Establishing the Bases and Extent of the Principle of "Adequate Protection" for Secured Creditors in Philippine Corporate Rehabilitation Proceedings

*Axel Rupert M. Cruz**

* J.D. '02 with Honors, Ateneo de Manila University School of Law. This note received a special citation for the Dean's Award for Best Thesis of Class 2002. The author was Business and Circulation Editor of Volume 46, *Ateneo Law Journal*.

Cite as 47 ATENEO L.J. 956 (2003).

I. INTRODUCTION

A. Background

Corporations, forming the backbone of modern day capitalism, require the constant input of capital in order to survive. Capital usually takes the form of either equity investment or credit. The factor that determines just how much a person would invest or lend to a corporation is the probability of gaining profit in the investment or loan. Creditors, to hedge themselves from debtor insolvency, may require security on the loan. Secured creditors, in the present credit and security system of the Philippines, stand on a pedestal higher than unsecured creditors and shareholders.

Businessmen prefer the corporation as the vehicle for their enterprise because of various advantages like the corporation's strong legal personality, limited liability for investors, free transferability of units of investment, and centralized management. Unlike unregistered associations, it also enjoys perpetual succession under its corporate name; it has the capacity to contract obligations in its own name; and its stockholders generally have no personal liability beyond the value of their shares.[1] However, the corporate form also has disadvantages such as complicated and costly formation and maintenance, lack of personal element, abuse of corporate management, and increased tax liability.[2] Regardless of the disadvantages, modern economic systems continue to be ruled by corporations.

In order to protect both the interests of creditors and debtors, the relief of straight bankruptcy proceedings, and recently, corporate rehabilitation, are made available to distressed corporations. The usual causes of business failure are overcapitalization, where excess capital must be paid even though unused; a top-heavy capital structure where earnings cannot support the debt service; a change in public demand for the company's products; dishonesty and incompetence of management;[3] large debt portfolios produced by "merger madness;" potential mass tort liability; and the avoidance of collective bargaining agreements.[4]

In rehabilitation, depreciation of collateral is unavoidable if such property is necessary for rehabilitation of the business. One of the grounds for applying for relief from stay is the lack of adequate protection that results from the continuous depreciation of the collateral, a concept arising out of

1. CESAR L. VILLANUEVA, PHILIPPINE CORPORATE LAW 18-20 (1998).
2. *Id.* at 20-21.
3. Robert J Rosenberg, *Beyond Yale Express: Corporate Reorganization and the Secured Creditor's Rights of Reclamation*, 123 U. PA. L. REV. 510 (1975).
4. Julia A. Goatley, *Adequate Protection and Administrative Expenses: Toward a Uniform System for Awarding Superpriorities*, 88 MICH. L. REV. 2168 (1990).

American case law and later codified in the 1978 Bankruptcy Act. The U.S. Legislature added such concept because it deemed the property rights of the secured creditor to enjoy and make the most out of his interest in the collateral a constitutional one protected by the takings and the contract clauses, both contained in the Fifth Amendment.

Some U.S. Circuit Courts have interpreted the extent of the secured creditor's interest as to include lost opportunity cost, sometimes referred to as the time-value of money, while others have ruled that lost opportunity cost are not entitled to adequate protection. *United Savings Association of Texas v. Timbers of Inwood Forest Assoc. Ltd.*[5] settled the issue and ruled that undersecured creditors are not entitled to postpetition interest for the delay caused by the stay. Strictly applying Timbers in this jurisdiction may open constitutional and policy issues on the extent of adequate protection a secured creditor is entitled. Therefore, the proponent will modify the application of Timbers by using the conditions for a valid exercise of police power found in *Home Building & Loan Association v. Blaisdell.*[6]

To illustrate the issue in this thesis, the proponent gives the following example: Corporation X is engaged in the business of selling different kinds of beverages. It has a large factory complete with all the machinery needed to produce the beverages. Corporation X uses trucks to transport the products in large volumes quickly. It also employs almost 500 employees. Because of poor sales, the corporation had to retrench some employees. Eventually, because of the inability to pay its obligations when they became due, it filed a petition for rehabilitation with the court.

The court granted the same and issued a stay order suspending all claims against the corporation. Corporation A has many creditors. One of them, Bank L, is an oversecured creditor. Another creditor, Bank M, is a fully secured creditor. Bank N, another creditor, is undersecured. Bank O, another creditor, is unsecured. Once the stay order is issued, all claims, whether secured or unsecured, are suspended.

The Interim Rules of Procedure on Corporate Rehabilitation provides that an undersecured creditor may be granted relief from the stay if it is shown that his collateral is not necessary for rehabilitation. Therefore, if such collateral is necessary, relief from stay will be denied. Because of this denial, the undersecured creditor may ask instead for adequate protection.

Bank O, the unsecured creditor, is not entitled to adequate protection, since he holds no collateral that may depreciate due to the stay. The other secured creditors, however, are all entitled to adequate protection to cover only the depreciation of their respective collateral. If the collateral of Bank

5. 484 U.S. 365 (1988).
6. 290 U.S. 398 (1934).

M, the fully secured creditor, is worth Php 100,000, any depreciation must be adequately protected. The same goes for the other secured creditors.

The lost opportunity cost, or the amount that a secured creditor would have gotten if he were able to foreclose on the property and use the proceeds in more profitable ventures is, however, another matter. If Timbers were to be strictly applied, only oversecured creditors would be entitled to postpetition interest, also known as lost opportunity cost, because of the "equity cushion" they enjoy. "Equity cushion" is the value of the property over the amount owed to the secured creditor that will protect the creditor from any loss due to the decrease in the value of the property. Postpetition interest for oversecured creditors will come from this "equity cushion," while in the case of undersecured creditors, they are not entitled to postpetition interest because of the lack of the "equity cushion." Fully secured creditors, *i.e.* those whose value of the collateral is exactly equal to the debt owed, is also not entitled to postpetition interest because of the lack of the "equity cushion." The only protection that undersecured and fully secured creditors have is protection against depreciation of their collateral. Postpetition interest may not be granted to them during the stay, for according to Timbers, a contrary view would only dissipate the remaining assets of the corporation, thereby lessening the chances of a successful rehabilitation.

The main issue, therefore, is whether or not undersecured and fully secured creditors are entitled to postpetition interest as part of their adequate protection. And, if so, in what manner should it be given so as not to prejudice the rehabilitation process.

In order to appreciate where this thesis is heading, it is best to give a brief history of bankruptcy and rehabilitation as well as a discussion on the ancillary remedies of the stay order, relief from stay, and the concept of adequate protection.

B. Brief History of Bankruptcy and Rehabilitation

1. Origin

Bankruptcy, as we know it today, is in stark contrast to its original concept. Bankruptcy traces its origin to ancient Roman law when debtors would be sold into slavery upon default. The word "bankruptcy" comes from the Latin word *Banca rotta* which means "broken board" as "it was the custom in Medieval Italy for angry creditors to break the work benches of defaulting merchants over their heads." Bankruptcy also came from the French word *Banqueroute* which means a debtor who has absconded without paying his debt and is living well of their ill-gotten wealth.[7] The concept of debtor discharge was unheard of at that time.

In England, before the mid-19th century, persons unable or unwilling to pay their debts were commonly thrown in prison to languish until they came up with the required sum.[8] Voluntary debtor petitions for bankruptcy were not allowed. Moreover, flogging of convicted bankrupts was a common form of punishment. Bankrupts were treated like thieves. Eventually, the concept of discharge was only made partially available in order to encourage bankrupts to appear and expose hidden property.

2. Early American Enactments

American bankruptcy laws followed English jurisprudence. The framers of the U.S. Constitution placed in Article 1, Section 8, the power of the federal government to establish "uniform Laws on the subject of Bankruptcies throughout the United States." Uniformity was imposed in order to prevent debtors from fleeing to another state to escape his creditors. The 1800 Bankruptcy Act lowered the penalty of death, found in English bankruptcy law, to a maximum of ten years. The depression following the Panic of 1893 gave way to the enactment of the 1898 Bankruptcy Act as a relief measure. The Bankruptcy Act of 1898 did not deal with the rehabilitation and reorganization of a debtor in financial distress. Rather, "[r]ehabilitation and reorganization were achieved through out-of-court composition and extension agreements, the Composition section of the Bankruptcy Act of 1898 and general receivership."[9] In the early 1900's, American lawyers created and developed the equity consent receivership which during that time was the principal vehicle in the U.S. for the reorganization of insolvent corporations, particularly railroad reorganizations.[10] In 1933, Sec. 77 of the Bankruptcy Act was enacted to regulate corporate reorganization which replaced the traditional equity consent receivership. The only standard that was required was that the rehabilitation plan be "fair and equitable."[11]

7. Joseph Pomykala, *Bankruptcy Reform: Principles and Guidelines, at* http://www.cato.org/pubs/regulation/reg20n4.html (last visited Aug. 16, 2001).

8. DANIEL V. DAVIDSON, BRENDA E. KNOWLES, AND LYNN M. FORSYTH, BUSINESS LAW: PRINCIPLES AND CASES 426 (1984).

9. ARTURO M. DE CASTRO, SECURITY INTERESTS IN BANKRUPTCY AND REORGANIZATION PROCEEDINGS IN THE UNITED STATES AND THE PHILIPPINES: A COMPARATIVE STUDY 80 (1982).

10. De Forest Billyou, *Priority Rights of Security Holders in Bankruptcy Reorganization: New Directions*, 67 HARV. L. REV. 556 (1954).

11. *Id.* at 561.

3. Bankruptcy Reform Act of 1978

Despite numerous slight amendments,[12] the 1978 Bankruptcy Act remains to be the governing law on straight bankruptcy and reorganization. Unlike past bankruptcy laws, the 1978 Bankruptcy Act was not an outgrowth of an economic collapse. It also gave the incumbent management control over the bankrupt company with the court-appointed trustee as a mere "watch-dog." The law was also the first one to provide for formal rehabilitation of distressed corporations under Chapter 11.

4. Bankruptcy Reform Act of 2001

Recently, the U.S. Congress passed the Bankruptcy Reform Act of 2001. Marked changes were made in Chapter 7 concerning straight liquidation of the debtor. In essence, the Act made it more difficult and expensive for people to file for bankruptcy by creating a presumption that abuse exists if the debtor's current monthly income exceeds an amount determined according to specified formulae. In other words, the debtor must overcome this presumption before he can be granted a discharge. Although no change was made in the relief from stay and adequate protection provisions in the area of rehabilitation, the change in the law's attitude toward the debtor's conduct or misconduct is significant.

The primary driving force behind the amendments was widespread mismanagement or abuse by the debtor of the remedy. Credit card issuers, car finance companies, and personal finance companies were the ones most affected by the abuse. There is growing statistical evidence that more and more Americans are using bankruptcy laws as a dodge to avoid paying debts even though they can pay back something. In 1999 alone, there were reported 1.31 million filings for bankruptcy.[13] The relatively easy substantive and procedural requirements in the former Act paved the way for bad management of personal finances and even fraud to escape the reach of creditors. Bankruptcy was becoming a first option instead of a last resort.

Though rehabilitation is a different creature from straight bankruptcy, the lessons learned are applicable. A bankruptcy or rehabilitation law which unduly favors the debtor is easily susceptible to abuse and fraud in escaping one's obligations and unnecessarily impairs the interest of creditors. The Philippines has to learn from the experiences of other countries that such type of laws have to strike a balance between the creditor's right to collect and the debtor's right to rehabilitate. Giving undue advantage to the debtor

12. Slight amendments were made from 1980 up to the present.

13. Mark Story, *Bankruptcy Reform Act Drives Increase in Filings, at* http://wichita.bcentral.com/wichita/stories/2001/10/01/story4.html (last visited Nov. 10, 2001).

is, on the one hand, detrimental to the credit and security system, but on the other hand, giving undeserved protection to creditors may also hinder the policy of rehabilitation.

C. *Corporate Rehabilitation*

"Corporate Rehabilitation," as defined by *Ruby Industrial Corporation v. Court of Appeals,* is one which "contemplates a continuance of corporate life and activities in an effort to restore and reinstate the corporation to its favor(able) position of successful operation and solvency."[14] Only corporations in distress and not individual natural persons may apply for rehabilitation.[15] To be considered a distressed corporation, it need not be insolvent, but merely illiquid. In other words, it has sufficient assets and properties, but cannot convert them into cash at the maturity of its obligations.

The main reason why rehabilitation is available as a remedy and even favored over straight liquidation is due to the central assumption that the value of an enterprise as a going concern will often exceed the liquidation value of the enterprise's assets.[16] This bias in favor of successful rehabilitation is one the elements in the balancing act to be attempted later on. Success of the rehabilitation will most likely depend upon massive infusion of new capital.[17] Sometimes, if the possibility of successful rehabilitation is small, it is more profitable and productive if the resources were utilized in more viable enterprises.

Professor Lo Pucki illustrates the conflict on the issue of whether to continue operation of the corporation in this wise:

> For example, where the future prospects of a business are for either moderate profits or large losses, and each is equally likely, the owner of a business which operated entirely on contributed capital would elect to cease operations. Expected losses would exceed profits, and the potential losses would be taken from the contributed capital as operating expenses exceeded revenues. If, instead, the business already had liabilities in excess of its assets, the potential losses would be borne by the creditors. Cessation of operation would fix the owners' losses and eliminate any possibility of gain, where continuation of operation would offer a moderate possibility of gain and not possibility of further loss to the owners. While the debtor may

14. 284 SCRA 445, 461 (1998), *citing* New York Title and Mortgage Co. v. Friedman, 276 N.Y.S. 72, 153, Misc. 697.
15. SEC Reorganization Act, P.D. No. 902-A, § 5(d), as amended.
16. James Steven Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause,* 96 HARV. L. REV. 973, 975 (1983).
17. Goatly, *supra* note 4, at 511.

> nevertheless be overcome with pangs of conscience, his financial incentive is to continue to operate a business that is likely to be unprofitable.
>
> If the insolvent, nonviable enterprise is permitted to continue operations, it probably will consume values that would otherwise have been available to creditors on liquidation. The source of this dysfunction is apparent: an insolvent business operates not at the risk of the owner, but at the risk of its creditors.[18]

Though the proponent has not witnessed first-hand a corporation under rehabilitation, stories by practitioners give the impression that the "balancing act" that occurs is a Herculean task. It is, therefore, not uncommon for tempers to flare and for reason to blur. The rehabilitation court is, then, tasked with the most arduous duty of keeping things in perspective amidst a crowd of claims.

D. *Philippine Laws on Bankruptcy and Corporate Rehabilitation*

What the Philippines lacks up to now is a comprehensive bankruptcy act to stay at par with other countries. What we have is piece-meal legislation in the form of Presidential Decree No. 902-A, as amended by Presidential Decrees Nos. 1653, 1758 and 1799, the Insolvency Law,[19] and even mere judicial rules in the form of the Interim Rules of Procedure on Corporate Rehabilitation which was approved on November 21, 2000 to take effect on December 15, 2000.[20]

P.D. No. 902-A, as amended, provided for the law on corporate rehabilitation only as an incidental power of the Securities and Exchange Commission. Section 6 (c) and (d) of such law provide:

> Section 6. In order to effectively exercise such jurisdiction, the Commission shall possess the following powers:
>
> xxx xxx xxx
>
> c) To appoint one or more receivers of the property, real or 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: *Provided,* however, That the Commission may, in appropriate cases, appoint a rehabilitation receiver of corporations, partnerships or other associations not supervised or regulated by other government agencies who shall have, in addition to the power of a regular receiver under the

18. ROBERT L. JORDAN AND WILLIAM D. WARREN, BANKRUPTCY 795 (1990).
19. Insolvency Law, Act No. 1956, as amended (1909).
20. A.M. No. 00-8-10-SC. The Supreme Court merely approved the Interim Rules submitted by the Committee on SEC Cases.

provisions of the Rules of Court, such functions and powers as are provided for in the succeeding paragraph (d) hereof: *Provided*, further, That the Commission may appoint a rehabilitation receiver of corporations, partnerships or other associations supervised or regulated by other government agencies, such as banks and insurance companies, upon request of the government agency concerned: *Provided*, finally, That upon appointment of a management committee, rehabilitation receiver, board or body, pursuant to this Decree, all actions for claims against corporations, partnerships or other associations under management or receivership pending before any court, tribunal, board or body shall be suspended accordingly.

d) To create and appoint a management committee, board or body upon petition or *motu propio* to undertake the management of corporations, partnerships or other associations in appropriate cases when there is imminent danger of dissipation, loss, wastage or destruction of assets or other properties or paralyzation of business operations of such corporations or entities which may be prejudicial to the interest of minority stockholders, parties-litigants or the general public.

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

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

The purposes or objectives of P.D. No. 902-A are seen in its first Whereas Clause. It says:

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.

In addition, the amending decree, P.D. No. 1758, shows its purposes in its first two Whereas Clauses:

WHEREAS, one of the objectives of the government as envisioned under Presidential Decree No. 902-A, as amended by P.D. 1653, is to attract and to mobilize investments, domestic and foreign, through the participation of private enterprises in activities identified as most contributive to the growth of the national economy;

WHEREAS, in order to attain this national objective, it is incumbent upon government to provide a favorable climate for investments to be vigorously mobilized to insure a wider and more meaningful equitable distribution of wealth.

It is seen in these Whereas Clauses, that the end goals of the decrees are economic development and more meaningful equitable distribution of wealth. To achieve these goals, the decrees work to encourage investments and to promote more active public participation in the affairs of private corporations and enterprises.

Before P.D. No. 1758 amended P.D. No. 902-A, the concept of stay was found in the Insolvency Law. While the Insolvency Law provided for suspension of payments and formal insolvency proceedings, the law did not have rehabilitation proceedings. In suspension of payments, the debtor is solvent but foresees the impossibility of meeting his obligations when they respectively fall due.[21] The difference between this remedy and rehabilitation is that in the former, the debtor must "muster 3/5 of its liabilities and 2/3 of the number of its creditors to act favorably on the intention to delay payments."[22]

E. *Function of Secured Transactions*

Inescapable in bankruptcy discussion is the subject of secured transactions. This is due to the difference in treatment between secured and unsecured obligations when it is time for payment. If the rehabilitation is successful in creating solvency and liquidity for the debtor, all creditors will be satisfied. If the effort fails, secured creditors can foreclose on the security and satisfy their claims from the proceeds of the sale since they enjoy a lien or a real interest in specific property of the debtor. No matter where the collateral goes, as

21. The Insolvency Law, Act No. 1956, § 2 (1909).

22. Marcial O.T. Balgos, *Effects of the Interim Rules on Corporate Rehabilitation*, The Lawyer's Review 7, 8 (Jan. 31, 2001) [hereinafter Balgos, *Effects of the Interim Rules*].

long as the security is perfected according to the laws of the forum state, the secured creditor is assured that his claim will be satisfied.

On the other hand, the unsecured creditor enjoys no lien. He merely relies on the borrower's reputation and the degree of trust he has on the borrower. If the rehabilitation fails, he will have to line up with the rest of unsecured creditors to get his share from the general assets of his debtor. Necessarily, he will not be able to collect the full amount of his credit since the general assets are insufficient. Nevertheless, the secured creditor will get the full amount of his credit as long as the value of his collateral does not depreciate below the value of the obligation.

Secured transactions have advantages for borrowers and lenders alike. Transaction costs are lower, and lenders do not need to gather much information about borrowers, resulting in efficient and speedy commercial dealings. When borrowers cannot use their assets as collateral for loans and cannot purchase goods on credit using the goods themselves as collateral, interest rates on loans tend to be higher to reflect the risk to lenders.

In other words, granting collateral lowers the aggregate costs of a lending transaction by lowering the pre-loan perception of the risk of default. The transaction cost is lower because the granting of the collateral increases the lender's ability to collect forcibly through liquidation of the collateral; in an indirect way, it decreases the borrower's ability to obtain subsequent loans. Moreover, it increases the lender's leverage over the borrower's activities.[23] Nevertheless, it also has slight disadvantages that make lenders wary, particularly the increased costs of lending because of the increasing costs of entering into the transaction as well as costs of administering the loan.[24]

In developing countries, where legal and regulatory constraints make it difficult to use movable property as loan collateral, the cost of loans makes capital equipment more expensive for entrepreneurs relative to their counterparts in industrial countries. Businesses either postpone buying new equipment or finance it more slowly out of their own limited savings. Small businesses, in particular, are hit hard by the scarcity of low-cost financing, but the whole economy suffers because the lack of new investment dampens productivity and keeps incomes down.

In developing countries, banks typically grant only loans secured by real estate or make unsecured loans to those who give evidence of owning real estate. Because the costs of mortgaging property are usually quite high, most bank loans are actually unsecured but made to borrowers who own real

23. Ronald J. Mann, *Explaining the Pattern of Secured Credit,* 110 HARV. L. REV. 638-60 (1997).

24. *Id.* at 661-68.

estate on the theory that, in the event of default, banks may seek a lien against the real estate.

Comparing industrialized and developing countries, most bank loans in industrial countries are secured (an example is the United States where 70% of bank loans are secured), while most loans in developing countries are not secured (such as in Argentina where there are about 90% of unsecured bank loans). Unsecured banking systems are necessarily more risky and prone to failure. Furthermore, because mortgages are unregistered, a lender would have no idea how many times a borrower has used the same property to indirectly back up a loan. If the borrower defaults, only the bank that files a lien the fastest will be able to back up the loan.[25]

In a nutshell, the world of creditors is generally divided into two: the secured and the unsecured. Their differences, advantages, and disadvantages have been discussed above. Secured creditors are further subdivided into the undersecured, the fully secured, and the oversecured. The undersecured creditor's collateral is worth less than his credit; the fully secured creditor's collateral is equivalent to the value of his credit; and the oversecured creditor's collateral exceeds the value of his credit. The oversecured creditor bargains for this excess value in anticipation of deprecation of the collateral. This value of the collateral above the amount owed is called the "equity cushion."

In the realm of corporate rehabilitation, the existence or non-existence of the "equity cushion" is significant because it determines whether or not a secured creditor is entitled to postpetition interest as part of adequate protection. This backdrop is significant if *Timbers* was to be applied in the Philippines. If undersecured creditors are absolutely denied postpetition interest, with the only exception of oversecured creditors up to the value of their collateral, lenders will hesitate in granting loans without oversecurity, thus making it even harder for entrepreneurs with few valuable collaterals to offer them as security.

The interest of undersecured creditors in lost opportunity costs needs adequate protection because developing countries that rely on undersecured and fully secured transactions are in dire need of investments. But to what extent of protection they are entitled has to be determined in the light of policy considerations found in *Timbers* and the due process requirements found in *Blaisdell.*

25. Heywood Fleisig, *Secured Transactions: The Power of Collateral, at* http://www.worldbank.org/fandd/english/0696/articles/0150696.htm. (last visited Nov. 10, 2001).

II. STAY, RELIEF FROM STAY, AND "ADEQUATE PROTECTION"

D. Corporate Rehabilitation Under the Interim Rules

1. Nature and Proper Petitioners

The proceeding called corporate rehabilitation is considered an *in rem* proceeding.[26] This means that jurisdiction over all interested parties and over the properties subject matter is acquired upon publication of the notice of the commencement of the proceeding. The proceeding is also supposed to be summary and non-adversarial in nature. Ironically, this is never the case. Those who may file the petition are the following: the debtor who foresees the impossibility of meeting its debts when they respectively become due or creditors holding at least twenty-five percent (25%) of the debtor's liabilities.[27]

2. Contents of Petition

The verified petition filed by the debtor must contain material facts such as (a) the name and business of the debtor; (b) the nature and business of the debtor; (c) the history of the debtor; (d) the cause of its inability to pay its debts; (e) all the pending actions or proceedings known to the debtor and the courts or tribunals where they are pending; (f) threats or demands to enforce claims or liens against the debtor; and (g) the manner by which the debtor may be rehabilitated and how such rehabilitation may benefit the general body of creditors, employees, and stockholders.[28]

The petition shall also be accompanied by audited Financial Statements, a Schedule of Debts and Liabilities, an Inventory of Assets, a rehabilitation plan, a Schedule of Payments, a Schedule of the Cash Flow, a Statement of Possible Claims, an Affidavit of General Financial Condition, a list of nominees for the position of receiver, and a Certificate attesting to the authority to file the petition given by the board of directors.[29]

The petition must also be verified as being filed in good faith.[30] This good faith requirement in part means that there is a mere reasonable possibility, not probability, of successful reorganization.[31] It can also mean the submission of a plan whose values are true and correct.[32] If the petition is

26. Interim Rules, Rule 3, § 1.

27. *Id.* Rule 4, § 1.

28. *Id.* Rule 4, § 2.

29. *Id.*

30. *Id.* Rule 4, § 3.

31. Rosenberg, *supra* note 3, at 529. *But see* discussion in Part IV.

32. DANIEL R. COWANS, COWANS BANKRUPTCY LAW AND PRACTICE 411 (1989).

filed by a creditor, it need only be verified and accompanied by a rehabilitation plan and a list of nominees for the position of receiver.[33]

3. Cramdown

If the court issues a stay order,[34] any conveyance, sale, payment, and agreement in violation of the stay order may be declared void.[35] After the initial hearing and the opportunity for the creditors to oppose or comment on the petition, the court may then decide to approve or deny the proposed plan.

The court should consider the following in the confirmation of the plan: (1) Feasibility Requirement which provides for confirmation only if it is not likely to be followed by liquidation;[36] (2) Best Interests of Creditors which requires that every dissenting creditor receives "not less than the amount that such holder would receive or retain if the debtor were liquidated;"[37] and (3) Absolute Priority Rule which requires for the fair and equitable treatment of creditors in a class.[38]

The "cram down" provision assures that reason, rather than emotion, will prevail in the approval or disapproval of the plan. Under Section 1129 (b) (1) of the Bankruptcy Code, "cram down" can be done "if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted the plan."

The plan does not discriminate unfairly if the plan "protects the legal rights of a dissenting class in a manner consistent with the treatment of other classes."[39] Moreover, it is generally fair and equitable if a senior class is paid or satisfied in full before a junior class receives anything.[40]

Under Rule 4, Section 23 of the Interim Rules, the first appearance of the "cram down" provision in Philippine bankruptcy and rehabilitation laws and procedure, the court may approve a rehabilitation plan *even over the opposition of the 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*

33. Interim Rules, Rule 4, § 4.

34. The stay order will be more thoroughly discussed in the next part because the author just wants to give a glimpse of the procedure involved.

35. Interim Rules, Rule 4, § 8.

36. Bankruptcy Code, 11 U.S.C. § 1129 (a)(11).

37. *Id.* § 1129 (a) (7).

38. *Id.* § 1129 (b) (2) (B) (ii).

39. COWANS, *supra* note 32, at 420, *citing* Klee, *All You Ever Wanted to Know About Cram Down Under the New Code*, 53 AM. BANKR. L.J. 133 (1979).

40. COWANS, *supra* note 32, at 421.

the creditors is manifestly unreasonable. The opposition is manifestly unreasonable (1) *when 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*; (2) when the shareholders or owners of the corporation lose at least their controlling interest as a result of the plan; and (3) when the Rehabilitation Receiver has recommended approval of the plan.[41] Thus, the Best Interest of Creditors and Feasibility requirements are made applicable in the Interim Rules.

4. Effects of Approval of Plan and Its Termination

The approval of the plan results in the binding effect of its provision upon the debtor and all affected persons. The debtor is obliged to comply with the provisions of the plan and to make payments to creditors according to the plan.[42] The Court, on motion or *motu proprio*, may revoke the plan within ninety (90) days after its approval on the ground of fraud.[43] The proceeding is terminated in case the debtor fails to submit the rehabilitation plan; the court disapproves the plan; the failure to achieve the desired targets or goals; the non-performance of the debtor of his obligations; that the plan may not anymore be implemented according to its terms; or upon the successful implementation of the plan.[44] In the United States, other reasons are "continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation."[45]

E. The Stay Order

1. Nature and Purpose

The filing of the petition triggers all the effects of rehabilitation including the possible the stay order of the court. A discussion of the stay is unavoidable in re-examining adequate protection, for the impairment of creditors' rights start at the commencement of the stay, while adequate protection, in connection with relief from stay, is the counter-balancing provision the creditor can avail of. Because of the restraint, a secured creditor may find himself in worse situation had he been allowed to exercise his right at the outset. It is also believed that the filing of the petition for rehabilitation is

41. This note will not discuss the constitutionality of the "cram down" provision in general and its appearance in mere procedural rules.

42. Interim Rules, Rule 4, § 24.

43. *Id.* § 25.

44. *Id.* § 27.

45. JORDAN AND WARREN, *supra* note 18, at 795.

usually a dilatory tactic by the debtor[46] and corporate officers usually conceal corporate assets. Success of rehabilitation will depend upon massive infusion of new capital or the assumption of the obligations of the distressed company by the parent company.[47]

The primary purpose of the stay is to give the debtor some breathing space from his creditors' collection efforts. It prevents harassment and all foreclosure actions to permit the debtor to successfully rehabilitate itself. Without an orderly administration and liquidation of debts, there would be a race of diligence by creditors, inherently detrimental to a situation abounding with conflicts of interests.[48] In the same light, the Philippine Supreme Court also held in *B.F. Homes, Inc. v. Court of Appeals*[49], that the:

> real justification is to enable the management committee or rehabilitation receiver to effectively exercise its/his powers free from any judicial or extra-judicial interference that might unduly hinder or prevent the 'rescue' of the debtor company. To allow such action to continue would only add to the burden of the management committee or rehabilitation receiver, whose time, effort, and resources would be wasted in defending claims against the corporation instead of being directed toward its restructuring and rehabilitation.

Although the primary purpose of the stay is debtor protection, ultimately, the creditors themselves are benefited, for the stay prevents one creditor from reaching property of the debtor to the detriment of other creditors. Thus, the purpose is clear, but its nature and effects are altogether another matter.

1. Effects of the Issuance of the Stay Order

Rule 4, Section 6 of the Interim Rules provides that:

> [i]f the court finds the petition to be sufficient in form and substance, it shall not later than five (5) days from the filing of the petition, issue an Order:
>
> a) appointing a Rehabilitation Receiver and fixing his bond;
>
> b) *staying enforcement of all claims, whether for money or otherwise and whether such enforcement is by court action or otherwise, against the debtor, its guarantors and sureties not solidarily liable with the debtor;*

46. Rosenberg, *supra* note 3, at 511.

47. Interview with Professor Cynthia Roxas del Castillo, Professor of Law in the Ateneo Law School, Corporate Rehabilitation practitioner (Sept. 4, 2001).

48. Marcial O.T. Balgos, *When Should the Queue Start?*, 13 J.I.B.P. 3, 4 (1985) [hereinafter Balgos, *Queue*], *citing* ASA S. HERZOG AND LAWRENCE P. KING, BANKRUPTCY CODE 145-46 (1984).

49. 190 SCRA 262, 269 (1990).

c) prohibiting the debtor from selling, encumbering, transferring, or disposing in any manner any of its properties except in the ordinary course of business;

d) prohibiting the debtor from making any payment of its liabilities outstanding as of the date of filing of the petition;

e) prohibiting the debtor's suppliers of goods or services from withholding supply of goods and services in the ordinary course of business for as long as the debtor makes payments for the services and goods supplied after the issuance of the stay order;

f) directing the payment in full of all administrative expenses incurred after the issuance of the stay order;

g) fixing the initial hearing on the petition not earlier than forty-five (45) days but not later than sixty (60) days from the filing thereof;

h) directing the petitioner to publish the Order in a newspaper of general circulation in the Philippines once a week for two (2) consecutive weeks;

i) directing all creditors and all interested parties (including the Securities and Exchange Commission) to file and serve on the debtor a verified comment on or opposition to the petition, with supporting affidavits and documents, not later than ten (10) days before the date of the initial hearing and putting them on notice that their failure to do so will bar them from participating in the proceedings; and

j) directing the creditors and interested parties to secure from the court copies of the petition and its annexes within such time as to enable themselves to file their comment on or opposition to the petition and to prepare for the initial hearing of the petition.[50]

C. *Significant Issues*

1. When Does It Start?

Of all issues regarding the stay, what has plagued Philippine jurisprudence most is the time the stay actually commences. This uncertainty is the complete opposite of the situation in American jurisprudence. Their courts are unanimous in affirming the self-executing nature of the stay, thus the descriptive word "automatic" attached before the word "stay."[51] In the Philippines, the Interim Rules seems to have compromised the two prevailing views with regard to the time of commencement. For a clearer picture of the confusion, the developments should be traced from the start.

50. Interim Rules, Rule 4, § 24 (emphasis supplied).

51. 9A AM.JUR. 2D *Bankruptcy* §1370 (1984).

a. Presidential Decree 902-A, As Amended

Section 4 of PD 902-A states that the stay is not triggered by the filing of the petition for rehabilitation but only upon the "appointment of the management committee, rehabilitation receiver, board or body." Because of this situation, prejudiced creditors, or even the debtor, rely on regular injunctions under Rule XVIII of the former New Rules of Procedure of the SEC.[52] Such injunctions are available but are often hard to get. The creditor or debtor is required to file a verified complaint plus a bond in an amount to be fixed by the Commission. Another difficulty faced is due to B.P. Blg. 224, wherein an injunction should regularly require a hearing and is only for a limited period of 20 days from the date of issue.[53]

In 1992, the Supreme Court ruled in *Rizal Commercial Banking Corp. v. Intermediate Appellate Court*,[54] that the prohibition against the foreclosure, and generally the stay of all other claims, "*attaches as soon as a petition for rehabilitation is filed.* Were it otherwise, what is to prevent the petitioner from delaying the creation of the management committee and in the meantime dissipate all its assets?"[55] This case reaffirmed the ruling in *Alemar's Sibal & Sons, Inc. v. Elbinias*[56] which said that:

> [d]uring rehabilitation receivership, the assets 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 an attachment, execution or otherwise. *For what would prevent an alert creditor, upon learning of the receivership, from rushing posthaste to the courts to secure judgments for the satisfaction of its claims to the prejudice of the less alert creditors. As between creditors, the key phrase is 'equality is equity'.*

In the *RCBC* case, Justice Feliciano dissented, siding with the literal interpretation of P.D. No. 902-A, as amended, but at the same time, admitting that "the appointment of a management committee or a rehabilitation receiver is not ordinarily effected immediately upon the filing of an application for suspension of payments and for rehabilitation."[57] In fact, the Securities and Exchange Commission (SEC) must first be satisfied that the requirements for the petition for suspension of payments[58] and for the creation of a management committee are all present,[59] *i.e.* that there is

52. Balgos, *Queue, supra* note 48, at 6.

53. *See* Dionisio v. CFI of South Cotabato, 124 SCRA 222 (1983).

54. 213 SCRA 830 (1992).

55. *Id.* at 838.

56. 186 SCRA 94 (1990).

57. 213 SCRA 830, 841 (1992).

58. P.D. No. 902-A, as amended by P.D. No. 175.

59. *Id.* § 6 (d).

imminent danger of dissipation, loss, wastage or destruction of assets or paralyzation of business operations, which would be prejudicial to the interest of minority stockholders, parties litigant, or the general public.

Justice Feliciano's literal interpretation of the law was followed in *Barotac Sugar Mills, Inc. v. Court of Appeals*[60] and later, in the Resolution[61] of the *RCBC* case. The Resolution still recognized the logic and wisdom of the original *RCBC* case but opted to be conservative in its interpretation of the law. The court reasoned that "[t]o insist on such ruling (original *RCBC* case), no matter how practical and noble, would be to encroach upon legislative prerogative to define the wisdom of law -- plainly judicial legislation."[62] Therefore, in the Philippines, there is no such thing as an "automatic stay" in corporate rehabilitation. The stay, in order to be effective, has to be ordered by the court.

A discussion of the stay is very significant to the main issue because the stay triggers the application of relief from stay and adequate protection. In the illustration given in the introduction, it can be seen that adequate protection becomes significant only when the stay order is issued. Before the issuance, a secured creditor may foreclose on his collateral, thereby saving it from depreciation. A determination of when the stay commences and what claims are covered is important because an earlier commencement and a more expansive reach of the stay will affect more creditors in the process.

b. The Interim Rules

The Interim Rules do not make much difference since the stay is still court-ordered and not self-executing in nature unlike in the United States.[63] However, contrary to a literal reading of P.D. 902-A, the stay order is issued first before the appointment of the receiver.[64] In the Interim Rules, the court's time to issue a stay order of all claims is limited to five (5) days from the filing of the petition.[65] The court must also appoint a rehabilitation receiver within the same time frame, whereas in P.D. No. 902-A and jurisprudence, the stay takes effect upon the appointment of a management committee or a rehabilitation receiver without giving any time frame for

60. 275 SCRA 497 (1997).

61. Resolution dated Dec. 9, 1999.

62. *Id.* at 10-11.

63. The automatic stay takes effect at the time the bankruptcy petition is filed, regardless of whether the creditor or other affected entity has knowledge of the bankruptcy. There is no need for any formal service of process, motion for a stay, or notice to the creditors.

64. Rule 4, § 6.

65. *See* Interim Rules, Rule 4, §§ 6 and 7.

such appointment.[66] In the Interim Rules, the Court is acting more as a court of equity.

2. Actions Stayed

The Court added in *Rubberworld Phils., Inc. v. NLRC*[67] that even labor claims are included in the phrase "all claims" since the law makes no distinctions or exemptions. In the Court's own words,

> [a]llowing labor cases to proceed clearly defeats the purpose of the automatic stay and severely encumbers the management committee's time and resources. The said committee would need to defend these suits, to the detriment of its primary and urgent duty to work towards rehabilitating the corporation and making it viable again.... Besides, even if the NLRC awards the claims of private respondents, as it did, its ruling could not be enforced as long as the petitioner is under a management committee.

In *Finasia Investment & Finance Corporation v. CA*,[68] and in *Arranza v. BF Homes, Inc.*,[69] the Court limited the word "claim" as referring only to *debts* or *demands of a pecuniary nature*. In this case, the cause of action simply sought the nullification of the Special Power of Attorney and other documents because the signature of Castro appearing therein was a forgery. Therefore, since there was no demand for a payment of a debt or enforcement of pecuniary liability it had nothing to do with the purpose of Section 6 (c) of P.D. 902-A, as amended, which is to prevent a creditor from obtaining an

66. P.D. No. 902-A, as amended, § 5 (d).

67. G.R. No. 76681, Resolution dated Aug. 31, 1987.

68. DE CASTRO, *supra* note 9, at 87: "The language of the new law is so broad and all encompassing that the stay is made to apply to proceedings to enforce security interests already commenced in another court or tribunal before the filing of the petition even in straight bankruptcy proceedings. This broad scope of the automatic stay is consistent with the grant of pervasive jurisdiction to the bankruptcy court eliminating custody of the court as an element for acquiring jurisdiction over the property of the debtor in straight bankruptcy proceedings, *citing* Kennedy, *Automatic Stay Under the New Bankruptcy Law*, 12 UNIV. MICH. J. L. REF. 3, 65 (1978). Before the enactment of the Bankruptcy Reform Act of 1978, the operation of the automatic stay in straight bankruptcy proceedings was dependent upon the custody of the property by the court. The court acquired jurisdiction only over the property in the actual or constructive possession of the debtor at the time of the filing of the petition. Where a foreclosure suit was already pending at the time of filing of the petition, the automatic stay would not apply because the property was in the custody of another court. Similarly, where the property was in the possession of the secured creditor and, therefore, would not come to the custody of the court when the petition for straight bankruptcy proceedings was filed, the automatic stay would not apply.

69. 305 SCRA 721, 729-31 (1999).

advantage or preference over another with respect to actions against a corporation under management or receivership and to protect and preserve the rights of party litigants as well as the interest of the investing public or creditors. The Court in this case simply did not recognize one of the purposes of the stay which is to prevent harassment of the debtor in order to insure that the corporation's resources and time be used in its rehabilitation.

Reacting to *Finasia Investment,* the Committee on Corporate Rehabilitation which drafted the Interim Rules placed therein in Rule 2, Section 2, that "'claims' shall include all claims or demand of whatever nature or character against the debtor or its property, whether for money or otherwise." Rule 6, Section 4 also clarified that the stay shall affect the enforcement, "whether by court action or others."[70] Moreover, the Interim Rules rejected the American view that the stay only acts against the debtor and does not apply to acts against non-debtors, such as co-debtors, guarantors, sureties, and insurers. The only exception in American jurisprudence is when there is such identity between the debtor and the third party that a judgment against the third party will in effect be a judgment or finding against the debtor.[71] The Interim Rules provide that the stay affects "all claims, whether for money or otherwise and whether such enforcement is by court action or otherwise, against the debtor, its guarantors and sureties not solidarily liable with the debtor."[72]

There was also the issue of whether all creditors, secured or unsecured, are stopped from filing an action or a claim against their debtor.[73] But this issue was laid to rest in the *RCBC Resolution*[74] where the Court gave the following rules of thumb:

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 P.D. No. 902-A.
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 a preference over unsecured ones.

70. Balgos, *Effects of the Interim Rules, supra* note 22, at 12.

71. 9A AM.JUR 2D *Bankruptcy* 297 (1984).

72. Rule 4, § 6.

73. See Philippine Commercial Bank v. CA, 172 SCRA 436 (1989); Alemar's Sibal & Sons v. Elbinias, 186 SCRA 94 (1990); Bank of the Philippine Islands v. CA, 229 SCRA 223 (1994).

74. Resolution dated Dec. 9, 1999 at 10-11.

In summary, the Supreme Court has strictly construed the wording of P.D. No. 902-A as to issues of the actual time the stay commences and what claims are stayed. The Court's interpretation is not consistent with the purpose of the stay which is to give the debtor a breathing spell from his creditors' collection efforts by preventing harassment and all foreclosure actions to permit the debtor to successfully rehabilitate itself. However, the Court has also tamed its own conservativeness through the Interim Rules by providing for a time-frame for the issuance of the stay order and including in the word "claims" literally all claims, whether for money or otherwise. The Court has also been consistent with the purpose of the stay and the proceeding called rehabilitation by including in the stay, all claims of creditors, whether secured or unsecured.

3. Period of Suspension of Claims

In P.D. No. 902-A, the stay is only vacated after the conclusion of the suspension of payments proceedings. The Interim Rules has tempered P.D. No. 902-A by providing a time frame for the approval of the plan. Under the Rules, the stay order is effective from the date of its issuance until the dismissal of the petition for rehabilitation or the termination of the proceedings. In addition, the petition will be dismissed if no plan is approved after one hundred eighty (180) days from the date of the initial hearing. The court may also grant an extension if it appears by convincing and compelling evidence that the debtor may be successfully rehabilitated. However, the approval or disapproval of the plan may not exceed eighteen (18) months from the filing of the petition.[75]

D. *Relief from Stay and Adequate Protection*

1. American Counterpart

Relief from stay is the most frequently used remedy in bankruptcy proceeding.[76] By filing a motion for relief, the court may, in its discretion, permit such creditor to make his claim against his debtor. The remedy of relief from stay in the Bankruptcy Code appears as follows:

> On request of a party in interest and after notice and a hearing, the court shall grant relief from stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay:

75. Interim Rules, Rule 4, § 11.

76. Cowans, *supra* note 32, at 353.

1. for cause, including the lack of adequate protection of an interest in property of such property in interest; or
2. with respect to a stay of an act against property under subsection (a) of this section, if:
   a) the debtor does not have an equity in such property; and
   b) such property is not necessary to an effective reorganization.[77]

As seen above, the remedy of relief from stay is inseparable from the concept of adequate protection which will be discussed later. The range or orders the court may make is quite broad for it can terminate, annul, modify, or condition the stay. To distinguish annulment from termination, the former has retroactive effect which validates actions taken by an entity during the pendency of the stay.[78] For annulment to be granted, the applicant must show that there was abuse or bad faith on the part of the debtor.[79]

The court, acting as a court of equity, must consider the impact of the automatic stay on the parties. In deciding whether there is sufficient "cause" present to grant relief from the automatic stay, the court must conduct a balancing test "whereby the interest of the estate are weighed against the hardships that will be incurred by the movants."[80] This is also known as the "balance of hurt" test.[81]

The lack of adequate protection is just one of the grounds to ask for relief. The word "cause" in subparagraph (1) was "intentionally made a broad and flexible concept in order to afford flexibility to the Bankruptcy Courts and to permit the courts to respond in equity to inherently fact-sensitive situations."[82] Plus, generally, the motion must be coupled with a notice and hearing to the other party. But U.S. Bankruptcy Rule 4001 (a) (2) (A) and (B) provide that relief from the stay may be granted without prior notice to the adverse party only if: (1) it clearly appears from specific acts shown by affidavit or by a verified motion that immediate and irreparable injury, loss, or damage will result to the movant before the adverse party or

77. *Id.*

78. Bankruptcy Code, § 362 (d).

79. 9A AM.JUR. 2D *Bankruptcy* § 1478 (1984).

80. *Id.* § 1494.

81. Courts have allowed tailoring of the automatic stay to permit continuance of a civil suit with the debtor where two conditions are met: 1) that no "great prejudice" to either the bankruptcy estate or the debtor results from the continuation of the civil action; and 2) that the hardship to the movant caused by the continuation of the stay considerably outweighs the hardship caused to the debtor by modification of the stay. 9A AM.JUR. 2D *Bankruptcy* § 1495 (1984).

82. 9A AM.JUR. 2D *Bankruptcy* § 1503 (1984).

the attorney for the adverse party can be heard in opposition; and (2) the movant's attorney certifies to the court in writing the efforts, if any, which have been made to give notice and the reasons why notice should not be required. The party obtaining *ex parte* relief must immediately give oral notice thereof to the trustee or debtor in possession and forthwith mail or otherwise transmit to such adverse party or parties a copy of the order granting relief.[83]

2. Interim Rules

The Interim Rules, as well as the former SEC Rules of Procedure on Corporate Recovery, also provide for the remedy of relief from stay similar to the Bankruptcy Code, obviously pointing to the model of the Rules. The Interim Rules properly combine in Rule 4, Section 12 the remedy of relief from stay and the concept of adequate protection.[84] According to the Rules,[85] the court may, on motion or *motu proprio*, terminate, modify, or set

83. Bankruptcy Code, § 362 (f).

84. In the 1978 Bankruptcy Act, the forms of adequate protection are placed in § 361 while the remedy of relief from stay is in § 362 (d).

85. The court may, on motion or motu propio, terminate, modify, or set conditions for the continuance of the stay order, or relieve a claim from the coverage thereof upon showing that

a. any of the allegations in the petition, or any of the contents of any attachment, or the verification thereof has ceased to be true;

b. a creditor does not have adequate protection over property securing its claim; or

c. the debtor's secured obligation is more than the fair market value of the property subject of the stay and such property is not necessary for the rehabilitation of the debtor.

For purposes of this section, the creditor shall lack adequate protection if it can be shown that:

a. the debtor fails or refuses to honor a pre-existing agreement with the creditor to keep the property insured;

b. the debtor fails or refuses to take commercially reasonable steps to maintain the property; or

c. the property has depreciated to an extent that the creditor is undersecured.

Upon showing of a lack of adequate protection, the court shall order the rehabilitation receiver to:

a. make arrangements to provide for the insurance or maintenance of the property, or

b. to make payments or otherwise provide additional or replacement security such that the obligation is fully secured.

conditions for the continuance of the stay order, or relieve a claim from the coverage thereof upon the following grounds: (1) allegations in the petition, any of the contents of any attachment, or the verification thereof has ceased to be true; (2) lack of adequate protection; and (3) the debtor has equity in the property and such property is not necessary for rehabilitation.

The same section also provides for the instances when there is lack of adequate protection for the property securing the debt: (1) lack of insurance promised; (2) lack of maintenance of the property; and (3) depreciation of the property causing the creditor to be undersecured.[86]

To remedy the lack of adequate protection, the court may order the receiver to: (1) insure the property; (2) maintain or preserve the property; (3) make payments; or (4) provide additional security to fully secure the property.[87]

In comparison, the Bankruptcy Code enumerates in Section 361[88] a non-exclusive list of forms of adequate protection: (1) making cash payments; (2) providing additional or replacement liens; or (3) granting other relief as will result in the realization by the creditor of the indubitable equivalent of his interest in the property.

c. If such arrangements are not feasible, the court shall modify the stay order to allow the secured creditor lacking adequate protection to enforce its claim against the debtor. Provided, however, that the court may deny the creditor the remedies in this paragraph if such remedies would prevent the continuation of the debtor as a going concern or otherwise prevent the approval and implementation of a rehabilitation plan.

86. *Id.*

87. *Id.*

88. When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by:

a. requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, or lease under 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;

b. providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease or grant results in a decrease in the value of such entity's interest in such property; or granting such other relief, other than entitling such entity to compensation allowable under section 503 (b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

WEST PUBLISHING COMPANY, BANKRUPTCY CODE, RULES AND OFFICIAL FORMS 90 (1989).

U.S. courts, acting more as arbiters, do not have the power to *motu propio* grant relief from stay, while Philippine courts, having a more active role in the rehabilitation proceeding, is vested with such power.

The Interim Rules do not provide the court with the power to annul the stay, but due to the more extensive power of the Philippine courts, it is believed that the power to annul is included in the power to modify the stay.

It is significant to note that the grounds for relief from stay in the Interim Rules are narrow compared to the Bankruptcy Code. It appears that the list is exclusive and will not permit a more open approach. U.S. courts have recognized that the grounds for relief from stay are not exclusive and that lack of adequate protection is just one of the causes. Other causes include the lack of connection with or interference with the pending bankruptcy case. Generally, proceedings in which the debtor is a fiduciary, or involving postpetition activities of the debtor, need not be stayed because they bear no relationship to the purpose of the automatic stay, which is the protection of the debtor from his creditors.

The Interim Rules incorporated the methods of adequate protection found in the Bankruptcy Code but added other forms such as providing insurance or maintenance of the property, which are also already recognized by U.S. courts as a mode of adequate protection. If the debtor cannot provide any of the modes of adequate protection, the court may allow the secured creditor to enforce his claim by allowing foreclosure on the collateral. The most radical part of the section on relief from stay is the last portion which essentially affirms the priority of possible successful rehabilitation over secured creditors' property rights. Relief from stay will not be granted if it will "prevent the continuation of the debtor as a going concern or otherwise prevent the approval and implementation of a rehabilitation plan."[89] This declaration of superiority will surely not be greeted well by secured creditors asserting vigorously their property rights.

III. PREVAILING VIEW ON THE BASES OF "ADEQUATE PROTECTION"

The concept of adequate protection first found its way in the 1978 U.S. Bankruptcy Act. Nonetheless, Congress did not create the concept out of thin air. Rather, they borrowed the same from case law.

A. Pre-Enactment History

As early as 1845, the U.S. Supreme Court has ruled that the bankruptcy court had the power to restrain creditors from enforcing liens after the

89. Interim Rules, Rule 4, § 12.

bankruptcy petition is filed.[90] Yet even before the codification of adequate protection, courts have equitably afforded secured creditors protection in connection with constitutional concerns raised by the latter. The courts developed four factors to determine whether to vacate a stay:

1. Would continuation of the stay result in an undue risk of material harm to the secured creditor?
2. Was there a reasonable possibility of reorganization or rehabilitation?
3. Was the property in question needed by the debtor or necessary to rehabilitation?
4. Was there any equity in the property that might be realized for the benefit of the debtor or its creditors?[91]

The first factor refers to the lack of adequate protection of the secured creditor that is remedied, under the present Interim Rules, by the form of periodic cash payment or maintenance of the collateral. The second factor refers to the feasibility requirement for the confirmation of the plan. The third and fourth factors are the elements of the third ground under the Interim Rules for relief from stay over which the issue in *Timbers* revolves.

The stay was usually vacated upon a finding of a possible material harm to a secured creditor, but no material harm is caused if the value of the lien is maintained during the stay. In *In re Yale Express*,[92] however, the Second Circuit Court softened the requirement of maintenance by assuring the secured creditor of an administrative expense priority at the termination of the proceeding because it found the requirement cumbersome to rehabilitation. *Yale Express* seems to have proceeded from the assumption that rehabilitation will always be successful and that administrative expenses will be always be paid in full.

B. *Compromise of Interests*

When the Legislature decided to codify the concept of adequate protection, the Senate and the House of Representatives came out with substantially different proposals. The House Report contained all the three present modes of adequate protection added to the *Yale Express* doctrine. The Report, however, did not contain the phrase "indubitable equivalent." Rather, it opted for the line "such other relief as will result in the realization by the protected entity of the value of its interest in the property involved."[93]

90. *Ex parte* Christy, 44 U.S. 292 (1845).

91. *In re* Timbers of Inwood Forest, 793 F.2d 1380, 1391 (5th Cir. 1986), *citing* 2 Collier on Bankruptcy 362-22, 362-23.

92. *In re* Yale Express, 384 F. 2d 990, 992 (2d Cir. 1967).

93. *In re* Timbers of Inwood Forest, 793 F.2d at 1397.

The Senate version, on the other hand, specified only two ways of providing adequate protection: periodic cash payment and additional or replacement lien to protect for any depreciation caused by the stay. The Senate followed the rule that it was the value of the collateral and not necessarily his rights in specific collateral that was entitled to protection. In addition, the Senate rejected the *Yale Express* ruling believing it was too risky for secured creditors.[94]

What now appears in the Code is a compromise between the proposals of the two Houses. The *Yale Express* rule, which admits administrative expenses as adequate protection, was discarded for it was found too risky to secured creditors. Plus, the phrase "indubitable equivalent" was inserted in place of the word "value." Representative Edwards, in his explanation of the compromise, said that "[a]dequate protection of an interest of an entity in property is intended to protect a creditor's allowed secured claim. To the extent the protection proves to be inadequate after the fact, the creditor is entitled to a first priority administrative expense under section 507 (b)."[95] This statement will later prove to be significant in the case of *Timbers*.

C. *Present Modes of Adequate Protection*

The first method of making cash payments to compensate for the expected decrease in value of the opposing entity's interest was derived from *In re Bermec Corporation*.[96] The use of periodic payments may be appropriate where, for example, the property in question is depreciating at a relatively fixed rate. The periodic payments would be compensation for the depreciation and might, but need not necessarily be, in the same amount as payments due on the secured obligation. Thus, *Bermec* found *Yale Express* too risky for the secured creditor.

The second method of providing additional or replacement lien was derived from *Wright v. Union Central Life Ins. Co.*[97] Its purpose is to provide the protected entity with an alternative means of realizing the value of the original property, if it should decline during the case, by granting an interest in additional property from whose value the entity may realize its value. It is important to note that it is the value of the secured creditor's collateral and not necessarily his rights in specific collateral that was entitled to protection.[98] Therefore, as long as the replacement lien had the same value as the original, the creditor cannot complain.

94. *Id.* at 1398.

95. *Id.* at 1399.

96. 445 F. 2d 367 (2d Cir. 1971).

97. 311 U.S. 273 (1940).

98. *Id.*

The third method which provides other relief as will result in the realization of the indubitable equivalent of the creditor's interest in the property was derived from *In Re Murel Holdings Corp.*[99] The phrase "indubitable equivalence" was first coined by Judge Learned Hand in this case and has been construed in different ways by the legislature as the guarantee by a third party, the permitting of the secured creditor to bid on his claim at the sale, as well as the payment of periodic obligations.[100] Judge Learned Hand also interpreted adequate protection as "completely compensatory," but this shall be discussed later in fuller detail. It is interesting to note that the Legislature has expressly excluded "the device current to some extent under the old law that grants to a secured creditor an administrative expense priority"[101] because, according to it, that remedy could only be satisfactory if all unsecured assets are still sufficient to pay all such administrative expenses in full.

1. The Unconstitutional Impairment Thesis

The "unconstitutional impairment" thesis, the basis of the Legislature for providing the above-mentioned methods of adequate protection in statute form, is credited primarily to Justice Brandeis in the seminal case of *Louisville Joint Stock Land Bank v. Radford.*[102] In his own words, "[t]he bankruptcy power, like the other substantive powers of Congress, is subject to the Fifth Amendment."[103] The Fifth Amendment in the U.S. Constitution includes both the takings clause and the non-impairment clause which are equivalent to the eminent domain[104] and non-impairment of contracts[105] provisions in the Philippine Constitution. Therefore, if Justice Brandeis' statement is interpreted in the context of adequate protection, any impairment of a secured creditor's property rights may only be justified if the constitutional and inherent limitations of the takings and contract clauses are applied. As will be seen later, this view is a radical departure from the 19TH Century view of bankruptcy as a comprehensive and superior power limited only by the bankruptcy clause itself.

According to the "unconstitutional impairment" thesis, in order not to violate the constitutional prohibition of taking private property for public use without just compensation, the debtor should provide some form of

99. 75 F. 2d 942 (2d Cir. 1935).

100. JORDAN AND WARREN, *supra* note 18, at 295-96.

101. *Id.* at 295.

102. 295 U.S. 555 (1935).

103. Radford, 295 U.S. at 589.

104. PHIL. CONST. art. III, § 9.

105. PHIL. CONST. art. III, § 10.

protection to secured creditors during the stay because of the inevitable depreciation of the collateral. With the advent of this thesis, the method of entitling the secured creditor to an unsecured claim having priority as an administrative expense was deemed insufficient to satisfy the constitutional requirement. The court's assessment that the earning power of the debtor will be enough to cover the depreciation is not given importance since it is required at the outset to provide substitute collateral or its equivalent in cash.

Another source of the concept of adequate protection, according to legislative history, is the contractual right to receive the benefit of their bargain, which according to *Radford* includes the right to foreclose on the collateral.

Radford was one of the cases that tackled the constitutionality of the Frazier-Lemke Act. The Frazier-Lemke Act of 1934 amended certain provisions of the Bankruptcy Act by assisting farmers who might lose their farms through mortgage foreclosures. The Act provided for: (1) a stay of foreclosure for a period of five (5) years; (2) the farmer staying in possession of the land but he must pay rent to creditors; and (3) the right of the debtor-farmer to acquire the mortgaged property within the period by paying the mortgagee the value of the land. The effect of the latter was to deprive the mortgagee-creditor the chance to foreclose on the mortgage and to acquire the property by bidding in the amount of his debt and hoping that future increase in its value will enable him to fully obtain repayment of his claim.[106] *Radford* found the Frazier-Lemke Act unconstitutional because it violated the takings clause by depriving the mortgagee, without compensation, of his original rights as such mortgagee.

Radford enumerated the five (5) property rights of the mortgagee-creditor: (1) the right to retain the lien until the indebtedness is paid; (2) the right to realize upon the security at a public sale; (3) the right to determine when such sale should be held subject only to the discretion of the court; (4) the right to protect its interest in the property by bidding at such sale; and (5) the right to control the property during the period of default subject only to the discretion of the court, and to have the rents and profits collected by a receiver for satisfaction of the debt.[107]

However, there is also the view that the secured creditor's rights in the collateral are not the five state-created rights found in *Radford*. Rather, they are the rights granted under the Bankruptcy Code itself.[108] For the proponent, the secured creditor's rights in the collateral is not necessarily the

106. 75 F. 2d 979 (2d Cir. 1935).

107. 295 U.S. at 594-95.

108. Note, *Adequate Protection and the Automatic Stay Under the Bankruptcy Code: Easing Restraints on Debtor Reorganization*, 131 U. PA. L. REV. 423, 446 (1982).

five rights mentioned in *Radford* but only what the forum state grants him at the time of the perfection of the security. The view that the only rights are those available in the bankruptcy law, to be valid, assumes that the condition of reasonableness is met.

Because the Act was declared unconstitutional, the Legislature came out with the Revised Frazier-Lemke Act. *Wright v. Vinton Branch of the Mountain Trust Bank*[109] upheld the constitutionality of the revised Act even if the changes were not substantial. The revised Act provided for a three (3) year stay instead of the original five (5) years.

Justice Brandeis, the same one who penned the *Radford* decision, interpreted the revised Act as allowing the shortening of the period if it appeared rehabilitation was not possible, but this interpretation was later on expressly repudiated in *John Hancock Mutual Life Insurance Co. v. Bartels*.[110]

Justice Brandeis also interpreted the revised Act as still giving the right to the mortgagee to acquire the land through judicial sale, but in the later case of *Wright v. Union Central Insurance Co.*,[111] the Court ruled that the debtor still had the opportunity to redeem the property for its appraised value before a judicial sale can be conducted. *Union Central* has been interpreted as establishing the view that the preservation of the value of the collateral is the key constitutional right of the secured creditor.[112]

The original Frazier-Lemke Act is indistinguishable from the Minnesota Mortgage Moratorium Act, upheld a year earlier in *Home Building & Loan Association v. Blaisdell*.[113] The disparity in the rulings, according to James Steven Rogers, is hard to explain. He goes on to say that

> [o]ne would hardly expect that Congress' explicitly granted power to deal with problems of financially troubled debtors is restricted by fifth amendment principles in a more rigorous fashion than the general police powers of the states to deal with similar matters are restricted by fourteenth amendment or contracts clause principles."[114]

In short, according to the "unconstitutional impairment" thesis, any impairment of the secured creditor's interest is considered a taking which requires proper and just compensation because there is: (1) a taking by the government in the person of the bankruptcy court; (2) a taking of the secured creditor's property in the form of the collateral; and (3) it is for

109. 300 U.S. 440 (1937).
110. 308 U.S. 180, 184 (1939).
111. 311 U.S. 273, 278-79 (1940).
112. Rogers, *supra* note 16, at 981.
113. 290 U.S. 398 (1934).
114. Rogers, *supra* note 16, at 983.

public use which is the pursuit of the public policy of promoting reorganization. In addition, any impairment of property rights, according to this view, is violative of the non-impairment clause because the secured creditor is entitled to receive the benefit of his bargain.

In summary, following the "unconstitutional impairment" thesis would justify the payment of postpetition interest to secured creditors since the thesis provides that they have the absolute right to foreclose on the collateral, and taking away that right, even temporarily, constitutes a taking requiring just compensation. Further, just compensation, including postpetition interest, have to be paid in full, even if at the end of the moratorium, the debtor is still unable to satisfy in full the claims of all his creditors. It can also be seen in *Radford* and *Vinton Branch* that the reasonableness of conditions in a moratorium law determines whether the law is a taking.

IV. Re-examining the Unconstitutional Impairment Thesis

A. An Overview

The traditional view is that the effects of rehabilitation as a taking have to be re-assessed by looking at the different views of when taking actually occurs and the problems arising from each. Police power and the non-impairment clause will be briefly correlated in this overview to see the bigger picture.

1. Reasonableness of Conditions

This writer observes that the methodology employed by the Philippine Supreme Court on the issue of whether there is a taking or not is similar to that in *Radford* in that the methodology is an exclusionary one. The Court starts by asking "If the government action is alleged to be an exercise of the police power, are the requisites for its validity present?" In other words, "Was due process afforded the aggrieved party?" If the law has a public purpose and is reasonable, it is declared as a valid exercise of police power. The law or government action, as will be observed in the cases, will be regarded as a taking only when the element of reasonableness is absent. In a much direct manner, it means that if the conditions of the law are unreasonable or arbitrary, a taking occurs which requires compensation. But remember that this methodology applies only when there is such an issue of whether the law is an exercise of eminent domain or of police power.

Proceeding from this perspective, *Radford*, in its rightful place, really involves the due process issue. It became regarded as a taking case because it found the elements of the Frazier-Lemke Act unreasonable. This is supported by the fact that in the subsequent case of *Vinton Branch*, the Revised Act was upheld as a valid exercise of police power because its terms were more reasonable than in the original Act. The key, therefore, in determining whether an act is a taking or mere regulation, is not the purpose of the law but the means employed in achieving such purpose.

The process, however, does not end here. If an act is considered an exercise of police power, one must, then, hurdle the next obstacle of the contracts clause. In this stage, the reasonableness of conditions is not enough to validly impair an obligation. Though the Court has affirmed the superiority of the police power over contracts, the contracts clause is not completely dead.

2. Balancing Conflicting Interests

To constitute a valid impairment, the purpose of the law must override or supersede the policy of protecting the sanctity of contracts. The Constitution gives examples of overriding considerations in the social justice provisions such as the protection of labor and the equitable diffusion of land under the agrarian and natural resources reform provisions. The question then is, "Is the policy of promoting rehabilitation enough to override the sanctity of the creditor-debtor agreement?" But to answer that, one must go deeper into the purpose and objective of the conflicting policies.

There is a difference in the primary purpose of rehabilitation in the eyes of Philippine and American courts. The trend in this jurisdiction is to pursue rehabilitation *"to restore and reinstate the corporation to its former position of successful operation and solvency,"* while in the American setting, it is *"mainly intended to provide creditors a better repayment scheme of their claims, not from the present property of the debtor, which are insufficient, but from future earnings of the business."*[115]

The Philippine trend is to place the business enterprise in the center of things. By business enterprise, the writer means all persons interested in the maintenance and profitability of the corporation, which includes all the shareholders, creditors, employees, and the general community. The Whereas Clauses of P.D. No. 902-A and its amending decrees provide that the goal of the decrees is to promote economic development and a more meaningful equitable diffusion of wealth. In America, the creditors, particularly the unsecured, are the focus and prime beneficiaries of the effort. However, with *Timbers*, the U.S. courts seem to have shifted their view.

The conflict of rights and policies is clearly seen in a rehabilitation proceeding. The stay seeks to promote the chances of successful rehabilitation by protecting the debtor-corporation from the harassment of claims of its creditors. The law assumes that maintaining the "going

115. Cesar L. Villanueva, *Revisiting the Philippine "Laws" on Corporate Rehabilitation*, 43 ATENEO L.J. 183, 234 (1999) [hereinafter Villanueva, *Revisiting*] (emphasis supplied).

concern" of the corporation, as opposed to straight liquidation, is more conducive to economic development. But in the process of promoting rehabilitation, the law must also not forget the equally important policy of protecting the integrity of the credit and security transactions system. Such policy undoubtedly also pursues the promotion of economic development and ultimately a more equitable diffusion of wealth for all. To promote one of the policies by stepping on the other is self-defeating. Thus, the concept of adequate protection is created to balance the two important State policies to achieve the twin goals of economic development and a more meaningful diffusion of wealth.

To explain this paternalistic attitude of "protecting the injured," one need only look at the Philippine Constitution and the history of the people. The Philippines, after *People v. Pomar*,[116] has never accepted fully the *laissez faire* philosophy. Article XII, Section 6 of the Constitution, a radical affirmation of the common good, recognizes the social function of private property:

> The use of property bears a social function, and all economic agents shall contribute to the common good, individuals and private groups, including corporations, cooperatives, and similar collective organizations, shall have the right to own, establish, and operate economic enterprises, subject to the duty of the State to promote distributive justice and to intervene when the common good so demands.

Interestingly, Section 6 (d) P.D. No. 902-A itself mentions the words "general welfare" or "general public" as standards for the continuation of the receivership or management committee, giving the inkling that the interest of the abstract "general public" may override the interests of the creditors whose interests are as real as can be.

The Filipinos' history of poverty and colonialism has also spawned an attitude of protectionism, always fearing and cautious of those who have the power to oppress or abuse. Somehow, this attitude has infected the debtor-creditor relationship. Instead of a symbiotic relationship, the trend in American and Philippine business environment has been a parasitic one. Debtors are using the remedies of bankruptcy and rehabilitation to fraudulently escape their creditors who are left holding the bag.

The purpose of the non-impairment clause, aside from preventing abuse by the State, is really a practical and necessary one -- to preserve order and prevent chaos. In the world of credit and security transactions, creditors will only lend if they have faith in a system which allows them to enforce their claims. If this confidence is destroyed, more businesses will go bankrupt because of the absence of capital to run their company. In turn, loss of business means greater unemployment. So the view that favoring the debtor

116. 46 Phil. 440 (1924).

in rehabilitation is better because it will result in the common good is erroneous since the policy of preserving creditor confidence also benefits the common good. If both profess to further the common good, then who must the law favor in case of conflict? To answer this, one must look at cases like *Blaisdell* and *Rutter,* which involved suspensions of claims akin to the stay order in rehabilitation, and *Agrix* which involved an invalid rehabilitation law.

B. *The Takings Issue: Problematic As Ever*

The issue of whether the stay is an act of eminent domain or of police power is important to resolve, not because of the presence or absence of just compensation, but because of the issue of extent of compensation. If the stay is an exercise of eminent domain, lost opportunity cost is compensable legally and not merely under equity. Although there is a line of decisions[117] which says that in determining the value of the property sought to be taken the present value or condition of the property at the time of the taking and not its potential for conversion to some other use must be used, there is also another line of cases[118] with a contrary view to which Professor Jacinto Jimenez believes to be the better rule.[119] In other words, future potential use is considered in the valuation of just compensation. This latter view, in addition, finds support in the modern view of taking in the United States, that the profit-making capacity of property has to be compensated. The Philippine cases discussed hereunder follow this modern view of taking.

If, on the other hand, the stay is an exercise of the police power, generally, compensation, including lost profit,[120] is not required especially if the property involved is a nuisance. However, in case of impairment of contracts, the presence or absence of compensation for lost opportunity costs is the standard for the law's reasonableness. Later, it will be seen that lost opportunity costs will be required either way, the differences being the manner of enforcement and the time when it may be granted.

117. Manila Electric Company v. Tuason, 60 Phil. 663,668 (1934); Municipality of Sagay v. Jison, 104 Phil. 1026, 1033 (1958); Republic v. Juan, 92 SCRA 26, 55 (1979); and National Power Corporation v. Court of Appeals, 129 SCRA 665, 674 (1984).

118. City of Manila v. Estrada, 25 Phil. 208, 215-16 (1913); City of Manila v. Corrales, 32 Phil. 85, 98 (1915); Garcia v. Court of Appeals, 102 SCRA 397, 608 (1981).

119. Jacinto Jimenez, *Taking Private Property for Public Purpose,* 45 ATENEO L.J. 1, 41 (2001).

120. *See* Ermita Malate Hotel and Motel Operators Association Inc. v. Mayor of Manila, 20 SCRA 849 (1967).

1. Distinguishing Eminent Domain from Police Power

The power of eminent domain is recognized as an inherent and inalienable aspect of government, without which no government can survive. Justice Story calls it as the ultimate right of the sovereign to appropriate, not only the public but also the private property of all citizens within the territorial sovereignty for public purpose.[121] To validate the taking of property, just compensation must be awarded. Just compensation means "the just and complete equivalent of the loss which the owner of the thing expropriated has to suffer by reason of the expropriation."[122]

Another essential aspect of government, considered as the most powerful and pervasive of powers, is police power. Chief Justice Shaw defined police power as

> [t]he power vested in the legislature by the constitution to make , ordain, and establish all manner of wholesome and reasonable laws, statutes, and ordinances, either with penalties or without, not repugnant to the constitution, as they shall judge to be for the good and welfare of the commonwealth, and of the subjects of the same.[123]

Police power rests upon public necessity.[124] It usually deals with the public health,[125] public safety,[126] public morals,[127] and the promotion of the general welfare.[128] Every law enacted as an exercise of police power enjoys the strong presumption of legality.[129] Eminent domain is the taking by the government of private property for public use while police power is the regulation, by the government, of certain actions, offensive or injurious to the community, for the general welfare. While police power does not require compensation for any loss that may occur, the exercise of eminent domain will only be justified if the "injured" party is justly compensated.

Fr. Joaquin Bernas S.J., relying on well-established doctrines on eminent domain and police power in jurisprudence, states the rule to distinguish the exercise of the two powers by providing the rule that if property interest is appropriated and applied to public purpose, it is a taking. But if it is only

121. Charles River Bridge v. Warren Bridge, 11 Pet. 420, 641 (1837).

122. Province of Tayabas v. Perez, 66 Phil. 467, 469 (1938).

123. Ermita-Malate Hotel and Motel Operators Association Inc. v. Mayor of Manila, 20 SCRA 849 (1967).

124. U.S. v. Toribio, 15 Phil. 85, 97 (1910).

125. People v. Sabarre, 65 Phil. 684 (1938).

126. U.S. v. Villareal, 28 Phil. 390 (1914).

127. U.S. v. Giner Cruz, 38 Phil. 677 (1918).

128. Philippine American Life Insurance v. Auditor General, 22 SCRA 136 (1968).

129. Morfe v. Mutuc, 22 SCRA 424 (1968).

restricted because it will cause injury to the public interest, there is no taking.[130] Fr. Bernas also observes that what is common in the cases of *U.S. v. Toribio,*[131] *Seng Kee & Co. v. Earnshaw,*[132] and *People v. De Guzman,*[133] is that "while the regulation in question affected the right of ownership, none of the property interests in the bundle of rights which constitute ownership was appropriated for use by or for the benefit of the public."[134] Even if there is total deprivation, there is no taking because nobody else acquires use of the property or any property interest therein.[135] This view is more in line with the noxious use theory which allows destruction of property if it causes nuisance or danger to the public.

The rule above-stated makes the use by the public or by a person in behalf of the public as determinative of the kind of power exercised. When a claim of a creditor is suspended, he is deprived of the right to use and enjoy property which is supposed to be his. In the meantime, the debtor enjoys the right to possess and use, in behalf of the public interest of rehabilitation, property that is rightfully due his creditors.

It may seem that each of the two powers have their own niche in the legal system whereby a person may easily invoke any of the powers to justify a government action or defend a right of an individual. However, that reality is not readily available. The history of jurisprudence, both local and foreign, has delved into this subject matter, attempting to delineate the boundaries between the power of eminent domain and the police power. But views have changed from time to time depending on the court's inclination towards liberality or conservativeness. The purpose of adequate protection cannot be fully appreciated without reviewing the important American cases on taking which, in hindsight, gave life to the concept.

2. The Different Faces of the Takings Clause

There are four generally accepted theories to determine when a taking occurs in the exercise of eminent domain:

1. The *diminution of value theory* where the criterion is the extent of loss, i.e. if the profit-making capacity has been severely reduced;

130. JOAQUIN G. BERNAS, S.J., THE 1987 CONSTITUTION OF THE REPUBLIC OF THE PHILIPPINES: A COMMENTARY 376 (1996).

131. 15 Phil. 85, 92 (1910).

132. 56 Phil. 204,214 (1931).

133. 90 Phil. 133, 136 (1951).

134. BERNAS, *supra* note 130, at 380.

135. *Id.*

2. The *invasion theory* where the question to be asked is whether or not the government has formally taken possession and title of the condemned property;

3. The *noxious use theory* which defines activities as socially undesirable and therefore as non-property; and

4. The *cause of the harm test,* which assumes that in case of conflicting activities between neighboring owners, one can be identified as causing harm to the other.[136]

a. Pre-*Pennsylvania Coal*

The United States Supreme Court, in its earlier years, mostly relied on the invasion and noxious use theories to solve a takings issue. In the early case of *Pumpelly v. Green Bay Co.,*[137] the Supreme Court ruled that for there to be a taking, there must be actual physical invasion of the property. Without the element of "actual physical invasion," the injury caused is not compensable. Four years later, the Supreme Court applied another theory, namely the noxious use theory, in *Mugler v. Kansas.*[138] The Court ruled that the difference between eminent domain and police power is one of *kind*, not *degree.* As long as a law is enacted for the public benefit, such is a valid exercise of police power. Justice Harlan explained further that

> [a] prohibition simply upon the use of property for purposes that are declared, by valid legislation, to be injurious to...the community, cannot, in any just sense, be deemed a taking or an appropriation of property for the public benefit....The exercise of the police power by...the prohibition of [property's] use in a particular way, whereby its value becomes depreciated, is very different from taking property for public use, or from depriving a person of his property without due process of law.[139]

These two theories, for many years, were found sufficient in deciding a case with a takings issue, until *Pennsylvania Coal Co. v. Mahon.*[140]

b. *Pennsylvania Coal Co. v. Mahon*

Pennsylvania Coal, through Justice Holmes, added the "difference in degree" or the diminution of value theory. Justice Holmes could not accept that injury to property or property rights caused to private individuals are not compensable if no actual physical invasion occurred. He goes on to say that

136. Joseph L. Sax, *Takings, Private Property, and Public Rights,* 81 YALE L.J. 149, 151 (1971).

137. 80 U.S. 166, 177-78 (1871).

138. 123 U.S. 623 (1887).

139. *Id.* at 668-69.

140. 260 U.S. 393 (1922).

"while property may be regulated to a certain extent, *if regulation goes too far, it will be recognized as a taking*."[141] One factor in determining when a regulation has "gone too far" is the extent of diminution in value of the affected property. This ruling puts a new dimension, easily recognized by modern readers, in the takings issue, that it is the extent of injury to the property that will be crucial and not the actual physical taking by the government. Fr. Bernas adopts the *Pennsylvania Coal* doctrine when he says "[n]either acquisition of title nor total destruction of value is essential to taking."[142]

According to the dissent of Justice Brandeis, who was the *ponente* of *Radford* and *Mountain Trust Bank*, police power is limited only by two requirements: (1) that it cannot have the effect of physically seizing or invading private property (*Pumpelly/Mugler* Test); and (2) that the purpose of the law is the protection of the public and it must consist of a scheme related to this goal.[143] In other words, Justice Brandeis deemed it sufficient to use the *Pumpelly* or the *Mugler* tests only. He added that "the purpose of a restriction does not cease to be public, because incidentally some private persons may thereby receive gratuitously valuable special benefits."[144]

However, in *Village of Euclid v. Ambler Realty Co.*, Justice Holmes and Justice Brandeis, co-writers of the decision, upheld the ordinance of a comprehensive municipal zoning as a valid exercise of the police power despite diminutions of up to 75 percent of the value without mentioning *Pennsylvania Coal*.[145] While in *United States v. Causby*, overflights of property by airplanes were considered as partial takings even if the loss was of much smaller value than in *Euclid*. The Court held that "invasions of [airspace] are in the same category as invasions of the surface."[146].

Another dimension in the takings issue appeared in the famous case of *Penn Central Transportation Co. v. City of New York*.[147] The owner of the Grand Central Terminal was prohibited from constructing a multi-story building to preserve a historic landmark. The owner was allowed compensation to mitigate the loss. The Court said that to determine whether a taking has occurred, one has to consider "the extent to which the regulation has interfered with distinct investment-backed expectations."[148]

141. *Id.* at 413 (emphasis supplied).

142. BERNAS, *supra* note 130, at 370.

143. 260 U.S. 393, 417 (1922).

144. *Id.* at 417-18.

145. 272 U.S. 365, 384 (1926).

146. 328 U.S. 256, 265 (1946).

147. 438 U.S. 104 (1978).

148. *Id.* at 124.

To contrast *Pennsylvania Coal* with *Penn Central*, *Pennsylvania Coal* uses the quantitative approach and asks, "How much of the value of the property has diminished?" while *Penn Central* uses the qualitative or the remaining-feasible-use approach and asks, "Whether or not there are any remaining profitable uses for the property as regulated?"[149]

The reason why the Holmesian test is more popular than the *Pumpelly* and *Mugler* tests is because the former comports with the public's notion of fairness. However, the Holmesian test is also too burdensome on government.[150]

According to Neal S. Manne, the original meaning of the takings clause supports the physical invasion test. The balancing approach of *the Holmesian test only puts into issue the wisdom of the law, which is beyond the scope of judicial review*. On the other side, the physical invasion test, aside from being a simple test, directly addresses the compensation issue. As long as there is actual physical invasion of property, it is compensable. Manne adds that "[t]he test surely does not yield absolute fairness in compensation, but, to the extent that it handles the most clearly compensable situations correctly, it is equitable."[151]

This thesis does not intend to weigh the wisdom of each theory on taking. The Holmesian approach, though criticized by some, remains to be the prevailing view; the Philippine Supreme Court approaches takings cases along the same view. If the Holmesian test were to be applied to the concept of adequate protection, even lost opportunity costs would have to be absolutely compensated.

c. Philippine Setting

In the Philippines, the case of *Republic v. Castellvi*,[152] citing American authorities, lays down the following elements of taking: (1) the expropriator must enter the private property; (2) the entrance into the private property must be for more than a momentary period; (3) the entry into the property should be under warrant or color of legal authority; (4) the property must be devoted to a public use or otherwise informally appropriated or injuriously affected; and (5) the utilization of the property for public use must be in such

149. Rogers, *supra* note 16, at 1024.

150. Neal S. Manne, *Reexamining the Supreme Court's View of the Taking Clause*, 58 TEX. L. REV. 1447, 1462 (1980).

151. *Id.* at 1465.

152. 58 SCRA 336 (1974).

a way as to oust the owner and deprive him of all beneficial enjoyment of the property.[153]

The elements in *Castellvi* are a curious mix of the *Pumpelly/Mugler* and *Pennsylvania Coal* tests because while there must be actual entry or appropriation of the property that actually ousts the owner of all beneficial use of the property, there can also be a taking when the property is "informally appropriated or injuriously affected." *Castellvi*, however, does not say how much injury is needed for a taking to exist.

Ansaldo v. Tantuico, Jr also adopts the ruling in *Causby* when it said that there is taking when the owner is actually deprived or dispossessed of his property or there is practical destruction or material impairment of the value of his property and he is deprived of the ordinary use thereof.[154]

The actual physical invasion theory was deemed abandoned in Philippine jurisprudence as shown in the case of *Republic v. PLDT*, which held that the interconnection of the government telephone system and of the PLDT system was an exercise of eminent domain requiring just compensation. The Court reasoned that eminent domain is not only the appropriating of the title to and possession of the expropriated property but also imposing a burden upon the owner of condemned property without loss of title and possession. It was considered as an easement of right of way for which the Civil Code requires compensation.[155]

In *People v. Fajardo*,[156] an ordinance prohibited the defendant from constructing a house in his lot because it would destroy the view and beauty of the public. The Court said that there was compensable taking even without transfer of title and that the prohibition was actually an easement on the property in which the public benefits so there was no need for compensation.

Also in *National Power Corporation v. Spouses Miseracordia Gutierrez*,[157] there was compensable taking even without the acquisition of title, because the limitation imposed on the kinds of plant to grow in one's land because of the height of the wires placed by NAPOCOR was found to be an unreasonable burden depriving the owner of all beneficial uses of his property.

153. Republic v. Castellvi, 58 SCRA at 350-52.

154. Ansaldo v. Tantuico, Jr, 188 SCRA 300, 304 (1990).

155. Republic v. PLDT, 26 SCRA 620, 628 (1969).

156. 104 Phil. 443, 448 (1958).

157. 193 SCRA 1 (1996).

In *Telecommunications and Broadcast Attorneys of the Philippines, Inc. (TELEBAP) v. COMELEC*,[158] television broadcasters like GMA corporation were obliged to provide COMELEC Time free of charge to candidates of the election. Petitioners contended that it was a taking requiring just compensation. In fact it was not a *de minimis* temporary limitation or restraint because it stood to lose up to 60 million pesos by giving free airtime. The Court rejected such contention and held that it was a valid exercise of police power: first, that a franchise is a mere privilege subject always to amendment for the common good;[159] second, that to promote the freedom of expression and the heightened awareness of the voting public, the rights of viewers and listeners prevail over the right of broadcasters;[160] and third, that since the petitioners did not own the airwaves or frequencies, but were merely being allowed their use by the government, no private property was taken.[161]

Justice Romero vigorously dissented. He echoed the view of Fr. Bernas that in the exercise of police power, there is a restriction of a noxious object or an intention for noxious purposes because every property owner holds it under the implied liability that use will not cause injury to others; while in the exercise of eminent domain, the property, which is wholesome as opposed to being noxious, is appropriated and applied to public purpose.[162] For Justice Romero, a regulation which deprives a person of the profitable use of his property constitutes a taking, impliedly rejecting the doctrine in *Andrus v. Allard*,[163] decided by U.S. Supreme Court, which said that the expectation to put property to its most profitable use is not constitutionally protected. He also said that the case essentially involved an imposition of a right of way which is traditionally considered as a taking requiring compensation.[164]

In summary, the Philippine Supreme Court has, most of the time, considered injury caused to private property by the government, when the property concerned is not considered a nuisance or danger to the community, as determinative of the exercise of eminent domain, and thus requiring just compensation.

In the stay, the creditors' rights are merely regulated for a valid purpose. Adequate protection acts not as just compensation but as an element of

158. 289 SCRA 337 (1998).

159. *Id.* at 347.

160. *Id.* at 349.

161. *Id.*

162. *Id.* at 365.

163. 444 U.S. 51 (1979).

164. TELEBAP, 289 SCRA at 374.

reasonableness in the conditions imposed. Such protection only ensures that the status of the secured creditor at the time of the filing of the petition is not impaired. Therefore, if no adequate protection is provided, the law becomes an invalid taking.

One also can observe in this line of cases that if a law purporting to be an exercise of police power imposes unreasonable conditions or burden, the government action becomes a taking. What is unreasonable has to be seen in the light of the particular circumstances.

Significant to note is the ruling in the *TELEBAP* case which upheld the law as a valid exercise of police power even if it meant losing millions to the aggrieved party. The conditions in the law were found to be reasonable since television broadcasters did not have an exclusive and vested right over the air waves or frequencies. Thus, the Court concluded, no private property was taken. This circumstance is absent in the case of the stay where a creditor's property right is undoubtedly a vested and exclusive right. Moreover, the right to information, a corollary right to the right to expression as found in the *TELEBAP* case can easily override the broadcasters' right to profit which is a mere property right. But in the case of the stay, both conflicting rights are property rights so a more exacting balancing test is required. One should not be hasty, however, to conclude that the stay is a taking. The reasonableness of the stay prevents it from becoming an undue taking, a principle that can be seen in the *Agrix* case and cases concerning suspension of payments which are to be discussed in the next part, since rehabilitation is but a specie of the latter. The reasonableness of the conditions imposed by the law is based on substantive due process, that it be neither arbitrary nor oppressive and the primary policy in the business world of enhancing the integrity of the credit and security transactions system.

In *PLDT*, a burden was imposed on the private property of respondent. The easement is itself a property right like PLDT's right to profit. Absent the particular circumstances in *TELEBAP*, the burden imposed had to have some form of compensation to become reasonable. *PLDT*, like *Radford*, became a takings case because it did not pass the due process requirement of reasonableness. Thus, in certain cases like *Radford* and *Blaisdell*, where both the issues of taking and non-impairment are relevant, the fact of compensation becomes a factor in the condition of reasonableness. The only point then in determining the nature of the government action in cases like *Radford* is not the fact of compensation but its extent, and this is where *Timbers* enters.

V. EXTENT OF "ADEQUATE PROTECTION"

A. *Depreciation and Lost Opportunity Costs*

It is clear both in the Bankruptcy Code and in the Interim Rules, that when either periodic cash payment or maintenance of the property are issued as adequate protection under the first two modes, the secured creditor's interest in the collateral is only up to the value of the collateral. Thus, payments made to the creditor or payments for maintenance of the collateral cannot exceed the extent of depreciation of the property. In other words, the secured creditor is only entitled to adequate protection only up to the value of his collateral. Rule 4, Section 12, in part says "[u]pon showing of a lack of adequate protection, the court shall order the rehabilitation receiver to: (a) make arrangements to provide for the insurance or maintenance of the property, or (b) to make payments or otherwise provide additional or replacement security such that the obligation is fully secured." Clearly, adequate protection in these cases exclude lost opportunity costs.

However, such clarity is absent when it comes to an action by an undersecured creditor against property necessary for rehabilitation. Rule 4, Section 12 of the Interim Rules provides as one of the grounds for relief from stay, "the debtor's secured obligation is more than the fair market value of the property subject of the stay and such property is not necessary for rehabilitation of the debtor." To avail of this ground, two conditions are mandatory: first, the creditor is undersecured; and second, the property is not necessary for rehabilitation. If the creditor is undersecured but the property is essential for rehabilitation, relief from stay will generally not be granted. The creditor's remedy is to ask for adequate protection. An undersecured creditor may feel that he is entitled to compensation not only for depreciation but also for the period when he is unable to use the collateral in more profitable ways. The opposing view, on the one hand, says that the undersecured creditor is only entitled to adequate protection for depreciation consistent with the interpretation of the first two modes of adequate protection. The undersecured creditor may then invoke *Murel* where it was held that adequate protection includes loss opportunity costs. Before *Timbers* settled the issue, several Circuit Courts tackled the same issue with different results.

The discussion of the following U.S. cases is significant because Philippine courts might fall into the trap of blindly following applicable and relevant American cases in the interpretation of local rehabilitation laws. The Interim Rules was patterned, with some modifications, after U.S. Reorganization Laws. The provisions on relief from stay and adequate protection in the Interim Rules remain true in spirit to the Bankruptcy Code. Considering the similarity, Philippine courts may strictly apply *Timbers* in the interpretation of the extent of adequate protection. By showing the different Circuit Court rulings, a better understanding of

Timbers might be gained; thus, challenging the local courts in fashioning the proper extent of adequate protection in the Philippine context.

1. American Mariner

The first of these cases is *In re American Mariner,*[165] which came out in 1984. In this case, Crocker, an undersecured creditor of American Mariner, a corporation under rehabilitation, filed a motion for relief from stay claiming that he was entitled to adequate protection in the form of monthly payments "equal to [his] prospective return from reinvestment of the liquidation value of the collateral."[166] The court decided in favor of Crocker and held that the debtor must compensate its undersecured creditors for delay in the exercise of his rights.[167] The amount of this compensation, according to the court, must be equal to the amount the creditor could have made if he were able to foreclose on the collateral and reinvest the proceeds at the market rate.[168]

The court arrived at this conclusion by literally interpreting the phrase "the value of [a creditor's] interest in the property" as extending to all the creditor's rights in the collateral, including the right of foreclosure and sale and not only protection from a decrease in the value of the collateral itself.[169] The court also relied heavily on legislative history which stated that the purpose of adequate protection is to ensure that the secured creditor receives the benefit of his bargain.[170] Moreover, the court cited Judge Hand's statement in *Murel* that adequate protection must include protection against loss occasioned by time.[171]

2. *Briggs* and *Grundy*

Shortly after *American Mariner,* the Fourth Circuit came out with *Grundy National Bank* which essentially followed the *American Mariner* doctrine. The Eighth Circuit, however, in *In re Briggs Transportation Co.*, tempered *American Mariner* by limiting postpetition interest payments only when justified by the equities of the case. The *Briggs* court said that there was no intention on the part of Congress to provide protection that would be "impossible or seriously detrimental to the policy of the bankruptcy laws."[172]

165. 734 F. 2d 426 (9th Cir. 1984).

166. *Id.* at 427.

167. *Id.* at 435.

168. *Id.*

169. *Id.* at 429-30.

170. *Id.* at 431.

171. *Id.* at 432-34.

172. *In re* Briggs Transportation, 780 F. 2d 1339 (8th Cir. 1985).

The court also recognized the fact that the essence of the creditor's bargain is not necessarily the right to foreclosure,[173] and suggested that the essence may be the full payment of the debt up to the lien value of the collateral.[174] To justify the award of postpetition interest to undersecured creditors, the court must consider the parties' reasonable expectations in the bargain, the effect of taxes, and the chances of successful rehabilitation.[175]

3. *In re* Timbers by the Fifth Circuit

American Marincr was expressly and absolutely repudiated in *In re Timbers of Inwood Forest Associates, Ltd.* decided by the Fifth Circuit. This court ruled that undersecured creditors are not entitled to payment of postpetition interest caused by the delay in rehabilitation proceedings as part of their adequate protection.[176] The attempt to foreclose on the collateral, however, was stayed by Timber's filing of a petition for rehabilitation. United filed a motion for relief from stay alleging lack of adequate protection and invoking *American Mariner* to receive periodic payments equal to the value he would have received if he were able to foreclose and reinvest the proceeds at the market rate.[177]

The court, acting through Judge Randall, flatly rejected United's claim and completely diverged from *American Mariner.* Judge Randall concluded that the secured creditor's bargain does not include the right to postpetition interest, but only the right "to receive the collateral or its value upon default."[178] He added that Congress only intended to give protection against the misuse and depreciation of the collateral,[179] therefore, there was no legal or constitutional justification for compensation merely for delay.

Aside from legislative history, the court also cited policy considerations in support of its decision. First, it said that following *American Mariner* would disrupt orderly bankruptcy proceedings because requiring payment of interest in addition to payments for depreciation allowable under the first mode of adequate protection, would roughly equal the payments of principal and interest that the debtor had been making before rehabilitation. This is nearly impossible since in the first place, the debtor, by filing the petition for rehabilitation, acknowledges that he is unable to make such payments. In

173. *Id.*

174. *See* Note, *"Adequate Protection" and the Availability of Postpetition Interest to Undersecured Creditors in Bankruptcy*, 100 HARV. L. REV. 1106, 1111 (1987).

175. *In re* Briggs Transportation, 780 F. 2d 1339, 1349.

176. 793 F. 2d 1380, 1382.

177. *Id.* at 1383.

178. *Id.* at 1397.

179. *Id.* at 1398-400.

addition, allowing claims for postpetition interests would open the floodgates to a race of diligence that the stay was supposed to suppress.[180] Another problem with *American Mariner* is that it would conflict with the Bankruptcy Code's policy of not allowing substantial assets to leave the estate before a finding of all relevant facts for the proper distribution of the remaining assets.[181] Finally, paying postpetition interest would shift the risk of a failed reorganization onto unsecured creditors, contradicting Congress' intention of putting some risk that the reorganization would fall on secured creditors.[182]

Requiring the payment of postpetition interests caused by delay, undermines the policy of promoting rehabilitation and the procedural requirement that the proceeding be speedy and summary in nature.[183] Payments of such sum would only induce every unsecured creditor to file a motion for relief from stay rendering useless the stay order.[184] Moreover, payment before the close of the proceedings would most probably cause the transfer of funds to creditors, who do not have first claim to them, since before the proceedings end, the creditors' priority in payment is not yet clearly established.[185]

Aside from depleting much needed resources, such payments will also increase the shift of the risk of loss resulting from a failed reorganization from the secured to the unsecured creditors, who already bear most of the risk.[186] This reason is criticized by the view which says that the costs of rehabilitation should necessarily fall on those who will benefit from a successful rehabilitation; that there is no rhyme, reason or logic in shifting the burden of rehabilitation upon secured creditors who are already protected by their lien on specific corporate property.

Another reason by the court is that the process of valuation of lost opportunity cost will also delay the process further.[187] According to the court, *American Mariner's* reasoning — that payment of postpetition interest would ensure that creditors receive the equivalent of what they would have received had they exercised their lien enforcement rights — is faulty since throughout the history of bankruptcy in the U.S., "stays have existed

180. *Id.* at 1408-09.

181. *Id.* at 1409-10.

182. *Id.* at 1410-11.

183. *Availability of Postpetition Interest, supra* note 174, at 1119.

184. *Id.*

185. *Id.*

186. *Id.* at 1120.

187. *Id.*

precisely in order to prevent creditors from getting what they would have gotten by exercising state lien enforcement rights."[188]

Timbers relies on *Sexton v. Dreyfuss*[189] and *Vanston Bondholders Protection Committee v. Green.*[190] Both cases, in short, said that allowing payment of postpetition interest in favor of one creditor would be inequitable to other creditors. *Vanston,* quoting *Thomas v. Western Car Co.*,[191] said that the

> Exaction of interest, where the power of a debtor to pay even his contractual obligations is suspended by law, has been prohibited because it was considered in the nature of a penalty imposed because of delay in prompt payment – a delay necessitated by law if the courts are properly to preserve and protect the estate for the benefit of *all* interests involved.... [T]he delay in distribution is the act of the law; it is a necessary incident to the settlement of the estate.

Nicholas v. U.S.[192] reiterated the *ratio* in *Sexton* and *Vanston,* saying that "inequity [would result] if through the continuing accumulation of interest in the course of subsequent bankruptcy proceedings, obligations bearing relatively high rates of interest were permitted to absorb the assets of a bankruptcy estate whose funds where already inadequate to pay the principal of the debts owed by the estate."[193]

The view that *Timbers* produces inequity because only oversecured creditors are entitled to postpetition interest under Section 506 of the Bankruptcy Code deserves no merit. This is because the reason for the rule barring payment of postpetition interest is inapplicable in the case of oversecured creditors. The oversecured creditor is only entitled to postpetition interest "only to the extent that the principal of the debt plus accrued interest [does] not exceed the value of the collateral securing the debt and the interest."[194]

In re Timbers was reaffirmed on rehearing. Upon its elevation to the U.S. Supreme Court, it again was affirmed unanimously.

188. *Id. See e.g. Ex parte* Christy, 44 U.S. 292, 312 (1845).

189. 219 U.S. 339, 344 (1911).

190. 329 U.S. 156, 163 (1946).

191. 149 U.S. 95, 116-17 (1893).

192. 384 U.S. 678, 686 (1966).

193. *Id.* at 683-84.

194. 793 F. 2d 1380, 1386 (5th Cir. 1986).

4. *Timbers* of Inwood Forest as Affirmed by the United States Supreme Court

Justice Scalia, delivering the opinion of a unanimous Court, summarized the merits of denying postpetition interests to undesecured creditors and at the same time pointed the flaws in *In re American Mariner.*

a. Pre-Code Rule on "Interest in Property"

Justice Scalia said that the "interest in property" entitled to protection does not include a secured party's right to immediate foreclosure for a contrary view contradicts Section 506 which codifies the pre-Code rule denying undersecured creditors postpetition interest on their claims.[195] Section 506 defines the amount of the secured creditor's allowed claim and the conditions in receiving postpetition interest. The relevant part of said provision reads as follows:

> (a) An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property. . . . and is an unsecured claim to the extent that the value of such creditor's interest... is less than the amount of such allowed claim.
>
> (b) To the extent that an allowed secured claim is secured by property the value of which . . . is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

Subsection (a) means that the secured creditor's "interest in property" is his security interest without taking account of his right to immediate possession of the collateral on default. Justice Scalia explains that "[i]f the latter were included, the "value of such creditor's interest" would increase, and the proportions of the claim that are secured and unsecured would alter, as the stay continues - since the value of the entitlement to use the collateral from the date of bankruptcy would rise with the passage of time."[196]

Subsection (b) permits postpetition interest to be paid only out of the "security cushion," the undersecured creditor, who has no such cushion, falls within the general rule disallowing postpetition interest. Justice Scalia adds,

> If the Code had meant to give the undersecured creditor, who is thus denied interest on his claim, interest on the value of his collateral, surely this is where that disposition would have been set forth, and not obscured within the "adequate protection" provision of 362(d)(1). Instead of the intricate phraseology set forth above, 506(b) would simply have said that

195. 484 U.S. 365, 367.

196. *Id.* at 368.

> the secured creditor is entitled to interest "on his allowed claim, or on the value of the property securing his allowed claim, whichever is lesser."[197]

Section 506(b)'s denial of postpetition interest to undersecured creditors merely codified pre-Code bankruptcy law. The denial was part of the "conscious allocation of reorganization benefits and losses between undersecured and unsecured creditors. To allow a secured creditor interest where his security was worth less than the value of his debt was thought to be inequitable to unsecured creditors."

Petitioner also alleged that the use of the phrase "indubitable equivalent" in Section 361 (3) meant that Congress intended to use the meaning it had in *Murel.* The Court dismissed such argument saying that the use of the phrase in *Murel* was in the context of cram down, thus, the Best Interests of Creditors required compensation for interest if the claim were to be paid over time.

b. Difference in Context

In the context of *Timbers* however, the phrase was used in adequate protection during the stay only. The Court goes on to say that the source of the right in Section 1129, or the cram down provision, is not the "indubitable equivalent" language but the provision guaranteeing payments of a value, "as of the effective date of the plan," equal to the value of the collateral. In other words, postpetition interest is given in the context of cram down, not because of the use of the phrase "indubitable equivalent," but by the provision guaranteeing payments of a value, "as of the effective date of the plan," equal to the value of the collateral. This provision was drafted in order to penalize the debtor who delays payment according to the plan.

Finally, when petitioner invoked legislative discussion saying secured creditors should not be deprived of the benefit of their bargain, the court brushed aside this argument by saying that general statements in the legislative history are inadequate to overcome plain textual indication.[198]

In summary, *Timbers* denies secured creditors who have no "equity cushion," namely undersecured and fully secured creditors, adequate protection to the extent of lost opportunity cost. Their adequate protection extends only up to the depreciation caused by the stay. On the other hand, oversecured creditors, or those who have an "equity cushion," are entitled to greater extent of adequate protection. Aside from depreciation cost, which all secured creditors are entitled to, oversecured creditors are also

197. *Id.* at 369.

198. *Id.* at 370.

entitled to lost opportunity cost up to the extent of their "equity cushion." *Timbers* came to this conclusion by looking at legislative history in construing the relevant provisions of the law. It interpreted the Bankruptcy Code as continuing the pre-Code rule denying undersecured creditors postpetition interest on their claims. It also added that granting postpetition interest to secured creditors without an "equity cushion" would unduly dissipate the remaining assets of the debtor that may be used in the rehabilitation.

5. Flaws in the "Completely Compensatory Theory"

Those who believe in the wisdom of *Timbers* easily point out the flaws in the *American Mariner.* The two main flaws are the misinterpretation of the phrase "indubitable equivalence" in *Murel* and the destructive effect it will have on rehabilitation.

According to Judge Learned Hand in *Murel,* adequate protection must be "completely compensatory." In his own words:

> In construing so vague a grant, we are to remember not only the underlying purposes of the section, but the constitutional limitations to which it must conform. It is plain that "adequate protection" must be completely compensatory; and that payment ten years hence is not generally equivalent of payment now....We see no reason to suppose that the statute was intended to deprive [the secured creditor] of that in the interest of junior holders, unless by a substitute of the most indubitable equivalence.[199]

The indubitable equivalent, therefore, is the value that the secured creditor would have received if he had an amount equal to the value of the collateral and was able to reinvest it. Unsatisfied with reasonable compensation sufficient to cover the interest of the creditor on the property, the "completely compensatory" view considers the time element of money and the myriad possibilities of investment.

Certain problems have been shown with the "completely compensatory" stand. For one, it undermines the "breathing spell" that the automatic stay was meant to provide by draining the available cash.[200] In other words, this view circumvents the stay because in effect, the debtor is not temporarily freed from the demand and claims of his creditors.

Another problem with the view is that it thwarts a voluntary settlement since the secured creditor will be completely compensated no matter what happens to the debtor.[201] It must be remembered that a voluntary settlement

199. Easing Restraints, *supra* note 108, at 432.

200. *Id.* at 433.

201. *Id.*

is always encouraged to avoid a long and tedious process and because the State knows well enough to leave business matters to businessmen.

A third problem is that it reintroduces the "race of diligence" sought to be avoided by the stay in the first place. Since the debtor's assets are already limited, undersecured creditors will be scrambling to be the first to request for adequate protection.[202]

And last, if courts provide undersecured creditors with payments above the amount necessary to compensate them for economic depreciation of their collateral, the status quo between secured and unsecured creditors may be disrupted.[203] The stay was never meant to improve the position of one creditor over another; rather, it was meant to place all creditors, during the pendency of the stay, on equal footing.[204]

These problems flow from flaws in the application of the "completely compensatory" standard. First, *Murel's* definition of the term "completely compensatory" was based on Section 77B (b) (5) of the Bankruptcy Act of 1898 where adequate protection was required to confirm the debtor's reorganization plan over the objection of a secured creditor; thus, the latter must be protected from the harm caused by the debtor's underlying business failure. In contrast, Section 362 of the current Bankruptcy Code requires adequate protection in the context of the automatic stay – a temporary, stop-gap measure designed merely to preserve the status quo between the filing of a bankruptcy petition and the ultimate confirmation of a reorganization plan.[205] The former application of the "completely compensatory" scheme was only consistent with the principle of the Best Interest of Creditors, which requires that each dissenting creditor must receive not less than the amount he would have received in straight liquidation.[206]

6. The Danger of *Timbers*

Advocates of *Timbers* place the focus of rehabilitation on the debtor — a perspective the Philippine Supreme Court has used in its decision. According to this view, the primary goal of rehabilitation is to restore the corporation to its former position of successful operation and solvency.[207] Professor Cesar L. Villanueva criticizes this view when he says "[t]he salvation of the corporation and its business operations [is not] the end itself;

202. *Id.* at 434.

203. *Id.*

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

205. Easing Restraints, *supra* note 108, at 436.

206. Bankruptcy Code, § 1129 (a) (7).

207. Ruby Industrial Corp. v. Court of Appeals, 284 SCRA 445 (1998).

it only constitutes the means by which the stakeholders may best be able to protect their interests in the corporation."[208] He gives the example of *Ruby Industrial Corp. v. Court of Appeals*[209] to show how the SEC then had the tendency to disregard the choice of creditors in favor of stockholders of the corporation. In summary, he observes that:

a) The approval of the stockholders of a rehabilitation plan seem to carry more weight than the opposition thereto by the vast majority (in this case 90%) of the creditors of the corporation and against a rehabilitation plan endorsed and approved by such creditors;

b) The determination of the SEC as to which rehabilitation plan is best for the corporation overrides the interest and overwhelming opposition of the corporation's creditors and minority stockholders, and even key members of the management committee; and

c) The SEC and the Supreme Court give no special value to the key ingredient necessary to proceed with rehabilitation: that a rehabilitation plan must show that its adoption would lead to successful rehabilitation of the company and not end up in liquidation eventually.[210]

This criticism on the shift in the primary purpose and focus of rehabilitation, from credit repayment scheme to debtor "salvation" at all costs, also exists in the U.S. Professor Jackson criticizes *In re Timbers* of the Fifth Circuit for imposing the costs of reorganization on secured creditors who do not benefit from the reorganization rather than on debtors and unsecured creditors who may benefit from a successful rehabilitation.[211] It is true that requiring compensation for secured creditors for loss of collateral imposes costs, but such rule places the cost of rehabilitation on the parties who stand to benefit from it, particularly the unsecured creditors and shareholders.

7. When Should Postpetition Interest Be Paid?

While *Timbers* denied postpetition interest to undersecured creditors, it nevertheless clarified that oversecured creditors are still entitled to it as expressly provided in Section 506 (b). The amount of postpetition interest must however come from the "equity cushion" or the value of the collateral over and above the value of the obligation. However, *Timbers* did not expressly say when such interest must be paid.

208. Villanueva, *Revisiting, supra* note 115, at 236.

209. 284 SCRA 445 (1998).

210. *Id.* at 234.

211. JORDAN AND WARREN, *supra* note 18, at 743, *citing* JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAWS 189-90 (1986).

In 1995, *In re Delta Resources, Inc.*,[212] decided by the Eleventh Circuit, interpreted *Timbers* as not allowing payment of such interest to preserve the value of the "equity cushion" and that interest may be paid only after completion of the case. This ruling abandons the "equity cushion" rule which requires adequate protection even for decrease of the equity cushion since it is part of the creditor's interest in the property. The court held that the reasoning employed in *Timbers* applies equally to oversecured creditors, and requires that an oversecured creditor, while entitled to interest on its claim, is not entitled to current payment of that interest until the court has made a final determination of the creditor's secured status. Another reason for refusing to grant adequate protection in the form of periodic payments is that generally bankruptcy courts accept that a sufficient equity cushion may constitute adequate protection in itself.

Delta Resources is problematic because it fails to recognize that the "equity cushion" is not an accident but is part of the creditor's bargain. The usual bank practice is to undervalue a collateral 30 percent lower than its market value to safeguard from any depreciation. When the borrower agrees to this kind of valuation, the lender enjoys added protection which is part of his bargain. If *Delta Resources* is followed, the oversecured creditor may risk losing a portion of the debt. If the interest that accrues is taken from the "equity cushion", reducing it considerably, the oversecured creditor will become an undersecured creditor who is not anymore entitled to interest according to *Timbers*. Moreover, he will not be entitled to administrative expenses since he was not granted adequate protection that proved to be inadequate, giving an originally oversecured creditor less rights than the undersecured creditor.

Following both *Timbers* and *Delta Resources* creates problems for both the undersecured and the oversecured creditors. Though *Delta Resources* is merely persuasive in the U.S., *Timbers* is a precedent in the same jurisdiction. Considering how debtor-friendly the Interim Rules already is, local courts may follow both U.S. cases in deciding the same issue. Though *Timbers* offers valid policy considerations in favor of rehabilitation, the same must be tempered by policy considerations and constitutional limitations in favor of the creditor. The *Timbers* assumption is that the stay in rehabilitation is an act of police power requiring no compensation for lost opportunity costs. If *Timbers* were to be applied here, lenders who are gracious enough to grant undersecured loans will not be as trusting since in a case of rehabilitation, they will surely lose the time-value of money. To balance this situation, the proponent wishes to temper *Timbers* with *Blaisdell*, since, the Timbers doctrine has already been made applicable in this jurisdiction in the case of *Rutter v. Esteban*.

212. 54 F.3d 722 (11th Cir. 1995).

8. Possible Constitutional Attacks on Timbers

Timbers may be open to constitutional attacks regarding the denial of postpetition interest to secured creditors who have no "equity cushion" and the allowance of postpetition interest to all secured creditors in a cram down case. Both issues concern the equal protection clause.

a. Undue Denial of Postpetition Interest?

Secured creditors without an "equity cushion" may attack *Timbers* on the ground of a violation of the equal protection clause; but this may not succeed. While the equal protection clause guarantees the equality of all persons before the law, it does not prohibit legislation based on reasonable classification. For a classification to be reasonable, it must: (1) rest on substantial distinctions; (2) be germane to the purpose of the law; (3) not be limited to existing conditions only; and (4) apply equally to all members of the same class.[213]

For this writer, the classification made by *Timbers* is valid. There is a substantial distinction between oversecured creditors on the one hand, and undersecured and fully secured creditors on the other, *i.e.*, the existence of the "equity cushion" in favor of oversecured creditors. The purpose of the stay is to give the debtor a breathing spell from the claims of his creditors and to conserve the remaining assets for use in the rehabilitation. Granting postpetition interest, in addition to depreciation cost, to all secured creditors during the stay, will defeat the purpose of the stay. Granting postpetition interest to oversecured creditors will not make rehabilitation futile because only the "equity cushion" will be affected. If the accumulation of interests exceeds the cushion, the oversecured creditor will not anymore be entitled to immediate payment of interest.

The other three requirements for a valid classification are also met. The classification is germane to the purpose of the law in promoting rehabilitation. It is also not limited to existing conditions only. Finally, the classification applies equally to all members of the same class.

b. Adequate Protection in Cramdown

Adequate protection should be given in both periods of the stay and upon confirmation of the rehabilitation plan. However, *Timbers* realized that the extent of adequate protection in each is different. While delay is not compensable during the stay, it is compensable after the plan is confirmed.[214] Secured creditors prejudiced by this set-up may again raise the constitutional

213. People v. Cayat, 68 Phil. 12, 18 (1939).

214. Timbers, 793 F. 2d at 1402.

issue of equal protection before the laws. This will be without merit again because of a substantial distinction between the two instances.

In a cram down case, the rights and obligations of the debtor and his creditors are governed by the rehabilitation plan. Once all the standards for confirmation of the plan are satisfied, the parties are bound by the plan. The amount of each creditor's property right has been determined and set forth in the plan. The period and priority of payment of the obligations has also been determined. On the other hand, before a plan is confirmed, the rights of creditors have not yet been clearly established

Therefore, the danger of immediate payment of postpetition interest during the stay is the possible transfer of funds to creditors who do not have first claim to them, since before the proceedings end, the creditors' priority in payment has not yet been clearly established.

Nevertheless unlike *Timbers*, the proponent believes that interest should still continue to run in favor of all secured creditors as part of their adequate protection. But payment of such interest to undersecured and fully secured creditors will have to wait until the end of the proceedings because of the lack of the "equity cushion." Payment in full of such interest is also not absolutely promised; rather, it will be given the highest priority in payment.

B. *The Non-Impairment Clause and the Police Power: A Question of Superiority*

1. Philippine Stand on the Issue

In the Philippines, it has been widely held that the constitutional provision on non-impairment of contracts[215] has little or no value when it concerns the valid exercise of police power. Fr. Bernas says that

> with the acceptance of the superiority of police power over contracts, the contract clause now has very limited usefulness. It can be removed from the Constitution without substantive loss. The 1986 Constitutional Commission nevertheless decided to retain the clause for fear that removing it might fan fears and cause more economic instability.[216]

In the 1935 Constitutional Convention, Delegate Jesus Perez wanted to eliminate the contract clause because there was already the due process clause, to which Delegate Locsin added, that its elimination would benefit workers because of the stark reality that such workers were bound to service by inequitable contracts.[217] Delegate Francisco also desired to render explicit the limiting force of police power because of the 5-4 decision in *Blaisdell*

215. PHIL. CONST. art. III, § 10.

216. Bernas, *supra* note 130, at 393-95.

217. *Id.*

showing a weak affirmation of the police power. However, this was rejected because it might be construed as limiting it only to the contract clause.[218]

The obvious reason why the contract clause cannot override the valid exercise of the police power is the law of necessity or even the priority of State survival. But another reason why the obligation of contracts is easily brushed away is the hierarchy of rights recognized by the Constitution. The Supreme Court discussed the difference between human rights and property rights in the case of *Philippine Blooming Mills Employees Organization v. Philippine Blooming Mills Co. Inc.*:

> The superiority of these freedoms over property rights is underscored by the fact that a mere reasonable or rational relation between the means employed by the law and its object or purpose – that the law is neither arbitrary nor discriminatory nor oppressive – would suffice to validate a law which impairs property rights. On the other hand, a constitutional or valid infringement of human rights requires a more stringent criterion, namely existence of a grave and immediate danger of a substantive evil which the State has the right to prevent.[219]

When asked when a law impairs the obligation of contracts, the Supreme Court in *Clemens v. Nolting* said 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 a law which impairs the obligation of a contract and is null and void.[220]

However, this view has to be coupled with that in *Worthen v. Kavanaugh* decided by the U.S. Supreme Court, which said that "a different situation is presented when extensions are so piled up as to make the remedy a shadow."[221] There is an alteration of the rights of creditors when, for example, the amount of the principal, interest rates, maturity, form or amount of collateral are changed.[222] The *Nolting* definition of impairment of contracts is criticized as insufficient. This view that if only procedural remedies are changed or impaired, no impairment of obligation of contracts

218. *Id.*

219. Philippine Blooming Mills Employees Organization v. Philippine Blooming Mills Co. Inc., 50 SCRA 189, 202-03 (1973)

220. 42 Phil. 702, 712 (1922).

221. 295 U.S. 56, 62 (1935).

222. Villanueva, *Revisiting*, *supra* note 115, at 195, *citing* Epstein, Nickles & White, Bankruptcy 770 (1993).

occurs is circular. If the deprivation results in loss, or a real potential loss, to the secured creditor, it must be substantive.[223]

Home Building & Loan Assoc. v. Blaisdell decided by the U.S. Supreme Court as early as 1934 which in essence said that the superiority of police power over contract is meant to protect the obligation of contract itself. It held that:

> Not only are existing laws read into contracts in order to fix obligations as between the parties, but the reservation of essential attributes of sovereign power is also read into contracts as a postulate of the legal order. The policy of protecting contracts against impairment presupposes the maintenance of a government by virtue of which contractual relations are worth while - a government which retains adequate authority to secure the peace and good order of society.[224]

But in *National Development Co. and New Agrix v. Phil. Veterans Bank*,[225] the Court decided otherwise. It said that Presidential Decree No. 1717 ordering the rehabilitation of *Agrix*, extinguishing all mortgages and liens attaching to the assets of *Agrix*, and ordering that all unsecured obligations shall not bear interest and all accrued interests, penalties, or charges shall not be recognized, was held to be an invalid exercise of police power since there was no lawful subject and lawful means.[226] No important public interest was pursued because it only favored a special group of investors and no consideration was paid for the extinction of mortgage rights. Mortgage liens, interests on loans, penalties and charges, once they accrue, are property rights according to the Court.[227] Obviously targeting the dictatorial president who promulgated such decree, the Court went on to say that "[p]olice power is not a panacea for all constitutional maladies"[228] and for the police power to prevail, the contract must be "congenitally susceptible to change by the legislature in the interest of the greater number."[229]

Despite the difference in conclusions in *Blaisdell* and *Agrix*, their reasoning was the same. Conditions imposed in a rehabilitation law or a moratorium law, to be reasonable, have to preserve the status of the creditors at the commencement of the stay. In concrete terms, interest should continue to run and depreciation of collateral should be protected to achieve the former positions.

223. Rosenberg, *supra* note 3, at 523.

224. 290 U.S. 398, 435 (1934).

225. 192 SCRA 257 (1990).

226. *Id.* at 262.

227. *Id.* at 263.

228. *Id.* at 261.

229. *Id.* at 264, *citing* Stone v. Mississippi, 101 U.S. 814 (1879).

Agrix, thus, gives the view of what makes a rehabilitation law reasonable so as not to violate due process. Mortgages and liens may not be extinguished, unsecured obligations must continue to bear interests, and accrued interests, penalties and charges should be recognized. Notice the difference in wording. With regard to interests of unsecured obligations, interests shall continue to run, but with interests which have actually accrued or vested, they shall be recognized. Therefore, interests that have not yet accrued continue to run, but their payment is not absolutely assured in case of a failure in rehabilitation.

The reason why oversecured creditors are entitled to postpetition interest is because of the "equity cushion" they enjoy from which interest is deducted. Undersecured creditors enjoy no "equity cushion" from which interest may be taken and applied immediately to cover lost opportunity costs. Such interest also has not yet accrued before the filing the petition, so immediate payment is not mandatory. But even if no immediate payment is required, interest must still continue to run awaiting the sufficiency of the remaining assets of the debtor. This was lacking in *Timbers.*

In *Republic Planters Bank v. Agaña, Jr.,*[230] the Central Bank of the Philippines, because of petitioner's chronic reserve deficiency, prohibited the redemption of preferred shares because it would reduce the assets to the prejudice of the depositors and creditors. The Court upheld the decision of the Central Bank saying that the regulation was a valid exercise of police power to preserve the status quo and to prevent financial ruin of petitioner,[231] conditions and reasons strikingly similar to a rehabilitation proceeding.

2. Deference versus Judicial Review of Legislative Wisdom

American jurisprudence is also rich with cases involving the tug-of-war between the non-impairment clause and the police power. In a bird's eye view, the U.S. Supreme Court has progressed from the recognition of the power of the contract clause, to deference for the police power, again to a recognition of the greater "bite" of the clause, and now with a more refined respect for the police power. This cycle does not give any indication to the proponent of when the contract clause will again prevail. But there may really not be a cycle to speak of. What may really affect the trend of the decisions are the different public interests to deal with, whether they are serious enough to warrant a virtual destruction of certain property rights and the particular circumstances of the time.

230. 269 SCRA 1 (1997).

231. *Id.* at 12.

The original and major purpose of the contract clause was to restrain State laws affecting private contracts aiming primarily at debtor relief laws, although not intended to be limited to private contracts.[232] Examples of these laws are the postponement of the payment of debts and laws authorizing payments in installments. However, the first interpretation of the contract clause involved public grants, like franchises, rather than private contracts.[233] Justice Marshall in *Dartmouth College,* however, did not exclude the possibility of applying the contract clause to private contracts, like what happened in *Sturges v. Crowninshield* where the court declared unconstitutional a New York insolvency law discharging debtors of their obligations upon surrendering their property.[234] Thus, the Court found the concept of discharge as unconstitutional for impairing the obligation of contract.

Even after *Dartmouth,* many states still did not include adequate reservations of amending powers in corporate charters. This unwillingness was due to the *laissez faire* philosophy of the day and the Court's assurance in its earlier rulings that "the contracts clause would not be an inflexible barrier to public regulation,"[235] thus, there was no need to expressly include a reservation clause.

After *Sturges,* the Court in *Ogden v. Saunders* clarified that the *Sturges* decision only applied to retroactive insolvency laws; hence, the Legislature can still enact insolvency laws affecting contracts made *after* the law was enacted.[236] *Ogden* also clarified that the contracts clause did not prohibit legislative changes in remedies.[237] Chief Justice Marshall, also in *Ogden,* gave a reminder of why the contracts clause was included in the first place:

> The power of changing the relative situation of debtor and creditor, of interfering with contracts, a power which comes home to every man, touches the interest of all, and controls the conduct of every individual in those things which he supposes to be proper for his own exclusive management, had been used to such an excess by the State legislatures, as to break in upon the ordinary intercourse of society, and destroy all confidence between man and man. The mischief had become so great and so alarming that not only to impair commercial intercourse, and threaten

232. Fletcher v. Peck, 6 Cranch 87 (1810).

233. GERALD GUNTHER, CONSTITUTIONAL LAW (12TH ED.) 478 (1991). See Dartmouth College v. Woodward, 4 Wheat. 518 (1819).

234. 4 Wheat. 122 (1819).

235. Gunther, *supra* note 233, at 479-80.

236. 12 Wheat 213 (1827).

237. *Id.*

the existence of credit, but to sap the morals of the people, and destroy the sanctity of the private faith.[238]

The doctrine that procedural remedies are not immune from legislative fiat was affirmed in *Manila Trading v. Reyes*, where the Philippine Supreme Court said that: (1) there is no vested right in particular remedies; (2) the legislature may change existing remedies without impairing the obligations of contracts; and (3) the regulation of the security of mortgage may not be cut down in an oppressive manner.[239]

In *Blaisdell*,[240] the Court gave guidelines on when the exercise of police power that impairs contracts becomes valid. *First*, an emergency must exist. This first condition will only be applicable if property rights are impaired. If property is only regulated, but no substantial destruction occurs, this condition is no longer deemed valid because the Court has recognized that the State can exercise its police power even without an emergency. *Second*, the law must be addressed to a legitimate end, which can only mean that there must be a public purpose that is beneficial to the general welfare. *Third*, the relief must be appropriate to the emergency and granted only upon reasonable conditions. And *fourth*, the law or its effect must be temporary in nature.[241]

The most elusive of these conditions, as always, is the requirement of reasonableness. The Court found the Minnesota Mortgage Moratorium law, which suspended mortgage foreclosures and executions of real property, as constitutional because it did not impair the integrity of the mortgage indebtedness and the other rights of the mortgagee remained. Plus, the mortgagor was obliged to pay rental value to the mortgagee which is equivalent to possession.[242] In short, the Court found the conditions imposed reasonable because the relief was only for 30 days; the mortgagee was obliged to pay the rental value of the property; and the concern of the creditors was the protection of their investment security and not for the preservation of their home or for farming.[243]

It may be safe then to imply from the decision that conditions would be considered reasonable if: (1) the time of the suspension is adequate to achieve the purpose of the law and incurring the least amount of damage to the creditor; (2) a reasonable rent would be paid and interest will continue to run; and (3) the original rights of the mortgagee are preserved.

238. *Id.* at 354-55.

239. Manila Trading v. Reyes, 62 Phil. 461, 470 (1935).

240. 290 U.S. 398 (1934).

241. *Id.* at 444.

242. 290 U.S. 398, 425 (1934).

243. *Id.* at 444.

It must be clarified that *Blaisdell* did not assure the validity of all exercise of the police power. In fact, soon after *Blaisdell*, the U.S. Supreme Court struck down an Arkansas law exempting payments to insurance policies from garnishment.[244] In *United States Trust Co. v. New Jersey*,[245] decided in 1977, the Court, through Justice Blackmun, insisted that the modern interpretation of the contracts clause has not rendered it inutile. Justice Blackmun applied a dual standard in the application of the contracts clause by saying that when the State interferes with private contracts, such as those of secured creditors, the courts must "defer to legislative judgment as to the necessity and reasonableness of a particular measure."[246] But when it comes to interfering with the State's own obligation, a "complete deference to a legislative assessment of reasonableness and necessity is not appropriate because the State's self-interest is at stake."[247] Thus, though interference with either private or public contracts require both reasonableness and necessity to serve an important public interest, the validity or wisdom of the legislative intent or purpose of law interfering public contracts is not highly persuasive. In addition, Justice Blackmun rejected the view that the police power justified state interference so long as impairment of the prior obligation is not total.[248]

In the 1980s, there was a partial return to greater deference for the police power, particularly in *Energy Reserves Group v. Kansas Power & Light Co.*,[249] also interestingly penned by Justice Blackmun. The Court rejected the challenge of unconstitutionality of a Kansas law providing for a limitation for a price increase of the sale of natural gas, whereas in the contract between the parties, the price could be raised to match any governmentally fixed price that exceeded the contract price. The Court announced a three-step inquiry to determine the validity of a law interfering with contracts. First, whether the law substantially impaired the contract. There need not be complete destruction of the property and the court should consider whether the industry has been regulated in the past. Second, there must be a significant and legitimate public purpose such as remedying a social problem. There need not be an emergency according to *United States Trust Co.* And finally, there must be reasonable conditions appropriate to the public purpose. These conditions, though similar to *Blaisdell*, liberalized the latter by doing away with the requirement of an emergency.

244. Worthen Co. v. Thomas, 292 U.S. 426 (1934).

245. 431 U.S. 1 (1977).

246. *Id.* at 8.

247. GUNTHER, *supra* note 233, at 479.

248. United States Trust Co., 431 U.S. at 15.

249. 459 U.S. 400 (1983).

In *Norman v. Baltimore & O.R.R.*,[250] Chief Justice Hughes commented that "[c]ontracts may create rights of property, but when contracts deal with a subject matter which lies within the control of the Congress, they have a congenital infirmity. Parties cannot remove their transactions from the reach of dominant constitutional power by making contracts about them."[251] Rogers gives this example of the futility in asserting contract rights in violation of public policy or legislation:

> Suppose, for example, that a debtor and one of his unsecured creditors signed a contract providing that in the event of insolvency the claim of that particular creditor would be paid before those of all other creditors. If the debtor went bankrupt and the creditor came into bankruptcy court to enforce this contract, he would be met with hearty laughter; if he claimed that failure to enforce his agreement would violate the Constitution, the laughter would only increase. One simply cannot contract out the bankruptcy power.[252]

The Philippine case of *Rutter v. Esteban*[253] also dealt with a moratorium law, applying the conditions required by *Blaisdell* in determining the constitutionality of the law. *Esteban* first discussed that western civilization has been using moratorium laws for some 1,400 years now. It is essentially a postponement of the fulfillment of obligations adopted usually "during times of financial distress, especially when incident to, or caused by, war."[254]

To pass the test of constitutionality, such suspension has to be definite and reasonable because the application of the reserved power to protect the integrity of the government and the security of the people should be limited to its proper bounds and must be addressed to a legitimate purpose. Moreover, the impairment should only refer to the remedy and not to a substantive right.[255] Citing *W.B. Worthen v. Kavanaugh*,[256] *Esteban* ruled that an invalid impairment of remedy is the "oppressive and unnecessary destruction of nearly all the incidents that give attractiveness and value to the collateral security."[257]

The Court ruled in *Esteban* that the moratorium law is void for the following reasons: (1) the period of suspension of eight (8) years, added to

250. 294 U.S. 240 (1935); also known as the Gold Clause Cases.

251. *Id.* at 307-08.

252. Rogers, *supra* note 16, at 995.

253. 93 Phil. 68 (1953).

254. *Id.* at 72, *citing* 41 C.J.S. 213.

255. *Id.* at 75.

256. 295 U.S. 56, 62 (1934).

257. Rutter, 93 Phil. at 76, *citing* W.B. Worthen v. Kavanaugh, 295 U.S. 56, 62 (1934).

another four (4) years of war, was too long; (2) the debtor is not required to pay interest to the creditor who is unsecured during the operation of the relief; and (3) the improvement in the country's economy.[258]

Taking *Blaisdell* and *Esteban* together, for a law suspending claims against a debtor to be valid it must: (1) have a reasonable time to achieve the purpose of the law without being unduly oppressive to the creditor; (2) oblige the debtor to provide a reasonable rent for the time that the creditor is deprived of the use of the property and interest must continue to run; and (3) have an important public purpose that, in the long run, will be beneficial to all.

3. Bridging the Gap between Suspension of Payments and Rehabilitation

The stay in rehabilitation is essentially a moratorium of claims. The American view of the primary purpose of rehabilitation as a means for paying off creditors is more in line with the view of stay as a moratorium. It is seen in the Interim Rules that rehabilitation has been patterned in the mold of suspension payments. The SEC Rules of Procedure on Corporate Recovery provides that the debtor-petitioner for rehabilitation must either be "insolvent because its assets are not sufficient to cover its liabilities but which may still be rehabilitated"[259] or be technically insolvent, meaning that the temporary inability to pay will last for a period longer than two (2) years.[260] On the other hand, Rule 4, Section 1 of the Interim Rules expressly states that the debtor must not be insolvent but merely illiquid, thus, making the core of rehabilitation very similar to ordinary suspension of payments. In fact, rehabilitation is resorted to as an alternative to ordinary suspension of payments when the debtor fails to muster three-fifths (3/5) of its liabilities and two-thirds (2/3) of the number of its creditors to act favorably on the intention to delay payments.

4. Tempering of *Timbers*

Applying the conditions in *Blaisdell* to *Timbers*, the denial of postpetition interest may constitute an unreasonable condition invalidating such rule. In *Blaisdell*, two important factors why the law was held valid was because interest continued to run and rent was paid for the use of the property. The lack of running interest in *Rutter* was crucial in finding the law unreasonable. Therefore, a reasonable suspension of claims requires that interest continues to run and that rent is paid.

258. *Id.* at 81-82.

259. Interim Rules of Procedure on Corporate Rehabilitation, Administrative Memorandum No. 00-8-10-SC, Rule 4 § 1 (2000).

260. Interim Rules, Rule 3 § 12.

It is hard to reconcile *Timbers* and *Blaisdell* when both tackled analogous situations. Significant, however, is the fact that in *Blaisdell*, the law provided for running interest but did not in fact say that it should be paid during the stay. What was only to be paid at once was the rent.

In rehabilitation, the rent paid in *Blaisdell* is equivalent to adequate protection for the depreciation of the collateral since the rent answers for depreciation that results from actual possession of the collateral. The rent, therefore, was to neutralize the effects of taking as if no taking occurred.

The interest, on the other hand, answers for the time-value of the money or the lost opportunity cost. The law in *Blaisdell* allowed such interest to run, whether the creditor was oversecured or undersecured, but did not order its immediate payment probably realizing the fact that the debtor would be unable to satisfy it.

The proponent, points to an alternative that will preserve the policy considerations of *Timbers* and at the same time, affording a degree of adequate protection to the undersecured creditor. The postpetition interest of the undersecured creditor should be treated as an administrative expense priority, particularly as a superpriority that has to be paid before other administrative expenses. This method is reasonable since *Blaisdell* did not absolutely assure that interest will be paid in full at the end of the moratorium. Some of the sound reasoning in *Timbers* will also be preserved, particularly the realistic view of the debtor's inability to pay both depreciation costs and lost opportunity costs at the same time. This proposal does not convert or downgrade the specific lien on the collateral to mere preference over that particular portion, since, in the first place, the value of postpetition interest exceeds the value of the collateral.

C. *Administrative Expense Priority for Postpetition Interest*

1. Nature and Definition

The Interim Rules defines "administrative expenses" as those expenses incurred in the ordinary course of business of the debtor after the issuance of the stay order, excluding interest payable to creditors.[261] The definition in the Bankruptcy Code says that it includes "the actual, necessary costs and expenses of preserving the estate," like wages, salaries, taxes[262] but the same is open to judicial construction.[263] In order for a claim to be entitled to administrative expense status: (1) the claim must arise from a debt incurred after the petition is filed; (2) the claim must arise in connection with a

261. *Id.* at Rule 2, § 1.

262. Bankruptcy Code, § 503 (b)(1978).

263. Goatley, *supra* note 4, at 2173.

transaction between the claimant and the trustee or debtor in possession and in a business case; and (3) the claim must represent a debt incurred to benefit the operation of the debtor's business.[264] In the Bankruptcy Code, the issue of administrative expenses is important because a person who has an administrative expense claim is prioritized over other regular claimants.

What is notable in the Interim Rules is the interest payable to creditors is expressly excluded from the definition of administrative expenses. This may be interpreted as a virtual acceptance of *Timbers* or a total repudiation of the same. If the former construction is used, interest is not entitled to adequate protection. If the latter construction is used, interest is immediately payable during the stay period. This writer interprets the Rules as adopting *Timbers* since there was no substantial change or clarification with regard to the secured creditor's "interest in the property" in the relief from stay and adequate protection provision.

Generally, allowed administrative expense claims have the first distributive priority against the assets of the debtor at the end of the proceeding.[265] If the remaining assets are insufficient to cover all claims, all administrative expense claimants must be treated alike on a pro-rata basis.[266] But there is also the so-called "superpriority" status of administrative claims that have to be paid first in full before paying the regular administrative claims and other regular claimants.

There are two kinds of superpriority administrative expenses under the Bankruptcy Code: (1) if the trustee or debtor in possession is unable to obtain unsecured credit allowable under Section 503 (b) (1) as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt with priority over any and all administrative expenses; and (2) if the trustee or debtor in possession provides adequate protection of the interest of a secured creditor, and if, notwithstanding such protection, such creditor has a remaining unsecured claim arising from the stay of the action against the collateral, the creditor's claim has priority over every other claim allowable under § 507 (a) (1).[267]

Administrative expenses were originally intended as a form of adequate protection, but was later on deleted because, too often than not, the assets would be inadequate to meet all the administrative expense claims.[268] Now it is available only to those who received adequate protection that later proved to be insufficient. This is called superpriority.

264. 9A AM.JUR 2D *Bankruptcy* § 2279 (1984).

265. Bankruptcy Code, § 503 (b)(1978).

266. 9A AM.JUR 2D *Bankruptcy* § 2277 (1984).

267. *Id.* § 2278.

268. Goatley, *supra* note 4, 2174.

If the trustee provides adequate protection over the interest of a holder of a claim secured by a lien on property of the debtor and, notwithstanding such protection, such creditor has a claim allowable arising from the stay of actions against such property then such creditor's claim under such subsection shall have priority over every other claim allowable under such subsection. But in order to be entitled to superpriority, the creditor has to ask for adequate protection beforehand. Before such request, the debtor can keep using the property. This is in line with the policy favoring rehabilitation.[269]

The main reason why administrative expenses were taken out as a form of adequate protection was because the legislature deemed it as an inadequate form of compensation. For them, it was not enough to compensate a creditor at the end of the proceeding for the use of the collateral necessary for rehabilitation.

2. *In re* Yale Express

According to legislative history, the U.S. Congress, intended to codify *In re Yale Express*,[270] which found the granting of an administrative expense priority to the extent of the loss as sufficient protection. However, this was never placed as a form of adequate protection for it would be risky considering the possibility of not being able to pay all administrative expenses. In *Yale Express*, the court rejected the claim for rent for the use or reclamation of the equipment because it was deemed necessary to rehabilitate the corporation. In its own words, it said:

> [I]t is clear beyond cavil that the prospects of reorganization would be frustrated if the reclamation petition were granted. In fact, such success as Yale is now having stems largely from its use of the very equipment Fruehauf seeks to reclaim. While it is true that the trustee finds himself dependent upon Fruehauf trucks and trailers since he has replaced older vehicles with modern Fruehauf equipment, the trustee is charged with using his best business judgment to cure the ailing corporation. The replacement of old conveyances by new and more efficient ones is certainly in the interest of the company.[271]

Also, the court found that the goal of rehabilitation is not a mere "will-o'-the-wisp," giving wide discretion to the district judge in determining the feasibility of rehabilitation. In lieu of paying rent, the court added that "to such extent as Fruehauf has been damaged by the use of its property pending

269. *Id.* at 2176.

270. *In re* Yale Express, 384 F. 2d 990, 992 (2d Cir. 1967).

271. *Id.* at 991.

reorganization, it is entitled to equitable consideration in the reorganization plan."[272]

Despite the exclusion of *Yale Express* in the adequate protection provision, there may be some use to it with regard to lost opportunity costs. Significant is the fact that the court in *Yale Express* acknowledged the advantage of giving administrative expenses instead of immediate cash payment or maintenance of the property saying that "such success as Yale is now having stems largely from its use of the very equipment Fruehauf seeks to reclaim."[273] It is proposed, that to alleviate the strict application of *Timbers*, which the Supreme Court seems to have done in the Interim Rules, postpetition interest should still continue to run to satisfy the element of reasonableness as provided for in *Blaisdell*, but to be treated as an administrative expense superpriority to be paid in full ahead of other regular claimants. The proponent is aware of the reason why *Yale Express* was excluded from the Bankruptcy Code but this should not stop the proposal since the reason stated in the case is also to be remedied.

Legislature excluded *Yale Express* because it would be too risky to the secured creditor in case the plan failed and the assets were insufficient to pay all administrative expenses. That is why this paper also proposes to impose a stricter standard for continuing the stay. Instead of mere possibility of rehabilitation, as seen in *Timbers*, there should be proven probability of successful rehabilitation so as not to place too much risk on secured creditors. The Interim Rules is already too debtor-friendly for allowing solvent but illiquid corporations to petition for rehabilitation instead of the stricter requirement of creditor approval in ordinary suspension of payments. Allowing interest to run without immediate payment is only consistent with *Blaisdell*.

To the proponent, taking all these factors together, the proposal to treat postpetition interest as an administrative expense superpriority is reasonable to both the debtor who will benefit in more available assets for rehabilitation and the secured creditors who are protected by the stricter standard for continuing the stay and a priority to be paid in full over other claimants. Moreover, adequate protection for depreciation of the property is be paid immediately, consistent with purpose of maintaining the status quo of claimants upon the filing of the petition and the ruling in *Blaisdell* which made rent for the use of the property immediately payable. However, *Delta Resources* should not be followed. Oversecured creditors are entitled to interest to be paid immediately during the stay but only up to the value of his collateral. This will clearly not prejudice the chance for rehabilitation

272. *Id.* at 992.

273. *Id.* at 991.

since interest is only taken from the "equity cushion" which the oversecured creditor exclusively enjoys.

D. Collateral Changes

1. Feasibility Standard: Probability v. Possibility

A problem with *Timbers* is its liberal attitude in allowing rehabilitation at all costs. On the issue of whether to grant relief from stay, *Timbers* allows relief as long as the property is necessary for rehabilitation. The other condition that there be "effective reorganization" is left in the dark. The proponent submits that the two conditions for relief must be mandatory and strictly construed against the movant. The collateral subject of the motion should not be necessary for rehabilitation and at the same time the rehabilitation has no reasonable likelihood of success. Not every financially distressed corporation should be saved for it only drains more resources that can be used for more financially viable ventures. Significant is the fact that the Interim Rules omits the requirement of "reasonably effective reorganization" in the third ground of relief from stay. Rule 4, Section 12, in part only says that the property is "not necessary for the rehabilitation of the debtor."

In approving a rehabilitation plan, the standard of possibility of rehabilitation should be made stricter. Instead of possibility, which implies the slightest hint of a successful rehabilitation, the standard should be one of probability. The courts should consider the circumstances of each case particularly the importance of the industry and the effects of its liquidation upon the public. By making the standard stricter, the creditors will not be unduly burdened with the sacrifice that comes with the proceeding. In addition, to deter bad faith filings of rehabilitation petitions, serious criminal and administrative sanction should be imposed upon the management and other persons found guilty of the act.

2. Time is Of the Essence

Under Commercial Law, in contrast to Civil Law, the general rule is that "time is of the essence." The Interim Rules says that the proceeding shall be summary and non-adversarial. There should be serious penalties imposed on persons filing frivolous claims against the debtor that only wastes the energy and time of everyone. The period of rehabilitation should also be reasonable since if it takes to long, there is a strong presumption that it will not lead to a successful rehabilitation. In the United States, the regular period allowed is three years, extendible up to five years if circumstances warrant it. There is also the suggestion that the proceeding should only take months and not

years,[274] but to the proponent, this short period of time is unrealistic especially if the debtor is a large corporation.

Future legislation should also provide for such reasonable periods in order to weed out the dilatory petitions from the valid ones. Professor Del Castillo adds that if the rehabilitation is found to be futile, liquidation and distribution should immediately follow to save the remaining assets and to protect as much as possible the property interests of all concerned. Since the driving force behind *American Mariner* is the delay of the rehabilitation proceeding, it is essential to cut down the delay in order prevent unnecessary loss to creditors.

VI. Conclusion

Laws on corporate rehabilitation have become an essential aspect of the modern economic system. To regulate the conflicting rights of a distressed corporation to rehabilitate and of its creditors to collect, the law must be fair and reasonable, as all laws should be. In a developing country like the Philippines, the secured financing system should be encouraged because of its inherent efficiency. The credit and security system, as well as bankruptcy and rehabilitation laws, should give assurance to lenders that they will get the benefit of their bargain. This policy, however, has to be balanced with the policy of promoting rehabilitation of deserving debtors because of the central assumption that the going concern of a business is much more valuable than its liquidation value.

The Interim Rules, as it is, is already very debtor-friendly. With the *Timbers* decision, creditors may be further discouraged from granting loans because of the danger that they cannot collect postpetition interest. Since the stay imposed in rehabilitation is an exercise of police power, it must possess reasonable conditions. Strictly applying *Timbers* is, according to the conditions placed by *Blaisdell*, an unreasonable exercise of police power. Recognizing the valid and strong policy considerations pointed by *In re Timbers*, the proponent is hesitant to discard it completely. By treating postpetition interest as a superpriority administrative expense, adequate protection is afforded that portion. *In re Yale Express* possesses strong points even if it was excluded as a form of adequate protection. The risk that postpetition interest may not be recovered in full is reasonable enough considering *Timbers*, which absolutely denied undersecured creditors the right to any postpetition interest.

Adequate Protection is meant to maintain the status quo of the secured creditor at the time of the filing of the petition. A system which absolutely prohibits payment of postpetition interests is an unreasonable way of

274. *See* Timbers, 793 F. 2d at 1405-07.

protecting the secured creditor. Unsecured creditors knew very well from the beginning that they were unsecured and that secured creditors had a primary lien on specific corporate property. Both are fully aware and accept the position that the law gives them, so a rehabilitation system should not try to improve the lot of the unsecured creditors at the expense of the secured creditors who, in fact, entered into the secured transaction to hedge themselves from the debtor's possible insolvency. Downgrading the position of the secured creditor will undermine the integrity of the credit and security transactions system. If lenders see that secured transactions do not really give them protection, they would resort to making credit more expensive, thereby making insolvency a more likely consequence.

Finally, legislators should not be afraid to be more creative in planning new forms of adequate protection that better balance conflicting rights. The law cannot be static and must adapt to the changing business and economic environment to answer the needs of creditors and debtors alike.

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