdings, regardless of how corporate insiders perform (St. Street Bank Trust Co. Fixed Inc., 772 F. Supp.2d 519, S.D.N.Y. 2011).

Active fund managers seek to outperform a benchmark market index. It is for this reason that they have the incentive to influence managerial behavior. Passive fund managers seek only to deliver the returns of a benchmark market index (George v. Kraft Foods Global, Inc., 641 F.3d 786, 7th Cir. 2011).

Active fund managers frequently re-balance the weights of individual stocks in their portfolio. Passive fund managers seek to replicate, at all times, the weights of individual stocks in their portfolio. For this reason, passive fund managers refuse frequent accumulation or divestment of shares in the corporation because it will lead to deviation from the weight distribution of shares in the portfolio\(^\text{20}\).

Active fund managers hold lesser stocks in their portfolio because they monitor managerial behavior. Passive fund managers do not dedicate their resources in monitoring managerial behavior. Active fund managers seek to influence the corporation's firm-specific policy choices, while passive fund managers do not closely monitor them (Weiss v. Morgan Stanley, 345 Fed.Appx. 713, 2d Cir. 2009).

In a Filipino corporation with 60% of stocks held by passive institutional investors and 40% held by foreign stockholders, the minority status of foreign stockholders is not a barrier to the exercise of de facto control. The foreign minority stockholders have the incentive to influence managerial behavior, while passive institutional investors do not have the same incentive. There is a reasonable expectation for passive institutional co-investors to defer the exercise of control to foreign minority stockholders.

Voting Caps

Voting caps are maximum limitations on voting rights held, regardless of the number of voting shares owned (Hansmann et al, 2013). These limitations are either required by law or written in the charter provisions of corporations. Foreign equity limits are a form of voting cap required by law while voting caps through charter provisions may apply to all or some classes of voting shares, regardless of the nationality of stockholders (Claessens et al., 2000).

Voting caps are of two kinds: ceilings and sliding scales. A ceiling can either be a limitation on a specific number of votes or a limitation on the percentage of the total voting rights represented at the meeting (Nenova, 2003). For example, under a ceiling, a stockholder who owns 50 shares is only entitled to cast 10 votes, or a stockholder who owns 20% of voting rights is only entitled to cast 10%. Under sliding scale, there is a progressive increase in voting rights as more voting shares are held, with decreasing marginal increase for every tranche of shares. For example, the first tranche of 100 shares represent 100 votes, the second tranche of 100 shares represent 50 votes, and the third tranche of 100 shares represent ten votes.

A voting cap may apply to a class of shareholders, but not to others (OECD Steering Group on Corporate Governance, Lack of Proportionality Between Ownership and Control: Overview and Issues for Discussion, 2007). In this case, stockholders with no voting cap have disproportional and higher voting power. Hence, voting caps decouple voting share ownership from actual voting rights.

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Illustration: a corporation demonstrates the use of a sliding scale by equating a tranche of 5 shares with 1 vote, 10 shares with 2 votes, 15 shares with 3 votes, and so on. Consider the following table:

<table>
<thead>
<tr>
<th>Share Tranches</th>
<th>Voting Rights</th>
<th>Effect of Prudent-Mean Scale</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>One Share – One Vote Principle</td>
<td>Proportionality Principle</td>
</tr>
<tr>
<td>A</td>
<td>B</td>
<td>C</td>
</tr>
<tr>
<td>5</td>
<td>5</td>
<td>1</td>
</tr>
<tr>
<td>10</td>
<td>10</td>
<td>2</td>
</tr>
<tr>
<td>15</td>
<td>15</td>
<td>3</td>
</tr>
<tr>
<td>20</td>
<td>20</td>
<td>4</td>
</tr>
<tr>
<td>30</td>
<td>30</td>
<td>6</td>
</tr>
<tr>
<td>40</td>
<td>40</td>
<td>8</td>
</tr>
<tr>
<td>60</td>
<td>60</td>
<td>12</td>
</tr>
<tr>
<td>80</td>
<td>80</td>
<td>16</td>
</tr>
<tr>
<td>100</td>
<td>100</td>
<td>20</td>
</tr>
<tr>
<td>140</td>
<td>140</td>
<td>28</td>
</tr>
<tr>
<td>180</td>
<td>180</td>
<td>36</td>
</tr>
<tr>
<td>200</td>
<td>200</td>
<td>40</td>
</tr>
</tbody>
</table>

The above table shows the share tranche system used in a hypothetical corporation, and the corresponding voting rights under three voting right distribution systems: One Share-One Vote Principle, Proportionality Principle, and Prudent-Mean Scale. The columns under the Effect of Prudent-Mean Scale demonstrate the deviation of voting rights under the Prudent-Mean Scale system from the other two voting right distribution systems.
The column on Share Tranches represents a numerical grouping of shares by range. The figures represent the minimum value of each range. Hence, holding 7 shares will give the same voting rights as holding 5 shares, and holding 300 shares will give the same voting rights as holding 200 shares. Under the column on One Share – One Vote Principle, the figures represent the amount of voting rights equated to each tranche of shares if one share is exactly equal to one vote. Hence, holding 5 shares give exactly 5 votes, holding 10 shares give exactly 10 votes, and so on. Under the column on Proportionality Principle, the figures represent the amount of voting rights equated to each tranche of shares if the relationship between voting rights and number of shares is linear. Hence, if the baseline tranche is 5 shares, which is equal to 1 vote, holding 200 shares should exactly equal 40 votes, because 200 shares divided by 5 shares per vote is equal to 40 votes. Under the column on Prudent-Mean Scale, holding 5 shares merit the same voting weight as holding 7 shares (i.e. less than the next higher tranche, which is 10 shares), holding 10 shares merit the same voting weight as holding 12 shares (i.e. less than the next higher tranche, which is 15 shares), and so on. The column on Amount of Deviation from the One Share – One Vote Principle represents the difference between the figures in the column on One Share – One Vote Principle and the figures in the column on Prudent-Mean Scale. The column on Ratio of Deviation from the One Share – One Vote Principle is equivalent to the figures under the Amount of Deviation from the One Share – One Vote Principle divided by the figures in the column on One Share – One Vote Principle. This represents the percentage by which voting rights in the hypothetical corporation using the Prudent-Mean Scale deviate from the One Share – One Vote Principle. The column on Amount of Deviation from the Proportionality Principle is the difference between the figures in the column on Proportionality Principle and the figures in the column on Prudent-Mean Scale. The column on Ratio of Deviation from the Principle is equivalent to the figures under the Amount of Deviation from the Proportionality Principle divided by the figures in the column on Proportionality Principle. This represents the percentage by which voting rights in the hypothetical corporation using the Prudent-Mean Scale deviate from the Proportionality Principle.

The tranche system is a form of a voting cap system. Every tranche system deviates from the One Share – One Vote Principle, but not all tranche systems deviate from the Proportionality Principle. Under the Prudent-Mean Scale, as voting shares increase, the marginal increases in voting rights decrease. This deviates both from the One Share – One Vote Principle and Proportionality Principle. Note that the ratios of deviation are not equal for all tranches of shares. The more shares are
held in the hypothetical corporation, the more voting rights deviate from the One Share – One Vote Principle and Proportionality Principle.

The fact that ratios of deviation are increasing demonstrate that voting rights get diluted as more voting shares are held. Consider this scenario:

<table>
<thead>
<tr>
<th>Stockholder</th>
<th>Voting Shares Owned</th>
<th>% of Voting Shares Owned</th>
<th>Actual Voting Rights held under One Share – One Vote Principle</th>
<th>% of Actual Voting Rights</th>
<th>Actual Voting Rights held under Proportionality Principle</th>
<th>% of Actual Voting Rights</th>
<th>Actual Voting Rights held under Prudent-Mean Scale</th>
<th>% of Actual Voting Rights</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreigner</td>
<td>100</td>
<td>33%</td>
<td>100</td>
<td>33%</td>
<td>20</td>
<td>33%</td>
<td>10</td>
<td>40%</td>
</tr>
<tr>
<td>Filipino</td>
<td>200</td>
<td>67%</td>
<td>200</td>
<td>67%</td>
<td>40</td>
<td>67%</td>
<td>15</td>
<td>60%</td>
</tr>
<tr>
<td>Total</td>
<td>300</td>
<td>100%</td>
<td>300</td>
<td>100%</td>
<td>60</td>
<td>100%</td>
<td>25</td>
<td>100%</td>
</tr>
</tbody>
</table>

Minority Blockholding

Through minority blockholding, foreign equity is concentrated in one or few stockholders (called the blockholder), while Filipino equity is dispersed among numerous stockholders (called the dispersed shareholders) (Morton’s Rest. Grp., Inc., 74 A.3d 656). The total foreign equity still complies with foreign equity limitations, but the foreign blockholder maintains effective control over corporate policy because it is difficult for dispersed shareholders to act in concert to veto the blockholder’s votes (PNB Hldg. Co. S’holders Litig., 2006 WL 2403999, at *9, Del. Ch. Aug. 18, 2006). A minority blockholder is considered a controlling stockholder if it has “such formidable voting and managerial power that [it], as a practical matter, [is] no differently situated than if [it] had majority voting control.” (Sanchez Energy Derivative Litig., C.A. No. 9132-VCG, Del. Ch. Nov 25, 2014) The actual control exercised by the minority blockholder must be “so potent that independent directors […] cannot freely exercise their judgment, fearing retribution” from the controlling minority blockholder (Morton’s Rest. Grp., Inc., 74 A.3d 656; In re PNB Hldg. Co. S’holders Litig., 2006 WL 2403999, at *9, Del. Ch. Aug. 18, 2006). “When a stockholder owns less than 50% of the corporation’s outstanding stock, ‘a plaintiff must allege domination by a minority shareholder

In one American case, “the blockholder not only held 35% of the company’s stock, but he was the company’s visionary founder, CEO, and chairman. The blockholder, in fact, exercised more power than a typical CEO because he had placed ‘two of his close family members in executive positions at the company,’ which gave the blockholder influence over even ‘the ordinary managerial operations of the company.’ Under these circumstances, the court found that that the minority stockholder possessed, ‘as a practical matter, ... a combination of stock voting power and managerial authority that enable[d] him to control the corporation, if he so wishe[d].’” (Morton’s Rest. Grp., Inc., 74 A.3d 656 citing In re Cysive, Inc. S’holders Litig., 836 A.2d 531, 551–52, Del.Ch.2003).

Empirical studies show the adverse governance effects of a minority blockholding structure. “[T]he [dispersed] shareholders will now be expropriated by the [blockholder] who will divert funds towards the generation of private benefits, by taking a disproportionate amount of the firm’s current earnings or investing in pet projects.” (Gutiérrez et al, 2004)

IAS 27 considers minority blockholding structure as an indicator of de facto control by the blockholder. “[C]ontrol is achievable if the balance of holdings is dispersed and the other shareholders have not organised their interests in such a way that they exercise more votes than the minority holder.” (BDO International, Definition of control under IAS 27 Consolidated and Separate Financial Statements, 1 International Financial Reporting Bulletin, 2006). Appendix B42 of IFRS 10 adopted the IAS 27 rule on minority blockholding structures by including “[t]he size of the investor’s holding of voting rights relative to the size and dispersion of holdings of the other vote holders” as a factor of control (Burton et al., 2015). For the purposes of UK broadcasting legislation, regulators consider the “size of the economic interest of each of the shareholders in the profits of the company” as an indicator of de facto control by the blockholder22.

One test to see whether a blockholder has significant influence is if the dispersed shareholders are (1) unrelated and (2) required to take concerted action to veto the votes of the blockholder. “The investor may have the power to unilaterally direct the investee unless a sufficient number of the remaining dispersed investors

22 This is in the course of implementing paragraph 1(3) of Part I of Schedule 2 of the Broadcasting Act 1990 (as amended) (“BA 1990”).
act in concert to oppose the influential investor. However, such concerted action may be hard to organise if it requires the collective action of a large number of unrelated investors.” (PwC, Consolidated financial statements: redefining control, Practical Guide to IFRS, 2011)

Redeemable Preferred Shares

Redeemable preferred shares give the preferred shareholder the right to sell the shares back to the corporation. Although the share has a stated maturity, the arrival of the maturity does not automatically trigger an obligation on the part of the corporation to redeem the shares. The maturity date only triggers the right of the shareholder to demand redemption by the corporation at a given redemption price23.

“A redemption by the corporation of its stock is, in a sense, a repurchase of it for cancellation.” (Republic Planters Bank vs. Agana, G.R. No. 51765, March 3, 1997). The redemption feature is equivalent to a put option held by the preferred shareholder (Wise, 2003). This gives these shares the characteristic of being a hybrid between equity and debt, susceptible to varying treatments, as follows:

“[...] redeemable preferred stock is currently listed as neither equity nor liability according to U.S. generally accepted accounting principles. [...] However, it is sometimes classified as equity in SEC opinions, [...] although international accounting standards list such stock as a liability, [...] and federal regulations forbid such stock from being listed as stockholders’ equity [...]” (Pearson v. Component Technology Corp., 247 F.3d 471, 3d Cir. 2001)

As a general rule, the corporation cannot purchase its own shares except out of current retained earnings (Republic Planters Bank vs. Agana, G.R. No. 51765, March 3, 1997). An exception to this rule is Section 8 of B.P. 68, which allows redemption of shares even if there are no unrestricted retained earnings on the books of the corporation. There is, however, an exception to this exception: the Trust Fund Doctrine and Section 5 of SEC Rules Governing Redeemable and Treasury Shares. While B.P. 68 allows redemption regardless of the existence of unrestricted retained earnings, the corporation must meet the following conditions: (1) after redemption, there are still sufficient assets in its books to cover the claims

23 Section 8, B.P. 68 provides that redeemable shares "may be purchased or taken up by the corporation upon the expiration of a fixed period."
of creditors, (2) the corporation is not currently insolvent, and (3) the redemption will not cause insolvency or inability of the corporation to meet its debts as they mature. In Canada, regulators consider the presence of significant amounts of redeemable preferred shares in determining de facto control of the corporation by minority stockholders. If the corporation is not liquid, or is not in the financial position to buy back the redeemable preferred shares held by the foreign stockholder, this may give de facto control rights to the foreign stockholder. Demanding redemption will force the corporation into insolvency. In Canadian tax law, power over the life of the corporation is a significant indicator of de facto control. In this example, a foreign investor holding redeemable preferred shares, with the correlative ability to force the corporation into insolvency if redemption is demanded, also has the practical ability to terminate the life of the corporation.

In the Philippines, the Trust Fund Doctrine limits the right of the corporation to redeem preferred shares. Redeemable preferred shareholders, who are foreigners, cannot force the Filipino corporation into insolvency and bankruptcy. In this sense, mere existence of substantial foreign investments in redeemable preferred shares may not necessarily cede de facto control to foreign redeemable preferred shareholders, unless coupled with other de facto control rights.

In reality, however, the Doctrine only protects the creditors of the corporation. What it does not address is the balancing of interest between the Filipino majority holders of common stock and foreign holders of redeemable preferred shares. Assuming the Filipino corporation has met the conditions under Section 5 of SEC Rules Governing Redeemable and Treasury Shares to make a valid redemption, the power to demand a repurchase of all redeemable preferred shares held by foreign investors is equivalent to the withdrawal of financing that allows

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24 Republic Planters Bank vs. Agana, G.R. No. 51765, March 3, 1997 citing Philippine Trust Co. vs. Rivera, 44 Phil 469 [1923]; Garcia vs. Lim Chu Sing, 59 Phil. 562 [1934]; Boman Environmental Dev’t. Corp. vs. Court of Appeals, 167 SCRA 540 [1988]; Hector De Leon, The Corporation Code of the Philippines, 1999 Ed., pp. 96-97. In some cases, however, the redemption by the corporation of redeemable preferred shares is treated as an exception to the Trust Fund Doctrine. See, e.g., National Telecommunications Commission v. Court of Appeals, G.R. No. 127937 July 28, 1999, 311 SCRA 508 (“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.”)

25 National Telecommunications Commission v. Court of Appeals, G.R. No. 127937 July 28, 1999, 311 SCRA 508 (“The ‘Trust Fund’ doctrine considers […] subscribed capital as a trust fund for the payment of the debts of the corporation, to which the creditors may look for satisfaction.”)
the corporation to continue its core business purpose, even if there are sufficient assets to pay the corporation’s liabilities.

It is submitted that, where a potential exercise of redemption rights cripples the corporation’s operations from continuing its main purpose, substantial investments by foreigners in redeemable preferred shares are indicative of *de facto* foreign control, even if the redemption is allowed under the Trust Fund Doctrine and Section 5 of SEC Rules Governing Redeemable and Treasury Shares.

**Conclusion**

Since corporate nationality clauses presuppose that stock ownership is a unified bundle of rights, foreign investors circumvent foreign equity limitations by unbundling stock ownership rights, as follows:
Unbundling economic rights leads to economic interest without legal ownership (Hu et al, 2007):

1. **Legal Title.** – Legal title is vested when shares of stock have been transferred in the books of the corporation in the name of the titleholder (Piaoco vs. McMicking, G.R. No. L-4237, March 5, 1908).

2. **Equitable Title.** – A holder of a certificate of stock, without transfer in the books of the corporation in his name, only has equitable title over the shares. This equitable title includes the right of such holder to demand the transfer of the shares in his name. However, for as long as such shares have not been transferred in the books of the corporation, the corporation does not formally recognize the equitable titleholder as a stockholder (Piaoco vs. McMicking, G.R. No. L-4237, March 5, 1908).

3. **Economic Interest.** – Economic interest over shares of stock is different from legal title and equitable title. A non-holder of a share of stock can be exposed to the risks and rewards of equity ownership, even without purchasing or acquiring the shares (Hu et al, 2006). There can be economic exposure to the value of shares, without legal or equitable title, when a person (not a stockholder) enters into a contractual arrangement in which the payoffs are contingent on the performance or value of a stock or company. The contract, in this case, references the price of the shares. Any changes in the stock price or value over a period of time affects the payoffs between the parties to the contract (Hu et al, 2006).

On the other hand, unbundling control rights leads to de facto control without majority of voting rights. Surprisingly, there is very little research on the concept of de facto corporate control. Thus far, Canadian tax law and Canadian financial institutions regulation provide the most comprehensive legal application of the theory of de facto corporate control without majority voting rights26. In international accounting, IFRS 10 provides the most comprehensive guidance on assessing de facto control for the purpose of consolidating financial statements27.

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26 See, e.g. Advisory 2007-02 (“Control in Fact”) issued by the Office of the Superintendent of Financial Institutions Canada.

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