Updating the Law on Corporate Rehabilitation

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I. INTRODUCTION

A severe financial crisis is presently sweeping the globe. It has been described as the worst economic crisis since the Great Depression of 1929. The blight in the financial markets is already spreading to the real economy. The constriction in credit will cripple many companies and lead to the closure of others. Some companies will be strong enough to weather this latest economic crisis; others will need a little breathing space and, possibly, financial assistance, to restore them to health. A good many will be left to die by the roadside, victims of fair but ruthless competition.

Insolvency laws are designed for companies that are under financial distress. The merely ailing may avail of the lifeline extended by the law, while the terminally ill undergo liquidation.

Now would be a particularly good time to review our outdated insolvency laws and take a look at the insolvency bill pending and languishing in Congress. Act No. 1956,[1] a relic of American rule and known as the Insolvency Law, will turn 100 years old on May 2009. The Insolvency Law has no provisions on corporate rehabilitation. It merely provides for suspension of payments,[2] voluntary insolvency,[3] and involuntary insolvency.[4]

Presidential Decree No. 902-A[5] (P.D. No. 902-A), the first, and so far only, law on corporate restructuring, is not as ancient as the Insolvency Law, but is equally in need of rehabilitation. The objective of P.D. No. 902-A was not so much the creation of a law on corporate rehabilitation but the reorganization of the Securities and Exchange Commission (SEC), as can be

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Cite as 53 ATENEO L.J. 547 (2008).

1. An Act Providing for the Suspension of Payments, the Relief of Insolvent Debtors, the Protection of Creditors, and the Punishment of Fraudulent Debtors [The Insolvency Law], Act No. 1956 (1909).
2. *Id.* §§ 2-13.
3. *Id.* §§ 14-19.
4. *Id.* §§ 20-28.
5. Reorganization of the Securities and Exchange Commission with Additional Powers and Placing the Said Agency under the Administrative Supervision of the Office of the President, as amended by Presidential Decree 1653, 1758 and 1799 [SEC Reorganization Act], Presidential Decree No. 902-A (1976).

gathered from its title and Whereas Clauses.[6] P.D. No. 902-A, known as the SEC Reorganization Act, clearly could not, without the aid of judicial interpretation, address the numerous issues that arise during rehabilitation proceedings.

In December 2000, the Supreme Court approved the Interim Rules of Procedure on Corporate Rehabilitation[7] (Interim Rules) drafted by the Committee on SEC Cases (Committee). The Supreme Court created the Committee in response to Republic Act No. 8799, otherwise known as the Securities Regulation Code, which transferred the jurisdiction over petitions for suspension of payments and rehabilitation from the SEC to the Regional Trial Courts (RTC). The Supreme Court observed that there were no rules to guide the RTCs in handling rehabilitation cases and tasked the Committee to address the deficiency.[8] The Interim Rules have provided a useful procedural framework for petitions for rehabilitation.[9] However, it is arguable that the Interim Rules have gone beyond the mere promulgation of rules insofar as some of the provisions of the Interim Rules are concerned.

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6. *Id.*

> WHEREAS, in line with the government's policy of encouraging investments, both domestic and foreign, and more active public participation in the affairs of private corporations and enterprises through which desirable activities may be pursued for the promotion of economic development; and, to promote a wider and more meaningful equitable distribution of wealth, there is a need for an agency of the government to be invested with ample powers to protect such investment and the public;
>
> WHEREAS, to achieve these national objectives, it is necessary to reorganize and restructure the Securities and Exchange Commission to make it a more potent, responsive and effective arm of the government to help in the implementation of these programs and to play a more active role in national-building;
>
> WHEREAS, it is necessary and desirable to professionalize such agency by investing it with adequate powers so that it could avail itself of the services of highly technical and qualified men in the government service.

7. Supreme Court, Interim Rules of Procedure on Corporate Rehabilitation [Interim Rules], A.M. No. 00-8-10-SC (Nov. 21, 2000).

8. *See* Minutes of the Meeting of the Committee on SEC Cases (Nov. 17, 2000).

9. The Committee did not consider suspension of payments in drafting the Interim Rules "since there is still a question whether Presidential Decree No. 902-A, as amended, created its own kind of suspension of payments on top of the suspension of payments authorized by the Insolvency Law." (See Minutes of the Meeting of the Committee on SEC Cases, *supra* note 8, at 5-7).

The Supreme Court may have strayed into legislative territory in approving certain provisions drafted by the Committee.

Although aware of the importance of insolvency laws to commerce and of the deficiencies and shortcomings of the present insolvency laws, a few legislators have authored bills on insolvency. The objective of this paper is to review and provide a commentary on these pending legislation on insolvency, in particular the salient provisions on corporate rehabilitation, and to offer some recommendations. An insolvency law has or should have two components, namely, rehabilitation and liquidation.

II. INSOLVENCY LAW AT PRESENT

The Insolvency Law makes no mention of rehabilitation or restructuring. It is limited to the suspension of payments and liquidation. While rehabilitation may involve a suspension of payments, it entails more than mere financial breathing space.

The first and only law to provide for rehabilitation is the SEC Reorganization Act. However, the legislative act did not lay down a complete or comprehensive framework for rehabilitation. The principal objective of this law was to "reorganize the Securities & Exchange Commission" and confer upon it "additional powers," as described in its title. Thus, the SEC's powers were expanded to include the appointment of "rehabilitation receivers"[10] and the authority to cause the stay of actions upon the appointment of a rehabilitation receiver or management committee.[11] The SEC Reorganization Act limited the appointment of a management committee to the following extreme instances: when there is imminent danger of dissipation, loss, wastage or destruction of assets or other properties; or of paralization of business operations of such corporations or entities which may be prejudicial to the interest of minority stockholders, parties-litigants or the general public.[12]

The management committee and rehabilitation receiver, for their part, were given the following powers:

> to take custody of, and control over, all the existing assets and property of such entities under management; to evaluate the existing assets and liabilities, earnings and operations of such corporations, partnerships or other associations; to determine the best way to salvage and protect the interest of the investors and creditors; to study, review and evaluate the feasibility of continuing operations and restructure and rehabilitate such entities if determined to be feasible by the Commission. It shall report and be responsible to the Commission until dissolved by order of the

10. SEC Reorganization Act, § 6 (c).

11. *Id.*

12. SEC Reorganization Act, § 6 (d).

> Commission: Provided, however, [t]hat the Commission may, on the basis of the findings and recommendation of the management committee, or rehabilitation receiver, board or body, or on its own findings, determine that the continuance in business of such corporation or entity would not be feasible or profitable nor work to the best interest of the stockholders, parties-litigants, creditors, or the general public, order the dissolution of such corporation entity and its remaining assets liquidated accordingly. The management committee or rehabilitation receiver, board or body may overrule or revoke the actions of the previous management and board of directors of the entity or entities under management notwithstanding any provision of law, articles of incorporation or by-laws to the contrary.[13]

Finally, P.D. No. 902-A provided that,

> the management committee or rehabilitation receiver shall not be subject to any action, claim or demand for, or in connection with, any act done or omitted to be done by it in good faith in the exercise of its functions, or in connection with the exercise of its power herein conferred.[14]

The SEC Reorganization Act was silent, among others, on the rights of the creditors vis-à-vis the debtor and the creditors vis-à-vis each other during the rehabilitation proceedings. It fell upon the courts to define the rights of the various parties.

Two decades later, in 2000, the Supreme Court adopted the Interim Rules, which are intended to be rules of procedure. That the Supreme Court saw the need to promulgate rules is not at all surprising. As explained by the Committee on SEC Cases in its Memorandum to the Supreme Court, there were "no rules to guide the RTCs in handling rehabilitation cases."[15]

These rules have, unquestionably, made the lives of the debtors, creditors, and rehabilitation courts easier. However, these rules arguably verge on judicial legislation. As held in *Fabian v. Desierto*,[16] it is sometimes difficult to distinguish a rule that is procedural from a rule that is substantive:

> It will be noted that no definitive line can be drawn between those rules or statutes which are procedural, hence within the scope of this Court's rule-making power, and those which are substantive. In fact, a particular rule may be procedural in one context and substantive in another. It is admitted that what is procedural and what is substantive is frequently a question of great difficulty. It is not, however, an insurmountable problem if a rational

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13. *Id.*
14. *Id.*
15. Minutes of the Meeting of the Committee on SEC Cases, *supra* note 8, at 1.
16. Fabian v. Desierto, 295 SCRA 470 (1998).

> and pragmatic approach is taken within the context of our own procedural and jurisdictional system.
>
> In determining whether a rule prescribed by the Supreme Court, for the practice and procedure of the lower courts, abridges, enlarges, or modifies any substantive right, the test is whether the rule really regulates procedure, that is, the *judicial process for enforcing rights and duties recognized by substantive law* and for justly administering remedy and redress for a disregard or infraction of them. If the rule takes away a vested right, it is not procedural. If the rule creates a right such as the right to appeal, it may be classified as a substantive matter; but *if it operates as a means of implementing an existing right then the rule deals merely with procedure.*[17]

However, the provision on the cram down power of the court and the provision on creditor-initiated petitions, where the Interim Rules specifies that required percentage of liabilities held by the creditors, appear to create rights.

The pending legislation that is subject of this paper addresses the very areas covered by the Interim Rules. In fact, *New Frontier Sugar Corporation v. Regional Trial Court, Branch 39, Iloilo City*[18] recently held that "[p]resently, the applicable law on rehabilitation petitions filed by corporations, partnerships or associations ... is the Interim Rules of Procedure on Corporate Rehabilitation (2000)."[19]

It is not the objective of this paper to investigate whether the Supreme Court's rules do in fact encroach upon the powers of Congress. As mentioned above, the objective of this paper is to study and give a critique on the bills on insolvency pending and languishing in Congress.

III. GUIDELINES IN EVALUATING THE QUALITY OF A CORPORATE REHABILITATION LAW

To be effective, an insolvency law must contain several essential principles and features. These principles and features are best summarized in the Declaration of Policy of House Bill 132:

> The State shall ensure a *timely*, *fair*, *transparent*, *effective and efficient* rehabilitation or liquidation of an insolvent juridical debtor. The rehabilitation or liquidation shall be made with a view to ensuring or maintaining *certainty* and *predictability* in commercial affairs, shall *preserve* and *maximize* the *value* of the assets of the debtor, shall recognize creditor rights

17. *Id.* at 491-92 (emphasis supplied).

18. New Frontier Sugar Corporation v. Regional Trial Court, Branch 39, Iloilo City, 513 SCRA 601 (2007).

19. *Id.* at 605.

> and respect priority claims, and shall ensure *equitable treatment* of creditors who are similarly situated.[20]

A. Certainty/predictability

Business abhors risk. Good laws minimize risk by giving business people advance notice of their rights, obligations, and remedies before they enter the arena. A company might be more inclined to invest in a given jurisdiction if it has the option of availing of rehabilitation in difficult economic times. Or a bank might be more inclined to lend a company money if it is confident that its rights and security will be protected in the event that the borrower defaults.

B. Timely

An insolvency law must provide for the timely rehabilitation of debtor companies. An unduly protracted rehabilitation unduly prejudices the rights of the creditors. It is bad enough that payment to creditors is deferred; but prolonged or indefinite deferment of payment becomes oppressive to the creditors. A prolonged rehabilitation is likewise not desirable from the point view of the debtor company. A debtor company that is in financial distress would want to free itself from all its obligations and start anew in the soonest time possible. A rehabilitation that takes many years to complete is also incompatible with the concept of a free market system where equal competition is encouraged. Finally, the longer the rehabilitation takes, the costlier the process becomes for all stakeholders and the less likely the debtor can successfully emerge from rehabilitation.

C. Fair and equitable

The law must be fair, as any law should be fair. A fair law recognizes and balances the competing interests of the parties. The balance to be achieved in rehabilitation is an especially delicate and sensitive one since the interests of secured creditors are at odds with the interests of the debtor and the unsecured creditors.

However, it must be emphasized that fairness and equity does not necessarily mean equal or identical treatment. In interpreting the Equal Protection Clause, *Central Bank Employees Association, Inc. v. Bangko Sentral ng Pilipinas*[21] recognized that "equal protection" does not necessarily mean

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20. H.B. 132, 14th Cong., 1st Sess. § 2 (July 2, 2007) (emphasis supplied).

21. Central Bank Employees Association, Inc. v. Bangko Sentral ng Pilipinas, 446 SCRA 299 (2004).

equal treatment, regardless of differences in condition or situation, to wit: "[i]t is settled in constitutional law that the 'equal protection' clause does not prevent the Legislature from establishing classes of individuals or objects upon which different rules shall operate — so long as the classification is not unreasonable."[22]

The law must recognize, for example, that not all creditors are similarly situated. A secured creditor has superior rights than an unsecured creditor and should accordingly be afforded different (i.e., preferential treatment).

D. Transparent

The law must ensure that the rehabilitation is transparent to inspire confidence in the process. In fact, transparency is especially critical in rehabilitation cases, given that there is the potential for abuse by unscrupulous debtor companies of the rehabilitation process. The Supreme Court recently recognized the potential for abuse of the rehabilitation process in *Banco de Oro-EPCI, Inc. v. JAPRL Development Corporation*.[23] There, the Supreme Court allowed the Regional Trial Court of Makati to proceed in determining whether the debtor company, who had filed a rehabilitation case in Laguna and successfully obtained a stay order against all debtors, committed fraud in borrowing money from Banco de Oro-EPCI. The ruling of the Supreme Court reads in part:

> Respondents abused procedural technicalities (albeit unsuccessfully) for the sole purpose of preventing, or at least delaying, the collection of their legitimate obligations. Their reprehensible scheme impeded the speedy dispensation of justice. More importantly, however, considering the amount involved, respondents utterly disregarded the significance of a stable and efficient banking system to the national economy.[24]

Creditors, who are asked to refrain from asserting and enforcing their claims, must be assured that the rehabilitation is not only necessary and feasible, but also above board. Thus, the law should provide for full access to the financial books of the debtor company.

E. Effective/efficient; preservation/maximization of value

Insolvency law is one of the laws that regulate commerce and the economy. Its aim is not or should not be the rehabilitation of a financially distressed company at all costs. If the rehabilitation cannot be done effectively or efficiently, then it should not be allowed. Resources that can be invested in more productive uses should not be squandered in an effort to prop up an

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22. *Id.* at 343.

23. Banco de Oro-EPCI, Inc. v. JAPRL Development Corporation, 551 SCRA 342 (2008).

24. *Id.* at 355.

inefficient company. If the debtor company is beyond rehabilitation or if the costs of rehabilitation outweigh the benefits, then the debtor company should be liquidated and the creditors be immediately allowed to recover whatever they can from the debtor company.

An insolvency law should be judged by the above criteria.

IV. ESSENTIAL COMPONENTS OF A REHABILITATION LAW

The following are the vital components of a rehabilitation law:

A. Stay Order

A stay order is sometimes essential to the survival of a distressed company. A stay order keeps at bay the pack of unhappy and understandably impatient creditors and prevents them from tearing apart and bringing about the certain death of the helpless company.

The critical issue, then, is not whether to empower the courts to suspend the assertion/enforcement of claims, but when the suspension takes effect and if it should apply wholesale to all claims. Under P.D. No. 902-A, it is the act of appointing the receiver that triggers that suspension of "all actions for claims."

B. Rehabilitation Plan

The Rehabilitation Plan is the map that guides the floundering company out of the shoals of financial distress. As provided in *Rombe Eximtrade (Phils.), Inc. v. Asiatrust Development Bank*,[25] it contains "the formula for the successful recovery of the corporation."[26]

It must contain enough information to persuade the creditors, receiver and the court that rehabilitation is feasible, profitable, and work to the best interest of the various stakeholders. The Plan must identify the source of the ailment; and prescribe the remedy. A Plan must set realistic targets and provide the details on how to achieve them.

C. Rehabilitation Receiver

The creditors and the debtor company have competing interests. It is desirable that an impartial and competent third person assist the rehabilitation court in assessing the feasibility of rehabilitation the debtor company and

25. Rombe Eximtrade (Phils.), Inc. v. Asiatrust Development Bank, 545 SCRA 253 (2008).

26. *Id.* at 261.

balancing the competing interests of the parties. The law should define the extent of the receiver's powers.

D. Rights of the Parties

The law should define and delineate the rights of the parties while rehabilitation is ongoing. For example, the law as it stands does not specify whether the rehabilitation court has the authority to relieve a debtor from paying interest rates or to require the debtor to pay higher interest rates to secured creditors compared to unsecured creditors.

E. Rehabilitation Court

Since rehabilitation involves the competing interests of the debtor and the creditors, as the public has, to an extent, a stake in the outcome of the rehabilitation process, the intervention of our courts becomes necessary. The court is tasked to consider and balance the competing interests of the debtor, creditors, and the public. The law should be flexible enough to allow the rehabilitation court to exercise some discretion in deciding issues but comprehensive enough to put reasonable limits on such discretion. Too much flexibility in the exercise of court discretion is tantamount to surrendering the Legislature's functions to the Judiciary. On the other hand, too little discretion would result in the mechanical application of the law and disregard the peculiar circumstances of each case.

V. COMMENTARY ON THE SALIENT PROVISIONS OF PENDING LEGISLATION ON CORPORATE REHABILITATION

That some members of Congress have filed bills on insolvency is, in itself, a welcome development. Our insolvency laws have, for the longest time, been crying for revisions. The bills pending in the House of Representatives and the subject of this paper are: House Bill No. 3542,[27] authored by Cong. Ma. Amelita Calimbas-Villarosa; House Bill No. 293,[28] authored by Cong. Jaime C. Lopez; and House Bill No. 132,[29] authored by Cong. Juan Edgardo M. Angara.

A. House Bill No. 3542

An Explanatory Note by the author usually accompanies the bill. The author explains his or her motivations and objectives in introducing the bill. In the words of Justice Puno, an "[e]xplanatory [n]ote is expressive of the purpose of the bill, it gives a reliable keyhole on the scope and coverage."[30] The

27. H.B. 3542, 14th Cong., 1st Sess. (Feb. 19, 2008).

28. H.B. 293, 14th Cong., 1st Sess. (July 2, 2007).

29. H.B. 132, 14th Cong., 1st Sess. (July 2, 2007).

30. Lim v. Pacquing, 240 SCRA 649, 724 (1995).

Explanatory Note often is a good gauge of how the author understands and approaches a given problem or issue.

The Explanatory Note reads:

> [b]ecause of economic forces which may be beyond their resources to absorb, Philippine private enterprises have folded up resulting in the stultification of the nation's forward march to economic stability, increased unemployment, idle resources and wasted talents.
>
> ...
>
> It is always possible to reverse financial distress. Indeed, when short term loans become overdue and the ratios of debt to equity had been breached, relief can still be afforded the distressed corporation so that it can become viable again, return to its former position of financial stability and profitability, by making productive the tools of production which would otherwise be idle because of non-use and open its gates to employment of otherwise idle manpower. This would contribute, if not preserve the economic well-being of the country.

On the other hand, the Declaration of Policy reads:

> [i]t is the policy of the State to encourage private initiative to form and establish enterprises which will contribute to the economic well-being of the country, and once established, the State shall assist these private enterprises when they become financially distressed for any reason, by providing for the mechanism by which they can be restored to their former positions of financial stability and profitability in a manner that will allow them to continue their business and at the same time ensure the orderly repayment of their obligations to their creditors.[31]

The Explanatory Note suffers from vagueness. It is not clear what the author is referring to when she speaks of "economic forces which may be beyond (the private enterprises) to absorb."

The Explanatory Note also reflects a lack of understanding of how the economy works and a misconception of the role of corporate restructuring. The premise that "it is always possible to reverse financial distress" is questionable. There are companies that are beyond salvation. For example, the fate of a company that sells pagers or typewriters in this age of the cellular phone and word processor can no longer be reversed, no matter how much money is thrown at the company. There is also the issue of the desirability or practicability of reversing financial distress. True, the State may choose to keep afloat a certain company even at a loss but to what end? To do so would be to reward and subsidize inefficiency. Is this not the

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31. H.B. 3542, § 2.

economic lesson from the collapse of the socialist States, who tried to prop up otherwise inefficient firms and industries? The "tools of production" may be more efficiently utilized if diverted elsewhere.

Finally, the Explanatory Note and the Declaration of Policy unduly focus on the debtor company. The creditors are ignored in the Explanatory Note and receive only a passing reference at the end of the Declaration of Policy.

1. Stay Order

Section 4 provides for the definition of "stay," which refers to:

> the automatic suspension of the assertion and/or enforcement of claims against the debtor in whatever stage and manner, and in whatever form, they may be, effective from the date of *filing* of the petition and continuing until the debtor is rehabilitated unless sooner modified or lifted under the provisions of this Act.[32]

The proposal, in effect, gives the debtor the power to decide whether and when to stay the assertion/execution of the creditors' claims. This proposal is unwise and unfair. The staying of claims should not be taken lightly since it interferes with and restricts the rights of creditors to assert and enforce their claims.[33] The staying of claims should be left to the determination of an impartial tribunal rather than to the debtor. The debtor can be expected to protect its own interests without regard to the interests of the creditors and, for this reason, the potential for abuse of such a power is great.

House Bill 3542 provides that the rehabilitation court may modify or lift the stay of all claims "upon motion of any creditor with notice to the debtor."[34] However, by the time the court is able to make an objective and independent evaluation of the facts and issues, grave prejudice may have already been done to the rights of the creditors. Thus, it is wiser policy to give to the courts the power to stay the enforcement of claims.

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32. *Id.* § 4 (emphasis supplied).

33. An Act to Ordain and Institute the Civil Code of the Philippines [CIVIL CODE], Republic Act No. 386, art. 1177 (1950).

> ARTICLE 1177. The creditors, after having pursued the property in possession of the debtor to satisfy their claims, may exercise all the rights and bring all the actions of the latter for the same purpose, save those which are inherent in his person; they may also impugn the acts which the debtor may have done to defraud them.

(Creditors have the right to pursue the property in possession of the debtor to satisfy their claims).

34. H.B. 3542, § 11.

2. Contents of Petition

As one of the contents of the petition, which shall be verified by a duly authorized officer of the debtor, Section 9 provides that there be a "nomination of three Rehabilitation Receivers with their accompanying bio-data, from which one may be appointed by the court: Provided that if the court does not find any of those nominated acceptable, it may, at its discretion, appoint a receiver of its own choice."[35]

The right to nominate the Rehabilitation Receiver should rightly belong to the debtor or, in cases where the rehabilitation is initiated by the creditors, with the creditors. The receiver has an important and sensitive role to play and it is crucial that he enjoy the trust and confidence of the parties.

If, as proposed under House Bill 3542, the courts are given the authority to disregard the nominees of the debtor/creditor, then the law should, at least, define the qualifications of the receiver in order to limit the discretion of the courts in appointing the receiver.

3. Ancillary or Incidental Powers of the Receiver

The Rehabilitation Receiver shall have the authority, to the extent necessary to effect the performance of his duties to monitor and oversee the implementation of the approved plan, to wit:

> [t]o sit as an ex-officio member of the debtor's Board of Directors and exercise veto authority over any resolution or plan of action sought to be taken by the Board of Directors should it appear in his judgment that such resolution or program of action would contravene or would not be in keeping with the terms of the plan.[36]

One of the issues that should be considered in a rehabilitation proceeding is whether the directors of the debtor company should continue to manage the company. An argument can be made that the company should not remain in the hands of those under whose watch the company fell into financial distress. On the other hand, it may be unwise policy to change horses in midstream and transfer management of the debtor company to persons not familiar with its business.

Giving the receiver absolute veto power over the acts of the Board regardless of the situation may be unnecessary and too extreme a remedy.

4. Implementation of Plan by the Rehabilitation Receiver

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35. *Id.* § 9.

36. *Id.* § 20.

The court may relieve the debtor from its authority of implementing the approved rehabilitation plan and direct the rehabilitation receiver to take over the implementation at any time during the period for rehabilitation of the debtor and on request of the rehabilitation receiver, any creditor or any party in interest in the following instances:

> (a) For cause, including fraud, dishonesty, incompetence, or gross mismanagement, by the debtor in the conduct of its affairs, or
>
> (b) If the implementation by the rehabilitation receiver is in the interest not only of the debtor but also of the creditors and other parties interested in the case.
>
> Within five (5) days from receipt by him of the order of the court, to take possession, supervision and control of the management of the business and personnel of the debtor, with full power and authority to dispense with the services of those whom he may find unnecessary in the operation of the debtor's business, but only upon authority of the court.[37]

An insolvency law should provide for the possibility of mismanagement by the debtor company and the consequent take over of management by a competent person. However, Section 21 (b) above is vague. Taking over the management of the debtor company is an extreme action. Therefore, the circumstances under which such take over is allowed should be defined as far as practicable. Furthermore, the rehabilitation plan, if approved, is presumably in the interest of all the stakeholders, and not just the debtor. Therefore, its implementation should not be made dependent on the receiver. It should be the duty of the rehabilitation court to ensure the plan's strict implementation.

5. Approval of the Rehabilitation Plan

The court may "approve the rehabilitation plan even over the opposition of creditors holding a majority of the total liabilities of the debtor if, in its judgment, the rehabilitation of the debtor is feasible and the opposition of the creditors is manifestly unreasonable."[38] In determining whether or not the opposition of the creditors is manifestly unreasonable, the court shall consider the following:

> (a) That the plan would likely provide the objecting class of creditors with compensation greater than that which they would have received if the assets of the debtor were sold by a liquidator within a three-month period;
>
> (b) That the shareholders or owners of the debtor lose at least their controlling interest as a result of the plan; and

37. *Id.* § 21.

38. *Id.* § 24.

(c) The Rehabilitation Receiver has recommended the approval of the plan.[39]

The above "cram down" provision is identical to Section 23 of the Interim Rules. A cram down provision is necessary to give the rehabilitation court the power force creditors to accept a rehabilitation plan because of the natural tendency of creditors, especially secured creditors, to oppose rehabilitation in any form. Secured creditors have their eyes fixed on the assets, and nothing else, and justifiably so, considering that their decision to extend credit is influenced primarily by the availability of security that minimizes their risk. Without such security, creditors would be less inclined to part with their money.

The standard of "feasibility" can be found in P.D. No. 902-A. The debtor company must be able to show that its rehabilitation is feasible. If it fails to clear this hurdle, then petition for rehabilitation should be dismissed. If, on the other hand, the standard of feasibility is met, the debtor company must be able to show that the opposition of the creditors to the proposed rehabilitation is not only unreasonable but "manifestly unreasonable." This rather high standard is reasonable considering that the creditors bear much of the sacrifice during the period of rehabilitation. It is only fair to give them the power to reject the rehabilitation of their debtor.

6. Appeals

Any final order or judgment of the court may be appealed to the Court of Appeals "pursuant to the provisions of Rule 45 of the Revised Rules of Court."[40] The Court of Appeals, in view of the nature of the proceedings is "mandated to render a decision denying outright the application for extraordinary legal remedies or the appeal should it find the same without basis: Provided, that in no case may the resolution or decision of the Court of Appeals be made beyond the period of thirty (30) days from the date of the filing of the application or appeal."[41]

The unfamiliarity of the bill's author with the Rules of Court is readily apparent. Rule 45 of the 1997 Rules of Civil Procedure provides for an appeal to the Supreme Court on pure questions of law. If passed into law, this bill will create confusion as to the proper mode of appeal from the decision of the rehabilitation court.

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39. *Id.*

40. H.B. 3542, § 42.

41. *Id.* § 43.

There is also a naiveté on the part of the author in mandating the Court of Appeals to render a resolution or decision within 30 days from the date of the filing of the appeal. To get the courts to dispose of the cases on their dockets more quickly, Congress has to strike at the root of the problem. Setting strict deadlines for the courts to resolve their cases is unrealistic.

B. House Bill No. 293

Compared to House Bill 3542, House Bill 293 has a better grasp of the nature and purpose of insolvency law.

The Declaration of Policy of House Bill 293 provides:

> [i]t shall be the policy of the State to encourage a juridical debtor and its creditors to collectively and realistically resolve and adjust competing claims and property rights under the supervision and approval of a court when the debtor can no longer pay its debts as they come due or when the debtor has become insolvent. When rehabilitation is not feasible, it is in the best interest of the State to facilitate a speedy and orderly liquidation of the juridical debtor's assets and the settlement of its obligations to the extent possible.[42]

House Bill 293 recognizes the fact that rehabilitation is not just about or principally about the debtor, but it involves equally compelling competing claims. The creditor cannot be taken out of the picture or reduced to a secondary or supporting role. The creditor has as much right to be heard, if not a greater right to be heard, as the debtor.

House Bill 293 also rightly recognizes that not all companies may or should be rehabilitated and that in cases where the rehabilitation is "not feasible," then liquidation should be done as quickly and as painlessly as possible.

1. Involuntary proceedings

Section 18[43] provides for the circumstances necessary to initiate involuntary proceedings. This provision allows creditors with sufficient interest (Php1,000,000.00 or 25% of the total paid-up capital, whichever is higher) to initiate the rehabilitation proceedings. There may be instances where the value of the existing assets is only a fraction of the outstanding obligations that the creditors, whose attention is invariably on the bottom line, would find rehabilitation a more attractive alternative to liquidation. A creditor-

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42. H.B. 293, § 2.

43. *Id.* § 18.

> Any three creditors with total claims equivalent to either one million pesos (P1,000,000.00), or twenty-five percent (25%) of the total paid-up capital or partners' contributions, whichever is higher, shall be entitled to initiate involuntary proceedings against a debtor.

initiated petition may also be used to forestall the further dissipation of the debtor company's assets by its profligate directors by asking for the appointment of a receiver and issuance of a stay order.[44]

2. Non-application of Suspension Order to Appeals and Specialized Proceedings

The effect of the commencement of proceedings prevents the application of suspension order "to appeals cases filed at the Court of Appeals or the Supreme Court prior to the commencement date: Provided that the execution of any judgment resulting from such appeal shall be referred to the court presiding over the rehabilitation proceedings for appropriate action."[45]

One of the purposes of staying the assertion/enforcement of claims is to allow the debtor company to focus its time, resources, and efforts to its rehabilitation. This provision excludes from the scope of the stay order the cases on appeal with the Court of Appeals and the Supreme Court. The rationale here may be that appeals are not as time-consuming as trial work. However, the proceedings can go no further than the rendition of judgment. Final awards against the debtor company remain unenforceable during the pendency of the rehabilitation proceedings. This is presumably because: (1) the enforcement of claims could very well drain the debtor company of its assets; and (2) allowing the enforcement of claims would be uneven, with creditors with cases on appeal enjoying preference over creditors whose claims are still being prosecuted with the trial courts.

Section 24 seems to strike a good balance between the interests of creditors and the debtor company. Given that the appeal process takes years to complete, it is desirable that it be allowed to run its course during the rehabilitation period. It is only when the rehabilitation court terminates the rehabilitation proceeding that the creditors are allowed to pursue their claims. However, the hopelessness of rehabilitation may sometimes not become apparent until after a few years from filing of the petition (and issuance of the stay order). Thus, in the meantime, the cases on appeal remain at a standstill and will again only begin to move after the termination of the rehabilitation.

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44. Interim Rules, rule 4, § 1.

> SEC 1. Who May Petition. — Any debtor who foresees the impossibility of meeting its debts when they respectively fall due, or any creditor or creditors holding at least twenty-five percent (25%) of the debtor's total liabilities, may petition the proper Regional Trial Court to have the debtor placed under rehabilitation.

45. H.B. 293, § 18.

Creditors or who have yet to file cases or whose cases are only at the trial court level may be heard to protest the preference given to creditors whose cases are already on appeal with the Court of Appeals or Supreme Court. In reply, it may be argued that the creditors already on appeal do in fact enjoy a preference since they filed their court actions ahead of the other creditors.

3. Rescission of Transfers or Encumbrances After Commencement of Proceedings

A "claw-back" provision gives the rehabilitation court the authority to undo acts of favoritism or fraud by the debtor company. The bill provides that:

> [t]he court may rescind any transfer or encumbering of the debtor's unencumbered property that occurs after the commencement of the proceedings and is outside the ordinary course of business: Provided, however, That the unencumbered property may be sold, encumbered or otherwise disposed of, upon order of the court after notice and hearing:
>
> ...
>
> (4) For payments to victims of quasi-delicts upon a showing that the claim is valid and the debtor has insurance to reimburse the debtor for repayment.[46]

However, it allows payment to be made to victims of quasi-delicts provided that the debtor is covered by insurance. The rationale for the exception is self-evident. Section 30 seeks to do justice to the victim of quasi-delicts but at the same time protects the interests of the creditors. There is, though, the risk of the insurance company not paying the debtor company. Also, the property that may be disposed of should not only be "unencumbered" but should likewise not adversely affect the operations of the debtor company.

4. Post Commencement Interest

The Bill provides that "[t]he rate and term of interest, if any, on secured and unsecured claims shall be determined and provided for in the rehabilitation plan."[47]

While this provision embodies what is already the practice in rehabilitation proceedings, it is desirable to set forth in the law the rights of the parties with respect to the rate and term of interest (and whether the rehabilitation court may relieve the debtor of any interest payment. The issue of interest payment is a sensitive and sometimes contentious issue, with creditors expectedly trying to get the highest interest rates they can on the ground that they are already being made to bear the heavy burden of

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46. *Id.* § 30.

47. *Id.* § 18.

deferred payments and the debtor company asking that interest be waived altogether. There is also the issue of secured creditors demanding that they be paid higher interest rates than the unsecured creditors.

5. Post Commencement Loans

Among the instances wherein the debtor may enhance its rehabilitation, with the approval of the court upon the recommendation of the rehabilitation receiver, is the capacity to "enter into credit arrangements, the payment under which shall be considered an administrative expense."[48] This is a significant provision. Often, a financially distressed company is in urgent need of capital infusion. However, the issue of how to treat the new creditor arises. Should the new creditor be paid ahead of the creditors whose claims existed prior to the commencement of the rehabilitation proceedings? Or, should the new creditor, in the name of "equality", be lumped together with the old creditors? The better policy would arguably be grant (or give the rehabilitation court the discretion to grant) preference to the new creditor/investor since: (1) without the new credit/capital, the debtor company might not long survive; and (2) the new creditor/investor is taking a great risk in extending credit to/investing in a company already on life support. It is only fair that the greater risk be offset by higher returns.

6. Treatment of Counter-Parties in Contracts

Unless specifically cancelled by a court judgment prior to issuance of the order commencing proceedings, or at anytime thereafter by the court before which the proceedings are pending, the Bill provides that:

> all contracts of the debtor with creditors and other third parties shall be deemed to continue in force, regardless of pre-commencement defaults by the debtor: Provided, That within ninety (90) days following the commencement of the proceedings, the debtor, with the consent of the rehabilitation receiver, shall notify each counter-party of whether it is confirming the particular contract … Contracts not confirmed by the required deadline shall be considered terminated. Claims for actual damages, if any, arising as a result of the election to terminate a contract shall be considered a pre-commencement claim against the debtor.[49]

The issue of what happens to existing contracts where one of the parties defaults in its payments, in a rehabilitation scenario, is not addressed in P.D. No. 902-A. The obvious answer is that the non-defaulting party has the

48. *Id.* § 36.

49. *Id.* § 38.

right to terminate the contract. Article 1191 of the Civil Code[50] provides that "[t]he power to rescind obligations is implied in reciprocal ones, in case one of the obligors should not comply with what is incumbent upon him." However, the survival of the debtor company might very well depend on the continuation of these contracts. This provision favors the debtor by restricting the right of a creditor to terminate the contract.

There is also the related issue of contracts that classify "insolvency" as an "event of default." It is not uncommon for parties to grant the non-defaulting party the right to terminate the contract in case the other party becomes insolvent. Under this provision, such stipulation is rendered void.

7. Who May Serve as Rehabilitation Receiver

The Bill allows any qualified individual or "[a] group of individuals who together are qualified, or a juridical entity with employees who together are qualified"[51] to serve as a rehabilitation receiver. Under the Interim Rules, only natural persons may be appointed as receivers.[52] This provision allows the appointment of juridical persons to act as receivers.

a. Initial Appointment of a Rehabilitation Receiver

There may be some wisdom in the provision that:

> [t]he rehabilitation receiver shall be appointed by the Court when relief is requested under Sub-Chapters 1, 2, or 3 of chapter IV of this Act; Provided that if a qualified individual or entity is nominated by more than fifty percent (50%) of the secured creditors and the general unsecured creditors, and if evidence is submitted to the satisfaction of the court, the court shall appoint the creditors' nominee as rehabilitation receiver.[53]

As discussed, it is arguably the creditors who are called upon to make the biggest sacrifice in the rehabilitation of their debtor. Thus, it is fair that they be given a substantial voice in the proceedings. The ability to nominate the receiver allows to the creditors more control in charting the recovery of the debtor company. It is important for the creditors to have confidence in the proceedings and to win their full cooperation.

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50. CIVIL CODE, art. 1191.

51. H.B. 293, § 41.

52. Interim Rules, § 42.

53. H.B. 293, § 42.

b. Role of the Rehabilitation Receiver

The task of the rehabilitation receiver revolves around ensuring "that the value of the debtor's properties is reasonably maintained during the proceeding."[54] The rehabilitation receiver has the role to:

> closely oversee and monitor the operations of the debtor as well as take custody and control of all assets and properties of the debtor … demand and obtain all the relevant information regarding the debtor; to evaluate the assets, liabilities, earnings, and operations of the debtor; to sue and recover the assets of the debtor; to facilitate the resolution of the various rights of the different stakeholders; to study, review, and evaluate the feasibility of continuing operations; and to cause the implementation of the rehabilitation plan upon its approval.[55]
>
> The rehabilitation receiver shall not take over the management and control of the debtor but may recommend the appointment of a management committee over the debtor in the cases provided by this act.

Compared to House Bill 3542, House Bill 293 envisions a different and less active role for the receiver. On balance, this provision is better than Section 20 of House Bill 3542. The power to assume the management of the debtor company should be given and exercised only under serious circumstances (see Section 46 below).

8. Role of the Management Committee

Upon motion of any stakeholder, the court may appoint a management committee that will undertake the management of the debtor, upon clear and convincing evidence of any of the following circumstances: (1) actual or imminent danger of dissipation, loss, wastage or destruction of the debtor's assets or other properties, (2) paralyzation of the business operations of the debtor, (3) gross mismanagement by the debtor, or (4) gross or willful violation by management of this act.[56]

This provision, which is similar to Section 6 (d) of P.D. No. 902-A, specifies the circumstances that necessitate the appointment of a management committee.

9. Creditors' Committee

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54. *Id.* § 43.

55. *Id.*

56. *Id.* § 46.

The creditors belonging to a class may formally organize a committee among themselves. In addition, the creditors may as a body, agree to form a creditors' committee composed of a representative from each class of creditors, such as the following: (a) secured creditors, (b) unsecured creditors, (c) trade creditors and suppliers, and (d) employees of the debtor.[57]

This provision recognizes that there are various types of creditors. The law should, however, go a step further and expressly allow for "unequal" treatment.

a. Role of Creditors' Committee

The Bill allows the creditors' committee to "assist the rehabilitation receiver in communicating with creditors and be the primary liaison between the rehabilitation receiver and the creditors."[58]

The role of the creditors' committee is apparently merely to facilitate coordination. The committee could be given more effective and relevant if, as discussed above, the law allows for differentiation among creditors.

10. Minimal Standards for Approval

Among the requirements to be met for the approval of a plan, the court must verify if the plan "is supported by (a) by the majority of each class or sub-class of voting creditors established in the plan, or (b) eighty percent (80%) of all the voting creditors."[59]

Rehabilitation affects creditors, especially secured creditors. It is, therefore, only fair that they be given a voice in deciding the fate of the debtor company. This provision sets the threshold for approval at "majority of each class or sub-class of voting creditors established in the plan" or "eighty percent (80%) of all the voting creditors."

This is an alternative to the cram down power proposed in Section 24 of House Bill 3542. Here, if the required voting percentage is obtained, the rehabilitation court has no power to overrule the creditors. The more the creditors in agreement, the greater should be their influence in the outcome of the proceedings.

11. Foreign Registered Corporations

In initiating proceedings, "[t]he court shall set a hearing in connection with an insolvency or rehabilitation proceeding taking place in a foreign

57. *Id.* § 52.

58. *Id.* § 53.

59. H.B. 293, § 65.

jurisdiction, upon the submission of a petition by the representative of the foreign entity that is the subject of the foreign proceeding."[60]

This and the immediately succeeding provision recognize the increasingly global nature of commerce. The rehabilitation of an American airline company, for example, may be hamstrung if their aircraft is seized in the Philippines to satisfy a final court judgment.

As such, Section 93 provides for the provision of relief where the court may issue the following orders:

> (1) suspending any actions to enforce claims against the entity or otherwise seize or foreclose on property of the foreign entity located in the Philippines;
>
> (2) requiring the surrender of property of the foreign entity to the foreign representative; or
>
> (3) providing other necessary relief.[61]

This provision specifies the types of remedies available to a foreign-registered company.

C. House Bill No. 132

The Declaration of Policy provides that:

> the State shall ensure a *timely*, *fair*, *transparent*, effective and efficient rehabilitation or liquidation of an insolvent juridical debtor. The rehabilitation or liquidation shall be made with a view to ensuring or maintaining *certainty* and *predictability* in commercial affairs, shall *preserve* and *maximize* the *value* of the assets of the debtor, shall recognize creditor rights and respect priority claims, and shall ensure *equitable treatment* of creditors who are similarly situated.[62]

1. Commencement of Proceedings

The Commencement Order shall "[a]ppoint a Rehabilitation Receiver, who may or may not be from among nominees of the petitioner/s."[63]

2. Treatment of Secured Creditors

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60. *Id.* § 92.

61. *Id.* § 93.

62. H.B. 132, § 2 (emphasis supplied).

63. *Id.* § 10 (f).

Upon recommendation of the rehabilitation receiver, there is no diminution of the right of a secured creditor as the court may allow a secured creditor to enforce his lien or foreclose upon the property of the debtor if "the said property is not necessary for the rehabilitation of the Debtor and the proceeds of the sale will be distributed in accordance with the order prescribed under the rules of concurrence and preference of credits."[64]

This is another provision that protects the interests of the creditors, without harming the rehabilitation of the debtor. The important requirement here is the requirement that the property is "not necessary for the rehabilitation of the Debtor."

3. Approval of Rehabilitation Plan

The Rehabilitation Receiver shall notify the creditors and shareholders that the Plan is ready for their examination. Within 20 days from notification, the rehabilitation receiver shall convene the Creditors, either as a whole or per class, for purposes of voting on the approval of the Plan. The Bill provides that:

> [t]he Plan shall be deemed rejected unless approved by all classes of Creditors whose rights are adversely modified or affected by the Plan. For purposes of this section, the Plan is deemed to have been approved by a class of Creditors if members of said class holding more than fifty percent (50%) of the total Claims of said class vote in favor of the Plan.[65]

This provision is a variation of Section 65 of House Bill 293. Both provisions give the creditors the power to reject the rehabilitation of the debtor company provided they are able to gather the sufficient voting percentage.

4. Cram Down

The court may confirm the plan, notwithstanding the rejection of the rehabilitation plan, if all the following circumstances are present:

> (1) the Rehabilitation Receiver recommends its confirmation;
>
> (2) the Shareholders or owners of the Debtor lose at least their controlling interest as a result of the Rehabilitation Plan; and
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> (3) the Rehabilitation Plan would likely provide the objecting class of Creditors with compensation which has a net present value greater than that which they would have received if under Liquidation.[66]

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64. *Id.* § 38.

65. *Id.* § 43.

66. *Id.*

5. Out-of-Court or Informal Restructuring Agreements or Rehabilitation Plans

Chapter IV[67] of this Bill contain novel ideas. House Bill 132 provides for the framework of "out-of-court" restructuring agreements/rehabilitation plans. Entering into restructuring agreements is nothing new. What is new are the consequences arising from the execution of such agreements, provided that certain requirements are met.

In order for an out-of-court or informal restructuring or workout agreement to qualify under this chapter, the following minimum requirements must concur:

(a) the Debtor must agree to the out-of-court or informal restructuring/workout agreement or Rehabilitation Plan;

(b) it must be approved by Creditors representing at least sixty-seven percent (67%) of the secured obligations of the Debtor;

(c) it must be approved by Creditors representing at least seventy-five percent (75%) of the unsecured obligations of the Debtor; and

(d) it must be approved by Creditors holding at least eighty percent (80%) of the total obligations, secured and unsecured, of the Debtor.[68]

6. Standstill Period

A standstill period shall be "effective and enforceable not only against the contracting parties but also against the other Creditors, provided that it is approved by Creditors representing at least seventy-five percent of the total obligations of the Debtor and the standstill period does not exceed 120 from the date of effectivity."[69]

The approval by the debtor and the creditors holding the required percentage of obligations has the effect of staying the prosecution of all claims for a limited period and, significantly, binds the non-participating creditors.

7. Cram Down Effect

A restructuring agreement or Rehabilitation Plan approved pursuant to an informal workout framework "shall have the same legal effect as

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67. *Id.* § 61-66.

68. H.B. 132, § 62.

69. *Id.* § 63.

confirmation of a Plan."[70] The approval by the debtor and required majority of creditors likewise binds the minority non-participating creditors.

The proposal on out-of-court restructuring agreements/rehabilitation plans seems a sensible one and may be worth pursuing. Sections 61 to 64 give the creditors holding a substantial amount of obligations the corresponding power to decide the best way to satisfy their claims.

VI. RECOMMENDATIONS

A. Passage of Comprehensive Insolvency Law by Congress

The first order of the day is for Congress to pass a law on corporate rehabilitation. Only by defining the rights of the various stakeholders in a rehabilitation proceeding and by providing for the essential components of a successful rehabilitation can the desired certainty and predictability be achieved.

The only law on corporate rehabilitation thus far is P.D. No. 902-A. Unfortunately, P.D. No. 902-A is clearly inadequate: it leaves too many issues unanswered and, consequently, breeds uncertainty by giving the courts much latitude in fashioning the law through its decisions. To be sure, most of the gaps in the law have been subsequently addressed by the Interim Rules, but the Interim Rules are the product of the Supreme Court.

It is high time that Congress reclaim its duty and power to re-mold our corporate rehabilitation law. Its power to conduct public hearings in aid of legislation[71] makes Congress the best suited and equipped of the three branches of Government to pass good laws. Public hearings can more effectively bring to light the various issues and problems encountered by the creditors and debtor company in a rehabilitation proceeding. As held by the Supreme Court in *Arnault v. Nazareno*:[72]

> In other words, the power of inquiry — with process to enforce it — is an essential and appropriate auxiliary to the legislative function. A legislative body cannot legislate wisely or effectively in the absence of information respecting the conditions which the legislation is intended to affect or change.[73]

Balancing competing interests is always a difficult and sensitive task since all stakeholders must surrender some ground if a workable compromise is to be reached and an acceptable law is to be passed.

70. *Id.* § 64.

71. PHIL. CONST. art. VI, § 21.

72. Arnault v. Nazareno, 87 Phil. 29 (1950).

73. *Id.* at 45.

The subject bills are a good starting point in understanding these competing interests. It is hoped after passing through the crucible of public hearings and debates these bills result in good law.

B. Appointment of the Receiver

The Interim Rules appear to confine the rehabilitation court's appointment of the receiver to the nominees submitted by the debtor.[74] The pending bills seek to grant the rehabilitation court greater discretion in choosing the receiver. It seems the better policy to have the debtor choose the receiver, since, after all the debtor has much stake in its successful rehabilitation and will presumable nominate a receiver who is competent, familiar with the business, and with whom the debtor can effectively work with. If the rehabilitation court is unimpressed with the debtor's initial nominees, then the debtor can be made to submit another list.

Also worth considering is the proposal that the creditors be given the power to override the debtor's choice of receiver. Between the creditor and the debtor, the creditor arguably makes the greater sacrifice. Hence, it is but fair to compensate the creditors by giving them greater participation in the process, including the appointment of the receiver if the debtor's choice is unacceptable to them.

C. Stay Order

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74. Interim Rules, rule 4, § 2.

> SEC 2. Contents of the Petition. — The petition filed by the debtor must be verified and must set forth with sufficient particularity all the following material facts: (a) the name and business of the debtor; (b) the nature of the business of the debtor; (c) the history of the debtor; (d) the cause of its inability to pay its debts; (e) all the pending actions or proceedings known to the debtor and the courts or tribunals where they are pending; (f) threats or demands to enforce claims or liens against the debtor; and (g) the manner by which the debtor may be rehabilitated and how such rehabilitation may benefit the general body of creditors, employees, and stockholders.
>
> The petition shall be accompanied by the following documents:
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> ...
>
> (j) At least three (3) nominees for the position of Rehabilitation Receiver as well as their qualifications and addresses, including but not limited to their telephone numbers, fax number and e-mail address.

That a stay order may sometimes be necessary to keep the debtor company alive is beyond dispute. However, since the stay order interferes with and restricts the contractual and legal rights of creditors in asserting and enforcing their claims in the event of breach of contract by the defaulting debtor company, it must be issued only to achieve its primary objective, i.e., preserve such assets of the debtor company that are necessary to maintain the viability of the debtor's business.

The recent ruling in *Pryce Corporation v. Court of Appeals*,[75] reiterates the reasonable requirement that a stay order should only be issued in "serious" situations. There, the petitioner, Pryce Corporation, a developer of memorial parks filed for rehabilitation. Pryce Corporation alleged that the 1997 financial crisis caused it financial distress and sought court protection from its creditors. The rehabilitation court appointed a receiver and simultaneously issued a stay order.

On appeal, the Supreme Court affirmed the ruling of the Court of Appeals. The Supreme Court reiterated its earlier ruling in *Rizal Commercial Banking Corporation v. Intermediate Appellate Court,*[76] and it laid down the "serious situation test," thus:

> We agree with the Court of Appeals that the petition for rehabilitation does not allege that there is a clear and imminent danger that petitioner will lose its corporate assets if a receiver is not appointed. In other words, the 'serious situation test' laid down by Rizal Commercial Banking Corporation has not been met or at least substantially complied with. Significantly, the Stay Order dated July 13, 2004 issued by the RTC does not state any serious situation affecting petitioner's corporate assets. We observe that in appointing Mr. Gener T. Mendoza as Rehabilitation Receiver, the only basis of the lower court was its finding that 'the petition is sufficient in form and substance.' However, it did not specify any reason or ground to sustain such finding. Clearly, the petition failed to comply with the 'serious situation test.'
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> …
>
> In the case at bench, when the commercial court appointed a rehabilitation receiver, the very next day after the filing of the Petition for Rehabilitation, *it is highly doubtful* and well-nigh impossible, that, *without any hearing yet held, the commercial court could have already gathered enough evidence before it to determine whether there was any imminent danger of dissipation of assets or of paralization of business operations to warrant the appointment of a rehabilitation receiver.*[77]

75. Pryce Corporation v. Court of Appeals, 543 SCRA 657 (2008).

76. Rizal Commercial Banking Corporation v. Intermediate Appellate Court, 213 SCRA 830 (1992).

77. *Pryce Corporation*, 543 SCRA at 664-65 (emphasis supplied).

It is not actually the fact of losing the corporate assets *per se* that justifies the appointment of the receiver and issuance of the stay order, but the fact of the paralyzation of business operations.

The ruling in *Pryce Corporation* now requires that the rehabilitation court first hold a hearing to determine whether there is a clear and imminent danger that it will lose its corporate assets, before issuing a stay order. "In determining whether petitioner's financial situation is serious and whether there is a clear and imminent danger that it will lose its corporate assets, the RTC, acting as commercial court, should conduct a hearing wherein both parties can present their respective evidence."[78]

The ruling in *Pryce Corporation* makes good sense considering that Pryce Corporation is in the business of developing and selling memorial lots. Foreclosing on or executing against the memorial lots, while involving the loss or dissipation of the corporate assets, did not cause the paralyzation of Pryce Corporation's business operations.

However, the Supreme Court in *Pryce Corporation* limited its ruling to whether or not the issuance of a stay order applicable to *all* claims was justified under the circumstances. The Supreme Court did not consider a situation where a particular secured creditor may be exempt from the coverage of the stay order on the ground that the property securing the debt is not essential to the operations of the debtor's business. It is submitted that the law should give the court the discretion to exempt certain non-essential properties from the coverage of the stay order or to selectively lift the stay order when warranted. If the seizure or foreclosure of debtor's assets will not adversely affect its operations, then the seizure or foreclosure should be allowed.

There is also the issue of who decides when the stay order is issued. Under P.D. No. 902-A, actions for claims are automatically suspended upon the appointment of the receiver. In contrast, House Bill 3542 is proposing that the suspension of action take effect upon the filing of the petition for rehabilitation. This is egregiously bad law. The decision to suspend the prosecution and enforcement of claims cannot be left to the will of the debtor for the obvious reason that the debtor will almost certainly abuse such power. An impartial judge should stand in between the debtor and the creditors and decide whether the suspension of claims is warranted under the circumstances.

D. Cram Down

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78. *Id.* at 665.

There is no cram down provision in either the Insolvency Law or in P.D. No. 902-A.

In a suspension of payments scenario under the Insolvency Law, the proposed "agreement" of the debtor is deemed rejected if not approved by a "double majority" in the creditors' meeting, i.e., two-thirds (2/3) of the creditors representing three-fifths (3/5) of the liabilities of the debtor.[79] The court has no power to force upon the creditors a suspension of payments agreement that does not obtain the requisite double majority.

On the other hand, P.D. No. 902-A is silent on whether creditors can be forced to accept a rehabilitation of the debtor. The only standards set forth in P.D. No. 902-A can be found in Section 6 (d), which provides:

> The management committee or rehabilitation receiver, board or body shall have the power to take custody of, and control over, all the existing assets and property of such entities under management; to evaluate the existing assets and liabilities, earnings and operations of such corporations, partnerships or other associations; to determine the best way to salvage and protect the interest of the investors and creditors; to study, review and evaluate the feasibility of continuing operations and restructure <u>and rehabilitate such entities if determined to be feasible by the Commission</u>. It shall report and be responsible to the Commission until dissolved by order of the Commission: <u>Provided, however, That the Commission may</u>, on the basis of the findings and recommendation of the management committee, or rehabilitation receiver, board or body, or on its own findings, <u>determine that the continuance in business of such corporation or entity would not be feasible or profitable nor work to the best interest of the stockholders, parties-litigants, creditors, or the general public, order the dissolution of such corporation entity and its remaining assets liquidated accordingly</u>. The management committee or rehabilitation receiver, board or body may overrule or revoke the actions of the previous management and board of directors of the entity or entities under management notwithstanding any provision of law, articles of incorporation or by-laws to the contrary.[80]

Thus, the only standards are whether or not the rehabilitation would be "feasible" or "profitable" or "work to the best interest of the stockholders, parties-litigants, creditors, or the general public." It would seem, then, that it is not sufficient for the creditors to simply object, but that they must persuade the rehabilitation court that the rehabilitation would not be to their "best interests."

The cram down provision under the Interim Rules is a reasonable one: the decision of the creditors is given much weight and can only be overridden if the objection to the rehabilitation is "manifestly

79. Insolvency Law, § 8.

80. SEC Reorganization Act, § 6 (d).

unreasonable."[81] The only problem with it the Interim Rules is that it is the progeny of judicial power, rather than of Congress, the branch of government tasked with the making of laws. Apart from the issue of the source of the "law," there is also the issue of the quality of the law. To be sure, the Interim Rules are well-crafted and has served the purpose of clarifying the rights of the parties in a rehabilitation proceeding. However, as discussed above, Congress would be in a better position to make the necessary adjustments in balancing the competing and clashing interests of the parties. In any event, the balance should be made to tilt in favor of the creditors.

E. Rights of Creditors

If there is any area of rehabilitation that Congress should study thoroughly, it is the area of the rights of creditors and debtors in a rehabilitation proceeding.

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81. Interim Rules, rule 4, § 23.

> SEC 23. Approval of the Rehabilitation Plan. — The court may approve a rehabilitation plan even over the opposition of creditors holding a majority of the total liabilities of the debtor if, in its judgment, the rehabilitation of the debtor is feasible and the opposition of the creditors is manifestly unreasonable.
>
> In determining whether or not the opposition of the creditors is manifestly unreasonable, the court shall consider the following:
>
> (a) That the plan would likely provide the objecting class of creditors with compensation greater than that which they would have received if the assets of the debtor were sold by a liquidator within a three-month period;
>
> (b) That the shareholders or owners of the debtor lose at least their controlling interest as a result of the plan; and
>
> (c) The Rehabilitation Receiver has recommended approval of the plan.
>
> In approving the rehabilitation plan, the court shall issue the necessary orders or processes for its immediate and successful implementation. It may impose such terms, conditions, or restrictions as the effective implementation and monitoring thereof may reasonably require, or for the protection and preservation of the interests of the creditors should the plan fail.

In several rulings, the Supreme Court has handed down the principle of "equality in equity." In *Ruby Industrial Corporation v. Court of Appeals*,[82] the Supreme Court held that:

> All assets of a corporation under rehabilitation receivership are held in trust for the equal benefit of all creditors to preclude one from obtaining an advantage or preference over another by the expediency of attachment, execution or otherwise. As between the creditors, the key phrase is equality in equity. Once the corporation threatened by bankruptcy is taken over by a receiver, all the creditors ought to stand on equal footing. Not any one of them should be paid ahead of the others. This is precisely the reason for suspending all pending claims against the corporation under receivership.[83]

This principle of "equality in equity" seems to give impression that the creditors should be treated equally during rehabilitation. If so, the logic is arguably defective. The problem apparently stems from the Supreme Court's understanding of the purpose of the stay order. The Supreme Court believes that the "reason for suspending all pending claims against the corporation under receivership" is so that "not any one of (the creditors) should be paid ahead of the others." But is this the reason for the stay order? If it is, then the ruling would imply that there is no basis to discriminate among the creditors during the rehabilitation period. However, the Supreme Court's ruling is not anchored on P.D. No. 902-A or any law.

It is submitted that the principal reason for the stay order is or should be to preserve the assets of the debtor company in order that the debtor may be able to continue its business operations. If so, then there is basis treat the differently situated creditors differently.

Some degree of discrimination is not inconsistent with the standard of "fairness" and "equitable treatment." What is "fair" and "equitable treatment" depends on the nature of the claim and other relevant circumstances.

One example of discrimination is the proposal under Section 36 of House Bill 293 that the post commencement loans be treated as an "administrative expense" helps to achieve certainty and predictability.

Section 36 provides:

> SEC. 36. Post-commencement loans. With the approval of the court upon the recommendation of the rehabilitation receiver, the debtor, in order to enhance its rehabilitation, may:
>
> 1. enter into credit arrangements, the payments under which shall be considered an administrative expense.

82. Ruby Industrial Corporation v. Court of Appeals, 284 SCRA 445 (1998).

83. *Id.* at 460.

New lenders will be less hesitant to infuse new capital if they have the statutory assurance that the repayment of their loan will be given preference over the claims of the existing debtors. At least, the courts should be given the discretion to give them such preference in light of all relevant circumstances.

There is also the issue of whether the rehabilitation courts have the power to impose interest rates, or not to impose interest rates, and whether the courts have the power to discriminate in fixing interest rates and in determining whether a certain class of creditors may receive payment ahead of other creditors or a greater fraction than other creditors. It is submitted that the courts be expressly granted the authority to discriminate among creditors when the circumstances warrant. Such discrimination is not new or unusual.

For example, under the Insolvency Law, an order of the suspension of payments does not apply to secured creditors.[84]

F. Rescission of Contracts

P.D. No. 902-A confers upon the management committee or rehabilitation receiver the power to "overrule or revoke the actions of the previous management and board of directors of the entity or entities under management notwithstanding any provision of law, articles of incorporation or by-laws to the contrary."[85] The receiver's power to "revoke" or overrule" refers to the actions of the "previous" management, i.e., the management prior to the filing of the petition. P.D. No. 902-A is silent on the power of the receiver with respect to the actions of the board of directors post-petition. Since the power to revoke board actions, like the power to suspend actions, interferences with contractual rights, it cannot be presumed conferred upon the receiver.

A related power is the power to compel the debtor company's counter-parties to continue with their contracts. Such power cannot be found in P.D. No. 902-A.

As discussed above, it is not uncommon for contracts to classify "insolvency" as an event of default and give the non-defaulting party the right to terminate the contract. Such stipulation is valid, not being contrary to law, morals, good customs, public order, or public policy.[86]

84. Insolvency Law, § 9.

85. *Id.*

86. CIVIL CODE, art. 1306.

However, the Interim Rules provide that the rehabilitation court shall have the power to prohibit the "debtor's suppliers of goods and services from withholding supply of goods and services in the ordinary course of business for as long as the debtor makes payments for the services and goods supplied after the issuance of the stay order."[87] This, arguably, is another instance of judicial legislation.

G. Role of the Receiver

The Receiver has the following powers under P.D. No. 902-A:

> (a) to take custody of, and control over, all the existing assets and property of such entities under management;
>
> (b) to evaluate the existing assets and liabilities, earnings and operations of such corporations, partnerships or other associations;
>
> (c) to determine the best way to salvage and protect the interest of the investors and creditors;
>
> (d) to study, review and evaluate the feasibility of continuing operations and restructure and rehabilitate such entities if determined to be feasible by the Commission. It shall report and be responsible to the Commission until dissolved by order of the Commission: Provided, however, That the Commission may, on the basis of the findings and recommendation of the rehabilitation receiver, or on its own findings, determine that the continuance in business of such corporation or entity would not be feasible or profitable nor work to the best interest of the stockholders, parties-litigants, creditors, or the general public, order the dissolution of such corporation entity and its remaining assets liquidated accordingly.[88]

In addition, the rehabilitation receiver may overrule or revoke the actions of the previous management and board of directors of the entity or entities under management notwithstanding any provision of law, articles of incorporation or by-laws to the contrary.

Although P.D. No. 902-A gives the receiver the power to overrule or revoke the actions of the previous management and board of directors, the law stops short of giving the receiver the power to take over the management of the debtor during rehabilitation.

An issue that may arise during rehabilitation is whether the approval of the receiver is necessary with respect to the contracts entered into by the debtor during the period of rehabilitation. If yes, should *all* contracts be submitted to the Receiver for review? Or should the Receiver review only certain types of contracts (e.g., contracts that are not in the ordinary course

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87. Interim Rules, rule 4, § 6 (e).

88. SEC Reorganization Act, § 6 (d).

of business)? The law should clarify the power of the rehabilitation receiver and the court with respect to the approval of contracts.

VII. CONCLUSION

Ironically, the law that provides for the rehabilitation of ailing companies is itself in need of rehabilitation. To be sure, the durable Insolvency Law has served us in good stead for many years, and so has P.D. No. 902-A. But there is much room for improvement.

The absence of "rules" or clearly defined rights in some crucial aspects of corporate rehabilitation has been a source of confusion and delay in rehabilitation proceedings. Consequently, the task of delineating the rules of the game and rights of the parties has fallen on our courts, guided only by the sparse provisions of P.D. No. 902-A on corporate rehabilitation.

For its part, the Interim Rules has done its bit to plug the many holes in P.D. No. 902-A. However, Congress should not abdicate to the judiciary its duty to pass "laws," whether in the form of "Rules" or court decisions. Congress is in a better position to craft more effective laws because it presumably sees the larger economic picture, is more in touch with the pulse of the people, and has the power to hold public hearings and debates and distill the many competing ideas and interests of the various stakeholders.

Congress must ensure that the balance that it strikes is a wise and fair one. A law that is overly protective of the debtor could restrict the flow of credit, the lifeblood of the economy. On the other hand, a law that leans too much in favor of the creditors could render corporate rehabilitation meaningless.

The bills pending in Congress contain proposals worth considering. The ongoing global economic crisis has made the case for reforming and modernizing our law on corporate rehabilitation more compelling. It is hoped that the dire and dismal prospect of relatively more businesses folding up and of Filipinos losing their jobs in the next several years serves as a sufficient prod to our legislators to give priority to the passage of a more modern insolvency law.