Rehabilitating the Law on Corporate Rehabilitation

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I. INTRODUCTION

In a free market, firms are left alone to compete against each other. As with any competition, however, the less efficient and competitive invariably fall by the wayside. The law will generally not come to the succor of the losers so long as the competitors play by the rules. Favoring one company or firm over others in the course of the competition is anathema to the concept of a free market, which presupposes a fair set of rules and a level playing field.

There are instances, however, when the law steps in to give the losing company a second chance. To be sure, the law does not intervene out of compassion for the juridical entity. In fact, the law does not bother with

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those firms that have little or no hope of rehabilitation. The State has better, more efficient uses for its limited resources than trying to bring back to life the hopelessly weak and moribund. The law offers assistance only when there is basis to believe that the ailing company can be nursed back to health and the resources devoted to such rehabilitation and the costs incurred in the process do not exceed the benefits.

It is the function of rehabilitation law and procedure to give assistance to the juridical person that still has a heartbeat — that is, whose rehabilitation is "feasible." Otherwise, the juridical person is made subject to liquidation,[1] where it is dismembered and its various parts are sold to the highest bidder.

The decision of whether or not to save or prolong the life of a financially distressed company is based on objective standards. Unlike a human being, the worth of a juridical person's life is measured in monetary terms. Thus, at the end of the day, the courts do not have to grapple with metaphysical or existential issues. The questions that have to be answered are questions of a practical nature: (1) is there a reasonable chance of saving the juridical life? And (2) will the juridical life have more value alive than dead? If it is determined during the rehabilitation process that the stakeholders will generally be better off by keeping the company alive, then the courts will put the company on temporary life support. On the other hand, if the bottom line is that rehabilitation will not be able to create significantly more value for the stakeholders, rehabilitation will be considered a waste of time: the plug will be pulled and the company will be left to die a natural death — another casualty of the free market.

Cite as 53 ATENEO L.J. 1 (2008).

1. Philippine Veterans Bank Employees Union-N.U.B.E v. Vega, 360 SCRA 33, 39 (2001).

> Liquidation, in corporation law, connotes a winding up or settling with creditors and debtors. It is the winding up of a corporation so that assets are distributed to those entitled to receive them. It is the process of reducing assets to cash, discharging liabilities and dividing surplus or loss.
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> On the opposite end of the spectrum is rehabilitation which connotes a reopening or reorganization. Rehabilitation contemplates a continuance of corporate life and activities in an effort to restore and reinstate the corporation to its former position of successful operation and solvency.
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> The concept of liquidation is diametrically opposed or contrary to the concept of rehabilitation, such that both cannot be undertaken at the same time. To allow the liquidation proceedings to continue would seriously hinder the rehabilitation of the subject bank.

This Article briefly traces the development of rehabilitation law and jurisprudence in the Philippines. It then discusses the rights of creditors during the period of rehabilitation as opposed to the rights of the creditors immediately upon the issuance of the stay order. It will also examine the "cram down" power of the courts, i.e. the courts' power to grant the petition for rehabilitation over the objection of the creditors or a class of creditors. Finally, this Article will offer some observations or recommendations on the following issues: the nature and scope of the cram down power, rehabilitation and the constitutional provision on the impairment of the obligations of contracts, and the principle of "equality in equity."

II. STATUTORY HISTORY OF CORPORATE REHABILITATION

The peculiarity of the Philippine law on corporate rehabilitation is that it did not emanate from Congress. Rather, it is the product of a Presidential Decree during the Martial Law years, when the powers of the Legislature and the Executive were consolidated in one person. Later on, "interim rules" on corporate rehabilitation were promulgated, laying down the procedure to be followed by debtor companies and their creditors. Neither did these "interim rules" come from Congress, it came from the third branch of government — the Judiciary.

A. Act No. (The Insolvency Law) and Suspension of Payments

Act No. 1956,[2] or the Insolvency Law, is an old law passed in 1909. It is the earliest law to extend assistance to financially-distressed companies. The assistance, though, is limited to a "suspension of payments." By definition, "suspension of payments" merely gives debtors some financial breathing space by allowing debtors to defer payment of their debts. To qualify for a suspension of payments, the debtor must "possess sufficient property to cover all his debts."[3]

Upon the filing of the petition for declaration of suspension of payments, together with the proposed agreement with the creditors, and upon finding that the petition is sufficient in form and substance, the court then issues an order containing

> an absolute injunction forbidding the petitioning debtor from disposing in any manner of his property, except in so far as concerns the ordinary operations of commerce or of industry in which the petitioner is engaged, and, furthermore, from making any payments outside of the necessary or

2. 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).

3. *Id.* § 2.

> legitimate expenses of his business or industry, so long as the proceedings relative to the suspension of payments are pending, and said proceedings for the purposes of this Act shall be considered to have been instituted from the date of the filing of the petition.[4]

Upon the debtor's request to the court, all pending actions and executions against the debtor are suspended, except for executions against property especially mortgaged.[5] Thus, under the Insolvency Law, a secured creditor could assert his preferred status during the period of suspension of payments.

The creditors exercise substantial influence in a suspension of payments scenario under the Insolvency Law. The petition for suspension of payments is deemed rejected if creditors representing at least three-fifths of the liabilities fail to attend the meeting fixed by the court;[6] or even if the required quorum is present, the double super-majority (i.e. two-thirds of the creditors present, representing at least three-fifths of the total liabilities) still has to be met for a proposed agreement to be approved.[7] And even if a quorum is present and a double super-majority obtained, a creditor who dissents from the majority vote can still go to the court and, under limited grounds, ask that the decision of the majority be set aside.[8] Basically, the fate of a debtor company asking for suspension of payments under the Insolvency Law lies in the hands of the creditors.

The Insolvency Law makes no mention of "rehabilitation."

B. Presidential Decree No. -A

The only general law on corporate rehabilitation, Presidential Decree (P.D.) No. 902-A,[9] came out in 1976 when then President Ferdinand Marcos reorganized the Securities and Exchange Commission (SEC) by, among others, expanding the jurisdiction of the SEC to include cases relating to suspensions of payment and the rehabilitation of corporations, partnerships,

4. *Id.* § 3.

5. *Id.* § 6.

6. *Id.* § 8.

7. *Id.*

8. The Insolvency Law, §§ 11-12.

9. 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).

and associations, thereby removing them from the jurisdiction of the regular courts.[10]

Under P.D. No. 902-A, the following corporations, partnerships, and associations could apply for a suspension of payments and rehabilitation: (1) those that have "sufficient property to cover all its debts but foresee[ ] the impossibility of meeting them when they respectively fall due;"[11] and (2) those that do not have "sufficient assets to cover [their] liabilities, but [are] under the management of a Rehabilitation Receiver or Management Committee."[12] P.D. No. 902-A expanded the coverage of debtors who can avail of suspension of payments to include a debtor company that "has no sufficient assets to cover its liabilities."[13]

Notably, P.D. No. 902-A does not expressly define or refer to "corporate rehabilitation." At most, it refers to a "rehabilitation receiver." The right of a debtor company to rehabilitation can merely be inferred from the powers conferred upon the SEC in the exercise of its expanded jurisdiction.[14]

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10. *See* SEC Reorganization Act, §§ 3 & 5; Teodoro Regala, Insolvency Law Reforms Report on Philippines, *available at* http://www.adb.org/documents/others/insolvency/local_study_phi.pdf (last accessed Sep. 12, 2008).

11. SEC Reorganization Act, § 5 (d).

12. *Id.*

13. *Id.*

14. *Id.* § 6 (c).

> To appoint one or more receivers of the property, real and personal, which is the subject of the action pending before the Commission in accordance with the pertinent provisions of the Rules of Court in such other cases whenever necessary in order to preserve the rights of the parties-litigants and/or protect the interest of the investing public and creditors.

Id. § 6 (d).

> To create and appoint a management committee, board, or body upon petition or *motu proprio* to undertake the management of corporations, partnerships or other associations not supervised or regulated by other government agencies in appropriate cases when there is imminent danger of dissipation, loss, wastage or destruction of assets or other properties or 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;
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> . . .
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> To determine whether or not the continuance in business of a corporation or entity would be feasible or profitable or work to the best interest of the stockholders, parties-litigants, creditors, or the

Under P.D. No. 902-A, the SEC's powers went beyond merely overseeing proceedings relating to suspension of payments. P.D. No. 902-A clothed the SEC with the power to appoint a receiver or management committee for the financially distressed company and to determine whether or not the continuance of the company's life is "feasible" or "profitable" or "work to the best interests" of the "stockholders, parties-litigants, creditors, or the general public." Whereas the will of the creditors in a suspension of payments under the Insolvency Law is supreme, corporate rehabilitation under P.D. No. 902-A required that the SEC take into account the interests of the other *dramatis personae*, namely, the debtor company, stockholders, and the general public. There is here a shift in view, an appreciation that there is more at stake in the demise of a company than the interests of creditors. Notably, P.D. No. 902-A is silent on the rights of the creditors to approve or reject the rehabilitation of a debtor company.

For its part, the management committee or rehabilitation receiver is 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 to restructure and rehabilitate such entities if determined to be feasible by the SEC.[15]

Thus, rehabilitation is a more expansive concept than suspension of payments. While rehabilitation may include suspension of payments, it consists of and entails much more than a deferment of payments. From the powers conferred upon the management committee or rehabilitation receiver, it can be inferred that rehabilitation contemplates a situation where the company is in serious financial distress and is in need of something more than temporary breathing space. Rehabilitation may call for creative solutions — definitely more than the mechanical deferment of payments — as the management committee or rehabilitation receiver grapple with the problem of how "best to salvage and protect the interest of the investors and creditors" and to "restructure and rehabilitate" the faltering company.

Finally, under P.D. No. 902-A, the *appointment* of a management committee or rehabilitation receiver has the effect of suspending all actions for claims against corporations, partnerships, or associations under management or receivership pending before any court, tribunal, board, or

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general public; and to order the dissolution of a corporation entity and its remaining assets liquidated accordingly.

15. *Id.* § 6 (d).

body.[16] While the suspension order of the court in suspension of payment proceedings under the Insolvency Law does not cover "execution against property especially mortgaged,"[17] the coverage of the suspension under P.D. No. 902-A upon the appointment of the management committee or rehabilitation receiver is sweeping — it covers both secured and unsecured properties.[18] This is consistent with the assumption that a company in need of rehabilitation is in a far more serious condition than a company that applies only for suspension of payments. Hence, the law offers a more drastic remedy to the gravely ailing company, sacrificing — or, in the words of P.D. No. 902-A, "suspending" — temporarily, the rights of the secured creditors.

C. Securities Regulation Code

On 19 July 2000, Congress passed Republic Act No. 8799,[19] otherwise known as the Securities Regulation Code. The Securities Regulation Code provides, among others, that the SEC jurisdiction over all cases enumerated under Section 5 of P.D. 902-A (except cases involving intra-corporate controversies pending with the SEC and suspension of payments or rehabilitation cases filed with the SEC as of June 30, 2000), shall be transferred to the Regional Trial Courts.[20]

Thus, jurisdiction over rehabilitation cases is now with the Regional Trial Courts.

16. SEC Reorganization Act, § 6 (d).

17. The Insolvency Law, § 6.

18. *See* Cesar L. Villanueva, The Philippine Experience: Specialized Court System for Insolvency Proceedings, *available at* http://www.oecd.org/dataoecd/7/43/1874140.pdf (last accessed Sep. 12, 2008).

19. The Securities Regulation Code, Republic Act No. 8799 (2000).

20. *Id.* § 5.2.

> 5.2. The Commission's jurisdiction over all cases enumerated under Section 5 of Presidential Decree No. 902-A is hereby transferred to the Courts of general jurisdiction or the appropriate Regional Trial Court: Provided, That the Supreme Court in the exercise of its authority may designate the Regional Trial Court branches that shall exercise jurisdiction over these cases. The Commission shall retain jurisdiction over pending cases involving intra-corporate disputes submitted for final resolution which should be resolved within one (1) year from the enactment of this Code. The Commission shall retain jurisdiction over pending suspension of payments/rehabilitation cases filed as of 30 June 2000 until finally disposed.

D. Interim Rules on Corporate Rehabilitation

On 21 November 2000, the Supreme Court *en banc* issued A.M. No. 00-8-10-SC, or the Interim Rules of Procedure on Corporate Rehabilitation.[21] The Interim Rules apply to petitions for rehabilitation filed by corporations, partnerships, and associations pursuant to P.D. No. 902-A, as amended.

The Interim Rules were adopted to provide for a summary and non-adversarial rehabilitation proceeding. This is in consonance with the commercial nature of a rehabilitation case, which requires expeditious resolution for the benefit of all the parties concerned and the economy in general.[22]

The basic procedure under the Interim Rules involves the submission of a petition with the regional trial courts. If such petition is found to be in accord with the formal requirements, a stay order is issued and published. If the petition is ultimately found to be meritorious, the court shall give it due course. The procedure likewise includes the constitution of a rehabilitation plan to be approved by the Court.[23]

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

22. New Frontier Sugar Corporation v. Regional Trial Court, Branch 39, Iloilo City and Equitable PCI Bank, 513 SCRA 601 (2007).

23. *Id.* at 608-09. The procedure is detailed as follows:

> (1) The petition is filed with the appropriate Regional Trial Court;
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> (2) If the petition is found to be sufficient in form and substance, the trial court shall issue a Stay Order, which shall provide, among others, for the appointment of a Rehabilitation Receiver; the fixing of the initial hearing on the petition; a directive to the petitioner to publish the Order in a newspaper of general circulation in the Philippines once a week for two (2) consecutive weeks; and a directive to all creditors and all interested parties (including the SEC) to file and serve on the debtor a verified comment on or opposition to the petition, with supporting affidavits and documents.
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> (3) Publication of the Stay Order;
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> (4) Initial hearing on any matter relating to the petition or on any comment and/or opposition filed in connection therewith. If the trial court is satisfied that there is merit in the petition, it shall give due course to the petition;
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> (5) Referral for evaluation of the rehabilitation plan to the rehabilitation receiver who shall submit his recommendations to the court;

One of the salient and potentially controversial rules is Rule 4, Section 23, which essentially provides that, notwithstanding the opposition made by the creditors who are deemed to hold a majority of the total liabilities, the court may nevertheless approve the rehabilitation plan if, in its judgment, the rehabilitation of the debtor is feasible and the opposition by the creditors is manifestly unreasonable. It then provided the guidelines or standards by which the manifest unreasonableness of the opposition may be determined.[24]

This power of the courts to approve the rehabilitation of a debtor company over the objection of the creditors is not found in P.D. No. 902-A and, arguably, goes beyond being merely procedural. Compared to creditors, especially secured creditors, in a suspension of payments proceeding, creditors in a rehabilitation proceeding under P.D. No. 902-A wield much less influence in determining the fate of the debtor company. Rule 4, Section 23 reduces even further this influence.

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(6) Modifications or revisions of the rehabilitation plan as necessary;

(7) Submission of final rehabilitation plan to the trial court for approval; and

(8) Approval/disapproval of rehabilitation plan by the trial court.

24. 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.
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> In determining whether or not the opposition of the creditors is manifestly unreasonable, the court shall consider the following:
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> (1) 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;
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> (2) That the shareholders or owners of the debtor lose at least their controlling interest as a result of the plan; and
>
> (3) The Rehabilitation Receiver has recommended approval of the plan.
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> 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.

III. REHABILITATION AND THE STAY ORDER

A. Purpose of Rehabilitation

According to the Supreme Court, rehabilitation proceedings are meant to enable companies to start anew which would consequently allow the payment of creditors to be made from the earnings of the corporation. Apart from this so-called "new lease on life," it also implies the continuation of the corporate life and a reinstatement to its former position of success.[25]

Thus, the purpose of rehabilitation is two-fold: first, it is to give the financially distressed company a second chance — a "new lease on life;"[26] second, it is to allow "creditors to be paid their claims."[27] The first purpose is self-explanatory, while the second purpose implies that rehabilitation is acceptable if, at the end of the day, the debtor company is able to *fully* pay the claims of *all* its creditors.

Nevertheless, enunciating the purpose of rehabilitation is one thing, making it work is another. The law is keenly aware that creditors are what they are: their principal concern is to get paid in full with little or no regard for the plight of the debtor company. Thus, the law provides a mechanism whereby the creditors are strictly kept at bay while the debtor company is recuperating — the stay order.

B. The Stay Order

It is the ailing animal that invariably catches the eye of watchful predators, which wait for the right moment to pounce on the hapless creature and strip it to the bone. Such is the law of the jungle, and such is the law of the market.

Upon the earliest signs of corporate distress and defaults in payments, creditors scramble to foreclose on the mortgages and prosecute their claims. Their apprehensions are understandable: the assets are presumably insufficient to satisfy all claims. It is thus each creditor to its own.

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25. Metropolitan Bank & Trust Company v. ASB Holdings, Inc., 517 SCRA 1, 15 (2007) (citing SEC Reorganization Act, 1st Whereas Clause).

> The purpose of rehabilitation proceedings is to enable the company to gain new lease on life and thereby allow creditors to be paid their claims from its earnings. Rehabilitation contemplates a continuance of corporate life and activities in an effort to restore and reinstate the financially distressed corporation to its former position of successful operation and solvency. This is in consonance with the State's objective to promote a wider and more meaningful equitable distribution of wealth to protect investments and the public.

26. *Id.* at 15.

27. *Id.*

Pleas from the debtor company for some financial breathing space usually fall on deaf ears. This is not surprising since a creditor's primary objective is to maximize recovery. Whether the debtor survives the creditors' assault on its assets is not the creditors' concern.

It is for this reason that the law provides for the suspension of actions against the debtor company. Without this suspension, the rehabilitation of a distressed company will rarely, if at all, be successful.

1. When Suspension Takes Effect

The timing of the suspension of the enforcement of actions or claims against the debtor company is, needless to say, critical.

A disagreement arose among the justices of the Supreme Court in the first *Rizal Commercial Banking Corporation v. Intermediate Appellate Court*[28] case as to when the suspension of actions against the debtor corporation takes place. Because of their apprehension that an unscrupulous debtor corporation might dissipate or dispose of its assets before a management committee or receiver could be appointed, the majority of the justices disregarded the plain language of P.D. No. 902-A and, instead, tried to uphold its spirit. The Supreme Court held that the suspension of all actions for claims against the debtor corporation attached upon the *filing* of the petition for rehabilitation, and not upon the appointment of the rehabilitation receiver.[29]

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

29. *Id.* at 838.

> [W]henever a distressed corporation asks the SEC for rehabilitation and suspension of payments, preferred creditors may no longer assert such preference, but … stand on equal footing with other creditors. Foreclosure shall be disallowed so as not to prejudice other creditors, or cause discrimination among them. If foreclosure is undertaken despite the fact that a petition for rehabilitation has been filed, the certificate of sale shall not be delivered pending rehabilitation. Likewise, if this has also been done, no transfer of title shall be effected also, within the period of rehabilitation. The rationale behind PD 902-A, as amended, is to effect a feasible and viable rehabilitation. This cannot be achieved if one creditor is preferred over the others.
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> In this connection, the prohibition against foreclosure attaches as soon as a petition for rehabilitation is filed. Were it otherwise, what is to prevent the petitioner from delaying the creation of a Management Committee and in the meantime dissipate all its assets. The sooner the SEC takes over and imposes a freeze on all the assets, the better for all concerned.

Justice Florentino Feliciano (joined by three other justices) dissented. He opined that the SEC acted prematurely and without jurisdiction or legal authority in enjoining Rizal Commercial Banking Corporation and the sheriff from proceeding with the public auction sale. The dissenting justices maintained that Section 6 (c) of P.D. No. 902-A was clear and unequivocal in that claims against the corporations, partnerships, or associations shall be suspended only upon the appointment of a management committee, rehabilitation receiver, board, or body.[30]

RCBC subsequently filed a motion for reconsideration, which the Supreme Court granted. This time, the Supreme Court acknowledged that the "first and fundamental duty of the court is to apply the law."[31]

Applying the letter of the law, the Supreme Court pointed out that the appointment of a receiver or management committee was not automatic upon the filing of a petition for rehabilitation, but depended upon the existence of certain "serious" situations.[32]

It ruled that it was the SEC's responsibility to determine the appropriateness and necessity of such an appointment under circumstance. Referring to Section 6 of P.D. No. 902-A, it recognized the fact that before a management committee may be constituted, certain situations must first be determined as existing. The situations are listed by the court, to wit:

> (1) when there is imminent danger of dissipation, loss, wastage or destruction of assets or other properties; or
>
> (2) when there is paralization of business operations of such corporations or entities which may be prejudicial to the interest of minority stockholders, parties-litigants or to the general public.[33]

As a matter of distinction, the Court indicated that receivers may be appointed when the following circumstances have been determined:

> (1) necessary in order to preserve the rights of the parties-litigants; and/or
>
> (2) protect the interest of the investing public and creditors. (Section 6(c), P.D. 902-A.)[34]

It is imperative that the determination of the existence of these situations or circumstances be made for the appointment of either a management committee or a rehabilitation receiver, as the case may be. Such

30. *Id.* at 829-44.

31. Rizal Commercial Banking Corporation v. Intermediate Appellate Court, 320 SCRA 279, 290 (1999).

32. *Id.* at 289-90.

33. *Id.* at 290.

34. *Id.*

appointments are vital for the preservation of the existing assets and properties of the corporation, which then results in the protection of both the interests of the investors and creditors. Clearly, it is necessary that when the situation calls for the suspension of the action for claims as indicated in Section 6, (c) of P.D. No. 902-A, such provision be complied with to ensure that any efforts to resuscitate a failing corporation will go unhampered.[35]

If it is, however, determined by the SEC that the circumstances indicated above are not present or when there is no real danger of losing any of the corporation's assets, there is likewise no need for the appointment of a management committee or a rehabilitation receiver. Likewise, the SEC may no longer order the suspension of actions for claims. The Court also ruled that if no appointment of a management committee or rehabilitation receiver is made by the Supreme Court, an assumption as to the sufficiency of corporate assets can be made, sufficient to sustain the rehabilitation plan and protect the interests of both investors and creditors.[36]

Under P.D. 902-A, the suspension of actions against the debtor company automatically took place upon the appointment of the receiver or the management committee. P.D. No. 902-A, however, did not fix any period for making such appointment.

The Interim Rules address the concern of the justices in *Rizal Commercial Banking Corporation v. Intermediate Appellate Court*[37] by requiring the rehabilitation court to make a determination on whether there is a need to appoint a rehabilitation receiver and issue a stay order within five days from filing of the petition for rehabilitation.

2. Claims Covered by the Suspension

Another important factor to consider is what types of claims are covered by the suspension order.

Under the Insolvency Law, the rights of the secured creditors were not affected by the filing of the petition for suspension of payments. Under P.D. No. 902-A, however, the distinction between a secured creditor and an unsecured creditor, insofar as the suspension of actions for claims was concerned, was eliminated.

35. *Id.*

36. *Id.*

37. *See* Rizal Commercial Banking Corporation v. Intermediate Appellate Court, 320 SCRA 279 (1999).

In 1989, however, in *Philippine Commercial International Bank v. Court of Appeals*,[38] the First Division of the Supreme Court held that the stay order applied only to unsecured claims.[39]

Soon after this ruling, the Supreme Court handed down contrary decisions in *Alemar's Sibal & Sons, Inc. v. Elbinias*[40] (decided by the Third Division) and *Araneta v. Court of Appeals*[41] (decided by the Second Division): both held that the automatic stay applied to both secured and unsecured creditors. Finally, in *Bank of the Philippine Islands v. Court of Appeals*[42] the Supreme Court explicitly declared that,

> [t]he doctrine in the PCIB Case has since been abrogated. In Alemar's Sibal & Sons v. Elbinias, BF Homes, Inc. v. Court of Appeals, Araneta v. Court of Appeals and RCBC v. Court of Appeals, we already ruled that whenever a distressed corporation asks SEC for rehabilitation and suspension of payments, preferred creditors may no longer assert such preference, but shall stand on equal footing with other creditors.[43]

Nevertheless, as noted by the Supreme Court in the second *Rizal Commercial Banking Corporation v. Intermediate Appellate Court*,[44] the contrary Division rulings that came after *Philippine Commercial International Bank* did not satisfy the constitutional requirement that "no doctrine or principle of law laid down by the court in a decision rendered en banc or in division may be modified or reversed except by the court sitting en banc."[45] It was only in the second *Rizal Commercial Banking Corporation* case that the Supreme Court *en banc* put the issue to rest and laid down what it referred to as the "rules of thumb."[46]

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38. Philippine Commercial International Bank v. Court of Appeals, 172 SCRA 436 (1989).

39. *Id.* at 440.

> SEC's order for suspension of payments of Philfinance as well as for all actions of claims against Philfinance could only be applied to claims of unsecured creditors. Such order can not extend to creditors holding a mortgage, pledge or any lien on the property unless they give up the property, security or lien in favor of all the creditors of Philfinance.

40. Alemar's Sibal & Sons, Inc. v. Elbinias, 186 SCRA 94 (1990).

41. Araneta v. Court of Appeals, 211 SCRA 390 (1992).

42. Bank of the Philippine Islands v. Court of Appeals, 229 SCRA 223 (1994).

43. *Id.* at 227-28.

44. Rizal Commercial Banking Corporation v. Intermediate Appellate Court, 320 SCRA 279 (1999).

45. *Id.* at 293 (citing PHIL CONST. art. VIII, § 4).

46. *Id.* These rules, as stated by the Supreme Court, read:

> (1) All claims against corporations, partnerships, or associations that are pending before any court, tribunal, or board, without

In summary, the Court ruled that, upon the appointment of a management committee or a rehabilitation receiver, all pending claims made against the failing corporation before any court, tribunal, board or body shall be suspended. The suspension of such claims, however, does not prejudice the secured creditor and does not affect his status as such, as compared to a unsecured creditor. What the suspension simply hopes to achieve is to provide the receiver the opportunity to rehabilitate the corporation, especially when the possibility of doing so is still extant. If such possibility no longer exists and it becomes clear that claims must be settled, the secured creditors will in fact enjoy a preference over the unsecured creditors, provided that the provisions of the Civil Code on the Concurrence and Preferences of Credit are acceded to.[47] The Supreme Court clarified that while it had previously ruled that equal standing will be afforded to all creditors of distressed corporations, it qualified such a ruling by stating that the same

> must be read and understood in the light of the foregoing rulings. All claims of both a secured or unsecured creditor, without distinction on this score, are suspended once a management committee is appointed. Secured creditors, in the meantime, shall not be allowed to assert such preference before the Securities and Exchange Commission. It may be stressed, however, that this shall only take effect upon the appointment of a management committee, rehabilitation receiver, board, or body, as opined in the dissent.[48]

> distinction as to whether or not a creditor is secured or unsecured, shall be suspended effective upon the appointment of a management committee, rehabilitation receiver, board, or body in accordance with the provisions of Presidential Decree No. 902-A.
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> (2) Secured creditors retain their preference over unsecured creditors, but enforcement of such preference is equally suspended upon the appointment of a management committee, rehabilitation receiver, board, or body. In the event that the assets of the corporation, partnership, or association are finally liquidated, however, secured and preferred credits under the applicable provisions of the Civil Code will definitely have preference over unsecured ones.

47. *Id.* at 294 (citing State Investment House, Inc. v. Court of Appeals, 277 SCRA 209 (1997)).

48. *Id.* at 293-94.

> (1) All claims against corporations, partnerships, or associations that are pending before any court, tribunal, or board, without distinction as to whether or not a creditor is secured or unsecured, shall be suspended effective upon the appointment of a management committee, rehabilitation receiver, board, or body in accordance with the provisions of Presidential Decree No. 902-A.

The suspension order does not make any distinction either among the different types of unsecured claims. Thus, for example, it applies equally to claims arising from a "breach of contract resulting in damages due to negligence in the custody of the missing luggages [sic]"[49] and to labor claims.[50]

3. Duration of the Suspension

The duration of the suspension of the enforcement of actions against the debtor company is, for obvious reasons, only temporary.[51]

A suspension that is indefinite or excessively long works as an injustice to the creditors and defeats the objective of an efficient and speedy rehabilitation.

4. Purpose of the Suspension of Actions or Claims

What *exactly* is the purpose of the suspension of actions or claims? The answer to this question determines the rights of the parties while the debtor company is undergoing rehabilitation. Unfortunately, the law itself does not provide any express explanation. Both Section 3 of Act No. 1956[52] and

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(2) Secured creditors retain their preference over unsecured creditors, but enforcement of such preference is equally suspended upon the appointment of a management committee, rehabilitation receiver, board, or body. In the event that the assets of the corporation, partnership, or association are finally liquidated, however, secured and preferred credits under the applicable provisions of the Civil Code will definitely have preference over unsecured ones.

49. Philippine Airlines v. Spouses Kurangking, 389 SCRA 588, 593 (2002).

50. *See* Rubberworld (Phils.), Inc. v. NLRC, 305 SCRA 721, 729-31 (1999).

51. BF Homes, Inc. v. Court of Appeals, 190 SCRA 262, 269 (1990).

In *BF Homes, Inc. v. Hon. Fernando P. Agdamag, et al.*, the Court of Appeals held: It must be emphasized that the suspension is only for a temporary period to prevent the irreversible collapse of the corporation and give the management committee or receiver the absolute tranquility to study the viability of the corporation. During this period, the law creates a wall around the corporation against all claims.

52. The Insolvency Law, § 3.

SEC. 3. Said order shall further contain an absolute injunction forbidding the petitioning debtor from disposing in any manner of his property, except in so far as concerns the ordinary operations of commerce or of industry in which the petitioner is engaged, and, furthermore, from making any payments outside of the necessary or legitimate expenses of his business or industry, so long as the proceedings relative to the suspension of payments are pending, and

Section 6 (c) of P.D. No. 902-A[53] are not instructive. Neither the title of P.D. No. 902-A[54] nor its whereas clauses[55] offer guidance on the rationale for the automatic stay of claims. One can only infer the purpose behind the suspension of the enforcement of actions against the debtor company.

Because the law did not specify the purpose of the suspension of actions for claims, the courts took it upon themselves to divine and expound on the lawmakers' intentions. Thus, the Supreme Court has, through the years, come up with various explanations.

One purpose of the automatic stay of all pending actions for claims is to "enable the rehabilitation receiver to effectively exercise its/his powers free from any judicial or extra-judicial interference that might unduly hinder or

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said proceedings for the purposes of this Act shall be considered to have been instituted from the date of the filing of the petition.

53. SEC Reorganization Act, § 6.

SEC. 6. In order to effectively exercise such jurisdiction, the Commission shall possess the following powers:

…

(c) that upon appointment of a management committee, rehabilitation receiver, board or body, pursuant to this Decree, all actions for claims against corporations, partnerships or associations under management or receivership pending before any court, tribunal, board or body shall be suspended accordingly.

54. *See* SEC Reorganization Act.

55. SEC Reorganization Act, Whereas Clauses.

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.

prevent the rescue of the corporation."[56] It is not unusual for a debtor company to have scores of creditors. The bigger debtor corporations, such as Philippine Airlines[57] and Negros Navigation, Inc.,[58] have hundreds of creditors, big and small. Thus, allowing these creditors to pursue their respective claims will distract and effectively hamper the receiver in the performance of his pressing duties. Instead of focusing his attention on the rehabilitation of the debtor company, the receiver will have to devote his precious time defending against numerous claims.

Another purpose of the automatic stay is to "avoid collusion between the previous management and creditors it might favor, to the prejudice of the other creditors."[59] Still another purpose of the stay order is to disqualify a person from gaining an advantage over others with similar claims by the mere reason of his speed in attaching or executing his claim. This is to ensure that judgments sought by more alert creditors do not prejudice those less alert but whose claims are arguably of equal importance.[60]

The Supreme Court, however, did not confine itself to simply enumerating the purposes of the suspension of action. It created an area of ambiguity or, worse, inadvertently intruded into the domain of the Legislature, when it 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"[61] and that the "key phrase is equality in equity."[62] "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

56. Garcia v. Philippine Airlines, Inc., 531 SCRA 574, 581 (2007) (citing Rubberworld (Phils.), Inc. v. NLRC, 305 SCRA 721, 728 (1999)).

57. In the Matter of the Petition for the Approval of a Rehabilitation Plan and for Appointment of a Rehabilitation Receiver, Philippine Airlines, Inc., SEC Case No. 06-98-6004 (Securities and Exchange Commission). This case is currently pending with the SEC.

58. In the Matter of: Petition for Corporate Rehabilitation with Prayer for Suspension of Payments with Approval of Proposed Rehabilitation Plan, Negros Navigation Co., Inc., Sp. Proc. No. 04-109532 (Regional Trial Court Manila, Branch 46). This case is currently pending with the Manila RTC Branch herein mentioned.

59. Ruby Industrial Corporation v. Court of Appeals, 284 SCRA 445, 460 (1998).

60. New Frontier Sugar Corporation v. Regional Trial Court, Branch 39, Iloilo City and Equitable PCI Bank, 513 SCRA 601, 606 (2007) (citing Alemar's Sibal & Sons, Inc. v. Elbinias, 186 SCRA 94, 99-100 (1990)).

61. *Ruby Industrial Corporation,* 284 SCRA at 460.

62. *Id.*

is precisely the reason for suspending all pending claims against the corporation under receivership."[63]

What exactly does the principle of "equality in equity" mean? Here lies the rub. By the Supreme Court's definition, the phrase means that none of the creditors "should be paid ahead of the others."[64]

The above ruling arguably exceeds the meaning of P.D. No. 902-A, which merely states that "upon appointment of a management committee, rehabilitation receiver, board or body, pursuant to this Decree, all actions for claims against corporations, partnerships or associations under management or receivership pending before any court, tribunal, board or body shall be suspended accordingly;"[65] but which, notably, says nothing about what will happen *within* the framework of rehabilitation.

IV. "CRAM DOWN"

A. The Interim Rules

As discussed above, the Interim Rules have conferred on corporate rehabilitation courts the power to overrule the objections of creditors to the rehabilitation plan if, in the opinion of the court, it finds that the rehabilitation plan is feasible and the objection of the majority of the creditors is "manifestly unreasonable."[66] The creditors still retain some degree of influence in the outcome of the rehabilitation proceedings, however, since the "manifestly unreasonable" standard is a difficult bar to overcome. Nonetheless, their influence has been significantly diminished relative to the influence enjoyed by creditors in suspension of payments under the Insolvency Law.

The issue of the constitutionality of Rule 4, Section 23 aside, the cram down power is a potentially useful judicial device. Given the many stakeholders in rehabilitation, it is only logical to give the court, which is tasked to look after and balance the interests of all the parties, the power to overrule the "manifestly unreasonable" and blinkered objections of creditors. It also gives the court flexibility in dealing with the various claims of the different creditors.

As with any given power, it is important to determine and define the scope of the court's cram down powers. If exercised judiciously, the cram down power can help accomplish the objectives of rehabilitation more

63. *Id.* (citing Araneta v. Court of Appeals, 211 SCRA 390 (1992)).

64. *Id.*

65. SEC Reorganization Act, § 6.

66. Interim Rules, rule 4, § 23.

effectively, efficiently, and speedily. If used indiscriminately, this power can trample on the rights of creditors.

B. Metropolitan Bank & Trust Company v. ASB Holdings, Inc., et al.

The recent decision of *Metropolitan Bank & Trust Company v. ASB Holdings, Inc., et al.*[67] addressed the issue of the extent to which the courts — or in this case, the SEC — can cram down a rehabilitation plan on the creditors.

In the case, petitioner Metropolitan Bank and Trust Company was a creditor bank of respondent corporations, collectively known as the ASB Group of Companies, owner and developer of condominium and real estate projects. The loans extended by petitioner bank were secured by real estate mortgages.

On 2 May 2000, the ASB Group of Companies filed with the SEC a "Petition For Rehabilitation With Prayer For Suspension Of Actions And Proceedings Against Petitioners," pursuant to P.D. No. 902-A, as amended.

Subsequently, the ASB Group of Companies submitted to the SEC for its approval a Rehabilitation Plan,[68] which petitioner bank objected to and

67. Metropolitan Bank & Trust Company v. ASB Holdings, Inc., *et al.*, 571 SCRA 1 (2007).

68. *Id.* at 7-8. The Rehabilitation Plan was stated as follows:

Metropolitan Bank and Trust Co.:

(1) Principal Amount — Principal (amount) plus any interest due and unpaid as of April 30, 2000, less any prepaid interest, without any penalties and charges.

(2) Form of Agreement — *Dacion en Pago* Agreement

(3) Purpose — To retire existing loans

(4) Tenor — Immediate *Dacion en Pago* of related properties, subject to the approval of the Securities and Exchange Commission (SEC)

(5) Effective Date — 1 September 2000, subject to the approval of the SEC.

Dacion En Pago

(1) Arrangement — ASB will *dacion* the bank's equity in St. Francis Square and apply the excess *dacion* value on its BSA Twin Tower loan. Further, Makati Hope, Buendia cor. Malugay, 21 Annapolis (which is expected to be released by PNB) and # 28 & 23 Eisenhower St., will be *dacioned* to Metrobank, the excess of which will also be applied to Metrobank's exposure on BSA Twin Towers. In return, State Condominium will be freed up and placed in the ASB creditors' asset pool. Further, Metrobank shall also undertake the completion of BSA Twin Towers.

declared that it is "not acceptable" because (1) petitioner did not agree with the valuation of the properties offered for *dacion*; (2) the waiver of interests, penalties and charges after 30 April 2000 was not feasible considering that the bank continued to incur costs on the funds owed by ASB Realty Corporation and ASB Development Corporation; and (3) since the proposed *dacion* was not acceptable to the bank, there was no basis to release the properties which serve as collateral for the loans.[69]

The SEC Hearing Panel, finding petitioner bank's objections unreasonable, issued an order approving the Rehabilitation Plan. Petitioner bank filed with the SEC *en banc* a Petition for Certiorari, alleging that the SEC Hearing Panel, in approving the Rehabilitation Plan, committed grave abuse of discretion amounting to lack or excess of jurisdiction. The SEC *en banc* denied petitioner bank's Petition for Certiorari and affirmed the SEC Hearing Panel's order.[70]

Petitioner bank then filed with the Court of Appeals a Petition for Review, which the Court of Appeals denied.[71]

On appeal to the Supreme Court, petitioner bank contended that the Court of Appeals erred in *not* ruling for the nullification of the 15 April 2003 Resolution which approved the Rehabilitation Plan. It stated that by virtue of the SEC approval, petitioner bank must accept, "through a *dacion en pago* arrangement, properties based on ASB Group of Companies' transfer values and to release part of the collateral."[72] The effect of this approval, it was contended, was a violation of the petitioner bank's constitutional right against the impairment of contracts and due process as it precluded the bank from enforcing its lien on the mortgaged property. Petitioner bank likewise alleged that the Rehabilitation Plan also has the effect of compelling the petitioner bank to waive the interests, penalties and charges accrued after the stay order was issued by the SEC. This again resulted in the violation of the bank's right against the impairment of contracts.[73]

The Supreme Court found that the Rehabilitation Plan did not impair petitioner's lien over the mortgaged properties since petitioner's right to enforce its preference over the said properties was merely "suspended."

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(2) Outstanding Loan Balance

(3) After *Dacion En Pago* — None.

69. *Id.* at 8.

70. *Id.*

71. *Id.* at 9.

72. *Id.* at 10.

73. Metropolitan Bank & Trust Company v. ASB Holdings, Inc., *et al.*, 571 SCRA 1, 10-11 (2007).

> By that statutory provision, it is clear that the approval of the Rehabilitation Plan and the appointment of a rehabilitation receiver merely suspend the actions for claims against respondent corporations. Petitioner bank's preferred status over the unsecured creditors relative to the mortgage liens is retained, but the enforcement of such preference is suspended. The loan agreements between the parties have not been set aside and petitioner bank may still enforce its preference when the assets of ASB Group of Companies will be liquidated. Considering that the provisions of the loan agreements are merely suspended, there is no impairment of contracts, specifically its lien in the mortgaged properties.[74]

The second part of the Supreme Court's ruling, which dealt with the issue of whether a creditor can be compelled to accept a *dacion en pago* arrangement and to waive all penalties and charges, is more interesting. The crux of Supreme Court's ruling is that there was no compulsion on petitioner to accept the terms of the Rehabilitation Plan.[75]

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74. *Id.* at 11-12.

75. *Id.* at 12-13. The Court ruled:

> Likewise, there is no compulsion on the part of petitioner bank to accept a *dacion en pago* arrangement of the mortgaged properties based on ASB Group of Companies' transfer values and to condone interests and penalties. The Rehabilitation Plan itself, under item IV-A, explains the *dacion en pago* proposal, thus:
>
> > IV. THE REVISED REHABILITATION PLAN
> >
> > A. The Total Approach
> >
> > It is apparent that ASB's corporate indebtedness needs to be reduced as quickly as possible in order to prevent rapid deterioration in equity.
> >
> > In order to reduce debt quickly, we must do the following:
> >
> > (1) Complete or sell on-going projects;
> >
> > (2) Invite secured creditors to complete *dacion en pago* transactions, waiving all penalties; and
> >
> > (3) Invite unsecured creditors to purchase real estate parcels and other assets and set-off the amount of their outstanding claim against the purchase price.
> >
> > The assets included in the above program include all real estate assets.
> >
> > In order to determine the feasibility of the above, representatives of our financial advisors met with or had discussions with most of the secured creditors. Preliminary discussions indicate support from the secured creditors towards the concepts of the program associated with them. The majority of these secured creditors appear to want to complete *dacion en pago* transactions based on MUTUALLY AGREED UPON TERMS … We continue to pursue

It appears from the above ruling that the courts do not have the power to compel creditors to accept a *dacion en pago* arrangement (or any other arrangement for that matter) and to waive interests and penalties. If so, then

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> discussions with secured creditors. Based on the program, secured creditors' claims amounting to PhP5.192 billion will be paid in full including interest up to April 30, 2000. Secured creditors have been asked to waive all penalties and other charges. This *dacion en pago* program is essential to eventually pay all creditors and rehabilitate the ASB Group of Companies. If the *dacion en pago* herein contemplated does not materialize for failure of the secured creditors to agree thereto, this rehabilitation plan contemplates to settle the obligations (without interest, penalties, and other related charges accruing after the date of the initial suspension order) to secured creditors with mortgaged properties at ASB selling prices for the general interest on the employees, creditors, unit buyers, government, general public and the economy.
>
> …

Indeed, based on the above explanation in the Rehabilitation Plan, the *dacion en pago* program and the intent of respondent ASB Group of Companies to ask creditors to waive the interests, penalties and related charges are not compulsory in nature. They are merely proposals for the creditors to accept. In fact, as explained, there was already an initial discussion on these proposals and the majority of the secured creditors showed their desire to complete *dacion en pago* transactions, but they must be 'based on MUTUALLY AGREED UPON TERMS.' The SEC En Banc in its Resolution dated April 15, 2003, affirming the SEC Hearing Panel's Order of April 26, 2001 approving the Rehabilitation Plan, aptly declared:

> … petitioner asserts that the Rehabilitation Plan is not legally feasible because respondents cannot dictate the terms of *dacion*.
>
> We do not agree. A cursory reading of the Rehabilitation Plan debunks this assertion. The Plan provides that *dacion en pago* transaction will be effected only if the secured creditors, like petitioner, agree thereto and under terms and conditions mutually agreeable to private respondents and the secured creditor concerned. The *dacion en pago* program is essential to eventually pay all creditors and rehabilitate private respondents. If the *dacion en pago* does not materialize in case secured creditors refuse to agree thereto, the Rehabilitation Plan contemplates to settle the obligations to secured creditors with mortgaged properties at selling prices. This is for the general interest of the employees, creditors, unit buyers, government, general public, and the economy.

the cram down power is meaningless — the concept of rehabilitation being limited to a mere suspension of payments.

V. OBSERVATIONS OR RECOMMENDATIONS

A. Cram Down

Clearly, the law on corporate rehabilitation calls for revision and updating. The few paragraphs devoted to rehabilitation in P.D. No. 902-A are unable to adequately address the various contentious issues that inhere in the rehabilitation of a distressed company, including the issue of the nature and scope of the courts' cram down power.

It must be remembered that rehabilitation is not always a consensual process and understandably so. One principal difficulty in rehabilitation is that there are many persons affected, both natural and juridical, when a debtor company finds itself teetering on the brink of bankruptcy. In one case, the Supreme Court identified the following as the stakeholders in rehabilitation: employees, creditors, unit buyers, government, general public, and the economy.[76] In another, the Supreme Court held that the rehabilitation of a financially distressed corporation benefits its employees, creditors, stockholders, and, in a larger sense, the general public.[77] These stakeholders have different and, sometimes, clashing interests.

Secured creditors simply want to foreclose on their securities. They are, understandably, indifferent to the plight of the other stakeholders. For their part, unsecured creditors simply want to be immediately paid what is owed them. On the other hand, the shareholders of the debtor company want breathing space to resuscitate the company — a concession which creditors are automatically averse to give. Rehabilitation means, at a minimum, deferment of the payment of debts — an unappealing prospect for any creditor. As for employees, they have no other interest than to keep their jobs. The public has an interest in the rehabilitation of a company as well: since the demise of a company leaves the playing field with one less competitor, and less competition in the market has a tendency to lead to less choices, higher prices, and poorer quality of products and services.

The foregoing diverse interests necessitate the enactment of a law that formulates an effective cram down provision that better balances them,

76. *See generally* Metropolitan Bank & Trust Company v. ASB Holdings, Inc., *et al.*, 571 SCRA 1 (2007).

77. Rubberworld (Phils.), Inc. v. National Labor Relations Commission, 305 SCRA 781, 729 (1999) (citing JOSE C. CAMPOS JR. & MARIA CLARA LOPEZ-CAMPOS, THE CORPORATION CODE: COMMENTS, NOTES AND CASES 27 (1990 ed.)).

especially in light of the Supreme Court's recent pronouncements in *Metropolitan Bank & Trust Company*.

The option of cramming down a *dacion en pago* or other fair and reasonable arrangement on a creditor should not be taken away from the rehabilitation court. Rehabilitation requires some degree of creativity in addressing the manifold pressing problems confronting the financially distressed company. This is not to say, however, that the creditor may not contest the *dacion en pago*. It may, and its objections should be heeded if they are not "manifestly unreasonable."[78] In *Metrobank and Trust Company*, for example, Metrobank took issue with what it considered as ASB Holdings, Inc.'s overvaluation of the subject property.[79] The issue of valuation is unquestionably a legitimate area of judicial inquiry.

It is worth noting, however, that the cram down power was misunderstood and misapplied by the trial court in *Leca Realty Corporation v. Manuela Corporation*.[80] There, petitioner Leca Realty Corporation contended that the approved Rehabilitation Plan drastically altered the terms of its lease contract with respondent Manuela Corporation and, hence, should be declared void. The contract of lease between Leca Realty Corporation and Manuela Corporation was for 25 years, from 1 August 1995 to 31 July 2020. The rates of rental in the Rehabilitation Plan on the leased parcel of land, however, did not correspond to the rates of rental stipulated in the contract.[81]

The Supreme Court held that the courts have no right to alter the rental rate of a lease contract.

> The amount of rental is an essential condition of any lease contract. Needless to state, the change of its rate in the Rehabilitation Plan is not justified as it impairs the stipulation between the parties. We thus rule that the Rehabilitation Plan is void insofar as it amends the rental rates agreed upon by the parties.
>
> It must be emphasized that there is nothing in Section 5 (c) of P.D. No. 902-A authorizing the change or modification of contracts entered into by the distressed corporation and its creditors.[82]

The cram down power of the rehabilitation court should be exercised only with respect to debts incurred prior to the issuance of the stay order. What the trial court did in *Leca* was to approve a rehabilitation plan that

78. *See* Interim Rules, rule 4, § 23.

79. *See* Metropolitan Bank & Trust Company v. ASB Holdings, Inc*, et al.*, 571 SCRA 1, 8-9 (2007).

80. Leca Realty Corporation v. Manuela Corporation, 534 SCRA 97 (2007).

81. *Id.* at 107-08.

82. *Id.* at 109-10.

altered the rental rates for the coming years. While the court has the power to determine how and when past debts are to be paid, it does not have the power to rewrite contract and impose new terms and conditions on the creditor moving forward.[83]

B. Rehabilitation and the Impairment of Obligations

The Constitution provides that "no law impairing the obligation of contracts shall be passed."[84] "Contract" refers to any lawful agreement on property or property rights, whether real or personal, tangible or intangible.[85] The "obligation" of the contract is the *vinculum juris*. It is the tie that binds the parties to each other. In a contract of loan, the obligation is the duty of the lender to extend the loan and of the borrower to repay it, according to their stipulations.[86] "Impairment" is anything which diminishes the efficacy of the contract.[87] In a contract of loan, there is an impairment of its obligation if, by subsequent law, the principal loan is reduced or increased, the period of payment is shortened or lengthened, conditions are added or removed, or the remedies for the enforcement of the rights of the parties are completely withdrawn.[88]

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83. *Id*. The Court stated that:

> In The Insular Life Assurance Company, Ltd., v. Court of Appeals, et al., we held:
>
> When the language of the contract is explicit leaving no doubt as to the intention of the drafters thereof, the courts may not read into it any other intention that would contradict its plain import. The Court would be rewriting the contract of lease between Insular and Sun Brothers under the guise of construction were we to interpret the 'option to renew' clause as Sun Brothers propounds it, despite the express provision in the original contract of lease and the contracting parties' subsequent acts. As the Court has held in Riviera Filipina, Inc. vs. Court of Appeals, 'a court, even the Supreme Court, has no right to make new contracts for the parties or ignore those already made by them, simply to avoid seeming hardships. Neither abstract justice nor the rule of liberal construction justifies the creation of a contract for the parties which they did not make themselves or the imposition upon one party to a contract of an obligation not assumed.' (G.R. No. 126850, 28 April 2004, 428 SCRA 79).

84. PHIL. CONST. art. III, § 10.

85. ISAGANI A. CRUZ, CONSTITUTIONAL LAW 243 (1993 ed.).

86. *Id*. at 245.

87. *Id*. (citing Clemons v. Nolting, 42 Phil. 702 (1922)).

88. *Id*. at 245.

The non-impairment clause was enacted to safeguard the integrity of valid contractual agreements against unwarranted interference by the State.[89]

> As a rule, contracts should not be tampered with by subsequent laws that would change or modify the rights and obligations of the parties. As stated by Justice Isagani A. Cruz "[T]he will of the obligor and obligee must be observed; the obligation of their contract must not be impaired."[90]

In *United States v. Diaz Conde and R. de Conde,*[91] the Supreme Court ruled that "[t]he obligation of the contract is the law which binds the parties to perform their agreement"[92] and "[a]ny law which enlarges, abridges, or in any manner changes the intention of the parties, necessarily impairs the contract itself"[93] "and is null and void."[94]

"The sanctity of contractual commitments is likewise emblazoned in basic provisions of the Civil Code of the Philippines."[95] Article 1159 of the Civil Code[96] provides that "obligations arising from contracts have the force of law between the contracting parties and should be complied with in good faith."[97]

The Supreme Court addressed the issue of impairment of obligations in the context of rehabilitation by reasoning that rehabilitation does not disregard the agreements between the parties but merely suspends their enforcement. It noted that when a rehabilitation plan is approved and consequently, a receiver has been appointed, the law commands the

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89. Siska Development Corp. v. Office of the President of the Phils., 231 SCRA 674, 680 (1994).

90. *Id.*

91. United States v. Diaz Conde and R. de Conde, 42 Phil. 767 (1922).

92. *Id.* at 769.

93. *Id.*

94. *Id. See also* Clemons v. Nolting, 42 Phil. 702, 717 (1922). In *Clemons v. Nolting*, the Supreme Court also held that,

> A law which changes the terms of a legal contract between parties, either in the time or mode of performance, or imposes new conditions, or dispenses with those expressed, or authorizes for its satisfaction something different from that provided in its terms, is law which impairs the obligation of a contract and is therefore null and void. An interference with the terms of a legal contract by legislation is unwarranted and illegal.

95. Cesar Villanueva, *Revisiting the Philippine "Laws" on Corporate Rehabilitation*, 43 ATENEO L. J. 183, 186 (1998).

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

97. *Id.* art. 1159.

suspension of actions for claims against the distressed corporation. It, however, has no bearing on the preferred status of the petitioner bank as a secured creditor with regard to the mortgage liens as the same is retained; however, "the enforcement of such a preference is suspended."[98] Since the enforcement of the liens have been merely suspended, such does not amount therefore to an impairment of contracts.[99]

Strictly speaking, the agreements between the creditors and the debtor company cannot help but be impaired, at least to the extent that the payment of the debts is deferred; and as held by the Supreme Court in *Clemons v. Nolting*,[100] "[a] law which changes the terms of a legal contract between parties, either in the time or mode of performance, … is law which impairs the obligation of a contract and is therefore null and void."[101] Nevertheless, the reality is that, collectively, the creditors in the context of rehabilitation usually cannot fully recover the amounts owing to them. The rationale of rehabilitation is that rehabilitation will enable the debtor company to create more value — in terms of generating more income, preserving the value of the company's assets, keeping jobs, etc. — than if the debtor company went straight to liquidation. Hence, rehabilitation is consistent "with the State's objective to promote a wider and more meaningful equitable distribution of wealth to protect investments and the public." In this sense, there is no impairment of obligations of contracts. On the contrary, the objective is to get the debtor company, as far as feasible, to fully pay its obligations. This is the reason why the Interim Rules require the inclusion of "a liquidation analysis that estimates the proportion of the claims that the creditors and shareholders would receive if the debtor's properties were liquidated."[102]

C. Equality in Equity

The rehabilitation of companies takes several years to complete and, while a grace period for the payment of debts is generally given, the rehabilitation plan contemplates the commencement of payments at some point within the rehabilitation period. It is submitted by the author that the secured creditors should be given some sort of preference during the course of the rehabilitation. That secured creditors are entitled to some preference is recognized under Rule 4, Section 5 of the Interim Rules (although, as with Rule 4, Section 23, this matter arguably falls within the province of the

98. Metropolitan Bank & Trust Company v. ASB Holdings, Inc., *et al.*, 571 SCRA 1, 11 (2007)

99. *Id.*

100. Clemons v. Nolting, 42 Phil. 702 (1922).

101. *Id.* at 717.

102. Interim Rules, rule 4, § 5 (e).

Legislature). Rule 4, Section 5 states that, "The rehabilitation plan shall include… (b) the terms and conditions of such rehabilitation which shall include the manner of its implementation, *giving due regard to the interests of secured creditors; ….*"[103]

"Giving due regard to the interests of secured creditors" implies that the rehabilitation plan may discriminate against unsecured creditors.

From the ruling in *Rizal Commercial Banking Corporation*, the status of secured creditors *vis-a-vis* unsecured creditors is quite clear upon the issuance of the stay order and, if the rehabilitation is unsuccessful, upon liquidation.[104] Upon the issuance of the stay order, all claims, secured and unsecured, are suspended. In this sense, the different types of creditors stand on equal footing the moment the stay order is issued. On the other hand, in a liquidation scenario, secured creditors may assert their preference over the unsecured creditors.

What is unclear is what the rights of secured creditors are *vis-à-vis* unsecured creditors *during* the rehabilitation of the debtor company. Can secured creditors demand that they receive payment ahead of the unsecured creditors while the debtor company is undergoing rehabilitation? Can they demand to be paid a higher rate of interest than the unsecured creditors? Can the debtor company propose to pay an unsecured creditor only a fraction of the unsecured debt?

The standard laid down by P.D. No. 902-A is that the rehabilitation should be "feasible," "profitable," or "work to the best interest of the stockholders, parties-litigants, creditors, or the general public."[105] The law makes no mention of how the various creditors are to be treated during the period of rehabilitation. On the other hand, the Interim Rules provide that the rehabilitation court has the power to 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."[106]

"Equality in equity"[107] should be understood to refer only to the *suspension* of all claims, without distinction, against the debtor company. It is in this regard that the creditors "stand on equal footing."[108] This is so since

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103. *Id.* § 5 (b) (emphasis supplied).

104. *See* Rizal Commercial Banking Corporation v. Intermediate Appellate Court, 320 SCRA 279 (1999).

105. *See* SEC Reorganization Act, § 6 (d).

106. Interim Rules, rule 4, § 23.

107. *See* Ruby Industrial Corporation v. Court of Appeals, 284 SCRA 445 (1998).

108. *See* Bank of the Philippine Islands v. Court of Appeals, 229 SCRA 223 (1994).

the principal purpose of the suspension of claims is arguably to preserve the debtor company as a going concern.

"Equality in equity" should not be construed to mean that all creditors stand on equal footing even *during* rehabilitation. A fairer rule would provide that secured creditors enjoy some preference over unsecured creditors and that the various types of unsecured creditors enjoy some preference over each other. Secured creditors have a preferred status over unsecured creditors immediately before the issuance of the stay order. There is no reason why secured creditors should lose this preferred status during the rehabilitation. There is already a sufficient sacrifice on the part of the secured creditors as they cannot enforce their rights upon the issuance of the stay order. For their part, unsecured creditors have no reason to complain that secured creditors are getting undue preferential treatment during rehabilitation since, after all, secured creditors *would have* gotten preferential treatment under liquidation if the debtor company had not decided to avail of rehabilitation. If any class of creditors has the most to gain from rehabilitation, it is the unsecured creditors.

Discrimination in favor of new creditors is also warranted. A company in financial distress often needs new capital to restore it to good health. Only the most venturesome of investors will, however, lend to a company that is on life support. To attract new capital, the reward to the investor should be commensurate to the risk that it is taking. The reward may come in the form of preferential treatment, such as being paid ahead of the other creditors or being paid a higher interest rate. Without such incentive, only the foolhardy can be expected to part with his money.

It is further submitted that unsecured creditors need not, in all cases, receive the full amount owing to them, provided that the amount paid to them during the rehabilitation period be no less than the amount they would have received in liquidation. The reason for this is that the law should also take into account the duration of the debtor company's rehabilitation. The sooner the debtor company comes out of rehabilitation, the better for that company and the general public.

VI. CONCLUSION

There will always be critics of corporate rehabilitation. Secured creditors will invariably resist the rehabilitation of debtor companies and the concomitant suspension and rescheduling of payments, preferring instead to instantly proceed against the mortgaged and pledged assets. Some will reject the very notion of rehabilitation as a form of unfair competition: the State should not come to the rescue of a company that can not, on its own, survive the rigors of the free market.

Despite this, rehabilitation is a remedy worth keeping in our statute books. The rehabilitation of Philippine Airlines, Negros Navigation, and

Trust International Paper Corporation, to name a few successful corporate rehabilitations, is proof that rehabilitation can and does work, and benefits not only the debtor company and its stockholders but also its employees and creditors. The general public also stands to benefit from the successful rehabilitation of a company, especially if the debtor company is from an industry where there are only a few players, such as the airline industry, shipping industry, and paper manufacturing industry. The fact that there are only a few firms able to invest and compete in these capital-heavy industries already renders the market imperfect. The demise of one of its players distorts the market even further. Thus, between keeping one of the competing companies alive, on the one hand, and allowing the market to lose one more precious competitor, on the other, the former option is arguably preferable.

Nevertheless, as with all law, there is always room for adjustments and improvements. The law on rehabilitation in the Philippines is an old law and has been slow to develop. The only major developments in recent years have come from the Judiciary, which, given our constitutional framework, has no power to make rules beyond matters of procedure. The task falls on Congress to reform the law with a view to making it more equitable and acceptable to secured creditors, who are often the source of resistance and opposition in rehabilitation proceedings. As everyone in rehabilitation is asked to make some sacrifices in one form or another, Congress may likewise look into the desirability of giving the courts the power to cram down on unsecured creditors a payment scheme whereby the unsecured creditors will merely get a proportion of their claims, but no less than what they would have gotten had the debtor company gone into liquidation. If wielded reasonably, this power provides the advantage of allowing the debtor company to recover and rejoin the free market more quickly, to the benefit of a public forever hankering for lower prices and better services.