

Uncertainty remains for foreign investors in the Philippines

Once again the Philippine Supreme Court ("SC") has changed the landscape with respect to the interpretation of foreign ownership restrictions in the Philippines. The SC has recently issued a final ruling tightening the rules on foreign investment in public utilities ensuring control remains with Philippine nationals. The new ruling is supplemented by a number of important *obiter dicta* (non-binding statements), which created new uncertainty. The Philippine Security and Exchange Commission ("SEC"), however, has a more liberal view and declared it shall follow the dispositive (binding portion) of the SC decision, but ignore the *obiter dicta*.

This uncertainty about the interpretation of the foreign ownership restrictions will also affect investment in other nationalised or partly nationalised industries in the Philippines.

Overview

In 2011, the SC issued its decision in *Gamboa v Finance Secretary Teves et al.* (the "Gamboa Decision")¹, which brought about a far-reaching change in the interpretation of the country's foreign ownership rules, leaving some foreign investors in the Philippines in an uncertain position. Please see our briefing [Ruling creates uncertainty for foreign investors in the Philippines](#) dated July 2011 for further information on this landmark decision.

That decision was followed by multiple motions for reconsideration filed by various parties, including the President of the Philippine Stock Exchange and the SEC.

In a resolution dated 9 October 2012 (the "Gamboa Resolution")², all motions for reconsideration of the *Gamboa* Decision were denied by the SC with finality, affirming the rule in the *Gamboa* Decision. However, much of the uncertainty created by the *Gamboa* Decision remains and new uncertainty has been created as the SC in the *Gamboa* Resolution made certain non-binding comments that question the legality of well-established investment structures.

Who are affected?

Philippine corporations engaged in partly nationalised business activities (including public utilities, land ownership and exploitation of natural resources) as well as their foreign and domestic investors.

¹ G.R. No. 176579, 28 June 2011. Note that dissenting opinions were delivered by Associate Justices Velasco, Jr. and Abad.

² G.R. No. 176579, 9 October 2012. Note that dissenting opinions were delivered again by Associate Justices Velasco, Jr. and Abad.

Following the *Gamboa* Decision and *Gamboa* Resolution ("the *Gamboa* Rulings") the SEC had issued, in November 2012, a draft memorandum circular³ for public consultation (the "Draft Circular") which appears to apply strictly the tests which were laid out by the Philippine Supreme Court in the *Gamboa* Rulings to any corporation engaged in a nationalised or partly nationalised activity (termed a "Covered Corporation"). This caused heavy criticism from many sectors as the non-binding comments of the SC in the *Gamboa* Resolution were perceived as too far-reaching, and leading to a possible pullout of investments.

After the SC issued the entry of judgment in the *Gamboa* Rulings citing again the full text of the dispositive/binding part of the *Gamboa* Decision, which was widely understood as a repudiation of the non-binding comments in the *Gamboa* Resolution, the SEC announced that the new SEC rules shall follow the *Gamboa* Decision, but no longer implement the non-binding comments made in the *Gamboa* Resolution. A new version of the Draft Circular is expected to be published sometime in March 2013 for public discussion and eventual implementation of final rules in June 2013.

Foreign ownership rules in the Philippines

There are foreign investment restrictions in a number of important sectors in the Philippines, such as a 40% ownership restriction in public utility companies, land-owning companies and co-production, joint venture and production-sharing agreements for the exploration, development and utilisation of natural resources. These restrictions are based on the Philippine Constitution as well as a number of Philippine laws and regulations governing foreign investment.

Section 11 of Article XII of the Philippine Constitution provides: "No franchise, certificate, or any other form of authorization for the operation of a public utility shall be granted except to the citizens of the Philippines or to corporations or associations organized under the laws of the Philippines, at least **sixty per centum of whose capital is owned by such citizens...**" Similar restrictions are contained in other provisions of the Constitution for other sectors of the economy.

The Philippine Constitution itself does not define "capital." Before the *Gamboa* Decision, the term "capital" had been understood, in practice, to mean the **total outstanding capital stock** (i.e. the combined total of all outstanding shares, without regard as to classification, par value or voting rights). Accordingly, a number of transactions had been structured by creating different classes of shares with different economic rights, and reserving the class of shares with superior economic (par value/dividends) rights for non-Filipino investors who were willing to infuse more capital than their Filipino counterparts, while still maintaining the 60/40 "capital" requirement. This approach had been confirmed by many Philippine Department of Justice ("DOJ") and SEC opinions.

What has changed?

The SC in the *Gamboa* Decision held that "capital" only means shares with **voting rights** to elect directors (and not, as previously understood, the entire issued capital) ("*Gamboa* Voting Control Test"). This decision was affirmed in the recent *Gamboa* Resolution. Foreign equity holdings in many corporations may therefore need to be restructured to ensure

How is foreign equity to be calculated post *Gamboa*?

The Supreme Court in the *Gamboa* Rulings clearly settle the definition of "capital" to include only shares with voting rights to elect directors.

Foreign equity holdings in many corporations may therefore need to be restructured to ensure compliance with the Supreme Court's Ruling.

³ (Draft) SEC Memorandum Circular No. ____ on Guidelines, Rules and Regulations on Registration, Monitoring, and Investigation of Compliance by Corporations engaged in Nationalized or Partly Nationalized Activities with Ownership Requirements in the Constitution and / or existing Laws, and imposing Penalties for Violations thereof, posted by the SEC on 5 November 2012.

compliance with the SC's Ruling.

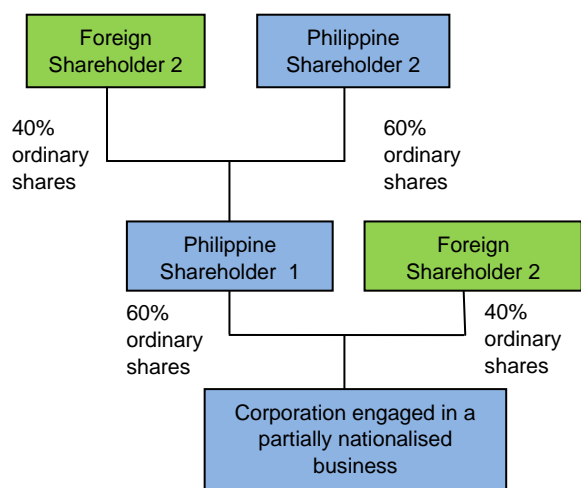
Another important point to note is that the SC in the *Gamboa* Resolution went further than the *Gamboa* Decision and made the following additional **non-binding statements**:

- 60% of the voting rights **and** 60% of each class of shares must be owned by Filipinos ("the Beneficial Ownership Test"). Consequently, for the Beneficial Ownership Test to be met in a 60-40 nationality requirement scenario, it is not enough that 60% of the voting shares are Filipino-owned as required under the *Gamboa* Voting Control Test, it is also required that each class of shares of the subject corporation be at least 60% Filipino-owned. Compliance with the Beneficial Ownership Test will make it impossible to structure by creating different classes of voting shares with different economic rights, and reserving the class of shares with superior economic (par value/dividends) rights for non-Filipino investors who were willing to infuse more capital than their Filipino counterparts; and
- for structures with two or more corporate layers, the Grandfather Rule must also be applied to the exclusion of the SEC Control Test (defined below).

The previously held view of the SEC and DOJ is that the Grandfather Rule should only be applied when the shareholders of a corporation are also corporations and Filipinos own less than 60% of the former corporation⁴. Where the 60% Filipino ownership of the shareholder-corporation is clearly established, the Grandfather Rule will not apply and such shareholder-corporation will be deemed of Philippine nationality even if only 60% thereof is owned by Filipinos (the "SEC Control Test")⁵.

An illustration of the two alternative tests

- If you were to use **only** the SEC Control Test, the Corporation would be considered to be of Philippine nationality because Philippine Shareholder 1 is considered a Philippine National due to the fact that 60% of its voting shares are held by a Philippine National (being Philippine Shareholder 2). Thus, the SEC would not need to use the Grandfather Rule.
- If you were to use the Grandfather Rule, as suggested by the SC in the *Gamboa* Resolution, the same structure would result in the Corporation being considered to be 64% foreign owned (40% direct foreign by Foreign Shareholder 1 and 24% indirect through Philippine Shareholder 1) and therefore not qualify to engage in a partially-nationalized activity.



So while the definition of "capital" has been decided with finality, the impact of the above non-binding statements in the *Gamboa* Resolution put into question whether corporate layering in accordance with the established practice and relying on the SEC's Control Test is still permissible, exposing many foreign investors in the Philippines to legal uncertainty.

⁴ SEC-OGC Opinion No. 26-11 dated 19 April 2011
⁵ DOJ Opinion No. 20 dated May 5 2005

Can investors rely on previously issued SEC Opinions?

In principle, Philippine law recognises certain protective effects of good faith reliance on official acts of the government. However, in the *Gamboa* Resolution, the Supreme Court categorically stated that the interpretation of 'capital' set forth therein does not constitute a change in law and that "foreign investors and their counsel, who relied on opinions of SEC legal officers ... do so at their own peril".

This view, however, was fiercely disputed by the Dissenting Opinion of Justice Velasco, who saw the *Gamboa* Rulings as a change in law and who discussed issues of estoppel and further opined that, under the "fair and equitable treatment" clause of the Philippine bilateral investment treaties and fair trade agreements, foreign investors have a right to rely on the same legal framework existing at the time they made their investments.

Sanctions for non-compliance and cure periods

Violations of the foreign ownership restrictions are subject to multiple sanctions, including possible criminal sanctions under the Anti-Dummy Law⁶ that may entail the dissolution of the corporation in question, imprisonment of up to 15 years, a fine not less than the value of the right in violation of the provisions thereof and forfeiture of the right or privilege that is subject of the nationality requirement.

The SC did not establish any general cure periods for investments that may be regarded non-compliant under the new interpretation, but stated "*public utilities that fail to comply with the nationality requirement under Section 11, Article XII and the FIA can cure their deficiencies prior to the start of the administrative case or investigation.*"

Since the time, when an administrative case or investigation is started, is hardly foreseeable, the resulting time pressure could have a significant adverse impact on the value of the affected corporations and the foreign and domestic investments in them.

New draft rules announced by the SEC

The SEC, in the Draft Circular of 5 November 2012, initially appeared to be strictly interpreting the decision of the SC in the *Gamboa* Rulings, but not necessarily all of the non-binding statements contained in these rulings. The proposed draft contained definitions of "Philippine national" and "beneficial ownership" that are widely based on the existing Foreign Investments Act ("FIA") and the Implementing Rules and Regulations of the FIA. The Draft Circular also clarified that constitutional or statutory ownership restrictions shall be observed **for each class of shares** (Section 4), which reflects one of the non-binding statements made in the *Gamboa* Resolution. However, during the first public hearing on the draft, it transpired that such clarification is likely to be removed, and the SEC was expected to publish a revised draft by early 2013 for further public consultation.

The Draft Circular also contemplated that proof of Filipino citizenship of an incorporator or stockholder may be required by the SEC in the implementation of the Circular (Section 8). Furthermore, the Draft Circular was supposed to introduce new reporting requirements, a system of internal controls and compliance and monitoring by the SEC for Covered Corporations, together with procedural rules and additional administrative penalties in case of non-compliance.

On 11 December 2012 the SC issued the entry of judgment in the *Gamboa* Decision citing again the full text of the dispositive/binding part of the *Gamboa* Decision. Although the entry of judgment merely repeats the dispositive/binding portion of the *Gamboa* Decision, as confirmed by the dispositive/binding portion of the *Gamboa* Resolution, this entry of judgment was nevertheless widely understood as a repudiation of the non-binding comments in the *Gamboa* Resolution,

⁶ Commonwealth Act No. 108, An Act to Punish Acts of Evasion of the Laws on the Nationalization of Certain Rights, Franchises or Privileges, as amended.

including the statements in relation to the purported requirement that 60% of the voting rights **and** 60% of each class of shares must be owned by Filipinos.

Shortly thereafter, on 10 January 2013, the SEC announced that the new SEC rules shall follow the *Gamboa* Decision, but no longer implement the non-binding comments made in the *Gamboa* Resolution. A new version of the Draft Circular is now expected to be published sometime in March 2013 for public discussion and eventual implementation of final rules in June 2013.

Who will be affected?

Philippine corporations engaged in partly nationalised business activities (including public utilities, land ownership and exploitation of natural resources) as well as their foreign and domestic investors will be affected by the *Gamboa* Rulings and the SEC Draft Circular, a revised version of which is expected for March 2013. This effect is not limited to investments subject to Section 11 of Article XII of the Philippine Constitution, as the term "capital" is also used in a number of other provisions of the Philippine Constitution that set out the constitutional framework for the Philippine economy.

What can foreign investors do?

Affected corporations as well as their foreign and Philippine shareholders should ensure compliance with the new interpretation of the term "capital" as well as the new rules to be promulgated by the SEC in due course. At this point, however, there is no definite timeline for any restructuring.

In addition, it will be prudent to carefully analyse the impact of the various non-binding statements that, albeit not binding today, may become law tomorrow, whenever the relevant issues are presented to the Supreme Court again. In this context we observe that many Philippine corporations take comfort from the fact that the SEC, based on recent pronouncements, is not going to implement the non-binding comments in the *Gamboa* Resolution. But a risk remains and such risk is likely to have impact on the structuring of investments as well as on the financing of investments and projects in the Philippines. In the event that the SC might confirm the non-binding comments it made in the *Gamboa* Resolution, this may happen with the risk of retroactive application bearing in mind that the SC held that investors who rely of SEC opinions do so at their own peril.

Obviously restructuring measures to comply with the changed application and interpretation of foreign ownership rules will dilute and remove any voting control of foreign investors. Their alternative is to divest part of their investments to bring them to the required thresholds which would have the same effect. Both scenarios may be undesirable or unacceptable for some foreign investors whose investment structure is substantially distorted by the change of rules.

As a result, foreign investors may decide to liquidate their entire investment in affected Philippine companies rather than giving up their entitlement to board seats. While this may seem a straightforward solution, there will be pricing pressure on foreign investors looking to exit. This is because the potential pool of buyers will be small, as it will (by virtue of the restrictions) be limited to local buyers. Local buyers may or may not have the liquidity to purchase the shares for market value, but even if they do they will know that they are dealing with a seller who is obligated to sell in some shape or form. Opportunistic buyers will view this as a means of acquiring some assets at a discount.

As discussed in detail in our [July 2011 Client Briefing](#), another potential option for affected investors is to assess whether any bilateral investment treaty or trade agreement applicable to their investment, either directly or by virtue of a most favoured nation clause, provides for an appropriate relief. The Republic of the Philippines entered into numerous bilateral investment treaties and trade agreements (with Investment Chapters) for the protection of foreign investments, which however provide for quite different levels of protection depending on the individual features of the respective agreements.

Conclusion

Most investors acknowledge that there is commercial risk involved with investing in an emerging market, which is why the return on their investments are so much higher than in more mature and developed markets. What is harder to accept is the

legal uncertainty that decisions such as the *Gamboa* Rulings create, which drastically change the rules by which they have made their investments.

Whether the new rules to be promulgated by the SEC are going to create a greater degree of legal certainty remains to be seen in view of the far-reaching non-binding statements in the *Gamboa* Resolution.

If you have concerns about your investment in the Philippines, we would also be happy to discuss the specific effect of the *Gamboa* Rulings and the contemplated new SEC rules on your investment and what you can do to protect your interests.

Further information

Members of Clifford Chance's Philippine Focus Group have extensive experience in the Philippines and continue to monitor developments in the country.

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