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INSOLVENCY SYSTEMS IN ASIA: AN EFFICIENCY PERSPECTIVE

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Corporate Rehabilitation: the Philippine Experience

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CORPORATE REHABILITATION: The Philippine Experience

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INTRODUCTION

Corporate rehabilitation is defined nowhere. It is a remedy provided in PD 902-A, but the procedure on how to avail of it, or the relief that goes with it is not spelled out in the law either. Before the promulgation of PD 902-A, as amended, corporate rehabilitation was unheard of. The statute in force at that time, Act 1956 otherwise known as the Insolvency Law, did not provide for the rehabilitation of distressed corporations.

REMEDIES UNDER ACT 1956

A financially ailing corporation has two remedies under Act 1956 a law promulgated in 1909. The two remedies are (1) suspension of payments and (2) insolvency. The first was taken from the Spanish Code of Commerce while the second was based on the California Insolvency Act of 1895. Both remedies were under the jurisdiction of, and were administered by the regular courts.

Suspension of Payments

Under the first of the two remedies, a corporation which possesses sufficient property to cover all its debts but foresees the impossibility of meeting them when they respectively fall due, may petition the court that it be declared in the state of suspension of payments.[1] This remedy allows the corporation to propose to its creditors a moratorium on payments of their claims while the corporation is suffering from some liquidity problems. This remedy, however, is creditor-driven or creditor-controlled inasmuch as the creditors are the ones who will decide the fate of the proposal. The creditors will approve or reject it by taking a vote in a meeting of the creditors called for the purpose.

Upon receiving the petition, the judge shall issue an order calling a meeting of the creditors and forbidding the corporation from disposing in any manner of its property, or from making any payment, of whatever nature, except in the ordinary course of the corporation's

[1] Section 2, in relation to Section 52Act 1956, as amended

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business or industry.[2] From the filing of the petition and during the pendency of the application, no creditor may sue or institute any proceeding to enforce payment of his claim against the corporation.[3] Excluded from this injunction, however, are payments to creditors for personal labor, and creditors whose claims are secured by legal or contractual mortgages.[4]

In the meeting of the creditors, the terms and conditions of the moratorium being proposed by the corporation will be submitted to a vote. The presence of creditors representing at least three-fifths of the liabilities shall be necessary for holding the meeting while the affirmative vote of at least two-thirds of the creditors representing three-fifths of the total liabilities is needed to approve the proposed moratorium.[5] The proposal shall be deemed rejected if the number of creditors required for holding the meeting did not attend thereat, or if the two numbers required to approve it were not obtained.[6]

If the vote is favorable to the corporation, the court shall order the proposal to be carried out. On the other hand, if the decision of the meeting be negative, the proceeding shall be terminated without recourse and the creditors shall be at liberty to enforce their respective claims against the corporation.[7] In other words, the creditors are free to foreclose on the securities or continue with their enforcement suits.

Insolvency

Under Act 1956, an insolvent corporation may not avail of the remedy of suspension of payments. This is because the law has reserved such remedy exclusively to a solvent corporation. To obtain relief from its creditors, an insolvent corporation has only one option *i.e.* petition for insolvency. Under this remedy, an insolvent corporation may petition the court to be adjudged as an insolvent. In its petition, the corporation shall set forth its inability to pay all its debts in full, its willingness to surrender all its property to an assignee for the benefit of its creditors, and an application to be adjudged an insolvent.[8]

Upon the filing of the petition, the court shall make an order declaring the corporation insolvent and shall direct the sheriff to take possession of, and safely keep all property of the corporation until the appointment of a receiver or an assignee. The said order shall forbid the payment to the corporation of any debts due to it, the delivery to the corporation, or to anyone on its behalf, of any property belonging to it, and the transfer by the corporation of any of its property. The order shall also fix the time and place for the holding of the meeting of the creditors where they will choose the assignee of all the property of the corporation. Upon the issuance of said order, all civil proceedings pending against the insolvent corporation shall be stayed.[9]

This remedy, however, is a poison pill for the corporation to swallow. For while it stays all actions against it, the corporation will have to surrender all its property to its creditors leaving nothing for its stockholders to share or keep. And unlike in the case of individual debtors who are discharged from all their obligations upon their being adjudged insolvent, it is not so in the case of a corporation. The law expressly declares that the insolvent corporation is not discharged from its liabilities despite having paid all its property

[2] Section 3, *supra.*
[3] Section 6, *ibid.*
[4] Section 9 in relation to Section 6, *ibid.*
[5] Section 8, *ibid.*
[6] Section 10, *ibid.*
[7] Section 11, *ibid.*
[8] Section 14, in relation to Section 52, *ibid.*
[9] Section 18, *ibid.*

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to its creditors.[10] In this regard, the petition for insolvency does not provide any relief at all when the petitioning debtor is a corporation.

REMEDIES UNDER PD 902-A

Act 1956 did not provide for the rehabilitation of distressed corporations. This remedy may not have been conceivable in the early 1900's but it surely is much a part of the common business life of today.

This inadequacy of the remedies provided for in Act 1956 was one of the reasons behind the promulgation of PD 902-A. This law affords an ailing corporation three remedies, namely: (1) suspension of payments, (2) rehabilitation, and (3) dissolution.

Jurisdiction over these remedies is lodged by PD 902-A exclusively on the Securities & Exchange Commission, the government agency which has supervision over all corporations incorporated in the Philippines. These remedies are regulator-driven or SEC-controlled inasmuch as in the exercise of this exclusive jurisdiction, the SEC has taken the position that the provisions of Act 1956 are not applicable to these remedies.

Normally, the SEC should have adopted the rules to govern these proceedings. Unfortunately, or fortunately to some, the SEC has not been able to formally adopt a set of rules to implement these remedies. It maybe because very few distressed corporations have availed of these remedies since its inception; too few to prompt the SEC to adopt those rules. Or maybe it was because the circumstances of those corporations were so different from each other making the crafting of a uniform set of rules inadvisable if not totally impracticable.

In the absence of the formal rules, the SEC has dealt with the applications for the availment of these remedies on a case by case basis. In the process, an informal set of rules has evolved in the form of practice and precedents. To date, the SEC has simply promulgated a list of internal guidelines to guide its hearing officers in proceeding with the applications for the remedies. Every new problem that crops up in the proceedings is discussed by the Commission for the adoption of the corresponding policy directions.

Times have changed and so have the fortunes of many businesses in this country. Unfortunately to some, the change was not for the better. Many of our domestic corporations, especially those in the export sector and the real estate business, have been hardly hit by the recent regional economic crisis. The severe illiquidity in the financial positions of these corporations brought about by the sudden foreign exchange movements has caused a big number of them to incur default in their obligations. In fact, many of them have already been forced by their predicament to apply with the SEC for debt relief.

The sudden rise in their number, not to mention the huge amounts of money and the number of creditors involved, has brought to fore the issue of what procedure the SEC will follow in deciding their applications for debt relief.

Not surprisingly, the creditors have espoused the position that no debt relief should take effect without their approval. On the other hand, the SEC has taken a firm stand that the grant of the remedies under PD 902-A depends solely and exclusively in its sound discretion albeit prudently exercised after notice and hearing. In other words, the implementation of these remedies are regulator-driven or SEC-controlled.

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[10] Section 52, *ibid.*

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To restrict the discretion of the Commission in dealing with rehabilitation applications, foreign creditors have been exerting pressure on the SEC to formally adopt the rules implementing these remedies. And not only to adopt them; but to make the proceedings swift, time-bound, predictable and, most importantly, creditor-driven.

I was made to understand that the World Bank and the IMF have required the adoption of the said rules a conditionality for the approval of some financial aid for the Philippines, and that our government, through the Bangko Sentral and the Department of Finance, has agreed to this conditionality within the legal framework of our country. In imposing this conditionality, the World Bank has cited as reason not the difficulty being encountered by the creditors in recovering the loans they extended to the ailing Philippine Airlines through the repossession of the aircraft they financed, but the alleged long term choking effect the regulator-driven remedies will have on the availability of credit to our businessmen. The World Bank predicts that the absence of a creditor-friendly remedy, will effectively discourage banks and other financial institutions from opening credit windows or facilities due to the uncertainty of recovery. It argues that banks require security when they grant loans to ensure the recovery of the money of their depositors and investors. If the banks are prevented from recovering their money by prohibiting them to foreclose on the security, they will in the end stop extending loans or become extremely selective in granting them. This is because no matter what they do to protect themselves against the defaulting debtor, all their efforts will become useless when the corporate-debtor has sought refuge in the safe harbor of the SEC-controlled remedies. As an inevitable result, the availability of credit to our businessmen will be constricted.

In response to the pressure, I was tasked by the Department of Finance to submit a draft of the proposed rules on corporate rehabilitation in compliance with the agreement had with the World Bank. I completed the draft in the early part of this year which was submitted to the Commission for its consideration.

It is in the light of the two opposing sides involved in the drafting of these proposed rules that I will proceed to discuss the remedies under PD 902-A; how they are being implemented by the SEC, and how, in my personal opinion, they should be modified or improved.

Suspension of Payments

Under this remedy, when a corporation possesses sufficient property to cover all its debts but foresees the impossibility of meeting them when they fall due, it may petition the SEC to be declared in the state of suspension of payments.[11] The petition shall contain, among other things, (1) the plan or strategy of the corporation on how the liquidity of its financial position will be recovered or improved during the period of suspension, (2) the date it will resume the servicing of its debts, and (3) the schedule of payments therefor.

The petition is designed to give the corporation a breathing space from its nagging creditors. This moratorium is founded on the notion that if no relief is extended to the corporation in the meantime, it will incur default in all its obligations. As the unavoidable consequence, foreclosures, attachments, and all other forms of enforcement suits will be commenced by the creditors to the great prejudice of the corporation and its stockholders. In most instances, the aggressive and unbridled efforts of the creditors at recovering their money will result in the corporation becoming insolvent and going out of business. Whereas, if the corporation is allowed the moratorium, it will be given the much needed break from the crippling effects of default thereby giving it the time to recover its liquidity and thereafter

[11] Section 5(d), PD 902-A, as amended.

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resume payment of all its obligations. Viewed in this light, it is not difficult to see that suspension of payments under PD 902-A is meant for the protection of the corporation and its stockholders against the unreasonable propensities of the creditors.

Upon filing of the petition, all claims against the corporation are automatically stayed.[12] The stay, however, is merely provisional designed to give immediate relief to the corporation against any impending set-off or foreclosure by a creditor. The stay covers all actions for the recovery of property being used by the corporation in its business operations even though those property do not belong to it. Example of this is the case of a taxi corporation where its fleet is on hire-purchase. To allow the lessors of the cars to repossess them from the corporation will no doubt make the stay useless. In that event, the corporation will have no taxis to operate its business and the stay will not benefit the corporation in any way.

If the corporation succeeds in proving its entitlement to the relief, the petition will be granted and the suspension order will become definitive. Otherwise, it shall be dismissed and the creditors will be free to pursue whatever action they may have against the corporation. In the former, the Commission will order the corporation to resume payment of its obligations in accordance with the payment schedule approved by the Commission.

In approving the recovery plan and the payment schedule, the Commission may impose terms and conditions for the protection of the creditors. Failure of the corporation to implement the recovery plan or to pay in accordance with the approved schedule will warrant the lifting of the suspension order and the dismissal of the petition for suspension.

The order of suspension covers all stages the action on the claims may be found[13] and to all creditors secured and unsecured alike. In case of foreclosure, the filing of the petition will enjoin the holding of the public bidding when one has not yet been done. When the petition was filed after the bidding, the sheriff will be enjoined from executing the deed of sale in favor of the highest bidder. If the deed has been executed or delivered, the filing of the petition will prevent the consolidation of title on the winning bidder. And when the petition was filed after the lapse of the redemption period, the filing of the petition will enjoin the Register of Deeds from recording the sale and from transferring the property in the name of the buyer.

Due to the sweeping and immediate application of this remedy, it is highly possible for an insolvent corporation to file the petition just to avail of the automatic suspension order and in the meantime, hide or dissipate its assets during the time the suspension is in effect. To prevent the commission of this abuse, the suspension order enjoins the corporation from applying, or transferring, or disposing any of its assets, for whatever purpose, without the prior approval of the Commission.

Under Act 1956, the injunction does not cover those dispositions which are necessary in the ordinary course of business. However, inasmuch as the determination of whether or not a disposition is in the ordinary course of business may itself be abused, I believe that it is more prudent to simply require prior Commission approval for whatever disposition the corporation will make.

For how long may the moratorium on payments be granted?

The Commission has not yet adopted any concrete policy on this question. I personally believe, however, that the moratorium should not last for a period longer than 2 or

[12] RCBC v. IAC, 213 SCRA 831
[13] BPI v. CA, 229 SCRA 226

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3 years. The moratorium should subsist only while the corporation is suffering a temporary liquidity problem and in my opinion, if the corporation is not able to resume the servicing of its obligations for a period of more than three years, its liquidity problem is not temporary. In reality, this corporation is **technically insolvent**. Such being the case, suspension of payments should not be the appropriate remedy but rehabilitation. Moreover, I am afraid that the three-year suspension will give the corporation lead time to dissipate or hide its assets. Hence, I propose the creation of an oversight committee which will work to ensure that the assets and business of the corporation are conserved during the moratorium. I envision this oversight committee to have the power to oversee the day to day operation of the business of the corporation which, however, should remain in the hands of the incumbent management. To my mind, depriving the incumbent management of their power to operate the business and handing it over to outsiders who do not know the ins and outs of the business may prove more disastrous.

The oversight committee shall be composed of a representative of the secured creditors, a representative of the unsecured creditors, and a representative of the Commission to be appointed from the private sector who is considered an expert in management, finance, or corporate rehabilitation. The oversight committee shall, at all times, be allowed access to all corporate records and transactions and to attend all board meetings. The members of the oversight committee may participate in the deliberation of the board but shall have no right to vote. In case of a disagreement between the management and the committee, the matter shall be resolved by the Commission after notice and hearing.

The lawyers of the World Bank have proposed, instead of an oversight committee, the appointment of an *interim* receiver to perform, among others, the functions of the former. They insist that the receiver must be an independent third party who is neither a creditor nor officer of the corporation. To help the *interim* receiver in discharging his duties and performing his functions, the World Bank would allow him to engage the services of the needed complement of staff and technical people. All expenses therefor are to be charged against the corporation.

I believe that this is too much for a distressed corporation to bear. I suggested the oversight committee involving no one but the creditors themselves to make the availment of the remedy as cheap as possible and without much complications.

Like Act 1956, a PD-902-A-suspension-of-payments is available as a remedy only to a solvent corporation. However, if at any time during the effectivity of the suspension order the corporation becomes insolvent, whether actual or technical, the Commission may treat the petition for suspension as one for rehabilitation.

Unlike the Act-1956-suspension-of-payments which was creditor-controlled, the PD-902-A-suspension-of-payments does not require the favorable vote of the creditors to be effective. The creditors are not called to a meeting and do not vote on the proposed moratorium although they are allowed to submit their opposition thereto. The remedy being regulator-driven, the decision on whether or not the corporation will be granted a reprieve lies solely on the discretion of the Commission. It is, however, presumed that the Commission will take into consideration the comments or objections of the creditors in deciding the application. And while the creditors do not take a formal vote at a meeting, the written opposition or comment that they will submit is in reality a casting of vote, albeit informally.

This is the existing legal framework being followed by the Commission. A big departure from Act 1956 but the deviation is not without rhyme or reason.

As a rule, creditors in the Philippines do not lend money without a security. Hence, it is not unusual if almost all the creditors of a given corporation are secured. If we require

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these creditors to meet and vote they, almost without fail, will reject the moratorium proposed by the corporation for the simple reason that a postponement of their recovery will greatly increase their risk of losing their money. Postponement of the foreclosure greatly increases the creditor's risk of loss in those cases where the value of the security is impaired with the mere passage of time. Examples of this security are machinery, vehicles, computer hardware and software, or aircraft as in the case of PAL. The value of these property depreciates rapidly with the mere passage of time due to obsolescence. Hence, it will be better for the secured creditor to foreclose now than to foreclose later.

Even the unsecured creditors will have good reason to demand the immediate foreclosure of the corporation's property. It is not difficult to see that a delayed foreclosure will also jeopardize their chances of recovery. Being unsecured, they will have to rely on the value of the security in excess of the claim of the lien holder. In other words, their chances of recovery also depreciate with the depreciation of the value of the security.

It is almost an impossibility, therefore, to find the majority of the creditors voting in favor of the proposed moratorium. For this reason the remedy of suspension of payments under Act1956, in reality, was at best illusory. For in case of default, and regardless of the cause thereof, the creditors will press, almost without exception, for the recovery of the loan by foreclosing on the security. In such unfortunate event, however, while the creditors will be paid, the corporation will collapse from the resulting loss of its assets, to the great prejudice of the stockholders who did not have a direct hand in the management of the corporation, and of those who depended on the continued operation of the corporation for their very livelihood. The resulting loss of investment will necessarily erode the confidence of the investing public in the capital market and, to some extent, in the financial system, while the resulting dislocation in manpower will certainly have dire and far reaching effects on the economy as a whole.

It is precisely to avoid this unfortunate consequences that PD 902-A removed the remedy from the coverage of the Insolvency Law and gave absolute discretion to the SEC in deciding the fate of the application for the relief. Hence, to claim that Act 1956 still applies to the remedy under PD 902-A is to blatantly disregard the very reason behind the change introduced by the latter.

When applied to the actual situations, this new system of SEC-controlled remedies have proven to be effective in curbing the pawnshop mentality of the creditors. Unbelievably, these creditors have initiated the move to bail the debtor-corporation out of its predicament if only to dissuade it from filing the petition. This is not because the creditors have miraculously been cleansed of their innate predisposition to exact the proverbial pound of flesh, but they have discovered to their consternation that the filing of a petition for suspension by the debtor-corporation has affected them more than they have imagined. The filing of the petition does not only postpone their right to recover their loans, it also affects the prices of their own security listed and traded in the exchange. In the case of creditor-banks, the filing of the petition fomented the occurrence of a bank-run. And if you will add on top of all of these worries the not so unlikely possibility of the SEC being creditor-hostile, you can just guess how many sleepless nights your banker will have to suffer, or the nightmares he has to survive assuming that he gets to sleep.

Oblivious of the reason behind the existing legal framework, the foreign creditors have been lobbying against this power of the SEC. They want to remove the discretion of the Commission in approving the petition for suspension and to lodge the power, instead, to the creditors by insisting on the applicability of Act 1956 to a PD-902-A-suspension-of-payments. To support this stance, they are invoking a pronouncement of the Supreme Court in

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Ching v. Land Bank[14] to the effect that the jurisdiction of the Commission on a petition for suspension of payments is "*based on the provisions of the Insolvency Law.*" Their argument is simple. They maintain that since the remedy is based on the old law, it follows that the procedure and requirements under the old law are the ones applicable.

Their reliance on this pronouncement of the Court to support their argument is misplaced. Not only is the conclusion not warranted by the words of the decision, this *dictum* by the Court is merely *obiter* inasmuch as the only issue for resolution by the Court in that case was whether or not the Commission has jurisdiction, at first instance, over an action for declaration of insolvency. The Supreme Court correctly ruled that the Commission has no original jurisdiction over a petition for the declaration of insolvency because it is not a remedy in PD 902-A. It is a remedy under Act 1956 that falls within the jurisdiction of the regular courts. An insolvent corporation cannot come to the Commission to surrender all its property to all its creditors and pray that it be declared an insolvent. The Court ruled, however, that the Commission may entertain such move but only as a sequel to a proceeding for suspension of payments or rehabilitation pending with the Commission. This is the remedy of dissolution.

As will be shown later, the creditors do not have a say in the approval of a rehabilitation plan which has the effect of suspending all actions for all claims against the debtor corporation by secured and unsecured creditors alike, and even in the case where the corporation is already insolvent. Therefore, to require the approval of the creditors for a "simple suspension of payments" where the corporation is solvent is not only illogical. It is absurd. Moreover, under the World Bank draft, the corporation may avoid the approval of the suspension by the creditors by simply including in the petition a prayer to place the corporation under rehabilitation.

Rehabilitation

Under Act 1956, an insolvent corporation has no remedy other than to be adjudged as an insolvent. Hence, even in those cases where the business of the corporation is still profitable and the insolvency was caused by a mere fleeting episode of mismanagement, or a temporary nationwide economic crises not of its own doing, the corporation will have no choice but to resort to insolvency. Under this remedy, the corporation will inevitably close down its business because all its assets will be surrendered to the assignee-in-bankruptcy for liquidation and, consequently, for the distribution of the proceeds to all its creditors many of whom will certainly receive less than the face value of their credits.

In an insolvency proceeding, the creditors are not the only ones adversely affected. To many of them the adverse effect is just failure to recover their money in full. But to the stockholders of the corporation it means total loss of their investment. And this will be allowed to happen by Act 1956 despite a showing of good chances that the corporation may be revived back to its former healthy financial condition through the adoption of a rehabilitation plan.

To address the interest of the stockholders, PD 902-A has provided a new remedy to an ailing corporation. A corporation which is insolvent because its assets are not sufficient to cover its liabilities but which may still be rehabilitated through the institution of some changes in its management, organization, policies, strategies, operations, or finances, may petition the Commission to be placed under rehabilitation.

[14] 201 SCRA 180

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PD 902-A does not provide for the mechanics under which this remedy may be availed of. It only provides that an insolvent corporation may petition the Commission to be declared in a state of suspension of payments if it is under the management of a Rehabilitation Receiver or Management Committee created under said decree.[15] Upon appointment of the management committee, rehabilitation receiver, board or body, all actions for claims against the corporation are suspended accordingly.[16]

Who determines whether or not the corporation will undergo rehabilitation, the creditors or the Commission?

Present legal framework gives the Commission the exclusive and absolute discretion in determining the feasibility of the rehabilitation plan.[17] In performing this task, the Commission relies on the proposal of the corporation, the opposition or comments of the creditors and the advice of independent experts who are called upon from time to time to help the Commission in this regard.

The World Bank, however, insists that the creditors must approve the rehabilitation plan in accordance with Act 1956. But how will Act 1956 apply to corporate rehabilitation when it is not even a remedy under that law?

To support their position, the lawyers of the World Bank argue that rehabilitation is not a remedy in itself but a type of the remedy of suspension of payments.

I am not surprised at all at this stance. To take rehabilitation as a separate remedy will take it out from the coverage of Act 1956 simply because there is no such remedy in the said law. This means that the proposed rehabilitation will not require the approval by the creditors to be effective. Only the approval by the Commission will be needed.

To make Act 1956 apply to corporate rehabilitation and require approval by creditors of the rehabilitation plan, the lawyers of the World Bank have to maintain the position that since suspension of payments is indispensable in corporate rehabilitation and the only effect of the appointment of a rehabilitation receiver, corporate rehabilitation must necessarily be a species of a petition to be declared in a state of suspension of payments. This being so, the provisions of Act 1956 on suspension of payments should apply.

I disagree with the position of the World Bank. It is my humble opinion that rehabilitation is a remedy by itself separate and distinct from suspension of payments. While suspension of payments may be an indispensable relief to allow a corporation to undergo rehabilitation, there is more to rehabilitation than a mere suspension of payments.

But even assuming, for the sake of argument, that corporate rehabilitation is just a mutant of suspension of payments, the provisions of Act 1956 are, nonetheless, not applicable to the proceedings. In a line of cases starting with **Alemar's Sibal & Sons v. Elbinias**[18], to **BF Homes, Inc. v. CA**[19], **Araneta v. CA**[20], **RCBC v. CA**[21], and **BPI v. CA**[22] the Supreme Court has held that "*whenever a distressed corporation asks SEC for rehabilitation and suspension of payments, preferred creditors may no longer assert such preference, but shall*

[15] Section 5(d), PD 902-A
[16] Section 6 (c), *ibid.*
[17] 2nd paragraph, Section 6 (d), *ibid.*
[18] 186 SCRA 94
[19] 190 SCRA 262
[20] 211 SCRA 390
[21] 213 SCRA 830
[22] 229 SCRA 223

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stand on equal footing with other creditors."[23] This dictum necessarily assumes that the provisions of Act 1956 are not applicable to the proceedings. For if they were, the Supreme Court should have ruled otherwise by applying Sections 6 and 9 of the Act which exclude preferred creditors from the effects of the suspension.

Therefore, whether or not rehabilitation is a remedy by itself or a mere species of suspension of payments, the legal framework remains the same: the creditors have no right to decide the fate of the remedy.

The lawyers of the World Bank have also put forward the view that an **insolvent** corporation may not avail of this remedy. They anchor their claim on a provision[24] of PD 902-A which says that where a corporation has no sufficient assets to cover its liabilities, it may petition to be declared in a state of suspension of payments only when it is under the management of a rehabilitation receiver or management committee. They believe that only a **solvent** corporation, in appropriate cases, may be placed under a rehabilitation receiver or management committee. To follow the logic of this argument, an insolvent corporation has no remedy under PD 902-A.

I cannot help but disagree with the position of the World Bank. There is nothing in PD 902-A that will warrant such conclusion. While it is true that in **Ching v. Land Bank**[25] the Court has opined that the appointment of a rehabilitation receiver under Section 6 (c) is a mere ancillary power which can be exercised only in connection with an appropriate action pending before the SEC, and that a petition for insolvency cannot be the pending action to authorize the use of Section 6 (c) the SEC not having jurisdiction over a petition for insolvency, nowhere in that decision is it held that the SEC has no original jurisdiction over the petition of an insolvent corporation to be placed under rehabilitation. Nowhere in PD 902-A or in any case decided by the Supreme Court is an insolvent corporation prohibited from filing with the SEC a petition to be placed under rehabilitation.

It is my view that the very petition for rehabilitation is the appropriate case that will authorize the use of the ancillary power under Section 6 (c). It is my position that the SEC has the exclusive and original jurisdiction to hear and decide a petition by an insolvent corporation to be placed under rehabilitation. This is in accordance with Section 5 of PD 902-A. This being so, that petition may well be the pending action where the ancillary power of appointing a rehabilitation receiver may be exercised. I need not belabor what is obvious. The lawyers of the World Bank cannot successfully argue that a petition for rehabilitation is the same as a petition for declaration of insolvency.

PD 902-A intended to clothe the Commission with the authority to hear petitions of distressed corporations, solvent or insolvent, to be placed under rehabilitation. All that the insolvent corporation has to do is file a petition for rehabilitation and pray for the appointment of a rehabilitation receiver. Upon the appointment of the receiver, all claims against the petitioning corporation are automatically suspended.

The remedy necessarily limits the rights of the creditors to recover their money but it should not be lost in mind that the underlying principle is the protection of the investing public against the sudden loss of the value of their investment in the shares of stock of the corporation. It is true that the law compels the creditors to postpone their right of recovery to save the corporation for the stockholders, but this is not necessarily prejudicial to their interest. For if the creditors are allowed to immediately pursue their remedies against the corporation, their recovery, specially the unsecured creditors, nevertheless will not be full.

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[23] BPI v. CA, *supra* at p228
[24] Section 5(d)
[25] *supra*

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This is true despite having exhausted all the assets of the corporation leaving nothing to the corporation and its stockholders. But if rehabilitation is successful, the creditors will in due time be able to collect in full their credits plus interest to boot and the corporation will survive for the stockholders and the people who depend on it. At the end of the rehabilitation, all parties will be happy: the creditors will be paid in full, the stockholders will not lose their investment, and the people who depend on the continued operation of the corporation will not lose their livelihood.

I agree wholeheartedly with the lawyers of the World Bank that the proceedings with the Commission must be swift and time-bound, and the rules which the Commission will adopt must address these concerns. I tried my best to cover these concerns in the draft rules I prepared by carefully balancing the interest of the creditors on the one hand, and the interest of the stockholders and the public on the other.

In the event the rehabilitation plan is approved, the Commission shall impose terms and conditions to ensure that the plan is implemented. Failure of the plan in any material respect will warrant the dismissal of the proceedings or the dissolution of the corporation under the third remedy.

Dissolution

If despite the suspension of payments or rehabilitation allowed by the Commission the financial condition of the distressed corporation did not improve, the Commission may on the basis of the findings and recommendation of the management committee, or rehabilitation receiver, or its own findings, determine that the continuance in business of such corporation 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 and its remaining assets liquidated accordingly.[26]

The effects of a petition for insolvency and dissolution are the same in so far as the recovery by the creditors is concerned: all the assets of the corporation will be liquidated and applied to all the claims of the creditors in accordance with the same rules on preference. There is, however, one difference between them. In insolvency, the corporation will not go out of existence. It will lose all its assets but may start afresh after being adjudged insolvent. In dissolution, however, the corporation goes out of existence. The stockholders of a dissolved corporation may engage in business again as a group but only by incorporating and doing business as a new corporation.

The pronouncement of the Supreme Court in Ching v. Land Bank[27] that the Commission has no original jurisdiction over a petition for insolvency is correct as insolvency is not a remedy under PD 902-A. However, the pronouncement in the same case that the Commission may entertain such petition as an incident of and in continuation of its already acquired jurisdiction over a petition to be declared in state of suspension of payments is inaccurate if not totally wrong. No law gives the Commission the power to entertain an action for insolvency whether as an original action, or as an incident of any proceeding pending with it. What PD 902-A provides as an incident of a suspension of payments is dissolution under Section 6 (d) thereof. In making the inaccurate pronouncement, the Court must have confused insolvency with dissolution.

[26] Section 6 (d), PD 902-A
[27] *supra*

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While dissolution may be a sequel to a pending suspension or rehabilitation proceedings under PD 902-A, it may also be an original action with the SEC under Section 119 of the Corporation Code. Under this provision, a corporation may dissolve itself by a majority vote of its Board of Directors and a two-thirds vote of its stockholders. At dissolution, the corporation will wind up its business and liquidate its assets for the payment of all its obligations. If the creditors will be affected by the dissolution, the corporation has to file the corresponding petition with the Commission.

PROBLEM AREAS

Who will prepare the Rehabilitation Plan

The World Bank has brought to fore the issue of who should prepare the rehabilitation plan for the distressed corporation. There are valid reasons to distrust the incumbent management but I believe they are more in a position to prepare it. They know the ins and outs of the business. The appointment of an outsider to do it may result in delay to the detriment of the creditors and the corporation.

The rehabilitation plan must be submitted by the corporation as an attachment to its petition. But to allow some elbow room in those cases where the drafting of the plan is a complex process, the corporation should be given a period of time to complete and submit it. Failure of the corporation to submit the plan on time will raise a doubt as to the motives of the corporation in filing the action. It may well be that the corporation has resorted to the remedy only as a ploy to buy time to dissipate its assets. In this situation of delay, I believe that the Commission, instead of dismissing outright the petition should instead appoint a committee composed of the representatives of the creditors and of the SEC, to look at the matter. Should they find out that the delay was justified, the committee should proceed to determine if the corporation may still be rehabilitated. In the negative, they should move for the dismissal of the petition. If in the affirmative, they should cause the drafting of the rehabilitation plan.

Who will manage the corporation during the pendency of the petition

Upon filing of the petition, the Commission will issue an order suspending all claims against the corporation. While the petition is pending, who will manage the affairs of the corporation? Not surprisingly, the creditors distrust the incumbent management. On the other hand, it will not be prudent to install the creditors at the helm of the corporation. As a compromise, the Commission will appoint an *interim* receiver who shall ensure that the assets of the corporation are conserved during the pendency of the petition. The receiver will not take over the control and management of the business operations of the corporation which shall remain in the hands of the corporation’s incumbent board or management. As a measure of protection to the creditors, the corporation is enjoined from disposing any of its property during the pendency of the petition without the approval of the receiver.

In case there is an imminent danger of dissipation, loss, wastage or destruction of assets or other properties, or paralization of the business operation of the corporation, or should it fail to submit the rehabilitation plan on time, the Commission shall create a

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Management Committee to take over the management of all the assets and business of the corporation.[28] Thereupon, the appointment of the receiver shall terminate.

The management committee shall be composed of not more than five nor more than nine members which the Commission will apportion among the secured and unsecured creditors, stockholders, and other interests the Commission believes should be represented, and a representative of the Commission to be chosen from the private sector. It shall be the duty of the management committee to determine if the corporation may still be rehabilitated. If it determines that it may not, the Commission shall dismiss the petition. Otherwise, the management committee shall prepare and submit the rehabilitation plan.

May the Commission order the suppliers not to stop supplying

In the case of PAL, the hearing panel, upon application of the receiver, ordered the suppliers of the airline to continue delivering the supplies despite non-payment of the past due accounts. The receiver needed the order so as not to paralyze the operations of the airline.

While the suppliers are to be paid for the current supplies and are justified not to deliver unless payment therefor is made, it is debatable on whether or not the Commission has the power to compel a supplier to continue delivering its supplies despite non-payment of the past accounts. It is not difficult to see that the rehabilitation plan of the airline will not take off the ground without the cooperation of the suppliers.

It is true that rehabilitation suspends all claims against the corporation. But to compel the suppliers to continue supplying is much more than the suspension of their claims for the past due accounts. Will it not constitute deprivation of property without due process? On the other hand, if the Commission has no such power, will not rehabilitation be an illusory remedy?

If the law intends to afford the corporation everything possible to save its business, I believe this order is within the powers of the SEC to make. Deprivation of property without due process is a weak argument considering that the mandatory deferment of the rights of the creditors to collect their money, or to foreclose on their security, is by itself a deprivation of property. And yet, no one has successfully challenged the power of the Commission to make the order. In fact even the Supreme Court has sustained the power of the Commission to suspend even the rights of the secured creditors to foreclose on their security.

The question is: what sanction may the Commission impose to enforce compliance with the order? May the commission jail those suppliers who had the courage to defy it?

May the Commission order the amendment of the corporation's charter

In the case of VMC, the feature of the rehabilitation plan is to raise the needed operating capital from the sale of the controlling interest at a public bidding. To do it, the Articles of Incorporation of VMC has to be amended to decrease its capital to wipe out the losses and to increase it to make the controlling interest available for disposition. Under the Corporation Code, any amendment to the corporate charter has to be approved by at least two-thirds of the outstanding capital stock. If this requirement is followed, it becomes highly

[28] Section 6 (d), *supra*

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probable for the minority stockholders to oppose the amendment and defeat the rehabilitation plan. May the Commission order the change in the charter without the approval of the stockholders?

It may be argued that the refusal of the minority to approve the change is a remote possibility inasmuch as it will only work to their disadvantage. For in such a case, the Commission will be well justified in dismissing the rehabilitation proceedings. However, it is not impossible to conceive a situation where the legal battle that will ensue from such a move on the part of the minority will prolong the proceedings, delay being the very premium of the exercise.

Just like in bankruptcy proceedings, I believe the Commission has the power to order the amendment of the corporation's charter without complying with the vote requirement prescribed in the Corporation Code.

May encumbered assets be disposed of

In almost all rehabilitation proceedings, infusion of additional capital is an indispensable ingredient of the rehabilitation strategy. However, it is next to impossibility to find a bank willing to lend that additional capital. An investor may become interested but, as demonstrated in the case of PAL, that situation is rare. Faced with the formidable predicament, the corporation may have no choice but to dispose of some assets and use the proceeds to operate the business. There will be no problem if the assets are unencumbered. But complications will develop if they are. May the Commission allow the disposition of encumbered assets?

I believe that the Commission has the authority to allow the lifting of the lien from an encumbered asset but only when a substitute security is given to the creditor. Rehabilitation, as a rule, merely postpones the right of the creditors to foreclose on the security. It does not work to remove the lien altogether.

Who will implement the rehabilitation plan

I believe that the rehabilitation plan should provide for how it should be implemented and who should implement it. It is not advisable for the Rules to provide that someone will take charge in implementing it. The VMC case is instructive.

In the rehabilitation plan of VMC it is provided that the controlling interest will be disposed of in a public bidding. If the Rules will provide that the rehabilitation receiver or the management committee will take charge in implementing it, no investor in his right mind will ever bid. For why will he buy the controlling interest, which in the case of VMC is 567 million pesos, if he will not be able to run the corporation? On the other hand, somebody has to see to it that the incoming investor will run the affairs of the corporation in accordance with the rehabilitation plan. This problem was made even more complicated by the proposal of the existing stockholders to exercise their preemptive right on the controlling interest at the floor price it will be put up in the bidding. Under the proposal, in case the stockholders fail to exercise the option in full, the bidding will push through.

In the situation where the stockholders have taken the controlling interest, who will implement the rehabilitation plan? Undoubtedly, the creditors will not agree to the existing management remaining at the helm. And expectedly, the stockholders will not agree to the Management Committee running the corporation after having pumped in 567 million pesos to

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its capital. Besides, the management committee will just be an added cost. As a compromise, the parties have agreed to simply run the affairs of the corporation through the corporation's board of directors but with the seats allocated to all of them in an agreed proportion. The same *modus vivendi* was agreed upon in case the controlling interest is disposed of by bidding. In this latter situation it was proposed, at first, that the management should pertain to the buyer of the controlling interest so as to make the bidding attractive, and to simply appoint a receiver to oversee the implementation of the rehabilitation plan. The parties, however, opted for the same arrangement to avoid the additional cost of the services of a receiver. The creditors are convinced that their representation in the board is enough to allow them to monitor the progress of the rehabilitation plan.

The agreement in the VMC case would not have been arrived at if the Rules were so rigid to allow them to improvise. The strategies to rehabilitate an ailing corporation are, to a certain extent, limitless. The Rules should not restrict those strategies but on the contrary should encourage the managers to innovate.

RECOMMENDATIONS

The Commission should adopt the Rules on Corporate Rehabilitation as soon as possible. The Rules should make the proceedings swift and time-bound. The remedies should remain SEC-controlled in accordance with the existing legal framework but the creditors may be allowed to meet and vote on the proposed rehabilitation or on whatever proposal they deem are relevant in the pending action. The result of the voting, however, will simply be recommendatory to the Commission. I wholeheartedly agree that the rules must strike a balance between the interest of the creditors on the one hand and that of the corporation and the stockholders on the other. The rules must contain a mechanism for the parties to decide outside the adversarial proceedings of the Commission.

I believe that it is high time to enact a new bankruptcy law transferring the jurisdiction over these remedies to a regular court. I propose to give to this bankruptcy court the jurisdiction of the SEC over intra-corporate disputes and to call this court The Corporate and Bankruptcy Court. This way, the SEC will be limited to the efficient, effective and pro-active regulation of the capital market.

It has been observed that the financial problems of the distressed corporations were brought about by bad management practices. The malady does not occur overnight but develops over a period of time. It has been observed, too, that the malady may be detected through an examination of the corporate governance practices within the corporation. I, therefore, propose the establishment of an organization which will list down good corporate governance practices to guide the managers of our corporations, and which will monitor their governance practices. It is hoped that the organization will discover the telltale signs of financial distress and raise an early warning signal before it is too late. This NGO may be named: The Philippine Institute of Corporate Governance. This NGO may also be tapped to evaluate the disclosure statements of corporations applying for the registration of their securities for public offering to find out if some material data are withheld or some material data ought to be disclosed.

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