Two Competing Interests: A Study of the Effectivity of the 50% Creditor Approval Provision in Relation to the Court's Cram Down Power Under the FRIA of 2010

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I. INTRODUCTION

In July 2010, Republic Act No. 10142, or the Financial Rehabilitation and Insolvency Act (FRIA) of 2010,[1] came into effect. Prior to its passage, Corporate Rehabilitation and Insolvency were governed by Act No. 1956 or the Insolvency Law,[2] which was enacted in 1909, and Presidential Decree (P.D.) No. 902-A or the Securities and Exchange Commission (SEC)

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1. An Act Providing for the Rehabilitation or Liquidation of Financially Distressed Enterprises and Individuals [Financial Rehabilitation and Insolvency Act (FRIA) of 2010], Republic Act No. 10142 (2010).
2. An Act Providing for the Suspension of Payments, the Relief of Insolvent Debtors, the Protection of Creditors, and the Punishment of Fraudulent Debtors [Insolvency Law], Act No. 1956 (1909).

Reorganization Act,[3] which was passed in 1976. These substantive laws were supplemented by the Supreme Court (SC), in the exercise of its rule-making power,[4] when it promulgated A. M. No. 00-8-10-SC or the 2000 Interim Rules of Procedure on Corporate Rehabilitation (2000 Rules)[5] and subsequently, the 2009 Rules of Procedure on Corporate Rehabilitation (2009 Rules).[6] Having been enacted decades after its predecessor, the FRIA "seeks to ... modernize our outdated insolvency and rehabilitation protocols in the country."[7] The main goal is "to provide a comprehensive, systematic, consistent, speedy[,] and cost-effective framework for insolvency and corporate rehabilitation that may prove helpful in the prevention of a financial crisis."[8] At the time of the sponsorship of the Bill,[9] the chances of corporate recovery in the country were estimated to be at a dismal 4.4%,[10] which further emphasized the need for the passage of the FRIA.

Its relatively recent enactment and the dearth of jurisprudence on Rehabilitation cases applying it have opened the door to many questions about the provisions of the FRIA, particularly the new ones. However, one aspect that remains the same under the FRIA is the recognition of the two competing interests that inevitably have to be reconciled and harmonized in the Rehabilitation process: that of the debtor and of the creditor. Particularly, two provisions of the FRIA, one novel and the other not, emphasize the struggle between the two. On the one hand is Section 64, or the Creditor Approval Provision, the effectivity of which is presently still at issue. On the other hand is the Cram Down Power of the Rehabilitation Court, a power that, for the first time, finds basis in substantive law under the FRIA. This Essay explores these two provisions, their dynamics, and their implications on the Rehabilitation process.

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3. 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 [SEC Reorganization Act], Presidential Decree No. 902-A, as Amended (1976).

4. PHIL. CONST. art. VIII, § 5 (5).

5. INTERIM RULES OF PROCEDURE ON CORPORATE REHABILITATION, A.M. No. 00-8-10-SC, Dec. 15, 2000.

6. RULES OF PROCEDURE ON CORPORATE REHABILITATION, A.M. No. 00-8-10-SC, Jan. 16, 2009.

7. S. JOURNAL Sess. No. 3, at 74, 14th Cong., 3d Reg. Sess. (July 29, 2009).

8. *Id.*

9. An Act Providing for the Rehabilitation or Liquidation of Financially Distressed Enterprises, S.B. No. 61, 14th Cong., 3d Reg. Sess. (2009).

10. S. JOURNAL Sess. No. 3, at 74.

II. THE COMPETING INTERESTS

Under the FRIA, it is the declared policy of the State

> to encourage *debtors*, both juridical and natural persons, and their *creditors* to collectively and realistically resolve and adjust competing claims and property rights. ... The rehabilitation ... shall be made with a view to ensure or maintain certainty and predictability in commercial affairs, *preserve and maximize the value of the assets of these debtors, recognize creditor rights and respect priority of claims, and ensure equitable treatment of creditors who are similarly situated.*[11]

One of the options available to financially-distressed corporations under the FRIA is Rehabilitation. It is the

> restoration of the *debtor* to a condition of successful operation and solvency, if it is shown that its continuance of operation is economically feasible *and* its *creditors* can recover by way of the present value of payments projected in the [P]lan, more if the debtor continues as a going concern than if it is immediately liquidated.[12]

Generally, discussion on Corporate Rehabilitation usually revolves around the debtor or the financially-distressed corporation. In fact, in his Sponsorship Speech of Bill No. 61, which was later enacted as the FRIA, Senator Edgardo J. Angara explained the rationale behind Rehabilitation. The reasoning primarily focused on the debtor's interest —

> [A]s many practical businessmen know, it is very difficult to start a business, get it off the ground[,] and get it going. But it is so easy to kill it, and very difficult to revive.
>
> So what this law for the first time provides is to give a break, give a chance or second life to enterprises in this country. We do not allow them to die instantly and suddenly.[13]

However, as quoted above, both the policy of the law and the definition of Rehabilitation, which is the more preferred option under the FRIA,[14]

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11. Financial Rehabilitation and Insolvency Act (FRIA) of 2010, § 2 (emphasis supplied).

12. *Id.* § 4 (gg) (emphasis supplied).

13. S. JOURNAL Sess. No. 3, at 75.

14. Rehabilitation is the preferred option over Liquidation, the latter being resorted to only when Rehabilitation is not feasible. This preference is emphasized by the provisions allowing the conversion of Rehabilitation proceedings into Liquidation proceedings only upon serious grounds such as the bad faith of the debtor, failure to cure a defect in the Rehabilitation Plan based on the objection of the creditor, failure to confirm a Rehabilitation Plan within one year from the filing of the petition, and breach or failure of the Rehabilitation Plan. *See* Financial Rehabilitation and Insolvency Act (FRIA) of 2010, §§ 67, 71, 74, & 75.

emphasize that there are two interests that have to be balanced in undertaking Corporate Rehabilitation. Neither can be disregarded in the process. Indeed, "[t]he purpose of rehabilitation proceedings is to enable the *company* to gain a new lease on life *and* thereby allow *creditors* to be paid their claims from its earnings. The rehabilitation of a financially distressed corporation benefits its employees, creditors, stockholders[,] and, in a larger sense, the general public."[15] In fact, both the debtor and the creditors are given the right to initiate the Rehabilitation proceedings.[16]

Likewise, the Rehabilitation Plan, which stands at the center of the process, is the result of the joint efforts among the rehabilitation receiver, debtor, and creditors.[17] Basically, the Rehabilitation Plan serves as the game plan for Rehabilitation. It specifies the steps to be undertaken for the protection of all the interests involved. The FRIA provides for a comprehensive list of matters that should be included in the Rehabilitation Plan.[18] These details place the debtor and the creditors on an even footing by requiring that the Plan:

> (a) specify the underlying assumptions, the financial goals[,] and the procedures proposed to accomplish such goals;
>
> (b) compare the amounts expected to be received by the *creditors* under the Rehabilitation Plan with those that they will receive if liquidation ensues within the next one hundred twenty (120) days;
>
> (c) contain information sufficient to give the various classes of *creditors* a reasonable basis for determining whether supporting the Plan is in their financial interest when compared to the immediate liquidation of the debtor[;]
>
> ...
>
> (f) indicate how the insolvent *debtor* will be rehabilitated[.][19]

That creditors are considered equally important in the Rehabilitation process is further underscored by the different provisions in the FRIA allowing the creditors to participate in the proceedings, whether they are

15. Pacific Wide Realty and Development Corporation v. Puerto Azul Land, Inc., 605 SCRA 503, 514-15 (2009) (citing Negros Navigation Co., Inc. v. Court of Appeals, 573 SCRA 434, 450 (2008); New Frontier Sugar Corporation v. Regional Trial Court, Branch 39, Iloilo City, 513 SCRA 601 (2007); Rubberworld (Phils.), Inc. v. NLRC, 305 SCRA 721 (1999); and Ruby Industrial Corporation v. Court of Appeals, 284 SCRA 445 (1998)) (emphasis supplied).

16. Financial Rehabilitation and Insolvency Act (FRIA) of 2010, ch. II, (A) I & II.

17. *Id.* § 63.

18. *Id.* § 62.

19. *Id.* (emphasis supplied).

secured creditors, unsecured creditors, trade creditors or suppliers, or employees of the debtor.[20] For example, the Petition for Rehabilitation must already contain a preliminary list of creditors.[21] This will be made more definite at the initial hearing of the Petition where the names of creditors who timely and properly filed their notice of claims are identified.[22] They are also directed at this stage to comment on the Rehabilitation Plan attached to the Petition and to object to the appointment of the rehabilitation receiver if needed.[23] Once the rehabilitation receiver assumes office, a registry of claims will be established and will be made available to the public.[24] More importantly, creditors are given the opportunity to challenge the claims of the other creditors.[25] This power magnifies the valuable role conferred upon creditors throughout the entire process.

Once a Petition for Rehabilitation is given due course by the court, the rehabilitation receiver will confer and consult with the debtor and the creditors regarding the Rehabilitation Plan.[26] These parties will review and revise the Plan submitted or decide to make a new Plan.[27] For this purpose, each class of creditors may opt to form a creditors' committee which shall "assist the rehabilitation receiver in communicating with the creditors and shall be the primary liaison between the rehabilitation receiver and the creditors."[28] Again, the interests of the creditors are sought to be protected by the caveat that this committee cannot agree to any offer or waive any right without the consent of the creditors themselves.[29]

However, there are two particular provisions which significantly highlight the competing interests of the debtor and the creditors in the Rehabilitation proceeding. These are the Creditor Approval Provision and the Cram Down Power Provision of the court, each of which has features with the aim of safeguarding the creditors and the debtor, respectively.

III. THE CREDITOR APPROVAL PROVISION

A. Under the FRIA

20. *Id.* § 42.

21. *Id.* § 12.

22. Financial Rehabilitation and Insolvency Act (FRIA) of 2010, § 22.

23. *Id.*

24. *Id.* § 44.

25. *Id.* § 45.

26. *Id.* § 63.

27. *Id.*

28. Financial Rehabilitation and Insolvency Act (FRIA) of 2010, § 43.

29. *Id.*

As previously mentioned, at the very core of the entire Rehabilitation process is the Rehabilitation Plan. All the requirements under the FRIA are geared towards the execution of a more effective Plan by giving all stakeholders a voice in the proceedings. This is why the Plan undergoes several stages before it is finally submitted for confirmation to the Rehabilitation court.

The final hurdle that the Plan must surpass before it is submitted to the court is its examination by the creditors.[30] Upon being notified by the Rehabilitation receiver, the creditors would convene and vote upon the Plan, either as a whole or on a per class basis.[31] Section 64 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 [S]ection, the Plan is deemed to have been approved by a class of creditors if members of the said class holding *more than fifty percent (50%)* of the total claims of the said class vote in favor of the Plan.[32]

Thus, a majority affirmative vote from the creditors is needed to approve the Plan. This presents a heavy burden upon the rehabilitation receiver or the debtor. Since the creditors are voting on a per class basis, the 50% requirement must be met in *each* class of creditors before it can be approved.[33] This is a stringent requirement that seems to underscore the protection that the law seeks to extend to the creditors' claims. By providing a strict standard, the creditors are ensured that their interests are not haphazardly sidelined by the Rehabilitation proceedings.

B. Under the 2009 Rules

The Creditor Approval Provision cannot be found under the 2009 Rules. Prior to the FRIA, no vote requirement was mandated to approve the Plan. The only rights given to the creditors are as follows:

> Section 9. Comments on or Opposition to Rehabilitation Plan. — Any creditor or interested party of record may file comments on or opposition to the proposed [R]ehabilitation [P]lan, with a copy given to the rehabilitation receiver, not later than sixty (60) days from the date of the last initial hearing. The court shall conduct summary and non-adversarial proceedings to receive evidence, if necessary, in hearing the comments on and opposition to the plan.
>
> Section 10. Modification of Proposed Rehabilitation Plan. — The debtor may modify its [R]ehabilitation [P]lan in the light of the comments of the rehabilitation receiver and creditors or any interested party and submit a

30. *Id.* § 64.

31. *Id.*

32. *Id.* (emphasis supplied).

33. *Id.*

> revised or substitute [R]ehabilitation [P]lan for the final approval of the court. Such [R]ehabilitation [P]lan must be submitted to the court not later than ten (10) months from the date of filing of the petition.[34]

Hence, the creditors are only allowed to air their oppositions to the Plan and present evidence in support thereof if necessary. Creditors are not convened to vote upon the Plan. Thus, the hearing of the creditors' comments and objections in the court-supervised summary proceeding is the last hurdle that the Plan has to overcome before it is properly presented to the court, unlike in the FRIA.

C. Effectivity of the Provision

Despite its laudable purpose, there is issue with respect to the effectivity of the Provision. The Creditor Approval Provision being a novel requirement, a question arises: Is the 50% vote requirement under the FRIA already in effect and enforceable? Is the fact that until present time, the SC has yet to promulgate rules and regulations implementing the FRIA an obstacle to its effectivity? To answer this query, two views are discussed below. These schools of thought diverge primarily on their treatment of the Provision as either self-executing or not.

1. As a Self-Executing Provision

Self-executing provisions of law are not dependent on implementing rules and regulations. These provisions are immediately effective upon passage of the law. In *Gutierrez v. Department of Budget and Management*,[35] the Court elucidated that when a section of the law is "complete in itself and [can be] operative without the aid of any supplementary or enabling legislation,"[36] then it is already in effect. Implementing rules and regulations are "necessary only for those provisions ... which [require] further clarification and interpretation."[37]

The issue of whether a certain provision is self-executing or not is often heavily discussed in relation to constitutional provisions. In *Manila Prince Hotel v. Government Service Insurance System*,[38] the SC explained that

> some constitutions are merely declarations of policies and principles. Their provisions command the legislature to enact laws and carry out the purposes of the framers who merely establish an outline of government

34. RULES OF PROCEDURE ON CORPORATE REHABILITATION, rule 4, §§ 9 & 10.

35. Gutierrez v. Department of Budget and Management, 616 SCRA 1 (2010).

36. *Id.* at 22.

37. *Id.*

38. Manila Prince Hotel v. Government Service Insurance System, 267 SCRA 408 (1997).

> providing for the different departments of the governmental machinery and securing certain fundamental and inalienable rights of citizens. A provision which lays down a general principle ... is usually not self-executing. But a provision which is complete in itself and becomes operative without the aid of supplementary or enabling legislation, or that which supplies sufficient rule by means of which the right it grants may be enjoyed or protected, is self-executing. Thus[,] a constitutional provision is self-executing if the nature and extent of the right conferred and the liability imposed are fixed by the constitution itself, so that they can be determined by an examination and construction of its terms, and there is no language indicating that the subject is referred to the legislature for action.[39]

Under the FRIA, substantive provisions on "tax exemptions, maintenance of the business by the Board and Management, disqualification of creditors to sit in the Management Committee, the requisite [that there] is no serious question of law or fact on the claims and the waiver of taxes" can be considered self-executing.[40] These are provisions that are already complete and do not depend on subsequent issuances to be effective. If Section 64 is held to be in the same category as these provisions, then even without rules and regulations from the SC, it is already operative.

2. As a Non-Self-Executing Provision

Section 6 of the FRIA provides that the SC shall "promulgate the rules of pleading, practice[,] and procedure to govern the proceedings brought under [the FRIA]."[41] No such rules have been issued by the SC at present time. It can thus be argued that the non-self-executing provisions of the FRIA are not yet in effect. However, pursuant to the FRIA's repealing clause, in the absence of such new rules and regulations, the 2009 Rules are still operative insofar as its provisions are *not inconsistent* with the FRIA.[42] Hence, even those provisions that are non-self-executing can still be considered operative already because of the existence of the 2009 Rules.

It is the position of the Author that Section 64 or the Creditor Approval Provision falls under this category. The Provision cannot be considered self-executing because it still requires an issuance which will clarify its terms. For example, the Provision states that the Plan has to be approved by the creditors who are "adversely modified or affected by the Plan"[43] yet no standard is given on how to determine who exactly these adversely affected

39. *Id.* at 431 (citing 16 AM. JUR. 2D 281-82).

40. Arturo M. de Castro, *Notes and Comments on Changes under the Financial Rehabilitation Act (FRIA) of 2010 (Republic Act No. 10142)*, LAW. REV., Feb. 28, 2011, at 33.

41. Financial Rehabilitation and Insolvency Act (FRIA) of 2010, § 6.

42. *Id.*

43. *Id.* § 64.

creditors are. Ambiguity can also be seen in the phrase "members of the said class holding more than fifty percent (50%) of the total claims of the said class."[44] The manner of voting is likewise not provided for. These are questions properly left to the office of the SC through its power to issue implementing rules of procedure.

Even the 2009 Rules cannot save the Provision from non-effectivity. As previously pointed out, there is an inconsistency between the FRIA and the 2009 Rules. The 50% vote requirement is nowhere to be found in the 2009 Rules. Since the 2009 Rules will only apply to the extent that it is not inconsistent with the FRIA, and since no rules have been promulgated by the SC to implement the FRIA, then the Creditor Approval Provision is not yet operative and the 50% vote requirement of the creditors is still inapplicable at present time.

V. THE CRAM DOWN POWER

Even if the Creditor Approval Provision is considered already in effect, it is still to be counter-balanced with or subjected to the Cram Down Power of the Rehabilitation court. This refers to the power of the court to confirm a Rehabilitation Plan despite of or over the objections of the creditors. Thus, they can, if warranted, "cram down" the throats of the creditors the Rehabilitation Plan. The relevant provisions on this Power of the court are provided below:

> Section 64. Creditor Approval of Rehabilitation Plan. —
>
> ...
>
> *Notwithstanding the rejection of the Rehabilitation Plan, the court may confirm the Rehabilitation Plan if all of the following circumstances are present:*
>
> (a) The Rehabilitation Plan complies with the requirements specified in this Act;
>
> (b) The rehabilitation receiver recommends the confirmation of the Rehabilitation Plan;
>
> (c) The shareholders, owners[,] or partners of the juridical debtor lose at least their controlling interest as a result of the Rehabilitation Plan; and
>
> (d) 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 the debtor were under liquidation.
>
> ...
>
> Section 69. Effect of Confirmation of the Rehabilitation Plan. — The confirmation of the Rehabilitation Plan by the court shall result in the following:

44. *Id.*

> (a) The Rehabilitation Plan and its provisions shall be binding upon the debtor and all persons who may be affected by it, *including the creditors, whether or not such persons have participated in the proceedings or opposed the Rehabilitation Plan or whether or not their claims have been scheduled*;
>
> (b) The debtor shall comply with the provisions of the Rehabilitation Plan and shall take all actions necessary to carry out the Plan;
>
> (c) Payments shall be made to the creditors in accordance with the provisions of the Rehabilitation Plan;
>
> (d) Contracts and other arrangements between the debtor and its creditors shall be interpreted as continuing to apply to the extent that they do not conflict with the provisions of the Rehabilitation Plan;
>
> (e) Any compromises on amounts or rescheduling of timing of payments by the debtor shall be binding on creditors regardless of whether or not the Plan is successfully implement[ed]; and
>
> (f) Claims arising after approval of the Plan that are otherwise not treated by the Plan are not subject to any Suspension Order.
>
> ...
>
> Section 86. Cram Down Effect. — A restructuring/workout agreement or Rehabilitation Plan that is approved pursuant to an informal workout framework referred to in this chapter shall have the same legal effect as confirmation of a Plan under Section 69 hereof.[45]

This Power can be seen to be more protective of the interests of the debtor. Potentially, if the Creditor Approval Provision was already in effect, then it would give an awesome power on the part of the creditors to obstruct the confirmation of the Rehabilitation Plan. However, in light of the general objective of the FRIA to encourage Rehabilitation, the Cram Down Power is used as a tool to further facilitate and speed up the process. Of course, even with this Power in their hands, the court is still expected to use it only when the circumstances so warrant. Although the Plan is "crammed down" the throats of the creditors, the court should consider if it is the best move for both the debtors and creditors. The Power is not boundless; the court must still be assured that "[t]he 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 the debtor were under liquidation."[46] The objective is still to rehabilitate for the best interests of both parties.

Prior to the passage of the FRIA, this Power had no basis in substantive law, since it was not provided for under the Insolvency Law or in P.D. 902-A. It first appeared only in the 2000 Rules and then was reproduced in the

45. *Id.* §§ 64, 69, & 86 (emphasis supplied).

46. Financial Rehabilitation and Insolvency Act (FRIA) of 2010, § 6.

2009 Rules.[47] When it first came out, it was assailed as unconstitutional for being beyond the rule-making powers of the SC, since it is a substantive provision of law.[48] However, this seems to have been resolved now since it is expressly provided for in the FRIA, a legislative act.

Another constitutional ground being used to attack the Cram Down Power of the court is the non-impairment clause,[49] since the Power may affect the claims of the objecting creditors. In the 2007 case of *Leca Realty Corporation v. Manuela Corporation*,[50] the SC declared a Plan void for changing the terms of the lease agreement between the parties.[51] However, in *Pacific Wide Realty and Development Corporation v. Puerto Azul Land, Inc.*,[52] the SC touched upon the impairment issue by briefly saying that "the non-impairment clause must yield to the police power of the State."[53] It must be noted that these cases were not decided under the FRIA and did not directly address the Cram Down Power of the court but only the possible impairing effect of the Rehabilitation Plan on the contract between the debtor and the creditor. Until it is declared otherwise, the Cram Down Power of the court remains to be valid and enforceable.

V. CONCLUSION

Rehabilitation is a process that must take into consideration the competing interests of both the debtor and of the creditors. The FRIA is replete with provisions that emphasize such goal. Two provisions stand out as perfect examples of the dynamic relationship between these two parties. First, the Creditor Approval Provision requires a majority affirmative vote by the creditors to approve the Rehabilitation Plan, a novel requirement. Given the absence of rules and regulations implementing the FRIA and the inapplicability of the 2009 Rules in this case, it is, however, argued that this Provision is not yet operative. Even if it is, the court can still step in and use its Cram Down Power to confirm the Rehabilitation Plan despite the non-approval of or rejection by the creditors if so warranted. The struggle

47. *See* INTERIM RULES OF PROCEDURE ON CORPORATE REHABILITATION, rule 4, § 24 and RULES OF PROCEDURE ON CORPORATE REHABILITATION, rule 3, § 20.

48. Atty. Augusto A. San Pedro, Jr., *Financial Rehabilitation and Insolvency Act (FRIA) of 2010*, BUS. MIRROR, July 12, 2011, *available at* http://www.businessmirror.com.ph/home/opinion/13739-financial-rehabilitation-and-insolvency-act-of-2010 (last accessed Feb. 24, 2011).

49. PHIL. CONST. art. III, § 10.

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

51. *Id.* at 110.

52. *Pacific Wide Realty and Development Corporation*, 605 SCRA at 503.

53. *Id.* at 517.

between these two provisions highlights the purpose of the law in ensuring that all parties be protected and that Rehabilitation be undertaken only when the best interests of the debtor and the creditors so require. With this framework in place, the only thing to be done is to await the SC's issuance of the FRIA's implementing rules and regulations in order to further see these dynamics in action.