The TRUST FUND DOCTRINE
Under Philippine Corporate Setting

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Corporate borrowings, aside from direct equity investments, often constitute the largest source of financing for large undertakings in modern settings. It is a business truism that opportunity should be taken of making profits out of the money of others. The important function of debt financing in the commercial world has spawn devices to encourage creditors to lend to corporate debtors with an assurance of adequate protection against rapacious directors and officers, who may or may not connive with stockholders.

The "trust fund doctrine" is a more-than-a-century-old corporate theory developed in the United States which seeks to protect the interests of corporate creditors, and is deemed to have been implanted in our jurisdiction with the adoption of the Corporation Law[1] patterned after American corporate statutes, and carried over to the present Corporation Code.[2]

The article discusses what facets of the American doctrine has been adopted under Philippine jurisdiction.

Historical Background

The trust fund doctrine is a judicial invention credited to Justice Story, which he first enunciated in the 1824 decision in *Wood v. Dummer.*[3] A suit in equity was brought by creditors of a banking corporation to hold the stockholders of such corporation personally liable, it appearing that the greater part of the capital of the corporation had been distributed to the stockholders as dividends, thereby rendering the bank insolvent and leaving the creditors unpaid. Justice Story announced the doctrine as follows: "It appears to me very clear upon general principles, as well as the legislative intention, that the capital stock of banks is to be deemed a pledge or trust fund for the payment of the debts contracted by the bank. The public, as well as the legislature, have always supposed this to be a fund appropriated for such purpose. The individual stockholders are not liable for the debts of the bank in their private capacities. The charter relieves them from personal responsibility and substitutes the capital stock in its stead. Credit is universally given to this fund by the public, as the only means of repayment. During the existence of the corporation it is the sole property of the corporation, and can be applied only according to its charter, that is, as a fund for the payment of its debts, upon the security of which it may discount and circulate notes. Why, otherwise, is any capital stock required by our charters? If the stock may, the next day after it is paid in, be withdrawn by the stockholders without payment of the debts of the corporation, why is its amount so studiously provided for, and its payment by the stockholders so diligently required? To me this point appears so plain upon principles of law, as well as common sense, that I cannot be brought into any doubt, that the charters of our banks make the capital stock a trust fund for the payment of all the debts of the corporation. The bill holders and other creditors have the first claims upon it, and the stockholders have no rights, until all the other creditors are satisfied. They have the full benefit of all the profits made by the establishment, and cannot take any portion of the fund, until all the other claims on it are extinguished. Their rights are not to the capital stock, but to the residuum after all demands on it are paid. . . If I am right in this position, the principal difficulty

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in the cause is overcome. If the capital stock is a trust fund, then it may be followed by the creditors into the hands of any persons, having notice of the trust attaching to it. As to the stockholders themselves, there can be no pretense to say, that, both in law and fact, they are not affected with the most ample notice. The doctrine of following trust funds into the hands of any persons, who are not innocent purchasers, or do not otherwise possess superior equities, has been long established."[4]

In adopting the rule, the U.S. Supreme Court held: "Though it be a doctrine of modern date, we think it now well established that the capital stock of the corporation, especially its unpaid subscription, is a trust fund for the benefit of the general creditors of the corporation. And when we consider the rapid development of corporations as instrumentalities of the commercial and business world in the last few years, with the corresponding necessity of adapting legal principles to the new and varying exigencies of this business, it is no solid objection to such a principle that it is modern, for the occasion for it could no sooner have arisen."[5]

Over the years the doctrine received close scrutiny by state supreme courts and the U.S. Supreme Court itself, with the controversy centering on the proposition as to whether or not the capital stock of a corporation is a trust fund for the benefit of creditors, and as such whether the capital stock should be protected and administered as such by the courts. Thus, in invoking the doctrine it was contended that a corporation debtor does not stand on the same footing as an individual debtor; that while the latter has supreme dominion over his own property, a corporation is a mere trustee, holding its property for the benefit of its stockholders and creditors, and that if it fails to pursue its rights against third persons, whether arising out of fraud or otherwise, it is a breach of trust, and corporate creditors may come into equity to compel an enforcement of the corporate duty.[6]

To such a legal position the U.S. Supreme Court held: "A corporation is a distinct entity. Its affairs are necessarily managed by officers and agents, it is true, but, in law, it is as distinct a being as an individual is, and is entitled to hold property (if not contrary to its charter) as absolutely as an individual can hold it. x x x When a corporation becomes insolvent, it is so far civiliy dead that its property may be administered as a trust fund for the benefit of its stockholders and creditors. A court of equity, at the instance of the proper parties, will then make those funds trust funds, which, in other circumstances, are as much the absolute property of the corporation as any man's property is his. We see no reason why the disposal by a corporation of any of its property should be questioned by subsequent creditors of the corporation any more than a like disposal by an individual of his property should be so. The same principle of law apply to each."[7] In a clearer language, the U.S. Supreme Court held in another case: "When a corporation is solvent, the theory that its capital stock is a trust fund upon which there is any lien for the payment of its debts has in fact very little foundation. No general creditor has any lien upon the fund under such circumstances, and the right of the corporation to deal with its property is absolute so long as it does not violate its charter or the law applicable to such corporation."[8]

It is generally accepted that the proper scope of the trust fund doctrine is as follows: that the capital stock of a corporation, as well as all its other property and assets are generally regarded in equity as a trust fund for the payment of corporate debts, the creditors of the corporation have the right to priority payment over any stockholder thereof.[9] However, this broad definition that encompasses all "property and assets" is more accurately applicable to a corporation that is insolvent.

An examination of the various cases will show that the trust fund doctrine usually applies in four cases: (a) Where the corporation has distributed its capital among the stockholders without providing for the payment of creditors; (b) where it had released the subscribers to the capital stock from their subscriptions; (c) where it has transferred the corporate property in fraud of its creditors; (d) where the corporation is insolvent.[10]

Thus, the more accurate definition of the doctrine is that "the capital stock of a corporation, or the assets of an insolvent corporation representing its capital, ia a trust fund for the benefit of the company's creditors."[11] As will be shown hereunder, this definition has been closely adhered to in Philippine jurisdiction.

Fraud Theory

Due to the difficulties met with the terminology and application of the trust fund doctrine, there have been advocates of the position that most issues relating to capital stock or corporate assets and as to unpaid subscriptions properly belong to the question of fraud rather than trust fund.[12] Under this theory, the actionable wrong is the fraud or misrepresentation by directors, officers, or stockholders in falsely representing that the capital stock has been fully paid or covered by binding subscription contracts. Under such theory only creditors who may have been defrauded are entitled to relief; also, creditors who had notice are not protected. This varies with the principle under the trust fund doctrine that seeks to protect all corporate creditors. The distinctions will be better discussed below when particular instances are covered.

The Philippine Setting

With the evident purpose of introducing into the Philippines the American corporation as the standard commercial entity and to hasten the day when the *sociedad anonima* of the Spanish law would be obsolete, the then Philippine Commission enacted the Corporation Law which become effective on 1 April 1906. The statute is a sort of codification of the American corporate law.[11] Key sections of the Corporation Law implanted in Philippine jurisdiction the trust fund doctrine. These key sections, with slight amendments, were adopted in the present Corporation Code (in May, 1980) and will be discussed in connection therewith. In addition new provisions have been incorporated into the Corporation Code related to the doctrine.

A. Declaration of Dividends

The concept of the trust fund doctrine is clearly acknowledged and its scope clearly delineated, in thepower of the corporation to declare dividends.

> Sec. 43. **Power to declare dividends.** – The board of directors of a stock corporation may declare dividends out *of the unrestricted retained earnings* which shall be payable in cash, in property, or in stock to all stockholders on the basis of outstanding stock held by them: Provided, That any cash dividends due on delinquent stock shall first be applied to the unpaid balance on the subscription plus costs and expenses, while stock dividends shall be withheld from the delinquent stockholder until his unpaid subscription is fully paid: Provided, further, That no stock dividend shall be issued without the approval of stockholders representing not less than two-thirds (2/3) of the outstanding capital stock at a regular or special meeting duly called for the purpose. (16a).
>
> "x x x."

In relation thereto, the relevant portion of Section 6 provides:

> Sec. 6. **Classification of Shares.** – x x x. Shares of capital stock issued without par value shall be deemed fully paid and non-assessable and the holder of such shares shall not be liable to the corporation or to its creditors in respect thereto: Provided, That shares without par value may not be issued for a consideration less than the value of five (P5.00) pesos per share; Provided, further, That the entire consideration received by the corporation for its no par value shares shall be treated as capital and shall not be available for distribution as dividends. x x x.

In the Philippines we have adopted by statutory provisions the two precursors of the trust fund doctrine, namely the capital impairment rule and the profit rule. Under these corollary rules a fixed capital must be preserved for protecting the claims of creditors so that dividend distributions to stockholders should be limited to profits earned or accumulated by the corporation. Impliedly therefore, for a solvent corporation, the trust fund doctrine encompasses only the capital stock.

The relevant provision of Section 16 of the Corporation Law from which Section 43 above was adopted read as follows: "No corporation shall make or declare any dividend except from ***the surplus profit arising from its business,*** or divide or distribute its capital stock or property other than actual profits among its members or stockholders until after the payment of its debts and the termination of its existence by limitation or lawful dissolution."

There was extreme difficulty in interpreting the phrase "surplus profit arising from the business" used under the Corporation Law. Controversies raged on whether the provision authorized declaration of dividends out of current profits although the accumulated losses over the years have impaired the capital; on whether dividends could be declared only from profits "realized in normal business operations" or would it include any kind of surplus not falling under the category of "capital."

There was also issue on what is covered by the phrase "capital stock or property"; on whether it covered the authorized capital stock, which the maximum number of shares that a corporation may issue without amending its articles of incorporation; or did it cover the outstanding stock, which covers the shares actually subscribed and issued to stockholders.

Salonga, in his treatise, discussed the controversy in this fashion:

"Another interesting question is presented regarding the referential use of the phrase, 'surplus profits arising from its business.' Is this confined to profits realized in normal business operations, or should it also include any kind of surplus not falling under the category of 'capital'? In fine, is the phrase narrowed down to earned surplus, or should it include any kind of capital surplus? It may be worth pointing out that in 1825, when the New York parent of the present dividend provision found in our statute was drafted, the problem of capital surplus was not contemplated. The New York legislature did not seem to recognize that there might be another fund available for dividends. Today, the distinction between earned surplus and other forms of surplus is acknowledged. In the United States, for example, several statutes, such as those of California and Michigan, carefully confine the fund for dividend distribution to earned surplus, thus ruling out the possibility of a corporation paying dividends out of donated assets or funds, paid-in surplus arising from issuance of no-par stock, premium on par value shares, revaluation surplus created through write-ups of the assets, and reduction surplus arising from reduction of the capital.

"There is no decided case as yet in the Philippines which may be cited to settle this particular point, at there is much to be said in favor of the view that, as a general proposition, any kind of surplus should be considered available for dividends. This interpretation follows from the very essence and meaning of balance sheet surplus, i.e., the excess property of a corporation, however acquired, over and above its debts and the stated capital reserved to protect the creditors. It is of course entirely possible for our courts to disregard past construction of American courts of statutes modelled upon the New York dividend law of 1825, and hold that the earned surplus test should prevail. The provision of Section 16 is ambiguous enough to permit such a holding."[13]

The present language of Section 43 of the corporation has avoided the controversy with the use of the terms "surplus profits" and "capital stock or property" and instead mandates that dividends shall be declared only "out of the unrestricted retained earnings."

The term "retained earnings" is a technical accounting term that has a definite coverage. Retained earnings represents the "cumulative balance of periodic net income dividend distributions, prior period adjustments (on prior years' net income, and special distributions to stockholders resulting from capital adjustments. (quasi-reorganization)"[14] It represents "the accumulated net income of a corporation from the date of incorporation (or from the date of the latest date when a deficit was eliminated in quasi-reorganization), after deducting therefrom distribution to stockholders and transfers to capital stock or other accounts."[15] In simple terms, retained earnings represents the accumulation of profits of the corporation over the years; if the accumulation resulted in a net loss over tne years, it is called a "deficit."

"Restricted" or "appropriated" retained earnings is that portion of the retained earnings specifically ear-marked or "set-aside" for specific purpose such as to meet contingent liabilities, or planned expansion of facilities. Restriction of retained earnings is but a memorandum notation in the books of accounts as a reminder that the amount restricted should not be declared anymore as dividends.

"Unrestricted" or "unappropriated" retained earnings represents that portion which is free and can be declared as dividends to stockholders.[16]

Thus, with the use of the term "unrestricted retained earnings" under the Corporation Code, many of the old issues have been laid to rest in that: (a) any and all items included in retained earnings (i.e., income of all types, prior period adjustments net income, special distribution to stockholders resulting from quasi-reorganization) can be declared as dividends, unless restricted; (b) all other items not falling within the term "retained earnings" is necessarily included in "capital" and is unavailable for dividend declaration (e.g., donated assets or funds, paid-in surplus arising from issuance of no-par stock, premium paid on par value shares, revaluation surplus created to write-ups of the assets).

It should be noted that when the corporation incurs a deficit (i.e., negative retained earnings), the operations have actually "eaten-up" into the capital stock and there is actually a capital impairment. Even if the corporation manages to make profits in succeeding years, no dividends can be declared until the deficit is "wiped-out" and the retained earnings shows a positive amount.

The decision in the case of ***Steinberg v. Velasco***[17] indicates that in determining the legality of declared dividends, the existence of unrestricted retained earnings alone cannot be the test. In that case, the board of directors passed and implemented a resolution authorizing the purchase of a substantial portion of the shares of stockholders and the declaration of dividends of P3,000.00. At the time of the adoption of the resolution, the corporation had a "surplus profit" of P3,314.72 and had as assets (accounts receivables) that far exceeded its liabilities. It turned out that the assets were practically worthless. The evidence indicated that the directors in adopting the resolution were either acting in bad faith or with the use of ordinary care could have determined the non-existence of "surplus profit." In holding the directors solidarilly liable to corporate creditors to the extent of the dividends paid-out, the Supreme Court held that the existence a "surplus profit" alone does not suffice but that the corporation should "have an actual *bona fide* surplus from which the dividends could be paid, and that the payment of them in full at that time would not affect the financial condition of the corporation."

As applied to Section 43 of the Corporation Code, *Steinberg* is a clear indicatin that only dividends declared from a *bonafide* unrestricted retained earnings is legally permissible. Thus, although a corporation's balance sheet provides for an unrestricted retained earnings, if the figure does not register the true value of the assets (such as when worthless assets have not been written-off), dividends declared on that basis would be illegal.

Steinberg also indicates the remedy available in case there is an illegal distribution of dividends: that directors who are in bad faith or are grossly ignorant of their duties shall be held solidarily liable for the reinbursement of the amount declared as dividends.

B. **Watered Stock**

Section 62 of the Corporation Code lays down the rule on what may be accepted by the corporation as valid consideration for the issuance of its shares —

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

1. Actual cash paid to the corporation;
2. Property, tangible or intangible, actually received by the corporation and necessary or convenient for its use and lawful purposes at a fair valuation equal to the par or issued value of the stock issued;
3. Labor performed for or services actually rendered to the corporation;
4. Previously incurred indebtedness by the corporation;
5. Amounts transferred from unrestricted retained earnings to stated capital; and
6. Outstanding shares exchanged for stocks in the event of reclassification or conversion.

Where the consideration is other than actual cash, or consists of intangible property such as patents or copyrights, the valuation thereof shall intially be determined by the incorporators or the board of directors, subject to approval by the Securities and Exchange Commission.

Shares of stock shall not be issued in exchange for promissory notes or future services.

The same consideration as provided for in this section, insofar as they may be applicable, may be used for the issuance of bonds by the corporation.

The issued price or no-par value shares may be fixed in the articles of incorporation or by the board of directors pursuant to authority conferred upon it by the articles of incorporation or the by-laws, or in the absence thereof by the stockholders at a meeting duly called for the purpose representing at least a majority of the outstanding capital stock. (5 and 16)

In giving added "teeth" to the provisions of Section 62, the Corporaion Codes makes directors and officers liable for watered stocks.

Sec. 65. Liability of directors for watered stocks. — Any director, or officer of a corporation less than its par or issued value or for a consideration in any form other than cash, valued in excess of its fair value, or who, having knowledge thereof, does not forthwith express his objection in writing and file the same with the corporate secretary, shall be solidarily liable with the stockholder concerned to the corporation and its creditors for the difference between the fair value received at the time of issuance of the stock and the par or issued value of the same.

Sections 62 and 65 are substantial adoption of the relevant portions of Sections 5 and 16 of the Corporation Law, and included in the enumerations

other items which although not enumerated under the Corporation Law were nevertheless generally accepted as valid consideration for issuance of stock, such as previously incurred debts and services already rendered.

Shares issued as fully paid when in truth the consideration received is known to be less than the par value or issued value of the shares are called "watered stock". The term sometimes is used to includes "bonus shares" under an agreement that nothing shall be paid to the corporation for them, and "discount shares" issued at a discount under an agreement to pay less than the par value in money.

Stock watering is prohibited because of the injuries caused to:

(1) The corporaitn which is deprived of needed capital and the opportunity to market its securities to its own advantage, thus hurting its business prospects and financial responsibility;

(2) Existing and future shareholders who are also injured by the dilution of the proportionate interests in the corporation of those who pay full value for their shares;

(3) Present and future creditors who are injured as the corporation is deprived of the assets or capital required by law to be contributed by all shareholders as substitute for individual liability for corporate debts; and

(4) Finally, those who deal with it or purchase its securities who are deceived because stock watering is invariably accompanied with misleading corporate accounts and financial statements, particularly by an overstatement of the value of assets received for the shares to cover up a capital deficit resulting from overvaluation and underpayment of purported capital contributions.[18]

Basically, three theories have been advanced as basis for holding stockholders and officers liable for watered stocks. First is the subscription contract theory, which holds that the subscription contract is the source and measure of the duty of a subscriber to pay for his shares; if the contract releases him from further liability, the subscriber ceases to be liable.[19] This theory is unacceptable in our jurisdiction because of the peremptory language of then Section 16 of the Corporation Law, and now Sections 62 and 65 of the Corporation Code.

Second is the fraud theory previously discussed, which holds a shareholder liable for watered stock on the basis of tort or misrepresentation. According to this theory, the wrong done to the creditor is fraud or deceit in falsely representing that the par value has been paid or agreed to be paid in full. Under this theory, subsequent creditor without notice is presumed to have been deceived by this misrepresentation; but prior creditors with notice are not protected. This was the ruling *Hospes v. Northwestern Manufacture & Car Co.*[20] even as it rejected the trust fund doctrine:

"The phrase that 'the capital of a corporation constitutes a trust fund for the benefit of creditors is misleading. Corporate property is not held in trust, in any proper sense of the term. A turst implies two estates or interests – one equitable and one legal; one person, as trustee, holding the legal title, while another, as the *cestui que trust,* has the beneficial interest. Absolute control and power of disposition are inconsistent with the idea of a trust. The capital of a corporation is its property. It has the whole beneficial interest in it, as well as the legal title. It may use the income and profits of it, the same as a natural person. It is a trustee for its creditors in the same sense and to the same extent as a natural person, but no further x x x. The capital of a corporation is the basis of its credit. It is a substitute for the individual liability of those who own its stock. People deal with it and give it credit on the faith of it. They have a right to assume that it has paid-in capital of the amount which it represents as having; and if the representation is false, it is a fraud upon them; and in case the corporation becomes insolvent, the law, upon the plainest principles of common justice, says to the stockholder, "Make that representation good by paying for your stock.'

"It certainly cannot require the invention of any new doctrine in order to enforce so familiar a rule of equity. It is the misrepresentation of fact in stating the amount of capital to be greater than it really is that is the true basis of the liability of the stockholder in such cases; and it follows that it is only those creditors who have relied, or who can fairly be presumed to have relied, upon the professed amount of capital, in whose favor the law will recognize and enforce an equity against the holders of (bonus) stock.

The third theory of course is the trust fund doctrine, under which all corporate creditors would have legal basis to recover against stockholders and guilty officers.

Despite the views of many foreign authors that the fraud theory is the prevailing view[21], nevertheless, it would seem that here in the Philippines the trust fund doctrine on watered stock prevails. Thus, in *Philippine Trust Co. v. Rivera*[22] the Supreme Court held –

"It is established doctrine that subscriptions to the capital of a corporatin constitute a fund to which creditors have a right to look for satisfaction of their claims and that the assignee in insolvency can maintain an action upon any unpaid stock subscription in order to realize assets for the payment of its debts. (Velasco vs. Poizat, 37 Phil., 802) A corporation has no power to release an original subscriber to its capital stock from the obligation of paying for his shares, without a valuable consideration for such release; and as against creditors a reduction of the capital stock and take place only in the manner and under the conditions prescribed by the statute or the charter or the articles of incorporation. Moreover, strict compliance with the statutory regulations is necessary (14 C. J., 498,620).

Likewise, under Section 65 of the Corporation Code, no distinction is made as to creditors whether they become such prior to or subsequent to the issuance of the watered stock and fraud is not made an element. In any event, Section 65 is by itself sufficient basis to hold a stockholder liable to any corporate creditor without need to resorting to any of the discussed theories.

The legal standing of corporate creditors against guilty stockholders and officers for watered stock is clear in a situation when the corporation is insolvent since then all corporate assets would be held for the satisfaction of the claims of

the creditors, before any distribution is made to the stockholders. But when the corporation is still a "going concern" and the watering of the stock does not actually render it insolvent, does Section 65 actually grant corporate creditors the legal standing to bring at that point a suit against the involved stockholder and the guilty officers?

In the payment of property for subscribed shares, Section 62 of the Corporation Code provides that "the valuation thereof shall initially be determined by the incorporators or the board of directors subject to approval by the Securities and Exchange Commission." In actual practice the watering of stock is not supposed to happen because property consideration for subscription is always evaluated by the Securities and Exchange Commission which often conducts an examination of the involved properties and appraisal reports are submitted to establish the fair value of such properties. When the Securities and Exchange Commission approves the valuation it may be difficult to sustain an assertion later on that there has been watering of the shares.

C. Releases from Subscription Obligation

The accepted rule in this jurisdiction is that a corporation can release a subscriber from liability on the subscription, in whole or in part, only with the express or implied consent of all of the shareholders, and only when there is no prejudice to corporate creditors.[23]

In *Lingayen Gulf Electric Power Company, Inc. v. Baltasar*[24] It was held that "a valid and binding subscription for stock of a corporation cannot be cancelled so as to release the subscriber from liability thereon without the consent of all the stockholders." The exceptions allowed are *bona fide* compromise, or to set off a debt due from the corporation, a release, supported by consideration, will be effectual as against dissenting stockholders and subsequent and existing creditors." Notice, however, that the "exceptions" mentioned in *Lingayen* really do not constitute a gratuitous release since a valuable consideration is actually received by the corporation such as cancellation of debt. Even under Section 62 of the Corporation Code a *bona fide* debt is sufficient consideration for the issuance of a share.

In the United States there is the view that a pre-incorporation subscription merely constitutes a continuing offer since the corporation still to be formed has yet not legal existence, and therefore the pre-incorporation subscription may be revoked anytime prior to legal incorporation.[25] Section 61 of the Corporation Code has rejected this view and in effect adopted the other view that pre-incorporation contract is a binding contract among the subscriber and no party may revoke the contract without the consent of the other.

Sec. 61. *Pre-incorporation subscription.* – A subscription for shares of stock of a corporation still to be formed shall be irrevocable for a period of at least six (6) months from the date of subscription, unless all of the other subscribers consent to the revocation, or unless the incorporation of said corporation falls to materialize within said period or within a longer period as may be stipulated in the contract of subscription: Provided: That no pre-incorporation subscription may be revoked after the submission of the articles of incorporation to the Securities and Exchange Commission. (n)

D. Subscription Contract vs. Purchase Agreement

Section 60 of the Corporation Code has done away with the distinction between a subscription contract and a purchase contract relating to shares of stock of a corporation.

> Sec. 60. *Subscription contract.* – Any contract for the acquisition of unissued stock in a existing corporation or a corporation still to be formed shall be deemed a subscription within the meaning of this Title, notwithstanding the fact that the parties refer to it as a purchase or some other contract.

In *Bayla v. Silang Traffic Co., Inc.*,[26] decided under the Corporation Law, the Supreme Court laid down the distinctions between a subscription contract and a purchase agreement:

> (a) In a purchase agreement, the promise to issue the shares and the promise to pay the price are considered to create dependent and concurrent duties; payment is a condition to the right to a certificate for shares and the status of a shareholder; under the subscription contract, the subscriber becomes a stockholder even if he has not paid his subscription;
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> (b) The pruchaser is not a debtor, and according to some courts, the measure of liability of the purchaser if he defaults, is in damages for the difference between the contract price and the market value of the shares. In subscription, the unpaid subscription is a debt of the subscriber.
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> (c) Bankruptcy or insolvency of the corporation will terminate its claim against the purchaser on the theory that it can no longer perform its side of an executory contract by delivery of a valid certificate and that the consideration has failed. But in subscription, insolvency of the corporation makes the unpaid subscriptions immediately due and demandable.
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> (d) The provisions of our Corporation Law regarding calls for unpaid subscriptions and assessment of stock (sections 37-50) do not apply to a purchase of stock.
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> (e) Likewise, the rule that the corporation has no legal capacity to release an original subscriber to its capital stock from the obligation to pay for his shares is inapplicable to a contract of purchases of shares.

With Section 60 of the Corporation Law the protection to corporate creditors has been strengthened so that any and all transactions relating to the issuance of shares of stock is a subscription contract for which, in case of insolvency, the corporate creditors may enforce even against one denominated as a purchaser.

E. The Acquisition of a Corporation's Own Share

Section 41 of the Corporation Code expressly empowers a corporation to acquire its own share "for a legitimate corporate purpose or purposes" with the limitation that "the corporation has unrestricted retained earnings in its books to cover the shares to be purchased or acquired."

> Sec. 41. *Power to acquire own shares.* – A stock corporation shall have the power to purchase or acquire its own shares for a legitimate corporate purpose or purposes, including but not limited to the following cases: Provided. That the corporation has unrestricted retained earnings in its books to cover the shares to be purchased or acquired:
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> 1. To eliminate fractional shares arising out of stock dividends;
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> 2. To collect or compromise an indebtedness to the corporation, arising out of unpaid subscription, in a delinquency sale, and to purchase delinquent shares sold during said sale; and
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> 3. To pay dissenting or withdrawing stockholders entitled to payment for their shares under the provisions of this Code. (n)

Section 41 has no direct counterpart provision in the Corporation Law, except that its paragraph 3 is carry-over, albeit broader, of the three (3) instances in the Corporation Law when a corporation is allowed to purchase its own shares to satisfy the appraisal right of dissenting stockholders, thus:

> 1. In order to acquire the shares of a dissenter from a corporate resolution "to invest its funds in any other corporation or business, or for any purpose other than the main purpose for which it was organized." (Sec. 17 1/2)
>
> 2. In order to acquire the shares of a dissenter from an amendment of the articles which adversely affects the value of his shares. (Sec. 18)
>
> 3. In order to acquire the shares of a dissenter from a resolution to sell substantially all the corporate assets. (Sec. 28 1/2)

Under the Corporation Law, the exercise of the appraisal right was subject to the following condition –

> A stockholder shall not be entitled to payment for his shares under the provisions of this section unless the value of the corporate assets which would remain after such payment would be at least equal to or aggregate amount of its debts, liabilities and the aggregate value and/or issued value of the remaining subscribed capital stock.

On the other hand, Section 82 of the Corporation Code on the exercise of appraisal right provides in part –

> x x x That no payment shall be made to any dissenting stockholder unless the corporation has unrestricted retained earnings x x x."

What is the effect of the change in pharseology? To illustrate, take a corporation which has the following financial condition:

Assets		Liabilities & Stockholders Equity	
Cash	P1,000,000	Liabilities	P 500,000
Other Assets	3,000,000	Capital Stock	3,000,000
		Retained Earnings	500,000
Total	P4,000,000		P4,000,000

Under the Corporation Law, in the exercise of appraisal right, the most that a corporation could purchase on the shares of dissenting stockholders is P1,000,000 (or 1/3 of the capital stock, since the 2/3 would have voted for the corporate transaction to be valid). Mathematically, there would be no legal obstacle to paying the extent of P1,000,000 to dissenting stockholders since the net result often payment would always be that the remaining assets would always be equal to the total amounts of liabilities and remaining capital stock. This can be appreciated from the fact that for every peso of capital stock reduced due to purchase, there is a corresponding decrease of an equivalent peso on the assets used as payment; thus, the equality of both sides of the balance sheet is always maintained.

This observation would not apply of course if we construe that when the Corporation Law said "value" of the remaining assets refers to their fair market value or realizable value. But this is unlikely the intention since for the covered transactions the corporation is still to function as a "going" concern and therefore the assets continue to be valued at their depreciated cost.

Using the same illustration above, under the Corporation Code, the most that the corporation can be obliged to pay to dissenting stockholders (whose shares may amount to as high as P1,000,000) is only P500,000.00 since that is only the extent of the unrestricted retained earnings. In effect, the Corporation Code offers a more stringent formula before it allows a corporation to buy-out a dissenting stockholders in instances allowed by law.

Under the Corporation Law, it would seem that the accepted view was that a corporation generally has no power to purchase its own shares and reduce the stated capital, and this was expressed in *Steinberg v. Velasco.*[27]

> "Creditors of a corporation have the right to assume that so long as there are outstanding debts and liabilities, the board of directors will not use the assets of the corporation to purchase its own stock, and that it will not declare dividends to stockholders when the corporation is insolvent."

Section 41 of the Corporation Code is an adoption of the American doctrine that a corporation should be allowed to purchase its own shares for legitimate corporate purposes provided it does not prejudice the corporate creditors. Such legitimate purpose should include a move by the corporation to exclude interested purchasers of its stock who represent an antagonistic interest, or to comply with its contraction commitment in financing contracts. It is perceived that so long the acquisition of shares does not exceed the unrestricted retained earnings, the corporate creditors are deemed protected. This is also an implied acknowledgment that the trust fund doctrine applies only to the subscribed capital stock as distinguished from the retained earnings.

Allowing a corporation to purchase its own shares to the extent of its unrestricted retained earnings has been viewed as equivalent to subjecting dividend declaration to the extent of unrestricted retained earnings.[28] Thus, it has been insisted that the purchase of a corporation's own share should be always from its own surplus.[29] But requiring the existence of unrestricted retained earnings does not really achieve such an end and it is not comparable to the situation of declaring dividends. Dividends when declared and paid-out are charged against retained earnings as is the standard accounting procedure. On the other hand, when a corporation acquires its own shares (which thereby become treasury shares) what is and can only be charged under accepted accounting procedures is not the retained earnings but the capital stock account.

To illustrate, in a corporation that has a capital stock of P1,000,000 retained earnings of P500,000 legally speaking the corporation can acquire its shares for legitimate purpose up to the extent of P500,000. The results would be:

Before Share Acquisition		After Share Acquisition	
Capital Stock	P1,000,000	Capital Stock	P1,000,000.00
Retained Earnings	500,000	Less: Treasury Shares	500,000.00
		Net Capital Stock	P 500,000.00
		Retained Earnings	500,000.00
Stockholders' Equits.	P1,500,000	Stockholders' Equits.	P 1,000.00

Even after the acquisition of the shares, there is still an available retained earnings of P500,000 because acquisition of shares is charged against capital stock (and not retained earnings). Legally speaking nothing prevents the corporation from thereafter declaring cash dividends because of the availability of retained earnings. However, it should be reasonably construed to mean that the retained eanings should be deemed restricted to the extent of the value of the shares acquired by the corporation. If the retirement of shares is permanent for all intents and purposes the affected portion of the retained earnings has been "capitalized."

F. Redeemable Shares

> Sec. 8. *Redeemable shares.* – Redeemable shares may be issued by the corporation when expressly so provided in the articles of incorporatin. They may be purchased or taken up by the corporation upon the expiration of a fixed period, regardless of the existence of unrestricted retained earnings in the books of the corporation, and upon such other terms and conditions stated in the articles of incorporation, which terms and conditions must also be stated in the certificate of stock representing said shares. (n)

In various ways, the law attempts to safeguard creditors, as by requiring full payment of subscriptions and preventing any return to shareholders out of capital, if claims of creditors would be impaired. Consequently, a purchase by a corporation of its own shares is objectionable from the standpoint of creditors when the purchase price is paid out of capital, that is, if corporate assets are paid out below the limit fixed by the legal capital. If shares are acquired by purchase and payment is made out of a surplus of assets over liabilities, including the legal capital, creditors have no cause for complaint.[14]

The express provisions of Section 8 which allows redemption "regardless of the existence of unrestricted retained earnings" would now constitute a clear exception to the trust fund doctrine. Nevertheless, the consistency is still there in the sense that creditors will not be misled since it is required that the redemption feature must be stated both in the articles of incorporation and the certificates of stock.

CONCLUSIONS

An examination of the relevant provisions of the Corporation shows that to a great extent the trust fund doctrine has been engrafted and sometimes strengthened in our jurisdiction. In few instances, such as on redeemable shares and in allowing a corporation to purchase its own shares, the doctrine has been relaxed, if not discarded, in response to legitimate needs of corporate entities to respond to business imperatives. But generally the need to preserve the capital stock of the corporation as fund "to which creditors may look upon for the satisfaction of their claim" has been preserved.

And although there have been much criticism against the doctrine, there are some who may find solace in what was said in *Witt v. Nelson*[30] that the "theory is not obsolete, and will not become obsolete anywhere until honesty shall become obsolete."

NOTES

1 Act No. 1459.

2 Batas Pambansa Blg. 68.

3 3 Mason 308, Fed. Cas. No. 17, 944.

4 As reported in Fletcher, 7370.

5 New Albany v. Burke, 11 Wall. (U.S.) 96, 20 L. ed. 155; Burke v. Smith, 16 Wall. (U.S.) 390, 21 L. ed. 361; Sawyer v. Hoag, 17 Wall. (U.S.)610, 21 L. ed. 731; Sangor v. Upton, 91 U.S. 56, 23 L. ed. 220.

6 Cf. Graham v. La Crosse & R. Co., 102 U.S. 148, 26 L. ed. 106.

7 Ibid.

8 Mc Donald v. Williams, 174 U.S. 397, 43 L. ed. 1022, 19 Sup. Ct. 743.

9 Chicago Rock Island & Pac. R. R. Co. v. Howard, 7 Wall 392, 19 L. ed. 117; Sawyer v. Hoag, 17 Wall. 610, 21 L. ed. 731; Pullan v. Upton, 96 U.S. 328, 24 L. ed. 818.

10 Thompson, 3427.

11 Fletcher, 7369.

12 Thompson, 3429.

13 Salonga, *Philippine Law on Private Corporations,* 1968 ed., pp. 524-525

14 Valix and Peralta, *Financial Accounting,* Vol. 2, p. 492.

15 Bulletin on Accounting Principles No. 10, dated November, 1975, issued by the Philippine Institute of Certified Public Accountants.

16 Valix and Peralta, Ibid.

17 52 Phil. 953.

18 Ballantine, 794.

19 Ballantine, 802.

20 48 Minn. 174, 50 NW 117.

21 Ballantine, 806; Thompson, 3429.

22 44 Phil. 469.

23 Salonga, Supra., p. 497; *Agbayani, Commercial Laws of the Philippines,* Vol. 3, 1984 ed., pp. 454-455.

24 93 Phil. 405, See also Phil. Trust Co. v. Rivera, supra., and Nava v. Peers Marketing Corp., 74 SCRA 65.

25 Collines v. Morgan Grain Co., 16 F. 2d 253; Ballantine, 444, Fletcher, 91-94.

26 73 Phil. 557.

27 Supra.

28 Campos and Lopez-Campos, Corporation Code, 1981 ed., p. 804; Agbayani, supra, pp. 341-343.

29 Ballantine, 605;

30 169 S. W. 381.