When Control No Longer Controlled — Assessing the Applicability of the Rules on Tender Offer to Pledge Arrangements

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I. INTRODUCTION

"[S]peculative schemes which have no more basis than a few feet of the blue sky"[1] — this, pronounced the Court more than six decades ago,[2] was the basis for the enactment of the Blue Sky Law,[3] the first securities legislation in the country.

A series of amendments and realizations of the inadequacy of past laws thereafter,[4] investors now seek refuge under a different law, the Securities

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1. People v. Fernandez, 65 Phil. 675, 679 (1938).
2. *Id.* at 675.
3. An Act to Regulate the Sale of Certain Corporation Shares, Stocks, Bonds and Other Securities, Act No. 2581 (1916).
4. *See* RAFAEL A. MORALES, THE PHILIPPINE SECURITIES REGULATION CODE (ANNOTATED) 3-5 (2005).

Regulation Code (SRC) or Republic Act (R.A.) No. 8799.[5] Essentially a by-product of the said groundbreaking piece of legislation,[6] its creation took into account the experiences of investors for the past generations.

However, along with the birth of more stringent policies relative to the protection of investor interest since the promulgation of the Blue Sky Law, a myriad of fraudulent schemes involving securities transactions also developed. Novel creatures such as insider trading,[7] related-party transactions,[8] wash sales,[9] and many other manipulative schemes[10] came into being. Thus, it really cannot be said with ease that today's investors are in a more advantageous position than those of the past. They may have more weapons in the law, but the adversaries grew more complex, not to mention more furtive.

A. Investment Landscape

Against this legal backdrop is the country's investment growth that is on a laudable stride. A recent report on Philippine economic performance dubbed investment in the country as contributing to "about 40% of total growth, the highest proportion in 10 years."[11] Assuming this trend to continue, the forecast estimates that "sustained increases in investment now appear achievable."[12] Coupled with the fact that "[t]he Philippine economy grew by 7.3 percent in 2010 — the highest in 34 years,"[13] these recent events undoubtedly prove favorable to the overall investment climate in the country.

This is not at all surprising, considering the various factors that make the country competitive in terms of investment opportunities. One attractive characteristic for foreign investors is the "country's strategic and centrally

5. The Securities Regulation Code [SECURITIES REGULATION CODE], Republic Act No. 8799 (2000).

6. *See* Act No. 2581.

7. *See* SECURITIES REGULATION CODE, ch. VIII.

8. Securities and Exchange Commission, Amended Implementing Rules and Regulations of the Securities Regulation Code, rule 17.1 (1) © (2003).

9. Amended Implementing Rules and Regulations of the Securities Regulation Code, rule 24-1 (b) (4) (v).

10. *See* Amended Implementing Rules and Regulations of the Securities Regulation Code, rule 24-1 (b).

11. ASIAN DEVELOPMENT BANK, ASIAN DEVELOPMENT OUTLOOK 2011: SOUTH-SOUTH ECONOMIC LINKS 201 (2011).

12. *Id.*

13. The World Bank, Philippines: Improved Investment Climate Could Push Up Growth Significantly, Create More Jobs — World Bank, *available at* http://go.worldbank.org/B2B15LZ1V0 (last accessed Aug. 31, 2011).

located position."[14] The same can also be said of the immense amount of natural resources that the country possesses.[15] On top of all these is the recognition given to the country as the world's third largest English-speaking nation,[16] translating to a work force equipped with more vigorous communication skills compared to its counterparts within the Asia-Pacific region.[17]

But this positive outlook on investment growth would have to deal with the now increasing number of fraudulent tactics employed by persons in the corporate landscape. This is made even more disparaging by other recent challenges plaguing today's investor. According to Corporate Governance (CG) Watch 2010, for instance, the Philippines is the worst performer in Asia in terms of corporate governance.[18] In addition, it has been observed that the country's "corporate governance framework still falls short of provisioning incentives for a transparent and efficient market."[19] Incidentally, this known weakness has earned the Philippine Stock Exchange the status of "the second smallest bourse in the region despite being among the oldest."[20]

With this array of events characterizing the nation's current corporate investment scenario, the need to execute the policy of the State to protect investors has never been timelier.[21] As more corporate exchanges are consummated each day and as corporate governance perception continues to

14. Manabat Sanagustin & Co., CPAs, *Preface* to A Guide for Businessmen and Investors 2010, *available at* https://www.kpmg.com/PH/en/IssuesAndInsights/ArticlesAndPublications/Investors-Guide/Documents/KPMG%20Philippines%20%20Guide%20for%20Businessmen%20and%20Investors%202010.pdf (last accessed Aug. 31, 2011).

15. *Id.*

16. Travel Video News, Philippines — World's Third Largest English-Speaking Nation Welcomes U.S. Visitors, *available at* http://www.travelvideo.tv/news/philippines/04-12-2006/philippines-worlds-third-largest-english-speaking-nation-welcomes-us-visitors (last accessed Aug. 31, 2011).

17. Manabat Sanagustin & Co., CPAs, *supra* note 14.

18. Amar Gill, *et al.*, CG Watch 2010 (A Report on Corporate Governance in Asia) 95, *available at* http://www.clsa.com/assets/files/reports/CLSA-CG-Watch-2010.pdf (last accessed Aug. 31, 2011).

19. The World Bank, Report on the Observance of Standards and Codes: Corporate Governance Country Assessment (A Report on the Assessment of Corporate Governance in the Philippines) 3, *available at* http://www.worldbank.org/ifa/rosc_cg_phl_07.pdf (last accessed Aug. 31, 2011) [hereinafter World Bank Report].

20. Miguel R. Camus, *Governance stigma crimps bourse growth*, BUS. MIR., Mar. 22, 2011, *available at* http://www.businessmirror.com.ph/home/top-news/8960-governance-stigma-crimps-bourse-growth (last accessed Aug. 31, 2011).

21. *See* SECURITIES REGULATION CODE, § 2.

struggle, the need to provide more adequate safeguards for investor protection becomes more relevant.

B. Survey of Existing Laws

In addition to the SRC, the country has an ample number of laws which provides protection to investors. Batas Pambansa Blg. 68,[22] otherwise known as the Corporation Code of the Philippines, is worth mentioning. Section 32 of the Corporation Code provides that the dealings of directors and other officers of the corporation with the corporation itself is, at the option of the latter, voidable, save in certain instances where certain conditions are present.[23] These conditions are:

(1) that the presence of such director or officer in the meeting in which the contract was approved was not necessary to constitute a quorum;

(2) that the vote of such director or officer was not necessary for the approval of the contract;

(3) that the contract is fair and reasonable under the circumstances; and

(4) that it has been previously authorized by the board of directors in case of an officer.[24]

Undoubtedly, the effect of this provision is to protect the stockholders and other investors from unscrupulous directors and officers who place their interests ahead of that of the corporation.[25]

The same logic pervades Section 33 of the Corporation Code which involves contracts between corporations with interlocking directors.[26]

22. The Corporation Code of the Philippines [CORPORATION CODE], Batas Pambansa Blg. 68 (1980).

23. *Id.* § 32.

24. *Id.*

25. *See* Prime White Cement Corp. v. Intermediate Appellate Court, 220 SCRA 103 (1993). *Prime White Cement Corp.* involved the application of Section 32 to a "dealership agreement," which the Court declared as unenforceable, citing that since the respondent, Alejandro Te, was a director, he had a "bounden duty [ ] to act in such manner as not to unduly prejudice the corporation." *Prime White Cement Corp.*, 220 SCRA at 109 & 113.

26. CORPORATION CODE, § 33. Section 33 provides —

> Except in cases of fraud, and provided the contract is fair and reasonable under the circumstances, a contract between two or more corporations having interlocking directors shall not be invalidated on that ground alone: Provided, That if the interest of the interlocking director in one corporation is substantial and his interest in the other corporation or corporations is merely nominal, he shall be subject to

Therefore, when the interest of a director in one corporation is substantial and in the other merely nominal, the requirements of Section 32 shall apply.[27] Certainly, the purpose is to prevent a director from favoring the corporation where he has a substantial interest over the other where his interest is merely nominal.

In addition, Section 47 of the same law provides that the by-laws of a corporation may specify the "qualifications, duties[,] and compensation of directors or trustees, officers[,] and employees."[28] Although not specifically allowing for the inclusion of a disqualification, additional grounds that can serve as bases for the ineligibility of erring directors may be provided. Thus, in *Gokongwei, Jr. v. Securities Exchange Commission*,[29] the Court upheld the validity of a provision in the by-laws of San Miguel Corporation that disqualified for directorship a person owning a business in competition with the corporation.[30] In ruling as it did, the Court recognized the inherent power of a corporation to adopt a set of by-laws that would govern its internal management[31] and further pronounced that a director is, without a doubt, occupying a fiduciary position in relation to the corporation in which he is a director.[32]

R.A. No. 8799 enumerates a number of provisions specifically governing the exchange of securities, the protection of which ultimately redounds to the interests of the shareholder and other investors. Thus, Section 24 of the SRC expressly prohibits the manipulation of security prices, which can be done in a variety of deceptive and fraudulent means.[33] Such means include the creation of misleading appearances of active trading and making false statements relative to any material fact likely to induce the purchase or sale of a security.[34]

Also prohibited under the SRC is an insider's act of trading while in possession of material information that is generally not available to the public.[35] In *Securities and Exchange Commission v. Interport Resources*

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the provisions of the preceding section insofar as the latter corporation or corporations are concerned.

Id.

27. *Id.* § 32.

28. *Id.* § 47.

29. Gokongwei, Jr. v. Securities Exchange Commission, 89 SCRA 336 (1979).

30. *Id.* at 390.

31. *Id.* at 365-66.

32. *Id.* at 367-69.

33. SECURITIES REGULATION CODE, § 24.

34. *Id.*

35. *Id.* § 27.

Corporation,[36] the Court explained that "[t]he intent of the law is the protection of investors against fraud, committed when an insider, using secret information, takes advantage of an uninformed investor."[37]

An interesting provision is Section 19 of the SRC, which relates to tender offers.[38] It mandates that the intention to acquire a certain number of shares which reach the threshold amount provided in the law will trigger the requirement of making a mandatory tender offer to the stockholders.[39] Consequently, this involves making an offer directed to the minority stockholders for them to tender their shares for a specified amount, which the purchaser has no choice but to accept in case he aims to purchase a certain amount of the corporation's shares.[40]

Added to the abovementioned list of laws is the recently enacted Revised Code of Corporate Governance,[41] which primarily outlines the rules that govern the conduct, duties, and responsibilities of the board of directors and of the management of the corporation.[42]

II. SCOPE AND LIMITATIONS

With all these laws in place, the Author still deems it imperative to explore various possible means by which offenders can circumvent the law. This especially gains significance considering the fact that the laws on securities constantly evolve[43] to address new concerns brought about by more complex deceptive schemes aimed at reducing the value of shareholder investments. Added to this fact is the surfacing of recent reports that indicate low corporate governance in the country.[44]

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36. Securities and Exchange Commission v. Interport Resources Corporation, 567 SCRA 354 (2008).

37. *Id.* at 381.

38. SECURITIES REGULATION CODE, § 19.

39. *Id.*

40. Cemco Holdings, Inc. v. National Life Insurance Company of the Philippines, Inc., 529 SCRA 355, 370 (2007) (citing LUCILA M. DECASA, SECURITIES REGULATION CODE ANNOTATED WITH IMPLEMENTING RULES AND REGULATIONS 64 (1st ed. 2004)).

41. Securities and Exchange Commission, Revised Code of Corporate Governance, SEC Memorandum Circular No. 6, Series of 2009 [SEC Memo. Circ. No. 6 (2009)] (July 15, 2009).

42. *See* SEC Memo. Circ. No. 6 (2009).

43. *See* Richard Y. Roberts, *The Constantly Evolving Nature of Federal Securities Law: An Introduction to the Symposium*, 45 ALA. L. REV. 729 (1994).

44. *See* Gill, *supra* note 18 & World Bank Report, *supra* note 19.

Consequently, this Essay explores the ways by which offenders are able to subvert the law. The Author does not seek to provide an enumeration of the various fraudulent means employed to achieve such a goal. Instead, the Author focuses on certain security arrangements and examines how these can be used as tools in evading legal mandates.

More specifically, the contract of pledge is examined. The Author deems this relevant in light of how the Court, in the 2007 case of *Cemco Holdings, Inc. v. National Life Insurance Company of the Philippines, Inc.*,[45] ruled with regard to the acquisition of control by virtue of the purchase of shares.[46] In entering into a contract of pledge, the pledgee does not legally acquire the ownership of the pledged shares,[47] yet he is able to acquire certain rights by virtue of said shares. The exercise of these rights, in turn, is the envisioned effect which the rules on tender offer aim to regulate but cannot due to the absence of an acquisition of shares — a requirement before the rules on tender offer can be made to apply. Hence, in this Essay, the Author looks at the ramifications of entering into a pledge arrangement vis-à-vis tender offer rules, while assessing the possibility of such an arrangement being used in circumventing the policy behind the rules on mandatory tender offers. The Essay thus examines, in addition, the propriety of expanding such rules to cover the abovementioned arrangements.

III. EXAMINATION OF RELEVANT LAWS

Before one can determine the ramifications of the proffered issue, it is necessary to first examine the relevant laws on the matter. Specifically vital to this is a study of the laws governing the rights of a shareholder, the laws governing pledge, and the laws and rules relative to tender offers.

A. On the Rights of a Shareholder

A shareholder is granted a number of rights under the Corporation Code.[48] Consequently, the law classifies the shares of a corporation into common or preferred, par or non-par, and voting or non-voting, and on this classification depends the rights that may be legally exercised by the shareholder.[49] Generally, the rights granted by these shares include the right to dividends[50] as well as the right to vote.[51] In addition, further rights and

45. *Cemco Holdings, Inc.*, 529 SCRA 355.

46. *Id.* at 364.

47. An Act to Ordain and Institute the Civil Code of the Philippines [CIVIL CODE], Republic Act No. 386, art. 2103 (1950).

48. *See, e.g.*, CORPORATION CODE, §§ 6, 39, 63, & 64.

49. CORPORATION CODE, § 6.

50. *Id.* § 43.

51. *Id.* §§ 6 & 89.

privileges as well as restrictions may be provided in the articles of incorporation.[52]

As an express mandate, the law requires "that [t]here shall always be a class or series of shares which have complete voting rights."[53] Subsequently, a share that has been granted complete voting rights allows the shareholder to vote for a particular corporate act.[54] There are, nonetheless, certain matters that may be voted upon even by holders of non-voting shares, thus:

(1) Amendment of the articles of incorporation;

(2) Adoption and amendment of by-laws;

(3) Sale, lease, exchange, mortgage, pledge[,] or other disposition of all or substantially all of the corporate property;

(4) Incurring, creating[,] or increasing of bonded indebtedness;

(5) Increase or decrease of capital stock;

(6) Merger or consolidation of the corporation with another corporation or other corporations;

(7) Investment of corporate funds in another corporation or business in accordance with [the Corporation] Code; and

(8) Dissolution of the corporation.[55]

Also, the right of a shareholder to transfer his shares of stock is recognized under Section 63 of the Corporation Code.[56] This is but a logical and necessary consequence of the law's treatment of these shares as that of personal property.[57] In fact the Court, in *Rural Bank of Salinas v. Court of Appeals*,[58] opined that subsequent to a sale of shares of stock, "[t]he right of the transferee/assignee to have stocks transferred in his name is an inherent right flowing from his ownership of the stocks."[59]

52. *Id.* § 6.

53. *Id.*

54. *Id. See also* Castillo v. Balinghasay, 440 SCRA 442, 453 (2004), where the Court noted that that the "right [of a stockholder] to participate in the control and management of the corporation [ ] is exercised through his vote." *Castillo*, 440 SCRA at 453.

55. CORPORATION CODE, § 6.

56. *Id.* § 63.

57. *Id.*

58. Rural Bank of Salinas, Inc. v. Court of Appeals, 210 SCRA 510 (1992).

59. *Id.* at 515.

As owner of the shares, the shareholder may exercise the rights of ownership relative to such shares. This extends to the right to pledge, which will be discussed below.

B. On Pledging Shares

Shares of stock may be pledged. Article 2094 of the Civil Code provides that "[a]ll movables which are within commerce may be pledged, provided that they are susceptible of possession."[60] A subsequent provision states that "[i]ncorporeal rights, evidenced by negotiable instruments, bills of lading, *shares of stock*, bonds, warehouse receipts and similar documents may also be pledged."[61]

By a contract of pledge, the creditor is given the right to possess the thing pledged as security for the loan obtained by the debtor.[62] The creditor then becomes the pledgee and the debtor the pledgor. Similar to a contract of mortgage, it is the characteristic of a pledge agreement that it be "constituted to secure the fulfillment of the principal obligation,"[63] which is the contract of loan.[64] Consequently, the pledgee is "given the right to retain the thing in his possession until the debt is paid."[65] Hence, the retention of the thing subject of the pledge depends on the duration of the principal contract of loan, which in turn depends on the stipulation of the contracting parties.

In this arrangement, the pledgor retains the ownership of the thing pledged. In fact, the creditor cannot appropriate the things subject of the pledge, rendering void any stipulation to the contrary.[66] In addition, "[u]nless the thing pledged is expropriated, the debtor continues to be the owner thereof."[67]

As a general rule, the pledgee cannot use the thing pledged.[68] This prohibition proceeds from the fact that only possession is transferred in this arrangement,[69] the ownership being retained by the pledgor.[70] The pledgee,

60. CIVIL CODE, art. 2094.

61. *Id.* art. 2095 (emphasis supplied).

62. *Id.* art. 2098.

63. *Id.* art. 2085, ¶ 1.

64. *Id.*

65. *Id.* art. 2098.

66. CIVIL CODE, art. 2088.

67. *Id.* art. 2103.

68. *Id.* art. 2104.

69. HECTOR S. DE LEON, COMMENTS AND CASES ON CREDIT TRANSACTIONS 346–47 (11th ed. 2010).

70. *Id.* at 350.

however, may exercise certain rights relative to the thing pledged. Hence, if the authority of the owner is given, the pledgee may use the thing subject of the pledge.[71] Consequently, the "right to use includes the right to exclude any person, as a rule, from the enjoyment and disposal thereof."[72]

Thus, with regard to shares of stock, the pledgee may be allowed to use such shares provided the consent of the pledgor is obtained. In fact, the Corporation Code allows the pledgee to vote by virtue of the pledged shares, to wit —

> In case of pledged or mortgaged shares in stock corporations, the pledgor or mortgagor shall have the right to attend and vote at meetings of stockholders, *unless the pledgee or mortgagee is expressly given by the pledgor or mortgagor such right in writing* which is recorded on the appropriate corporate books.[73]

For the pledgee to exercise the right to vote, the only requirements appear to be an express consent in writing from the pledgor as well as a record of such given consent in the books of the corporation.

C. On Tender Offer Rules

A tender offer has been generally defined as "a publicly announced intention by the purchaser to acquire a certain block of equities of a company through open market purchases or private negotiations."[74] Conventionally, it has been understood as a "publicly made invitation addressed to all shareholders of a corporation to tender their shares for sale at a specified price."[75]

In the Philippines, it is Section 19 of the SRC that lays down the rule on tender offers. Section 19 provides that

> [a]ny person or group of persons ... who intends to acquire 15% of any class of equity of a listed corporation[,] ... with assets of at least fifty million pesos and having two hundred (200) or more shareholders, at least one hundred (100) shares each, or thirty per cent (30%) of such equity over a period of twelve (12) months, shall make a tender offer to stockholders.[76]

With the belief that "the tender offer threshold of [15%] is too low for a small market like the Philippines,"[77] and considering the resulting effect of

71. CIVIL CODE, art. 2104.

72. 2 EDGARDO L. PARAS, CIVIL CODE OF THE PHILIPPINES ANNOTATED 87 (16th ed. 2008). *See also* MORALES, *supra* note 4, at 153.

73. CORPORATION CODE, § 55 (emphasis supplied).

74. DECASA, *supra* note 40, at 64.

75. Note, *The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934*, 86 HARV. L. REV. 1250, 1251 (1973).

76. SECURITIES REGULATION CODE, § 19.

77. *See* DECASA, *supra* note 40.

restricting investments and acquisitions in corporations, the Securities and Exchange Commission (SEC) issued SEC Memorandum Circular No. 12, Series of 2001,[78] which suspended the 15% threshold and increased it to 35%.[79] Subsequently, by virtue of SEC Memorandum Circular No. 12, Series of 2003,[80] the 35% threshold was extended indefinitely.[81] Such threshold "is now embodied in the Amended SRC Implementing Rules and Regulations [(IRR)]."[82]

As it now stands, the rules on mandatory tender offer is explained in Rule 19.2 of the IRR.[83] It provides that "a person or a group of persons

78. Securities and Exchange Commission, SEC Memorandum Circular No. 12, Series of 2001 [SEC Memo. Circ. No. 12 (2001)] (Sep. 18, 2001).

79. *See* SEC Memo. Circ. No. 12 (2001).

80. Securities and Exchange Commission, SEC Memorandum Circular No. 12, Series of 2003 [SEC Memo. Circ. No. 12 (2003)] (Sep. 9, 2003).

81. *See* SEC Memo. Circ. No. 12 (2003).

82. DECASA, *supra* note 40, at 65 (citing Amended Implementing Rules and Regulations of the Securities Regulation Code).

83. Amended Implementing Rules and Regulations of the Securities Regulation Code, rule 19.2. This Rule on mandatory tender offer provides —

> (a) Any person or group of persons acting in concert, who intends to acquire thirty five percent (35%) or more of equity shares in a public company shall disclose such intention and contemporaneously make a tender offer for the percent sought to all holders of such class, subject to paragraph (9) (E) of this Rule.
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> (b) In the event that the tender offer is oversubscribed, the aggregate amount of securities to be acquired at the close of such tender offer shall be proportionately distributed across both selling shareholder with whom the acquirer may have been in private negotiations and minority shareholders.
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> (c) Any person or group of persons acting in concert, who intends to acquire thirty five percent (35%) or more of equity shares in a public company in one or more transactions within a period of twelve (12) months, shall be required to make a tender offer to all holders of such class for the number of shares so acquired within the said period.
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> (d) If any acquisition of even less than thirty five percent (35%) would result in ownership of over fifty one percent (51%) of the total outstanding equity securities of a public company, the acquirer shall be required to make a tender offer under this Rule for all the outstanding equity securities to all remaining stockholders of the said company at a price supported by a fairness opinion provided by an independent financial advisor or equivalent third party. The acquirer in

acting in concert who intends to acquire [35%] or more of equity shares of a public company shall disclose such intention and contemporaneously make a tender offer for the percent sought to all holders of such class."[84] Nonetheless, even if an acquisition relates to less than 35%, yet would result in ownership of more than 51% of the total outstanding shares of the company, the purchaser shall be required to make a tender offer for all the outstanding equity securities to all remaining stockholders.[85]

In *Osmeña III v. Social Security System of the Philippines*,[86] the Court had occasion to expound on the purpose of the rules on mandatory tender offers. In defining the term as "an offer by the acquiring person to stockholders of a public company for them to tender their shares therein on the terms specified in the offer,"[87] the Court explained its purpose, thus —

> Tender offer is in place to protect the interests of minority stockholders of a target company against any scheme that dilutes the share value of their investments. It affords such minority shareholders the opportunity to withdraw or exit from the company under reasonable terms, a chance to sell their shares at the same price as those of the majority stockholders.[88]

It was the earlier case of *Cemco*, however, which delved into the intent of the legislators in including the rules on mandatory tender offers into the country's securities laws. In this case, petitioner Cemco Holdings, Inc. (Cemco), was one of the two principal stockholders of Union Cement Corporation (UCC), a publicly listed company, the other principal stockholder being Union Cement Holdings Corporation (UCHC).[89] In

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such a tender offer shall be required to accept any and all securities thus tendered.

(e) In any transaction covered by this Rule, the sale of the shares pursuant to the private transaction shall not be completed prior to the closing and completion of the tender offer. Transactions with any of the seller/s of significant blocks of shares with whom the acquirers may have been in private negotiations shall close at the same time and upon the same terms as the tender offer made to the public under this Rule. For paragraph (2)(B), the last sale meeting the threshold shall not be consummated until the closing and completion of the tender offer.

Id.

84. *Id.*

85. *Id.*

86. Osmeña III v. Social Security System of the Philippines, 533 SCRA 313 (2007).

87. *Id.* at 324 (citing MORALES, *supra* note 4, at 153).

88. *Id.* (citing *Cemco Holdings, Inc.*, 529 SCRA at 370).

89. *Cemco Holdings, Inc.*, 529 SCRA at 360.

turn, majority of the stocks of UCHC, which is a non-listed company, is owned by Bacnotan Consolidated Industries, Inc. (BCI) and Atlas Cement Corporation (ACC).[90] Subsequently, BCI and ACC wrote the Philippine Stock Exchange (PSE) a letter disclosing their intention to sell their stocks in UCHC to Cemco.[91] Because the sale would have the effect of indirectly increasing Cemco's total ownership in UCC to at least 35% of the latter's shares, an issue arose as to whether the rules on mandatory tender offer would apply.[92]

In ruling that the mandatory tender offer rule applies even in indirect stock acquisitions such as in the case at bar, the Court had occasion to look at the deliberations of the Bicameral Conference Committee on the Securities Act of 2000.[93] From these deliberations, the Court concluded that the rule applies to any type of acquisition, stating that

> [t]he legislative intent of Section 19 of the Code is to *regulate activities relating to acquisition of control* of the listed company and for the purpose of protecting the minority stockholders of a listed corporation. Whatever may be the method by which control of a public company is obtained, either through the direct purchase of its stocks or through an indirect means, mandatory tender offer applies.[94]

Ultimately, the Court emphasized that control may be obtained either through direct or indirect means. Because of this, the Court did not hesitate to apply the rule even in cases of indirect purchases of shares.

IV. ASSESSING THE APPLICABILITY OF TENDER OFFER RULES TO PLEDGE ARRANGEMENTS

Realizing that a shareholder may pledge his shares of stock in a corporation as security for a loan contracted with a creditor, the following scenario may arise: considering that the rules on tender offer are in place to protect minority shareholders, what happens when one deliberately enters into a false contract of loan, thereby allowing the creditor to exercise control over the shares of stock of the debtor by virtue of an agreement to confer voting rights upon the former, therefore allowing control to be obtained without going through the requirement of a mandatory tender offer validly made to the rest of the shareholders?

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90. *Id.* at 360-61.

91. *Id.* at 361.

92. *Id.*

93. *Id.* at 372-74 (citing Securities Act of 2000, Hearings on Senate Bill No. 1220 Before the Bicameral Conference Committee on Securities Act of 2000, 11th Cong, 3d Sess. 41-42, 50 (2000) (statements of Senator Sergio R. Osmeña and Representative Gilbert C. Teodoro, Jr.)).

94. *Id.* at 373-74 (emphasis supplied).

For the mandatory tender offer rule to apply, the transaction must refer to an acquisition. This is clear from Rule 19.2 A of the IRR, which speaks of a person who "intends to acquire."[95] The said Rule also speaks of an "acquisition," but one that would result in ownership of more than 51% of the equity securities of a corporation.[96]

In the United States (U.S.), it is the Williams Act[97] that regulates large purchases of stocks in public corporations by broadening the rules on tender offers.[98] It requires disclosure arrangements in cases of purchases or offers to purchase of more than five percent of a company's equity securities.[99] The theory behind the requirement has been explained as being premised on the fact that "when *control of a corporation shifts* by reason of large equity purchases, the substance of an existing shareholder's investment is materially affected."[100]

In the Philippine context, it was *Cemco* that expounded on the intent behind the law, which is to regulate activities with regard to the acquisition of control of a corporation.[101] Thus, as regards those types of acquisitions which may be deemed to be indirect, the Court categorically based its decision to apply the rule on the fact that control is still shifted by virtue of the purchase, notwithstanding the latter's indirect character.[102] Hence, *Cemco* in effect broadened the set of circumstances by which the rule would apply — to any type of acquisition, as long as control is perceived to shift. This, according to *Cemco*, is for the protection of minority stockholders, to whom the law gives "the opportunity to decide whether or not to sell in connection with a transfer of control."[103]

Thus, by virtue of *Cemco*, it can be gleaned that an acquisition of either 35% or more of shares, or that which would result in obtaining ownership of more than 51% of the equity shares, is subject to tender offer rules as these would have the effect shifting control in the corporation. Interestingly, this

95. Rules and Regulations Implementing the Securities Regulation Code, rule 19.2 (A).

96. *Id.* rule 19.2 (C).

97. Williams Act, 15 U.S.C.A. §§ 78 (m) (d)-(f) & 78 (n) (d)-(f) (West 2010) (U.S.).

98. Nathaniel D. Smith, *Defining Tender Offer Under the Williams Act*, 53 BROOK. L. REV. 189, 196 (1987).

99. *Id.* at 189–190.

100. *Id.* at 190 (emphasis supplied).

101. *See Cemco*, 529 SCRA 355.

102. *Cemco*, 529 SCRA at 373–74.

103. *Id.* at 374.

has also been the view with regard to the mandated increase in the threshold for the rule's application, thus —

> Market participants believe that the ideal trigger point for the required tender offer would be the take over of '*majority control*' sufficient to give the offeror a seat in the board of the issuer for him to be able to participate in corporate decisions. A standard based on the acquisition of control accompanied with strict disclosure requirement will provide for level-playing field among the investors.[104]

It has therefore been shown that the intent behind the law is really to provide the shareholders the opportunity to tender their shares in cases where there is a shift in control, i.e., when the requisite thresholds have been reached. Subsequently, one may ask: are voting rights that go with the pledged shares sufficiently indicative of control?

Control has been defined as the ability "to exercise a restraining or directing influence over something."[105] Following this definition, for a shareholder to obtain control, the ability to influence should at least be present. Indeed, the shares allow the shareholder to vote on an array of matters pertaining to the corporation's acts. As discussed, even if the share is a non-voting share, the holders are nonetheless entitled to vote on essential matters such as the amendment of the articles of incorporation as well as the dissolution of the corporation.[106] Clearly, the right to vote is a powerful right, considering that a corporation, despite its separate corporate personality, is not a natural person, but instead acts through its board of directors with the concurrence of the shareholders in certain instances.[107] Consequently, voting power, empowered by the necessary number of shares, is clearly indicative of the ability to influence — the ability to control.

To summarize, the law allows the debtor to pledge his shares in a corporation to the creditor as security for the loan contracted. Subsequently, the parties may enter into an agreement giving the pledgee creditor the right to vote said shares, the only requirement being the express consent in writing by the pledgor as well as the recording of such agreement in the books of the corporation. Also, it has been established that because the pledgee has been given voting rights, he thereby exercises a certain amount of control of the corporation. This arrangement, the Author believes, can be used as a tool to bypass the mandatory tender offer requirements and at the

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104. DECASA, *supra* note 40, at 65 (emphasis supplied).

105. BLACK'S LAW DICTIONARY 378 (9th ed. 2009).

106. CORPORATION CODE, § 6, ¶ 7.

107. *See* CORPORATION CODE, § 2. This Section defines a corporation as "an artificial being created by operation of law, having the right of succession and the powers, attributes[,] and properties expressly authorized by law or incident to its existence." *Id.*

same time obtain control, assuming that the amount of the pledged shares reach the threshold as provided by the rules on mandatory tender offers.

However, requiring the rules on mandatory tender offer to apply to the aforesaid scenario would not be the solution to the problem, for a number of reasons.

First, it is to be noted that not all persons who enter into a contract of pledge have the fraudulent intent to gain control of a corporation. Making the rule apply, therefore, to all transactions involving the pledge of shares of stock would be detrimental to innocent creditors whose only wish is to be secured of the payment of their loan. If such rules would be made to apply, then an innocent creditor would eventually face the situation in which he will be required to purchase the shares of the minority stockholders at the latter's tendered prices, without even having the intention to buy the shares subject of the pledge in the first place, and, therefore, producing incongruous results.

Second, an innocent pledgee forced to make a tender offer despite the absence of a stipulation to such effect between the parties in the original contract of pledge would run counter to established laws governing contracts. When the parties agree to enter into a contract, the law respects the stipulations contained in such contract, save in instances when the latter is contrary to law, morals, good customs, public order, and public policy.[108] Thus, a creditor who enters into a contract of pledge by virtue of the original contract of loan ordinarily does not envision entering into a contract of sale in the process. These are different contracts involving different considerations. In light of this, Article 1378 of the Civil Code provides that

> [w]hen it is absolutely impossible to settle doubts by the rules established in the preceding articles, and the doubts refer to incidental circumstances of a gratuitous contract, the least transmission of rights and interest shall prevail. If the contract is onerous, the doubt shall be settled *in favor of the greatest reciprocity of interests.*[109]

The above-quoted Article is a rule on the interpretation of doubtful contracts. Thus, in *Castelo v. Court of Appeals*,[110] the Court ruled that "in case of ambiguity in contract language, that interpretation which establishes a less onerous transmission of rights or imposition of lesser burdens which permits greater reciprocity between the parties, is to be adopted."[111] Applying the rule by analogy to the instant case, the innocent pledgee cannot be forced to make a tender offer, the latter not being contemplated in

108. CIVIL CODE, art. 1306.

109. *Id.* art. 1378 (emphasis supplied).

110. Castelo v. Court of Appeals, 244 SCRA 180 (1995).

111. *Id.* at 192.

the contract of pledge entered into. There being no stipulation to such effect, the policy of the law is in favor of the greatest reciprocity of interests — for the pledgor, greater assurance that the pledgee would grant the loan; for the pledgee, more probability that the pledgor would not renege in his obligation. Generally, it is not in the interest of the pledgor to part with his shares. On the other hand, it cannot possibly be surmised that it is part of the innocent pledgee's intention to purchase the shares of the tendering shareholders, let alone those subject of the pledge.

Third, it cannot be doubted that security contracts serve a vital role in society. In this day and age, security contracts are in place in order for more commercial exchanges to be possible — "[b]y the use of credit, more exchanges are possible, persons are able to enjoy a thing today but pay for it later."[112] These arrangements are certainly vital economic tools, allowing persons to invest money and let it grow, paying for it later out of the proceeds of the investment. Hence, requiring the pledgees to consummate tender offers would be unduly burdensome, causing pledgees to think twice in, and even refuse to, enter into contracts of pledge. Certainly, this would have the effect of undermining the strength of security contracts as a whole, which have been almost necessary in current society.

With all these unfavorable effects, requiring tender offers to apply in cases of pledged shares would certainly not be the solution in deflecting those transactions that seek to subvert the policies behind the securities laws. Hence, the need to look for other answers arises.

Examining once again the contract of pledge, it is evident that the title to the pledged shares remains in the name of the pledgor. Only certain rights, such as the right to vote, are granted to the pledgee. Hence, it is really the beneficial ownership which the pledgee derives from the pledgor.

In *La Bugal-B'laan Tribal Association, Inc. v. Ramos*,[113] the Court had occasion to explain the nature of beneficial ownership. In the process, it made a distinction between beneficial and naked ownership, saying that the former is "the enjoyment of all the benefits and privileges of ownership, as against possession of the bare title to the property."[114] It furthermore noted the two senses in which the term is used. Thus, it may be understood to refer to "the beneficiary's in trust property — [a]lso called 'equitable ownership'"[115] or as "the power of a corporate shareholder to buy or sell the shares, though the shareholder is not registered in the corporation's books as

112. DE LEON, *supra* note 69, at 1 (citing CLIFFORD L. JAMES, PRINCIPLES OF ECONOMICS 130 (9th ed. 1956)).

113. La Bugal-B'laan Tribal Association, Inc. v. Ramos, 445 SCRA 1 (2004).

114. *Id.* at 156.

115. *Id.* (citing BLACK'S LAW DICTIONARY 1215 (9th ed. 2009)).

the owner."[116] Applying the foregoing definitions to shares of stock, it is clear that beneficial ownership entails exercising the rights of ownership over the stocks without necessarily being considered as the owner.

Rule 23 of the IRR, on the reports to be filed by directors and other officers and stockholders, provides the guidelines on beneficial ownership of shares of stock. It requires "[e]very person who is directly or indirectly the beneficial owner of 10% or more of any class of any security of a company which satisfies the requirements of Subsection 17.2 of the Code"[117] to:

> (a) within ten (10) days after the effective date of the registration statement for that security, or within ten (10) days after he becomes such beneficial owner, director or officer, subsequent to the effective date of the registration statement, whichever is earlier, *file a statement with the Commission, and with an Exchange if the security is listed on that Exchange,* on Form 23-A indicating the amount of all securities of such issuer of which he is the beneficial owner;
>
> (b) within ten (10) days after the close of each calendar month thereafter, if there has been any change in such ownership during the month, file a statement with the Commission, and with an Exchange if the security is listed on that Exchange, on Form 23-B indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during that calendar month; and
>
> (c) notify the Commission if his direct or indirect beneficial ownership of securities falls below ten percent (10%), or if he ceases to be an officer or director of the issuer. After filing such notification, he shall no longer be required to file Form 23-B.[118]

Hence, reportorial requirements are imposed upon those who obtain beneficial ownership of over 10% of the securities of a corporation. Clearly, the threshold amount of 35% and 51% that would trigger the imposition of a mandatory tender offer falls within the coverage of the aforementioned provision. In the instant case, the pledgee, being the beneficial owner of the shares, is required to file a statement with the SEC and with the PSE if the security is listed thereon. Accordingly, the law provides that the failure to abide by these rules exposes the offender to administrative sanctions, without prejudice to the filing of criminal charges, if applicable.[119]

In *Interport Resources*, although referring to the now defunct Revised Securities Act,[120] the Court pronounced that the rules on beneficial

116. *Id.*

117. Amended Implementing Rules and Regulations of the Securities Regulation Code, rule 23.

118. *Id.* (emphasis supplied).

119. SECURITIES REGULATION CODE, § 54.

120. The Revised Securities Act, Batas Pambansa Blg. 178 (1982).

ownership relative to securities are not vague, but actually "straightforward" rules which do not need interpretation.[121]

By virtue of the rules on beneficial ownership, the persons intending to gain control would have to disclose their ownership. This would require the revelation of those transactions that appear to be fraudulent, which would then give the shareholders and other stakeholders the needed information that would influence future actions. Transparency is thus attained. Furthermore, as one of the intent behind the establishment of the rules on mandatory tender offers was the disclosure of as much information as possible relative to a purchase, the disclosure requirements relative to beneficial ownership would, in essence, possess the same enlightening effect to shareholders. This would, in turn, give the latter the necessary basis that would guide their investment plans.

V. CONCLUSION AND RECOMMENDATION

The laws on securities are in place to protect shareholder interests. Especially in today's times of economic growth, the need for these laws that protect the investor cannot be highlighted more. As seen, the Philippines actually has a number which addresses this concern. There are the rules on mandatory tender offers, for instance. These rules undoubtedly serve a valid and timely purpose.

Despite, however, the valid purpose of the mandatory tender offer rules, these cannot be applied to pledge arrangements involving shares of stock. With the ramifications enumerated, the Author deems its application as that which, although presenting an answer to the problem of one group, unduly burdens another sector. Such cannot be countenanced.

A World Bank report on corporate governance in the Philippines[122] states full disclosure as one of the country's key concerns. It observed that both the SEC and the PSE employ the "Full Disclosure Approach" as regards company transactions.[123] The report also signified approval of the recent adoption of international standards with regard to financial statements and other reports.[124] In addition, the report also took note of the rules governing ownership disclosure provided in the law, making a reference to the mandated disclosure requirements relative to beneficial ownership as well as the sanctions imposed in the event these are not followed.[125]

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121. *Interport Resources Corporation*, 567 SCRA at 387.

122. World Bank Report, *supra* note 19.

123. *Id.* at 4.

124. *Id.* at 5.

125. *Id.* at 6.

Hence, disclosure requirements are already in place to provide safeguards that could detect possibly fraudulent pledge arrangements, which could be used to circumvent the intent behind the laws. In turn, the above-cited report agrees with the fact that laws and regulations on corporate governance are strong in the Philippines.[126]

Enforcement, however, is a different matter altogether. The government can enact the most effective laws that curb fraudulent transactions, yet fail in their execution. The failure to properly set the rules in motion is in no conceivable way better than the absence of such rules. Thus, the same report abovementioned presents as one of its recommendations that which would strengthen the enforcement by the SEC and the PSE of the existing laws and regulations on the matter.[127]

Considering the vital importance of disclosure requirements, the Author believes that these should be prioritized. Disclosure requirements are among the easiest to enforce, necessitating only the presentation of certain information to the proper parties and the institution of checking mechanisms relative to the truth of the statements given. Yet, its effects are immense — not only for the investor who is afforded the opportunity to assess his investment plans accordingly, but also for the overall investment climate of the country, which is ensured of the needed transparency. Undeniably, an investor may seek refuge under the potent laws aimed at protecting his interests. Yet ultimately, there can be no more equipped investor than an informed one.

126. *Id.* at 7.

127. *Id.*