

# Ruling creates uncertainty for foreign investors in the Philippines

The Philippines is an increasingly attractive destination for foreign investors, particularly in the past year with the change in administration and promises made by newly appointed President Benigno "Noynoy" Aquino III to end graft and corruption, as well as ensuring more transparency and openness, particularly for foreign investment.

## Foreign ownership rules – new interpretation

However, a far-reaching decision recently handed down by the Supreme Court of the Philippines in *Gamboa v Finance Secretary & Ors*<sup>1</sup>, has changed the interpretation of the country's foreign ownership rules, and thereby left some foreign investors in the Philippines in an uncertain position.

There are foreign investment restrictions in a number of important sectors in the Philippines, such as a 40% ownership restriction in public utility companies and co-production and JV agreements for the development of natural resources.

Foreign investors' shareholdings have been structured to comply with that 40% restriction limit on capital ...or what was generally understood to be meant by that restriction. But the Supreme Court's definition of 'capital' means that it is likely that a number of foreign investors may be holding more than the 40% limit, as calculated pursuant to the rules pronounced by the Supreme Court and thereby breaching the restriction. A breach of the relevant restrictions may translate into a violation of the so-called Anti-Dummy Law and thus to criminal prosecution and to confiscation.

What does this mean for foreign investors? In short, if the shareholdings are in breach of the restriction under the new definition, the foreign investors may be required to divest their shareholdings, and the investee companies may be perceived as holding their respective franchises in violation of the law. This obviously may have potentially disastrous implications for foreign investors' interests.

In this client briefing we outline the key points of the decision before looking at the likely fall-out from the decision and potential options for foreign investors.

## The decision – in a nutshell

The action related to the public utility, Philippine Long Distance Telephone Company (PLDT), the largest telecommunications company in the Philippines, and was brought by a Philippine national, Wilson Gamboa, over the sale of some of its shares to foreign entities. The Supreme Court's decision focused on the meaning of "capital" in the limitation regarding foreign ownership of public utilities provided for in the Constitution:

## Key Issues

### Foreign ownership rules – new interpretation

### The decision – in a nutshell

### Article XII National Economy and Patrimony

### Fall-out from the decision

### Who will be affected?

### What can foreign investors do?

### Conclusion

### Further information

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

### Article XII National Economy and Patrimony

Section 11. 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..." (emphasis added).

The Constitution itself does not define "capital." Until now it has been understood in practice to mean the total outstanding capital stock (ie the combined total of common and non-voting preferred shares), and accordingly the 40% rule has been calculated on that basis. The Supreme Court has now determined that "capital" only means shares with voting rights to appoint directors. The practical consequence of that interpretation being that the pool of shares according to which the 40% calculation is made is now smaller, as it still includes common shares, but may exclude preferred shares, depending on the features combined to the relevant preferred shares under the investee companies' articles of incorporation. As a result, a foreign investor's shareholding in that smaller pool may be greater than they thought...and consequently may exceed the 40% cap.

### Fall-out from the decision

At the conclusion of its judgment, the court directed the Chairperson of the Securities and Exchange Commission (which was a party to the proceedings) to apply this definition of capital in determining the extent of allowable foreign ownership in PLDT, and went on to direct the Securities and Exchange Commission that " if there is a violation of Section 11, Article XII of the Constitution, to impose the appropriate sanctions under the law" if there was found to be a violation of the 40:60 capital restriction as now defined. Such sanctions can involve fines, imprisonment, the forfeiture of the restricted right and the dissolution of the investee company.

Although PLDT has indicated that it will appeal the decision, it has also had to announce plans for compliance with the court's determination if unsuccessful, which will see 150 million preferred shares being issued with voting rights to Filipino nationals.

### Who will be affected?

Foreign investors across various key sectors will be affected by the decision. The far-reaching consequences of its decision was not lost on the Supreme Court, which noted that the term 'capital', in the context of restrictions on foreign ownership, appears elsewhere in the Constitution in relation to co-production and JV agreements for the development of natural resources, ownership of private lands, educational institutions and advertising companies.<sup>2</sup>

The impact was felt immediately; the Philippine Stock Exchange index plunged dramatically following the announcement of the decision. PLDT which is a major component of the index suffered a fall in its share price by as much as 3.75% after the decision was handed down.

### What can foreign investors do?

Many foreign investors are looking at their options in the wake of the decision. Do they sell up now, or wait and see if the decision is overturned on review? If it is not overturned, then what remedies do they have if forced to divest at least part of their shareholdings?

Philippine companies affected by the Supreme Court decision may look at ways of helping their foreign investors structure their investments in the Philippines to ensure compliance with the Supreme Court's decision. As mentioned, PLDT has announced that it will look to issue voting preferred shares to Philippine nationals to meet the new foreign investment ratios created by the Supreme Court decision.

Obviously such measures will dilute the voting control of foreign investors. Time will tell whether foreign investors will accept this solution to maintain their current investments. 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.

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<sup>2</sup> *Gamboa v Finance Secretary & Ors* G.R. No. 176579, 28 June 2011, at page 12-13

Another potential option that may be available to investors is to commence an action directly against the Philippine government for a breach of one of the protections afforded to investors under the numerous bilateral investment treaties (BITs) and trade agreements (with Investment Chapters) into which the Philippines has entered, including those with Australia, China, France, Germany, Indonesia, India, South Korea and the United Kingdom, and as a member of ASEAN.<sup>3</sup>

Typically, these trade/investment agreements afford protections to qualifying 'investors' who make a qualifying 'investment', against improper interference from the host State. Common protections include:

- **National Treatment:** qualifying foreign investors to be treated no less favourably by the host State than its domestic investors.
- **Most Favoured Nation Treatment:** qualifying foreign investors to be treated at least as favourably as the investors from other States.
- **Fair and Equitable Treatment:** the meaning of this protection continues to evolve, but is generally defined by reference to meeting the legitimate expectations of the investor, and has in some circumstances been extended to include an obligation on a host State to maintain a stable legal and business environment. This standard is commonly linked with another standard of non-impairment by arbitrary and unreasonable measures.
- **Full Protection and Security:** the host State must afford a foreign investor full protection and security, which has been construed by some tribunals to extend beyond physical security to include legal protection.
- **Expropriation/nationalisation:** commonly the treaties will provide expressly for compensation to be paid in the event of expropriation (which is broader than just the physical seizure of assets).
- **Umbrella clauses:** these clauses require States to observe any specific obligations they have entered into with an investor (e.g. which may include some contractual obligations).

Such standards of protection are construed in accordance with international law.

Trade/investment agreements also typically include an investor-state dispute resolution provision that allows the investor to bring international arbitration proceedings against the host State for violation of one or more of the standards of protection and to claim damages. The ISDR provisions commonly provide for a staged approach starting with conciliation/negotiation between the parties during a specified "cooling off period", followed by international arbitration. Most treaties allow the investor to choose arbitration under the rules of the International Centre for the Settlement of Investment Disputes (ICSID), based in Washington, or the United Nations Commission on International Trade Law (UNCITRAL) Arbitration Rules.

The Philippines is no stranger to such claims.<sup>4</sup>

## 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 *Gamboa v Finance Secretary & Ors* create, which drastically change the rules by which they have made their investments.

The Philippine government, the Securities and Exchange Commission and the Philippine Stock Exchange recognise that the Supreme Court's decision sends a bad message to foreign investors who have invested, or are looking to invest, in the Philippines. Moves are afoot to address the consequences of the Supreme Court's decision to remove the uncertainty now faced by foreign investors in the Philippines.

These moves will take time however, and in the interim, companies such as PLDT will need to find ways to calm the concerns of foreign investors.

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<sup>3</sup> Philippines has BITs in place with Argentina, Australia, Austria, Bangladesh, Belgium, Burma, Cambodia, Canada, Chile, China, Czech Republic, Denmark, Finland, France, Germany, India, Indonesia, Iran, Italy, Luxembourg, Mongolia, Netherlands, Pakistan, Portugal, Romania, Russian Federation, Saudi Arabia, South Korea, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, United Kingdom of Great Britain and Northern Ireland, and Vietnam. Additionally, Philippines is a part of the ASEAN FTA, ASEAN - China FTA, ASEAN - Japan CEP, ASEAN - Korea FTA, ASEAN - ANZ FTA, ASEAN - India FTA and the ASEAN - EU FTA.

<sup>4</sup> *Fraport AG Frankfurt Airport Services Worldwide v. Republic of the Philippines* (ICSID Case No. ARB/11/12); *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines* (ICSID Case No. ARB/02/6); *Fraport AG Frankfurt Airport Services Worldwide v. Republic of the Philippines* (ICSID Case No. ARB/03/25). Note this list only refers to cases under ICSID, and is therefore not an exhaustive list of all investor-state cases that may have been brought against the Philippines.

If you have concerns about your investment in the Philippines, we would also be happy to discuss the specific effect of the decision on your investment and what you can do to protect your interests.

**Further information**

Clifford Chance is running Master Classes in the region to explain the consequences of the Supreme Court's decision and the options available to foreign investors that are affected by the decision. Please contact Eddie Hobden at [eddie.hobden@cliffordchance.com](mailto:eddie.hobden@cliffordchance.com) for further information.

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This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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