Unbundled Shares:
Circumventing Corporate Nationality Rules Through Swaps, Options, and Other Devices

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INTRODUCTION

“The law has not kept pace with financial market reality.”

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. These rights include economic and control rights. 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. We shall call this the Bundle Theory of Shares, illustrated as follows:

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2 See, e.g., Const. (1987), art. XII, § 11 (Phil.) (“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”).


6 Control rights are also called ‘voting rights,’ since it is through the exercise of formal voting power that stockholders can pass shareholder resolutions. See Liping Dong, Konari Uchida & Xiaohong Hou, How Do Corporate Control Rights Transactions Create Shareholder Value? Evidence from China 5 (June 15, 2014), http://ssrn.com/abstract=2396514.

7 Koen Greens & Carl Clottens, One Share - One Vote: Fairness, Efficiency and (the Case for) EU Harmonisation Revisited 7 (Feb. 6, 2010), http://ssrn.com/abstract=1547842.

8 Grant M. Hayden & Matthew T. Bodie, The False Promise of One Share, One
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. 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.” 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.

In reality, however, advances in finance and contract law are eroding the **Bundle Theory of Shares**. 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.

These devices can unbundle a share of stock in two ways: either by unbundling economic rights or by unbundling control rights. Unbundled economic rights lead to a **Separation of Legal Ownership and Economic Vote**.

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12 Piet Sercu & Tom Vinaimont, *Deviations from “one share, one vote” can be optimal: An entrepreneur’s point of view*, AFA 2004 San Diego Meetings Annual Meetings 1 (2008).


Interest over the shares.\textsuperscript{15} Unbundled control rights lead to a Separation of Control in Law and Control in Fact.\textsuperscript{16} 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.\textsuperscript{17}

This process is illustrated as follows:

\begin{itemize}
\item Economic rights
  \begin{itemize}
  \item Right to receive dividends
  \item Right to sell shares
  \item Right to net proceeds upon dissolution
  \end{itemize}
\item Control rights
  \begin{itemize}
  \item Right to elect directors
  \item Right to vote on fundamental matters
  \item Right to vote on submitted matters
  \end{itemize}
\item Financial Derivatives
\item Hybrid Instruments
\item Other Securities
\item Variable Interests
\item Loan Agreements
\item Other Contractual Arrangements
\end{itemize}

\begin{itemize}
\item Unbundling Economic Rights
\item Separation of Legal Ownership and Economic Interest
\item Unbundled Shares
\end{itemize}

\begin{itemize}
\item Unbundling Control Rights
\item Separation of Control in Law and Control in Fact
\item Unbundled Shares
\end{itemize}


\textsuperscript{17} Burkart & Lee, supra note 11, at 2.
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. 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. In short, there is power without majority of voting rights.

In both modes of unbundling shares of stock, there is apparent compliance with foreign equity limits. To illustrate, consider the following scenarios:

1. **Scenario using Swaps.** – A Filipino stockholder holds majority of the total capital stock and majority of all the voting shares in a corporation engaged in nationalized activities. On the other hand, a foreigner owns a debt instrument that pays fixed and periodic interest. The foreigner is not a stockholder.

   The Filipino stockholder and the foreigner enter into a contract, called a total return swap, where the foreigner promises to pay the Filipino stockholder an amount equal to the loss in the value of the stock (if any), and the Filipino stockholder promises to pay the foreign investor an amount equal to the gain in the value of the stock (if any), at the end of the life of the contract. In addition, the foreigner promises to pay the Filipino stockholder an amount equal to the fixed and periodic interest on the debt instrument, without any condition.

2. **Scenario using Options.** – A Filipino stockholder holds majority of the total capital stock and majority of all the voting shares in

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a corporation engaged in partially nationalized activities. A foreigner holds the minority position. The Filipino stockholder purchased the shares at an original purchase price of $X$.

The two stockholders execute a *loan agreement*, where the foreigner lends to the Filipino an amount equivalent to $X$. At the same time, they execute a *call option*, where the foreign stockholder has the right, but not the obligation, to purchase all the shares held by the Filipino stockholder, at a strike price equivalent to $X$. They also execute a *put option*, where the Filipino stockholder has the right, but not the obligation, to sell all his shares to the foreign stockholder, also at a strike price equivalent to $X$.

Both call and put options can only be exercised at a definite date. Upon the arrival of that date, however, both parties are precluded from exercising either option through an actual delivery of the shares from the Filipino stockholder to the foreign stockholder. Foreign equity limits prohibit them from executing the sale.²²

Both scenarios seem to comply with foreign equity regulation. *First*, the Filipino stockholder holds majority of the voting shares, in compliance with the *Gamboa Control Test*.²³ *Second*, the Filipino stockholder holds the majority of the total outstanding capital stock and the majority of each class of outstanding shares (whether voting or non-voting), in compliance with the *Gamboa Two-Tier Test*.²⁴ *Third*, the Filipino stockholder retains the right to receive dividends and the right to vote in stockholder meetings, in compliance with the *Gamboa Beneficial Ownership Doctrine*.²⁵ *Fourth*, there is no illegal partnership, agency or trust arrangement between the Filipino and the foreigner, in compliance with the Anti-Dummy Law.²⁶ *Fifth*, there is no clear badge of fraud, since these arrangements are

²² This scenario is an example of a put-call parity transaction. See David F. Babbel & Larry Eisenberg, *Generalized Put-Call Parity*, 1 J. Fin. Eng’g 243, 244 (1993).

²³ *Gamboa*, G.R. No. 176579 (Phil.) (prescribing that voting shares determine control in a corporation because of the power to select members of the Board of Directors).

²⁴ *Gamboa v. Teves*, G.R. No. 176579, October 9, 2012 (“In short, the 60-40 ownership requirement in favor of Filipino citizens must apply separately to each class of shares, whether common, preferred non-voting, preferred voting or any other class of shares.”).

²⁵ *Id.* (“Mere legal title is insufficient to meet the 60 percent Filipino-owned ‘capital’ required in the Constitution.”).

²⁶ Sec. 2, Commonwealth Act (C.A.) No. 108.
conventional devices in legitimate business transactions. Financial derivatives, which include options and swaps, are common hedging devices.27

Nothing, however, is what it seems. A closer analysis reveals that the foreign investor’s economic position is now equivalent to a majority stockholder of the Filipino corporation, as follows:

1. Analysis of the Swap Scenario. – Through the use of total return swap, the Filipino stockholder becomes economically indifferent to any changes in the value of the shares. He is guaranteed to receive a fixed return from the foreigner, pegged at the rate of the debt instrument. It is as if the Filipino stockholder is holding the debt instrument, not the shares of stock. While the foreigner did not actually purchase the shares held by the Filipino stockholder, the foreigner has exposure to the risks and rewards of stock ownership. The foreigner benefits from any increase in the value of the shares, and absorbs any decrease in value. Note that legal title over the shares does not transfer from the Filipino stockholder to the foreigner.28

2. Analysis of the Options Scenario. – The Filipino is a holder of the shares, entitled to dividends and capital appreciation, while the foreigner is the lender in the loan agreement, entitled to interest and repayment of principal. The structure of the transaction, however, has effectively transformed their respective economic positions: the Filipino is now in the financial position of a lender and the foreigner is now in the financial position of a stockholder.29

If at exercise date, the value of the stock has increased beyond $X$ (or the original purchase price paid by the Filipino stockholder to acquire the shares), the foreigner will exercise the call option, because the value of the stock is greater than the exercise price, which is also $X$. On the other hand, if the value of the stock has decreased below $X$, the Filipino stockholder will

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exercise the put option, because the exercise price, which is also $X$, is greater than the value of the stock.\textsuperscript{30}

Whatever happens to the value of the stock at exercise date, the Filipino obtains a guaranteed value, which is $X$. It is as if he has become the lender in the loan agreement, where the payout is exactly $X$. Even though the foreigner is the real lender, he is exposed to the risks and rewards of equity, even though he is not the holder of the shares of stock. He benefits from any marginal gains in the value of the stock above $X$, or absorbs marginal losses in the value of the stock below $X$.\textsuperscript{31}

By authority of \textit{J.G. Summit v. CA} (2005), the foreigner is legally allowed to hold an options contract over shares in the corporation, for two reasons: (1) the foreigner can validly assign his right under the options contract to a qualified Filipino, and (2) no law disqualifies the foreigner from purchasing shares in the corporation, even if the foreigner will exceed the allowed foreign equity.\textsuperscript{32}

\textsuperscript{30} \textit{Id.}


\textsuperscript{32} [I]f PHILSECO still owns land, the right of first refusal can be validly assigned to a qualified Filipino entity in order to maintain the 60%-40% ratio. This transfer, by itself, does not amount to a violation of the Anti-Dummy Laws, absent proof of any fraudulent intent. The transfer could be made either to a nominee or such other party which the holder of the right of first refusal feels it can comfortably do business with. Alternatively, PHILSECO may divest of its landholdings, in which case KAWASAKI, in exercising its right of first refusal, can exceed 40% of PHILSECO’s equity. In fact, it can even be said that if the foreign shareholdings of a landholding corporation exceeds 40%, it is not the foreign stockholders’ ownership of the shares which is adversely affected but the capacity of the corporation to own land – that is, the corporation becomes disqualified to own land. This finds support under the basic corporate law principle that the corporation and its stockholders are separate juridical entities. In this vein, the right of first refusal over shares pertains to the shareholders whereas the capacity to own land pertains to the corporation. Hence, the fact that PHILSECO owns land cannot deprive stockholders of their right of first refusal. No law disqualifies a person from purchasing shares in a landholding corporation even if the latter will exceed the allowed foreign equity, what the law disqualifies is the corporation from owning land.

\textit{J.G. Summit Holdings Inc. v. Court of Appeals, G.R. No. 124293} (S.C., Jan. 31, 2005) (Phil.).
Is the foreigner legally allowed to exercise the options contract? It depends on the mode of settlement between the parties. The foreigner cannot exercise the option, if the option is settled through an actual delivery of shares. This will contemplate a transfer in legal title from the Filipino stockholder to the foreigner, which is prohibited. However, the foreigner can validly exercise the option, if the exercise is settled through a cash netting arrangement. Under this mode of settlement, the foreigner applies the Filipino stockholder’s debt under the loan agreement, which is $X$, to the satisfaction of the monetary equivalent of the value of the shares on exercise date. If $X$ is greater than the value of the shares, the foreigner will pay the balance to the Filipino stockholder (i.e. the foreigner absorbs the marginal loss in the decline in the value of the stock below $X$). If $X$ is lesser than the value of the stock, the Filipino stockholder will pay the balance to the foreigner (i.e. the foreigner benefits from the marginal gains in the increase in the value of the stock above $X$).

Do these transactions circumvent foreign equity limits? What other similar transactions sidestep corporate nationality rules? Does the current regulatory regime render them illegal? If not, what regulatory measures should be introduced to curtail their use?

To answer these questions, this paper undertakes these three objectives:

1. Theory of Unbundled Shares. – Part I of this paper discusses the following: (1) brief history of the bundle theory of shares, (2) how modern finance and contract law have eroded the bundle of stockholder rights, (3) the modes of unbundling a share of stock, (4) the meaning of separation of legal ownership and economic interest, and (5) the meaning of separation of control in law and control in fact.

2. Analysis of Unbundling Devices. – Part II of this paper provides concrete examples of the unbundling mechanism discussed in Part I. It presents 20 examples of unbundling devices: 10 devices that unbundle economic rights and 10 that unbundle control rights. Part II also provides an analysis of how each device can

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structure a transaction to sidestep corporate nationality rules in a post-Gamboa v. Teves regime.

3. Critique of Existing Regulation. – Part III of this paper shows that the existing regulatory regime in enforcing corporate nationality rules and foreign equity limits is inadequate to address the phenomenon of unbundled shares. It recommends new regulatory measures to address the problem created by such shares.

I. THEORY OF UNBUNDLED SHARES

A. History of Bundle Theory of 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.34 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.35

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.36 This is similar to the design of control rights in a non-stock corporation, where one member is entitled to exactly one vote.37

34 Burkart & Lee, supra note 11, at 2 (explaining how the publicani is a precursor to the modern corporation through its issuance of shares).


37 Tan v. Sycip, G.R. No. 153468 (S.C., Aug. 17, 2006) (Phil.) (“[I]n 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
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.

In early nineteenth century United States, 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. 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.”

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.”

In late nineteenth century United States, the use of cumulative voting became prevalent in upholding minority stockholder rights. In early twentieth century United States, corporations started to issue non-voting shares, but dominant stockholders retained voting shares. This is similar to the issuance of preferred shares today.

In the same period, corporations responded to the prevalence of non-voting shares by moving toward the One Share – One Vote Principle. In 1926, the New York Stock Exchange (“NYSE”) prohibited the listing of corporations with non-voting shares.

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38 Burkart & Lee, supra note 11, at 1.
39 Id.
40 Grant M. Hayden & Matthew T. Bodie, One Share, One Vote and the False Promise of Shareholder Homogeneity, 30 CARDOZO L. REV. 445, 471 (2008).
41 See id., at 470.
42 Hayden & Bodie, supra note 40, at 470.
43 Id. at 471.
45 Corporation Code, § 6, B.P.Blg. 68 (Phil.).
47 Burkart & Lee, supra note 11, at 2 (citing Joel Seligman, Equal Protection in
In late twentieth century United States 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.\(^{48}\) In 1986, the NYSE discarded its \textit{One Share – One Vote Principle} because both the United States Stock Exchange and NASDAQ allowed the listing of corporations with multi-class equity structure.\(^{49}\) In the same period, European countries introduced legislation allowing deviations from the \textit{One Share – One Vote Principle}. Nevertheless, subsequent legislation again prohibited such deviations.\(^{50}\)

In 1988, the U.S. Securities and Exchange Commission introduced Rule 19(c)(4). This rule prohibited multiple classes of shares with disproportionate voting rights. This rule, however, was subsequently invalidated by the D.C. Circuit.\(^{51}\) Presently, stock exchanges no longer prohibit corporations to deviate from the \textit{One Share – One Vote Principle}.\(^{52}\)

In summary, the history of corporation law shows the prevalence of deviation from the \textit{One Share – One Vote Principle} in the following forms: (1) multi-class equity structure, (2) \textit{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 \textit{One Share – One Vote Principle} are, in fact, devices that circumvent corporate nationality rules and foreign equity limitations.

\section*{B. \textit{Old Devices for Unbundling Stockholder Rights}}

The following are traditional or “old” devices for sidestepping foreign equity limitations, now declared illegal, expressly or impliedly, by

\begin{quote}
\end{quote}


\(^{49}\) Burkart & Lee, supra note 11, at 2.


\(^{52}\) Hayden & Bodie, supra note 40, at 471 (citing NYSE, Inc., Listed Company Manual § 313(B) (2005)).
Gamboa v. Teves\textsuperscript{53} and subsequent cases on corporate nationality rules\textsuperscript{54}:

1. **Nominee shareholder agreement.** – A Filipino stockholder acts as a nominee shareholder, while the foreigner is the ultimate and unknown beneficiary of the shares.\textsuperscript{55} The relationship between the Filipino nominee shareholder and the foreign beneficial owner is of the nature of agency and trust.\textsuperscript{56} Under the agency relationship, the Filipino nominee shareholder acts within the authority provided by the foreign beneficial owner.\textsuperscript{57} Under the trust relationship, the Filipino nominee shareholder holds proceeds arising from the share's economic rights for the benefit of the foreign beneficial owner.\textsuperscript{58}

2. **Multi-class equity structures.** – Shares are classified into voting and non-voting shares. Filipino stockholders own majority of the total capital stock, while foreigners own majority of the voting shares. This was the device utilized by PLDT in *Gamboa v. Teves*.\textsuperscript{59}

Under a multi-class equity structure, it is also possible to create shares with inferior, differential or disproportionate voting rights, rather than shares with no voting rights, similar to the prudent mean rule advocated by Alexander Hamilton in early 19\textsuperscript{th} century United States.\textsuperscript{60}

\textsuperscript{53} G.R. No. 176579 (S.C., Oct. 9, 2012) (Phil.).


\textsuperscript{55} See, e.g., Regala v. Sandiganbayan, G.R. No. 105938 (S.C., Sept. 20, 1996) (Phil.).

\textsuperscript{56} See, e.g., Martinez v. CA, G.R. No. 131673 (S.C., Sept. 10, 2004) (Phil.) (“In Hongkong, the nominee shareholder of CLL was Baker & McKenzie Nominees, Ltd., a leading solicitor firm. However, beneficially, the company was equally owned by Messrs. Ramon Siy, Ricardo Lopa, Wilfrido C. Martinez, and Miguel J. Lacson.”).

\textsuperscript{57} See, e.g., Regala v. Sandiganbayan, G.R. No. 105938 (S.C., Sept. 20, 1996) (Phil.).

\textsuperscript{58} See, e.g., J.G. Summit v. CA, G.R. No. 124293 (S.C., Jan. 31, 2005) (Phil.) (“Thereafter, on February 27, 1987, a trust agreement was entered into between the National Government and the APT wherein the latter was named the trustee of the National Government’s share in PHILSECO.”).

\textsuperscript{59} G.R. No. 176579 (S.C., Oct. 9, 2012) (Phil.).

Non-voting shares pertain to shares that do not have the right to elect directors nor the right to vote in matters submitted by the board of directors. By mandate of law, however, these shares retain the right to vote in fundamental matters.  

3. *Stock pyramids.* – A foreign stockholder who has equity interest in a Filipino corporation also holds equity interest in a stockholder corporation that has equity interest over the Filipino corporation. This is also called “corporate layering.” This is the device involved in two Supreme Court decisions on foreign equity regulation following *Gamboa v. Teves.*

4. *Cross-ownership.* – Parent corporations have equity interest in subsidiaries or associates, which in turn have equity interest in their parent corporations. Both parent corporations and their subsidiaries and associates have foreign equity within the limits provided by law and regulation. The totality of foreign equity “across” these corporate entities allows the foreign stockholders to entrench their control over the entire group.


6. *Special voting trust.* – A Filipino stockholder retains all other rights of a stockholder, but transfers voting rights to a foreigner.

Note that existing regulatory measures have tried to address these devices, as follows:

<table>
<thead>
<tr>
<th>DEVICE</th>
<th>REGULATORY MEASURE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominee shareholder agreement</td>
<td>Anti-Dummy Law,</td>
</tr>
</tbody>
</table>

(2007).

61 Corporation Code, § 6 B.P.Blg. 68 (Phil.).


This paper identifies twenty other unbundling devices not yet addressed by these regulatory measures.

C. New Devices for Unbundling Stockholder Rights

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. It is important to distinguish the following concepts:

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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.\(^{67}\)

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. Nevertheless, 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.\(^{68}\)

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.\(^{69}\) 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.\(^{70}\)

A graphic illustration of economic interest without legal ownership is made in Section A of Part II, involving options, swaps, forwards, hybrid instruments, securitized participation rights, and variable interests.

On the other hand, unbundling control rights leads to *de facto* control without the 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 regulation of institutions regulation provide the most comprehensive legal application of the theory of *de facto* corporate control without majority voting rights.\(^{71}\) In international accounting, IFRS


\(^{68}\) Id.


\(^{71}\) See Advisory 2007-02 (“Control in Fact”) issued by the Office of the Superintendent of Financial Institutions Canada (www.osfi-bsif.gc.ca/Eng/ fi-if/app/rla-
10 provides the most comprehensive guidance on assessing *de facto* control for the purpose of consolidating financial statements.\(^2\)

It is important to distinguish control in law from control in fact, as follows:

1. Control in law pertains to the concept of corporate control provided by statute and regulation. Control in fact pertains to the actual or effective exercise of control, independent of statute and regulation.\(^3\)

2. Control in law usually expresses control as a quantitative concept—i.e. capable of being measured using objective factors, like percentage ownership of voting stock.\(^4\) This is a bright line rule and does not require an inquiry into the totality of facts and circumstances of each case.\(^5\) Control in fact, on the other hand, contemplates control as a qualitative concept. It is broad and not limited to objective factors. It requires an inquiry into all relevant facts and circumstances.\(^6\)

There can be a separation of control in law and control in fact if control in law fails to capture the full scope of control in fact.\(^7\) Another scenario is when control in law contemplates corporate control as a quantitative concept.\(^8\) A graphic illustration of control in fact is made in Section B of Part II.

II. 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.

\(^2\) Ball, R., *IFRS—10 years later*, 46 ACCT. AND BUS. RES. 5, 545-571 (2016).


\(^4\) *Id.*


\(^6\) Bernstein, *supra* note 73, at 1437.

\(^7\) *Id.* at 1428.

\(^8\) *Id.* at 1438.
A. 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.

1. 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.79 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.80 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).83

ILLUSTRATION: A Filipino corporation operates a TV broadcasting station. A Filipino stockholder owns all the stocks of the broadcasting corporation as of January 1, 2010. Assume the value of the stock on this date is ₱1 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.84 Instead, he lends ₱1 billion (i.e. equivalent to the value of the stock as of January 1, 2010) to the Filipino stockholder.85 Assume that the Filipino stockholder does not expect an interest payment on the loan.86 The

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79 Knoll, supra note 29, at 64.
81 In theory, this element can be any equity interest or any asset that provides variable returns, such as land.
82 This element can be any debt instrument that guarantees protection of the principal amount, with or without interest payment.
83 Knoll, supra note 29, at 65.
84 See Foreign Investment Negative List, Exec. Ord. No. 858 (Feb. 05, 2010) (Phil.) (prescribing foreign equity restrictions in various industries).
85 Knoll, supra note 29, at 66-67.
86 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 v. Republic, G.R.
foreign investor holds a call option over the stock to be exercised at a future date, January 1, 2015, and at the exercise price of ₱1 billion.\(^87\) 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. January 1, 2015), and at the same exercise price of ₱1 billion.\(^88\)

How does this transaction allow the foreign investor to replicate the economic characteristics of equity ownership? When future date January 1, 2015 arrives, two scenarios can happen: the value of the stock will either increase or decrease. If the stock is worth ₱1.1 billion (i.e. ₱100 million increase in value), the foreign investor will exercise the call option because it will allow him to purchase the stock at ₱1 billion, giving him a gain of ₱100 million. On the other hand, if the stock is worth ₱900 million (i.e. ₱100 million decrease in value), the Filipino stockholder will exercise the put option because it will allow him to sell the stock at ₱1 billion, protecting him from incurring a loss of ₱100 million.\(^89\)

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 ₱1 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.\(^90\)

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. The call and put options, however, can also be settled in cash through a netting arrangement. At future date January 1, 2015, if the value of the stock is ₱1.1 billion, and the foreign investor exercises the call option at the strike price of ₱1 billion, the Filipino stockholder will have the obligation to deliver the stock valued at ₱1.1 billion, and the foreign investor will have the obligation to pay at ₱1 billion. Under cash settlement, the Filipino stockholder will pay ₱100 million to the foreign investor because the foreign investor can apply the Filipino stockholder’s debt of ₱1 billion to the monetary value of the shares. On the other hand, if the value of the stock as of January 1, 2015 is ₱900 million, and the Filipino stockholder exercises the put option at the strike price of ₱1 billion, the

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\(^87\) Knoll, supra note 29, at 67-70.

\(^88\) Id. at 70-71.

\(^89\) Id. at 78-83.

\(^90\) David Yermack, Shareholder Voting and Corporate Governance, 2 ANNU. REV. FINAN. ECON. 2.1, 2.12 (2010).
foreign investor has the obligation to pay ₱1 billion, while the Filipino stockholder has the obligation to deliver the shares valued at ₱900 million. Under the same netting arrangement, the foreign investor will pay ₱100 million to the Filipino stockholder because the foreign investor can apply the Filipino stockholder’s debt of ₱1 billion to the monetary value of the shares.\(^91\)

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 bond.\(^92\)

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.

2. 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.\(^93\) 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, means that it is not dependent on the performance of the stock.\(^94\)

ILLUSTRATION: Company X is engaged in nationalized or partially nationalized economic activities, like mining. A Filipino stockholder owns shares in Company X worth ₱1 billion on January 1, 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

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\(^{92}\) Knoll, supra note 29, at 63 (formally stating the put-call parity theorem: “[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.”)


total voting shares.\textsuperscript{95} However, the foreigner holds a bond with a par value of $\text{P}2$ 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 on the bond to the Filipino stockholder, which is $\text{P}60$ million per year (3% of $\text{P}2$ billion).

On January 1, 2015, which is the expiration of the swap, the shares in Company X are worth $\text{P}1.4$ billion, so the Filipino stockholder remits $\text{P}400$ million (the difference of the current value of the shares at $\text{P}1.4$ billion and the original value of said shares at $\text{P}1$ billion) to the foreign bondholder. On the other hand, if the shares in Company X are worth $\text{P}900$ million on January 1, 2015, the foreign bondholder will remit $\text{P}100$ million (the difference of the original value of the shares at $\text{P}1$ billion and the current value of the shares at $\text{P}900$ million) to the Filipino stockholder.\textsuperscript{96}

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.\textsuperscript{97}

The swap also allows the foreign counterparty to benefit from the underlying stock “without expending high capital outlays.”\textsuperscript{98}

3. Synthetic Lease

Under a synthetic lease, a Filipino corporation borrows money from a third party lender to finance the purchase of land. The Filipino corporation thereafter leases out the land to a foreign corporation within a period allowed by law. The parties structure the rental payment in such a way as to merely cover the debt financing obtained over the land, without contemplating profit for the lessor. The lease agreement also includes a "residual value guarantee", which stipulates the following: (1) if the fair value of the land at the end of the lease is less than the original purchase price of the land (which is equivalent to the loan procured by the lessor), the foreign corporation assumes the debt obligation of the Filipino corporation to the third party lender, but only that portion of the loan which is not covered by the total rental payments, and (2) if the fair value of the

\begin{footnote}
\textsuperscript{95} See Exec. Ord. No. 858, \textit{supra} note 84.


\textsuperscript{98} Id.
\end{footnote}
land is greater than the original purchase price of the land, the Filipino corporation will apply the difference between the fair value and original purchase price to the rental obligation of the foreign corporation.99

The Filipino corporation does not bear any financial risk for taking out the loan, for the amount of rental payments, or for the fair value of the land at the end of the lease term. The foreign corporation bears all these risks and effectively absorbs economic benefits of landownership.100

4. 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.101 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.102

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.103

The forward contract appears to be an ordinary stock purchase agreement. However, the manner of settlement makes it special. 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.104

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


100 See N. R. Little, Unraveling the Synthetic Lease, 11 PROB. & PROP. 22 (1997).

101 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).


104 Nagel v. Adm Investor Servies, Inc., 217 F.3d 436 (7th Cir. 2000); Grain Land Coop. v. Kar Kim Farms, Inc., 199 F.3d 983 (8th Cir. 1999); The Andersons, Inc. v. Horton Farms, Inc., 166 F.3d 308 (6th Cir. 1998); Commodity Futures Trading v. Noble Metals Int., 67 F.3d 766 (9th Cir. 1995); In re Bybee, 945 F.2d 309 (9th Cir. 1991).
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 transaction.\textsuperscript{105}

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.\textsuperscript{106}

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.\textsuperscript{107}

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 representing the 20% of total capital stock is P5 billion. Assume also that the forward contract has a life of five

\textsuperscript{105} For examples of synthetic transactions involving forward contracts, see


years. The forward price is ₱5.2 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 ₱200 million (₱5 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 ₱7 billion, the foreign investor profits from the transaction by ₱1.8 billion (the difference of the fair value of ₱7 billion at the end of the 5-year contract and the forward price of ₱5.2 billion). On the other hand, if the fair value is ₱4.9 billion, the foreign investor suffers loss from the transaction by ₱300 million (the difference of the forward price of ₱5.2 billion and the fair value of ₱4.9 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 ₱200 million, which is the indicative gain on a government security.108

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 ₱1.8 billion. If the fair value decreases below the forward price, the foreign investor will pay the Filipino stockholder ₱300 million.

5. 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.”109 It is created through a subordination agreement, whereby the creditor usually waives his priority lien, if any.110 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.111 A subordinated debt is akin to equity holding, which means

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108 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).


that it has 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.\textsuperscript{112}

6. 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.\textsuperscript{113}

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. \textit{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.\textsuperscript{114}

2. \textit{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.\textsuperscript{115}

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\textsuperscript{112} Peterson v. CIR, 380 F.2d 1 (9th Cir. 1967); Gregg Co. of Delaware v. Com. of Int. Rev., 239 F.2d 498 (2d Cir. 1956).
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\textsuperscript{114} Gulf Resorts, Inc. v. Philippine Charter Insurance Corp., G.R. No. 156167 (S.C., May 16, 2005) (Phil.).
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\textsuperscript{115} Philippine Health Care Providers, Inc. v. CIR, G.R. No. 167330 (S.C. June 12, 2008) (Phil.).
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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.\(^{116}\)

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.\(^{117}\)

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.\(^{118}\)

7. **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

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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. \(^{119}\)

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 ₱1 billion. The foreign investor lends ₱1 billion to a Filipino issuer but only delivers ₱950 million. The ₱50 million difference represents the discount on the note. The Filipino issuer enters a call option over the shares of stock, with strike price at ₱1 billion, with the same maturity date as the zero coupon bond. At maturity date, assume that the shares of stock are worth ₱1.1 billion. The Filipino stockholder exercises the call option. He then pays back ₱1 billion under the zero coupon bond to the foreign investor, and also pays him ₱100 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 ₱900 million, the Filipino stockholder does not exercise the call option. He pays back ₱1 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.

8. Depositary Receipts

A Deposit Agreement is an agreement among three parties: a Filipino corporation whose shares are subject of deposit, a depository of the deposited shares, and foreign holders of depositary receipts. Depositary receipts evidence interests in the deposited shares. \(^{120}\) The Deposit Agreement allows the Filipino corporation to deposit shares, and the

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\(^{120}\) COMPAQ Computer Corp. Subs. v. Commissioner, 113 T.C. 214 (T.C. 1999).
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.\footnote{121}

Only the depositary has the power to exercise votes on the deposited shares.\footnote{122} This is because the depositary maintains legal title over the shares.\footnote{123} Hence, the depositary must be of Philippine nationality.

9. 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.\footnote{124} “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.”\footnote{125} 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.\footnote{126}

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.

10. 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.\footnote{127}

\begin{itemize}
  \item \footnote{121} Pinker v. Roche Holdings Ltd., 292 F.3d 361 (3d Cir. 2002).
  \item \footnote{123} John Hanna, \textit{Trust Receipts}, 29 COL. L. REV. 545 (1929).
  \item \footnote{124} \textit{In re} Life Ins., 76 P.3d 366 (Alaska 2003).
  \item \footnote{125} Buffo v. Graddick, 742 F.2d 592 (11th Cir. 1984).
  \item \footnote{126} \textit{Id}.
\end{itemize}
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.\footnote{Robert A. Jarrow & George S. Oldfield, \textit{Forward Contracts and Futures Contracts}, 9 J. FIN. ECON. 373 (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.\footnote{Saunders, supra note 122.}

B. \textit{Power Without Majority of Voting Rights}

The following are devices that create or indicate \textit{de facto} control in a corporation, without the 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.


Where a simple majority would ordinarily suffice, super-majority voting requirements impose a higher-than-majority threshold to pass shareholder resolutions.\footnote{Frank H. Easterbrook & Daniel R. Fischel, \textit{Voting in Corporate Law}, 26 J. L. & ECON. 395 (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.\footnote{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}
2. **Veto Rights**

A shareholders agreement can create express or implied veto rights in favor of one or more stockholders.\textsuperscript{132} Veto rights are express when the agreement states that the approval or consent of the foreign stockholder is necessary to pass a resolution.\textsuperscript{133} 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.\textsuperscript{134} 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

- **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.

- **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.

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

- **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.


\textsuperscript{133} O’Neal, F. Hodge, *Arrangements which Protect Minority Shareholders against Squeeze-Outs*, 45 MINN. L. REV. 537 (1960).

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.

3. 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 the amount of foreign loan is relative to the equity held by Filipino stockholders, the greater the credit risk assumed by the foreign creditor is, and the greater the credit risk is, the greater the restrictiveness imposed by the foreign creditor is in the loan covenants.\(^{135}\)

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.\(^{136}\)

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.\(^{137}\)


\(^{136}\) Id.

\(^{137}\) Id.
4. 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.138

5. 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.139 Exercising the call option means that the foreign minority stockholder will elect to purchase the shares.140 The exercise date of the call option indicates the period within which the option can be exercised.141 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.142 The underlying shares refer to the shares subject to purchase if the foreign minority stockholder exercises the call option.143

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.144 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.145

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.

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139 Allaire Corp. v. Okumus, 433 F.3d 248 (2d Cir. 2006).
140 Glass v. Commissioner of Internal Revenue, 87 T.C. 1087 (T.C. 1986).
142 Dewees v. C.I.R, 870 F.2d 21 (1st Cir. 1989).
143 Board of Trade of City of Chicago v. SEC, 883 F.2d 525 (7th Cir. 1989).
145 See, e.g., *In re* Digital Island Securities Litigation, 357 F.3d 322 (3d Cir. 2004).
or sells it to a third party. The foreign minority stockholder can legally exercise the call option, even if it will breach foreign equity limitations. The consequence of exercising the call option is the disqualification of the Filipino corporation from engaging in partially nationalized activities, or from holding land. In this way, foreign holders of call options over majority of the shares in a Filipino corporation have the potential to destroy stockholder value.

6. 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. The purpose is to preserve the strategic alliance between the foreign and Filipino investors as co-stockholders.

7. 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. 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

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146 For an example of selling call options to a third party, see U.S. v. Nacchio, 573 F.3d 1062 (10th Cir. 2009).

147 J.G. Summit Holdings, Inc. v. CA, G.R. No. 124293 (S.C. January 31, 2005) (Phil.).

148 Id.


150 Gray v. Bicknell, 86 F.3d 1472 (8th Cir. 1996).

151 See, e.g., J.G. Summit Holdings, Inc. v. CA, G.R. No. 124293 (S.C. January 31, 2005) (Phil.).


perform.\textsuperscript{154}

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.\textsuperscript{155}

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.\textsuperscript{156}

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.\textsuperscript{157}

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 \textit{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.

8. Voting Caps

Voting caps are maximum limitations on voting rights held, regardless of the number of voting shares owned.\textsuperscript{158} 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.\textsuperscript{159}

\begin{itemize}[<1.5ex]
\item \textsuperscript{154} \textit{In re St. Street Bank Trust Co. Fixed Inc.}, 772 F. Supp. 2d 519 (S.D.N.Y. 2011).
\item \textsuperscript{155} George v. Kraft Foods Global, Inc., 641 F.3d 786 (7th Cir. 2011).
\item \textsuperscript{156} \textit{See In re State St. Bank & Trust Co. Fixed Income Funds Inv. Litig.}, 842 F. Supp. 2d 614, (S.D.N.Y. 2012).
\item \textsuperscript{157} \textit{See Weiss v. Morgan Stanley}, 345 Fed.Appx. 713, (2d Cir. 2009).
\item \textsuperscript{159} Claessens, Stijn, Simeon Djankov, and Larry HP Lang, \textit{The Separation of Ownership and Control in East Asian Corporations}, 58 J. FIN. ECON. 81 (2000).
\end{itemize}
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.\footnote{160}{Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J. FIN. ECON.325 (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 represents 100 votes, the second tranche of 100 shares represents 50 votes, and the third tranche of 100 shares represents ten votes.\footnote{161}{See Rosen v. Brookhaven Capital Management Co., Ltd., 113 F. Supp. 2d 615 (S.D.N.Y. 2000).}

A voting cap may apply to a class of shareholders but not to others.\footnote{162}{OECD Steering Group on Corporate Governance, *Lack of Proportionality Between Ownership and Control: Overview and Issues for Discussion* (2007). Available at: www.oecd.org/daf/ca/corporategovernanceprinciples/40038351.pdf.} 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.\footnote{163}{See Appendix for a detailed illustration.}

9. 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).\footnote{164}{See In Re 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.\footnote{165}{In re 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.”\footnote{166}{In re 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.\footnote{167}{In Re Morton's Rest. Grp., Inc., 74 A.3d 656, 665 (Del. Ch. 2013); In re PNB
50% of the corporation’s outstanding stock, ‘a plaintiff must allege domination by a minority shareholder through actual control of corporate conduct.”

In one United States 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].’

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.”

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.” 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. For the purposes of UK broadcasting legislation, regulators consider the “size of the economic interest of each of


169 In Re Morton's Rest. Grp., Inc., 74 A.3d at 665-66 (citing In re Cysive, Inc. S'holders Litig., 836 A.2d 531, 551–52 (Del.Ch.2003)).


the shareholders in the profits of the company” as an indicator of de facto control by the blockholder.\footnote{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”).}

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 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.\footnote{PwC, \textit{Consolidated financial statements: redefining control}, PRACTICAL GUIDE TO IFRS (2011).}

10. Redeemable Preferred Shares

Redeemable preferred shares give the preferred shareholder the right to sell the shares back to the corporation.\footnote{Republic Planters Bank v. Agana, G.R. No. 51765, (S.C., Mar. 3, 1997) (Phil.), \url{http://sc.judiciary.gov.ph/jurisprudence/1997/mar1997/51765.htm}.} 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 price.\footnote{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."}

“A redemption by the corporation of its stock is, in a sense, a repurchase of it for cancellation.”\footnote{Republic Planters Bank, G.R. No. 51765.} The redemption feature is equivalent to a put option held by the preferred shareholder.\footnote{Richard M. Wise, \textit{Closely Held Preferred Stock: A Review of the Common Value-Drivers}, 22 BUSINESS VALUATION REV. 149 (2003).} This gives these shares the characteristic of being a hybrid between equity and debt, susceptible to varying treatments, as follows:

[R]edeemable 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 . . .\textsuperscript{179}

As a general rule, the corporation cannot purchase its own shares except out of current retained earnings.\textsuperscript{180} An exception to this rule is Section 8 of Batasang Pambansa (B.P.) Blg. 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 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.\textsuperscript{181}

In Canada, regulators consider the presence of significant amounts of redeemable preferred shares in determining \textit{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 \textit{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 \textit{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.\textsuperscript{182}

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.\textsuperscript{183} In this sense, mere existence of substantial foreign

\textsuperscript{179} Pearson v. Component Technology Corp., 247 F.3d 471, 494-95 (3d Cir. 2001).

\textsuperscript{180} Republic Planters Bank, G.R. No. 51765.

\textsuperscript{181} \textit{Id.} (citing Philippine Trust Co. v. Rivera, 44 Phil 469 [1923]); Garcia v. Lim Chu Sing, 59 Phil. 562 [1934]; Boman Environmental Dev’l Corp. v. Court of Appeals, 167 S.C.R.A. 540 [1988]; Hector De Leon, \textsc{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. 12793, 311 S.C.R.A. 508 (July 28, 1999) (“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.”).

\textsuperscript{182} Corporations: Association and Control (Consolidated), \textsc{Interpretation Bulletin} IT-64R4 dated October 13, 2004.

\textsuperscript{183} Republic Planters Bank, G.R. No. 51765 (citing Hector De Leon, \textsc{The...}}
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 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.

III. CRITIQUE OF EXISTING REGULATION

A. Existing Regulatory Regime

The following summarizes the existing regulatory regime that enforces foreign equity restrictions:

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184 National Telecommunications Commission v. Court of Appeals, G.R. No. 127937, 311 S.C.R.A. 508 (July 28, 1999) (“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.”).
B. Limitation of Beneficial Ownership Doctrine

The concept of beneficial ownership in the Philippines is used in several contexts, as follows:

a. Foreign Equity Regulation. – Gamboa v. Teves requires that “Full beneficial ownership of the stocks, coupled with appropriate voting rights, is essential,” for the purpose of determining corporate nationality.185

b. Anti-Dummy Law. – DOJ Opinion No. 165 s. 1984 provides the following indicators of a dummy status, in connection with joint ventures and exploitation of natural resources: (1) That the foreign investors provide practically all the funds for the joint investment undertaken by these Filipino businessmen and their foreign partner; (2) That the foreign investors undertake to provide practically all the technological support for the joint venture; (3) That the foreign investors, while being minority stockholders, manage the company and prepare all economic viability studies.186

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186 DOJ Opinion No. 165 s. 1984.
In *In Re Linear Works Realty*, the SEC stated: "However, we are aware that some unscrupulous individuals employ schemes to circumvent the constitutional and statutory restrictions on foreign equity. In the present case, the fact that the shares of the Japanese nationals have a greater par value but only have similar rights to those held by Philippine citizens having much lower par value, is highly suspicious. This is because a reasonable investor would expect to have greater control and economic rights than other investors who invested less capital than him. Thus, it is reasonable to suspect that there may be secret arrangements between the corporation and the stockholders wherein the Japanese nationals who subscribed to the shares with greater par value actually have greater control and economic rights contrary to the equality of shares based on the articles of incorporation.”187

c. *Stock Transfer Cases.* – In cases involving stock transfer, a stockholder who has legal title is the person who is registered in the books of the corporation as a stockholder. If the legal titleholder sells or transfers the shares to buyer or transferee, the latter is deemed to possess mere equitable title. Equitable title entitles the buyer or transferee to demand that the shares be registered in his name in the books of the corporation. Until such shares are so transferred, the corporation does not formally recognize the equitable titleholder as the stockholder.188

*Lee v. CA* (1992), in particular, provides that the “execution of a voting trust agreement [...] may create a dichotomy between the equitable or beneficial ownership of the corporate shares of a stockholders, on the one hand, and the legal title thereto on the other hand”.189

*Thomson v. CA* (1998) provides that equitable title by the beneficial owner over shares of stock arises from “trust”, not from “debt”.190


189 Id.

d. Securities Regulation. – Section 23.1 of the Securities Regulation Code (SRC) requires the beneficial owner of more than 10% of any class of shares in a corporation covered by the SRC to file a statement in the SEC. Section 1 of SRC Rule 3 defines a “beneficial owner” as follows:

i. any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise has or shares: voting power, which includes the power to vote, or to direct the voting of, such security; and/or investment returns or power, which includes the power to dispose of, or to direct, the disposition of such security;

ii. a person shall be deemed to have an indirect beneficial ownership interest in any security which is: (i) held by members of his immediate family sharing the same household; (ii) held by a partnership in which he is a general partner; (iii) held by a corporation of which he is a controlling shareholder; or (iv) subject to any contract, arrangement or understanding which gives him voting power or investment power with respect to such securities[.]

iii. A person shall be deemed to be the beneficial owner of a security if that person has the right to acquire beneficial ownership within thirty (30) days, including, but not limited to, any right to acquire; through the exercise of any option, warrant or right; through the conversion of any security; pursuant to the power to revoke a trust, discretionary account or similar arrangement; or pursuant to automatic termination of a trust, discretionary account or similar arrangement.

SEC v. Interport (2008)\(^{191}\) adopts the following definition of a “beneficial owner” in applying Section 36(a) of the Revised Securities Act:

[F]irst, to indicate the interest of a beneficiary in trust property (also called "equitable ownership");

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and second, to refer to the power of a corporate shareholder to buy or sell the shares, though the shareholder is not registered in the corporation's books as the owner. Usually, beneficial ownership is distinguished from naked ownership, which is the enjoyment of all the benefits and privileges of ownership, as against possession of the bare title to property.

*People v. Tan* (2010)\(^{192}\) used the concept of “beneficial owner” the way it is understood in stock transfer cases, i.e. the possession of equitable title to shares.

e. *Ill-gotten Wealth Cases.* – In cases involving ill-gotten wealth of public officers, the concept of beneficial owner is similar to that in ordinary stock transfer cases, i.e. the beneficial owner is one who has equitable title to the shares, or the right to have the shares registered in his name in the books of the corporation.\(^{193}\)

f. *Law on Natural Resources.* – In the area of mining and other cases involving natural resources, the concept of beneficial owner involves the actual power to exploit, develop and utilize natural resources.\(^{194}\)

g. *Property Law.* – A person is said to be the beneficial owner of a property if it has the right to possess and exploit the property. This is in contrast to the concept of an owner with mere naked title.\(^{195}\)

What can be learned from these beneficial ownership rules in connection with unbundled shares? It is submitted that swaps, options, forwards, hybrid instruments, securitized participation rights, and variable interests (collectively, "devices that unbundle economic rights") do not vest beneficial ownership to a foreign investor, for the following reasons:


a. These devices do not vest voting rights to the foreign investor, and do not divest the owner of the underlying shares of any voting rights.

b. These devices do not vest right to the foreign investor to dispose of or to direct the disposition of the underlying shares.

c. These devices do not create an agency relationship between the foreigner and the Filipino stockholder. The latter is not bound by the instructions of the foreigner in exercising stockholder rights.

d. These devices do not create a fiduciary or trust relationship between the foreigner and the Filipino stockholder. The latter is not bound to transfer dividends and proceeds on the disposition of the shares to the foreigner.

   What the Filipino stockholder does, under these devices, is to contract away his economic exposure to the risks and rewards of stock ownership. This means that the economic rights (such as dividends) must have first accrued to his own benefit, after which he is free to make use of such economic rights under the freedom to contract.

e. These devices do not vest equitable title to the foreigner. The foreigner gains no right to demand that the underlying shares should be transferred in his name in the books of the corporation.

f. These devices do not vest any right to the foreigner over the assets of the corporation represented by the underlying shares of stock.

The only regulation that comes close to labeling these devices as “beneficial ownership” rights is Section 1 of SRC Rule 3, which states:

A person shall be deemed to be the beneficial owner of a security if that person has the right to acquire beneficial ownership within thirty (30) days, including, but not limited to, any right to acquire; through the exercise of any option, warrant or right; through the conversion of any security; pursuant to the power to revoke a trust, discretionary account or similar arrangement; or pursuant to automatic termination of a trust, discretionary account or similar arrangement.

Note, however, that Section 1 of SRC Rule 3 is limited to securities

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196 Section 1 of Rule 3, Securities Regulation Code.
covered by the SRC. Secondly, it is limited to the "right to acquire". Recall that *J.G. Summit v. CA* allows a foreign stockholder to execute an options contract over shares, even if exercising the options contract will breach foreign equity limitations. Since *J.G. Summit v. CA* is a Supreme Court decision, and Section 1 of SRC Rule 3 is an administrative issuance, the former is more authoritative than the latter.

### C. Limitation of Control Test

As a qualitative concept, control in fact includes the following:

1. **Control as power to choose directors.** – According to Berle and Means, corporate control is the power to choose majority of the members of the board of directors. Unlike the *Gamboa* Control concept, however, this power of choice is not only exercised through formal voting rights, but through whatever means possible.

2. **Control as power over senior management.** – According to Jensen, control is the power to employ, dismiss and determine the remuneration of senior management. According to Onu, Akinlabi and Fakunmoju, corporate control refers to the power to direct the activities of senior management, for the purpose of achieving the firm’s objectives.

3. **Control as policy-making power.** – According to Ruilong and Ye’an, control is broadly defined as the power to make strategic decisions about the corporation. This is also in line with the definition adopted by China’s Guidance on Enterprise Accounting Standards – Disclosure of Related Party Relationships and Transactions, which provides that control is the “entitlement to determine an enterprise’s financial and operational policies and to be able to obtain benefit based on the enterprise’s operational activities.”

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200 *Id.*
4. *Control as power over resources.* – According to Zhaoliang, control is the power to allocate, manage and use resources of the corporation.\textsuperscript{201}

5. *Control as power over operations.* – According to the U.S. Federal Securities Act, control is "the power to exercise a controlling influence over a company’s operational management or general and specific policies or the activity of a natural person directly or indirectly whether by voting, through one or more intermediaries, a contract or other means".\textsuperscript{202}

6. *Control as power over financing.* – According to International Accounting Standards (IAS) 27 on Consolidated and Separate Financial Statements, control includes the power to govern financial policies (along with operating policies) to obtain benefits from the corporation's activities.\textsuperscript{203}

7. *Control as de facto influence.* – The French Commercial Code considers a person in control over a company if the person has *de facto* power to determine the company's decision-making process.\textsuperscript{204}

On the other hand, control in law, when expressed as a quantitative concept, includes the following:

1. *Control defined through a numerical threshold of voting rights.*
   – Under the Regulations of Hong Kong Regarding Acquisitions and Mergers, control means “ownership or joint ownership of 30% or more of the voting rights in a company, whether or not the amount owned constitutes (is equivalent to) the actual voting rights.”\textsuperscript{205}

2. *Control defined through an enumeration of objective factors.* – According to China's Method of Managing Acquisitions of

\textsuperscript{201} Id.

\textsuperscript{202} Id.

\textsuperscript{203} BDO International, *supra* note 171.

\textsuperscript{204} R. Porta, F. Lopez-de-Silanes & A. Shleifer, 1999, *Corporate ownership around the world*, 54 J. Fin. 471 (1999).

Listed Companies, control is present when any of the following exists: “(1) ownership of the majority of shares in the register of shareholders of a listed company unless there is evidence to the contrary; (2) the ability to exercise voting rights to control a listed company exceeding the maximum number of shares owned by shareholders on its register; (3) the ratio of possession and control of a listed company’s shares or voting rights reaches 30% or more unless there is evidence to the contrary; (4) half or more of the appointments of members of the board of directors of a listed company can be decided through the exercising of voting rights; (5) other situations identified by the China Securities Regulatory Commission.”

3. *Presumption of control expressed as numerical threshold of voting rights.* – According to IAS 27.13, there is a presumption of control when the "parent owns, directly or indirectly through subsidiaries, more than 50% of the voting power of an entity". Note that this presumption can be overcome by proving that control in fact exists, through its qualitative aspect.

4. *Control defined as threshold of stock ownership.* – Under the French Commercial Code, control over a company exists if a person “directly or indirectly holds a fraction of capital conferring on it a majority of the voting rights in that company”.

5. *Control defined as a relative holding of voting rights.* – The French Commercial Code considers a person to have control over a corporation if it holds more than 40% voting rights, and "no other single shareholder holds a bigger interest."

6. *Control as potential to acquire voting control.* – IAS 27 considers a stockholder to have control even if it only has potential voting rights. However, the amount of potential voting rights must meet the following quantitative test: "1. Where an entity currently owns 50% or less of the voting power of another entity but has the current ability to acquire additional voting rights and increase its holding above 50%; and 2. Where another

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206 Id.
207 BDO International, supra note 171.
208 Porta, Lopez-de-Silanes & Shleifer, supra note 204.
209 Id.
party has the current ability to reduce an entity’s percentage of voting rights to less than 50%.”\(^{210}\)

In order to prevent the separation of control in law and control in fact, control in law must have an omnibus test of control – i.e. a test that covers both qualitative and quantitative concepts of control. The following are examples of omnibus tests of control:

1. **Control in any manner.** – Under Canadian tax law, an entity is not considered a Canadian Controlled Private Corporation (CCPC) if it is "controlled, directly or indirectly, in any manner whatever" by a non-resident stockholder. This broad standard requires courts to examine the factual circumstances of each case to determine the existence of control.\(^{211}\)

2. **Control defined by indicia of influence.** – Under Canadian financial institutions regulation, courts and regulators may examine any indicia of actual control exercised by a stockholder over a financial institution. These indicia include any relevant fact or combination of facts.\(^{212}\)

3. **Control defined by broad standards.** – Under IAS 27.13, there is control when any of the following exists: "a) power over more than half of the voting rights by virtue of an agreement with other investors; b) power to govern the financial and operating policies of the entity under a statute or agreement; c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body."\(^{213}\) Under IFRS 10, there are three requisites to establish the existence of corporate control: 

\[ 210 \text{ BDO International, } \textit{supra} \text{ note 171.} \]
\[ 211 \text{ Advisory 2007-02 (“Control in Fact”) issued by the Office of the Superintendent of Financial Institutions Canada.} \]
\[ 212 \text{ Corporations: Association and Control (Consolidated), Interpretation Bulletin IT-64R4 dated October 13, 2004.} \]
\[ 213 \text{ BDO International, } \textit{supra} \text{ note 171.} \]
\[ 214 \text{ PwC,} \textit{Consolidated financial statements: redefining control, Practical Guide} \]
D. **Limitation of Anti-Dummy Law**

There is temptation to characterize a put-call parity transaction (*see Section A of Part II*), or any derivative transaction, as a shareholder nominee arrangement, in violation of the Anti-Dummy Law. This is because a put-call parity transaction effectively transfers the economic rights of stock ownership from the Filipino stockholder to a foreign investor, while the Filipino stockholder retains legal title over the shares. Hence, if put-call parity transactions are, in essence, nominee arrangements, and nominee arrangements are a prohibited “dummy” relationship, it follows that put-call parity transactions are also prohibited.

This position is legally untenable, for the following reasons:

1. **A put-call parity transaction is not a contract of agency.** – A nominee arrangement is an agency contract, whereby the Filipino stockholder is an agent of the foreign investor, who is the principal. *On the other hand*, a put-call parity transaction is merely the concurrence of three contracts: a loan agreement, a call option, and a put option. The Filipino stockholder is a debtor in the loan agreement, while the foreign counterparty is a creditor. The Filipino stockholder is the holder of the put option, while the foreign counterparty is the holder of the call option.

2. **A put-call parity transaction does not uphold anonymity of party identity.** – The purpose of a nominee arrangement is anonymity of party identity (specifically the identity of the foreign beneficial owner), while a put-call parity transaction does not give relevance to anonymity of party identity in the design of the loan agreement, call option and put option.

3. **A put-call parity transaction does not create a fiduciary obligation in the receipt of dividends.** – If the nominee shareholder receives dividends on the stock, he holds the dividends in trust for the foreign beneficial owner. He is thereby obligated to assign and transfer the dividends to the foreign beneficial owner. *On the other hand*, if the Filipino stockholder in a put-call parity transaction receives dividends, he has no obligation to assign or transfer the dividends he has received to the foreign counterparty. The dividends accrue for his benefit, and there is nothing in the provisions of the loan agreement, call option and put option that obligate him to assign and transfer dividends.

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to IFRS (2011).
4. A put-call parity transaction does not create a fiduciary obligation in the purchase and sale of shares. – Under the nominee arrangement, the foreign beneficial owner funds the purchase of shares to be held by the Filipino nominee shareholder. Upon receipt, the Filipino nominee shareholder holds the funds in trust, and he is obligated to use such funds for the purchase of stock. If the foreign beneficial owner instructs the Filipino nominee shareholder to sell the shares, the latter holds the proceeds in trust, and he is obligated to assign and transfer the proceeds of the sale to the foreign beneficial owner.

On the other hand, under a put-call parity transaction, the foreign beneficial owner funds the purchase of shares to be held by the Filipino counterparty, not by way of trust but by way of a loan. The Filipino counterparty is still obligated to repay the loan, so that if the foreign counterparty decides to exercise the call option, the parties settle the option by way of legal compensation—i.e., the amount of the strike price which the foreign counterparty is obliged to deliver to the Filipino counterparty is reduced by the amount of the loan. The same process of legal compensation still operates if the Filipino counterparty decides to exercise the put option. In both instances, either of the counterparty is obligated to deliver the margin or difference between the strike price and the loan. Such delivery is not equivalent to an assignment or transfer of funds held in trust.

5. The put-call parity transaction does not contemplate a separation of legal and beneficial title. – Under the nominee arrangement, the foreign beneficial owner holds beneficial title, while under the put-call parity transaction, the foreign counterparty does not hold title of any kind whatsoever, unless the doctrine of beneficial ownership is expanded to include hedging transactions by way of financial derivatives. No such doctrine is in effect at present in the Philippines.

6. The put-call parity transaction has nothing to do with the exercise of control. – The Filipino nominee shareholder exercises voting rights in accordance with the instructions of the foreign beneficial owner, while the Filipino counterparty in the put-call parity transaction retains his discretion in exercising voting rights. In fact, a put-call parity transaction has nothing to do with the transfer of voting control. It may, however, divest the Filipino counterparty of any economic motive to exercise his control rights, for the reason that he has transferred his exposure in the variability in the fair value of the shares to the foreign counterparty.
7. The put-call parity transaction does not contemplate a periodic transfer of economic rights. Under the nominee arrangement, the transfer of economic rights from the Filipino nominee shareholder to the foreign beneficial owner is periodic—i.e. the Filipino nominee shareholder assigns and transfers dividends or other cash flow benefits as they accrue or are received. On the other hand, under a put-call parity transaction, the transfer of economic rights happens only at the expiration of the put and call options, at which point the counterparties may exercise their rights under the options.

The solution in regulating a put-call parity transaction is not to characterize it as a nominee arrangement. The remedy is to expand the “beneficial ownership” doctrine, as applied in financial derivatives and hedging transactions.

E. Limitation of Debt-Equity Distinction

Corporate nationality clauses and foreign ownership restrictions pertain to limitations on the holding of equity or capital in a corporation. Hence, a foreign investor may hold as much claim against the same corporation through loans, bonds and other kinds of indebtedness without breaching corporate nationality rules. The traditional distinction of debt and equity is as follows:

1. **Existence of maturity.** – Debt has maturity, while equity does not mature. The stockholder can transfer his equity interest to another party.

2. **Possibility of default.** – Under debt, a debtor can default if payments are not made on time. Under equity, the corporation generally has no obligation to declare dividends, except in special cases provided by law, and the stockholder generally has no right to demand a dividend declaration.

3. **Periodicity of income.** – Under debt, the creditor is entitled to periodic payment of interest. Under equity, the issuance of dividends is discretionary on the part of the board of directors, unless mandated otherwise by law.

4. **Pre-determination of yield.** – Under debt, the return on investment is pre-determined through a stipulated or legal rate of interest. Under equity, the return on investment is not pre-determined. Stockholders have no contractual or legal guarantee to receive a minimum rate of return.
5. **Security of principal.** – Under debt, the debtor guarantees the repayment of the principal. Under equity, the corporation does not guarantee that the fair value of the shares will increase beyond the original purchase price and beyond the par value of the stock. There is also the possibility that the fair value will decrease below the original purchase price and below the par value.

6. **Control rights.** – Under debt, the creditor does not make corporate decisions. Under equity, stockholders have voting rights, which are exercised to pass shareholder resolutions.

7. **Subordinated interest.** – The interest of equity-holders is subordinated to the claims of creditors.

Financial innovation has eroded these traditional distinctions, as in the following examples: (1) a perpetual bond, which is a debt instrument, does not have a stated maturity; (2) a preferred share, which is equity, contemplates a periodic payment of dividends at pre-determined rates; (3) a surplus note, which is a debt instrument, does not provide security of principal because the final payment is subject to the existence of surplus profits in the corporation; (4) a loan agreement, which creates a debt, may contain covenants that give the lender control rights over the corporation, even before bankruptcy; and, (5) subordinated bonds, which are debt instruments, are subordinated to the claims of other creditors.

The problem, therefore, is that the separation of debt and equity is not always clear-cut. The judicial solution to this problem is to introduce a re-characterization doctrine, which treats debt as equity, or equity as debt, for equitable purposes.215

F. **Proposal for Expanded Regulatory Regime**

The existing regulatory regime described in Section A of Part III is insufficient to address the role of unbundled shares in sidestepping corporate nationality rules. Philippine courts and regulators must adopt the following regulatory measures, in addition to the ones already existing:

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215 The following factors are included in recharacterizing debt as equity, vice versa, in the U.S.: "(1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments." See Roth Steel Tube Co. v. CIR, 800 F.2d 625 (6th Cir. 1986).
(1) Expanded Beneficial Ownership Doctrine. – The concept of beneficial ownership of shares must include economic interest without legal ownership arising from derivative transactions, hybrid securities, other securitized participation rights, variable interests, and other complex contractual arrangements. Once courts limit the definition of beneficial ownership to having legal and equitable title over shares, they have also effectively excluded economic interest without legal ownership from the definition.

(2) Totality-of-Circumstances Test of Corporate Control. – The concept of corporate control must not be limited to the possession of majority voting rights, but must be expanded to include any and all facts and circumstances showing the practical ability to influence corporate policy.

(3) Re-characterization Doctrine. – For the purpose of determining corporate nationality, unbundled shares must be considered in the computation of percentage ownership of foreign stockholders. Hence, economic interest without legal ownership of shares and de facto control without majority voting rights must both be counted as part of foreign equity.

These new rules may be integrated in the current regulatory regime, as follows:
Step 1: Identify the foreign equity cap.

Step 2: Determine the percentage share of foreign stockholders in the legal ownership of outstanding total capital stock.

Step 3: Determine the percentage share of foreign stockholders in the legal ownership of outstanding voting stock.

Step 4: Identify facts and circumstances that cast doubt on the percentage ownership of total capital stock and of voting stock by foreign stockholders.

Step 5(a): Determine the corporate nationality of the stockholder corporations.

Step 5(b)(1): Determine whether economic interest is decoupled from legal ownership.

Step 5(b)(2): Determine percentage share equivalent of decoupled economic interest.

Step 5(c): Determine whether foreign stockholders have control in fact.

Step 6: Re-characterize as legal ownership by foreign stockholders.

Gamboa Two-Tier Analysis
Gamboa Control Test
Totality of Circumstances Test

Analysis of Separation of Economic Interest and Legal Ownership
Analysis of Separation of Control in Law and Control in Fact

Unbundled Shares Analysis
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>One Share - One Vote Principle</th>
<th>Proportionality Principle</th>
<th>Prudent-Mean Scale</th>
<th>Amount of Deviation from the One Share - One Vote Principle</th>
<th>Ratio of Deviation from the One Share - One Vote Principle</th>
<th>Amount of Deviation from the Proportionality Principle</th>
<th>Ratio of Deviation from the Proportionality Principle</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>5</td>
<td>1</td>
<td>1</td>
<td>A - C</td>
<td>(A – C) divided by A</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>10</td>
<td>10</td>
<td>2</td>
<td>2</td>
<td>8</td>
<td>80%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>15</td>
<td>15</td>
<td>3</td>
<td>3</td>
<td>12</td>
<td>80%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>20</td>
<td>20</td>
<td>4</td>
<td>4</td>
<td>16</td>
<td>80%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>30</td>
<td>30</td>
<td>6</td>
<td>5</td>
<td>25</td>
<td>83%</td>
<td>1</td>
<td>3%</td>
</tr>
<tr>
<td>40</td>
<td>40</td>
<td>8</td>
<td>6</td>
<td>34</td>
<td>85%</td>
<td>2</td>
<td>5%</td>
</tr>
<tr>
<td>60</td>
<td>60</td>
<td>12</td>
<td>7</td>
<td>53</td>
<td>88%</td>
<td>5</td>
<td>8%</td>
</tr>
<tr>
<td>80</td>
<td>80</td>
<td>16</td>
<td>8</td>
<td>72</td>
<td>90%</td>
<td>8</td>
<td>10%</td>
</tr>
<tr>
<td>100</td>
<td>100</td>
<td>20</td>
<td>10</td>
<td>90</td>
<td>90%</td>
<td>10</td>
<td>10%</td>
</tr>
<tr>
<td>140</td>
<td>140</td>
<td>28</td>
<td>11</td>
<td>129</td>
<td>92%</td>
<td>17</td>
<td>12%</td>
</tr>
<tr>
<td>180</td>
<td>180</td>
<td>36</td>
<td>12</td>
<td>168</td>
<td>93%</td>
<td>24</td>
<td>13%</td>
</tr>
<tr>
<td>200</td>
<td>200</td>
<td>40</td>
<td>15</td>
<td>185</td>
<td>93%</td>
<td>25</td>
<td>13%</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></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreigner</td>
<td>100 (33%)</td>
<td>100 (33%)</td>
<td>20 (33%)</td>
<td>10 (40%)</td>
</tr>
<tr>
<td>Filipino</td>
<td>200 (67%)</td>
<td>200 (67%)</td>
<td>40 (67%)</td>
<td>15 (60%)</td>
</tr>
<tr>
<td>Total</td>
<td>300 (100%)</td>
<td>300 (100%)</td>
<td>60 (100%)</td>
<td>25 (100%)</td>
</tr>
</tbody>
</table>
Note in this table that ownership of voting stock is different from actual voting rights held. This is a consequence of implementing a voting cap system, in the form of a tranche system, similar to the hypothetical corporation in the example.

The Filipino stockholder has a majority stockholder status by virtue of his ownership of 67% voting shares. In observing the One Share – One Vote Principle, ownership of 67% of voting shares exactly equate to 67% voting rights. In observing the Proportionality Principle, ownership of 200 voting shares will not equal to 200 votes during a stockholder meeting, but his voting power is exactly equal to 67%, which is the same voting power held under the One Share – One Vote Principle.

Under the Prudent-Mean Scale, however, the voting power of the Filipino stockholder is diluted from 67% to 60%, while the voting power of the foreign stockholder increased from 33% to 40%. The 7% difference represents the transfer of voting power from the majority to the minority stockholder, by virtue of employing the tranche system coupled with the Prudent-Mean Scale.