

## THE PHILIPPINE EXPERIENCE: SPECIALIZED COURT SYSTEM FOR INSOLVENCY PROCEEDINGS

Prepared by  
**Mr. Cesar Villanueva,**  
Senior Partner, Bernardo & Gabionza  
Makati City, Philippines

### PHILIPPINE MILIEU ON BANKRUPTCY PROCEEDINGS

#### 1. RECOGNITION OF THE CONCERNS OF LOCAL AND FOREIGN INVESTORS

- (a) Existence and clarity of bankruptcy laws;
- (b) Substantive contents to allow protection of contractual rights;
- (c) Effectiveness of the judicial or quasi-judicial agencies covering bankruptcy proceedings.

#### 2. THE CONSTITUTIONAL SETTING

- (a) Protection of contracts and property rights under the “due process” clause;<sup>1</sup>
- (b) Sanctity of the contracts and contractual commitments under the “non-impairment” clause;<sup>2</sup>
- (c) Advocacy of the free enterprise system<sup>3</sup> *vis-à-vis* the “social function” of property.<sup>4</sup>

#### 3. CIVIL CODE PROVISIONS ON CONTRACT LAW

- (a) Freedom to contract and stipulate terms and conditions<sup>5</sup>
- (b) Binding effect of contracts on both parties<sup>6</sup> in any form perfected and contracting parties mandated to comply with all the consequences thereof<sup>7</sup>
- (c) Contracts creating real rights over property bind the world who take possession of the property<sup>8</sup>

#### 5. HIERARCHICAL RULE ON CLAIMS

- (a) The accepted principle of hierarchical claims granting priority to creditors over equity holders on the business enterprise, its assets and properties.
  - The “Trust Fund” Doctrine (Sec. 122, Corporation Code)
- (b) The sub-hierarchical rule granting priority of claims of secured creditors over non-secured creditors over specific properties of the debtor.
  - Unsecured creditor’s security is on the “going concern”

### TYPES OF BANKRUPTCY PROCEEDINGS

#### 1. SUSPENSION OF PAYMENTS PROCEEDINGS

This is Spanish in origin, copied from the provisions of the Code of Commerce. In cases of doubts, we would go back to the Spanish authorities. Under the Philippine Insolvency Law,<sup>9</sup> a corporation “possessing sufficient

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<sup>1</sup>Sec. 1, Art. III, 1987 Constitution.

<sup>2</sup>Sec. 10, Art. III, 1987 Constitution.

<sup>3</sup>Sec. 20, Art. II, 1987 Constitution.

<sup>4</sup>Sec. 6, Art XII, 1987 Constitution.

<sup>5</sup>Art. 1306, Civil Code of the Philippines.

<sup>6</sup>Art. 1308, Civil Code of the Philippines.

<sup>7</sup>Art. 1315, Civil Code of the Philippines.

<sup>8</sup>Art. 1312, Civil Code of the Philippines.

<sup>9</sup>Act No. 1956, as amended.

property to cover all [its] debts . . . but foresees the impossibility of meeting them when they respectively fall due, may petition that [it] be declared in the state of suspension of payments by the court."<sup>10</sup>

## 2. INSOLVENCY PROCEEDINGS

Insolvency proceedings work under the premise that the debtor has neither cash nor property of sufficient value pay all the debts. There are two types of proceedings covered by the Law:

- (a) *Voluntary Insolvency* — It is the debtor who files the petition for insolvency; and
- (b) *Involuntary Insolvency* — It is the creditors who ask for the declaration of the debtor's insolvency.

### **Objectives of Insolvency Proceedings:**

- (a) Not to distort nor amend property and contractual rights and obligations, but to provide for an orderly means by which the claims against the business enterprise may be satisfied in line with the underlying hierarchical rules on claims; and
- (b) To provide the insolvent debtor a "fresh start" by the scheme of discharge (but not for corporate debtors).

## 3. REHABILITATION PROCEEDINGS

Rehabilitation that contemplates "a continuance of corporate life and activities in an effort to restore and reinstate the corporation to its former position of successful operation and solvency."<sup>11</sup>

"[R]ehabilitation of a financially distressed corporation benefits its employees, creditors, stockholders and, in a larger sense, the general public. And in considering whether to rehabilitate or not, the SEC gives preference to the interest of creditors, including employees [because] shareholders can recover their investments only upon liquidation of the corporation, and only if there are assets remaining after all corporate creditors are paid."<sup>12</sup>

### ***HISTORICAL DEVELOPMENTS:***

#### **WHAT ARE THE INITIAL ASSESSMENTS OF THE INSOLVENCY COURTS IN THE PHILIPPINES? WHAT ASPECTS HAVE WORKED WELL AND WHAT ASPECTS REQUIRE FURTHER IMPROVEMENTS?**

The Philippine experience to create specialized courts to handle insolvency proceedings may be divided into three main stages:

##### **A. THE AMERICAN TRANSPLANT - 1909 TO 1980**

In 1909, when the Philippines was under the sovereignty of the United States of America, the Philippine Commission, representing American sovereignty, promulgated Act 1956, or the "The Insolvency Law," which is still in effect up today.

##### **1. Proceedings Covered:**

The Law basically provided for two types of proceedings, namely:

- (a) Suspension of payments; and
- (b) Insolvency proceedings, both voluntary and involuntary proceedings.

The concept of rehabilitation or reorganization is not recognized at all in the Law.

##### **2. Court System Employed:**

Jurisdiction over suspension of payments and insolvency proceedings was with the regular courts of general jurisdiction (Courts of First Instance, later renamed Regional Trial Courts).

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<sup>10</sup>Sec. 2, The Insolvency Law.

<sup>11</sup> *Ruby Industrial Corp. v. Court of Appeals*, 284 SCRA 445, 90 SCAD 407 (1998).

<sup>12</sup>*Rubberworld (Phils.), Inc. v. NLRC*, 305 SCRA 721, 105 SCAD 485 (1999).

### 3. Features of the Law:

- (a) Provides for an orderly payment of unsecured creditors and does not at all modify the contractual rights and prerogatives of secured creditors;
- (b) Allows only a limited suspension of proceedings as not to compromise contractual rights;
- (c) Requires the consent of the creditors to any schedule of payment plan; and
- (d) Proceedings and the automatic stay do not cover secured creditors.

### 4. Effectiveness of the Law:

Since its enactment, the Insolvency Law has had very little applications, and financially distressed individuals, partnership and corporations did not much avail of it, basically because of two reasons:

- (a) The automatic stay or suspension of action provisions did not cover secured creditors, and consequently, its basically was ineffective as a remedy for distressed enterprises, who would anyway find key assets being subjected to foreclosure proceedings;
- (b) The Law does not provide for a “discharge” to a corporate debtor;
- (c) The lack of clear fraud laws and the absence of a tradition of fraud enforcement, together with inefficient judicial system, motivated the use of extra-legal means of making one's self judgement-proof or insulating one's assets from levy or execution;
- (d) The Asian culture giving much importance to "face" prevented most insolvent individuals and the corporations they controlled from being declared "bankrupt";
- (e) More importantly, due to the heavy case loads on other types of proceedings and the infrequent resort to insolvency proceedings, judges of regular courts never developed special competence necessary to competently handle intricate insolvency proceedings; and
- (f) Since the only proceedings recognized were suspension of payment and insolvency proceedings, there never was developed the various support expertise needed for rehabilitation proceedings.

## **B. MARTIAL LAW INITIATIVES - YEARS 1981 TO 2000**

In 1981, Pres. Decree 902-A, which basically constituted the charter of the Philippine Securities and Exchange Commission (SEC), was amended to constitute the SEC also as a quasi-judicial agency, granted original and exclusive jurisdiction over corporate and partnership suspension of payments and rehabilitation proceedings, while the RTC retained jurisdiction over individual insolvency proceedings and over corporate and partnership simple suspension of payments and insolvency proceedings.

### 1. Environment Under Which Promulgated and Amended

“The odd number of the inserted decree itself intimates a rush in its drafting, enactment and promulgation; intimating a lack of contemplative evaluation of the language of the decree; resulting in a patch-up job for what the decree itself addressed to be an imperative need to encourage public confidence in the corporation as a medium for doing business.”

The Decree, which was issued and amended under the martial law power of Pres. Marcos, was viewed as a means by which the autocrat, through the SEC, could employ better control over corporate enterprises in the Philippines.

### 2. Proceedings Covered by Decree

The Decree covered two (2) types of proceedings covering only partnerships and corporations:

- (a) Petitions to be declared in the state of suspension of payments in cases where the corporation possesses sufficient property to cover all its debts but foresees the impossibility of meeting them when they respectively fall due and has been placed under a management committee; or

- (b) In cases where the corporation has no sufficient assets to cover liabilities, but is under the management of a rehabilitation receiver or management committee.

#### 4. Special Features of Bankruptcy Proceedings under the Decree

- (a) The Decree instituted for the first time the concept of “corporate rehabilitation” in Philippine jurisdiction, but provided for sketchy procedural requirements;
- (b) Its “automatic stay” clause provided for the suspension of all actions by creditors, both secured and unsecured, during the pendency of the SEC proceedings, with no time limitation placed on the duration;
- (c) The Decree did not provide the role of creditors in the proceedings nor did it provide for the necessity of their voting approval to any rehabilitation plan, and seemed to grant discretion on the SEC to determine what plan would be for the best interests of the stakeholders; and
- (d) Empowered the SEC to appoint rehabilitation receiver or management committee to directly undertake management of the corporate enterprise.

#### 5. Surge in Corporate Rehabilitation Cases

Unlike under the Insolvency Law where recourse to insolvency proceedings was hardly employed, there eventually began to be filed with the SEC several cases for corporate suspension of payment/rehabilitation proceedings. The following reasons can be attributed for such surge:

- (a) The automatic stay,<sup>13</sup> which covered both secured and unsecured creditor, ensured to the corporate debtor complete “insulation” during the proceedings from all sorts of actions and foreclosure suits;
- (b) The effectiveness of getting relief from an administrative body which had less case-load, and was more adept to handling corporate issues, allowed for easier access to remedies.

#### 6. Effectiveness of Decree

Nevertheless, since the Decree was essentially not a substantive corporate recovery law, but its main thrust was to effect the reorganization of the SEC and to define its jurisdiction, there was not much substantive provisions by which to determine the substantive and procedural rights of the various stakeholders. No reliance could be made on the Insolvency Law, which did not even recognize rehabilitation proceedings.

Important issues that beset the SEC, acting as an insolvency court, had to be decided by decisions of the Supreme Court interpreting its jurisdiction and power, including such issues as:

- (a) How long can the automatic stay be enforced, without violating contractual rights?
- (b) What would be the voting requirements with respect to the adopting or rejection of a rehabilitation plan?
- (c) The priority of claims and recognition of the priority contractual claims of secured creditors vis-à-vis not secured creditors and equity holders.

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<sup>13</sup>First interpreted to mean that it did not include secured creditors, *Philippine Commercial and International Bank v. Court of Appeals*, 172 SCRA 436 (1989); but eventually ruled to cover both secured and unsecured creditors. *Alemar's Sibal & Sons v. Elbinias*, 186SCRA 94 (1990); *B.F. Homes, Inc. v. Court of Appeals*, 190 SCRA 262 (1990); *Araneta v. Court of Appeals*, 211 SCRA 290 (1992); *State Investment House, Inc. v. Court of Appeals*, G.R. No. 123240, 5 February 1996.

At first, the automatic stay was held effective upon filing of the petition, *Rizal Commercial Banking Corp. v. Intermediate Appellate Court*, 213 SCRA 830 (1994); but based on the peculiar wordings of PD 902-A, was held to take effect only upon the appointment of the rehabilitation receiver or the management committee. *Barotac Sugar Mills, Inc. v. Court of Appeals*, 275 SCRA 497 (1997); *Rizal Commercial Banking Corp. v. Intermediate Appellate Court*, G.R. No. 74851, 9 December 1999.

- (d) The extent of the power of the SEC to enforce a rehabilitation plan (cram-down power) rejected by majority of the creditors.

### **7. Abuses of a Specialized Administrative Agency**

The grant of seemingly vast powers to the SEC over corporate rehabilitation and suspension of payments proceedings involving corporations and partnerships, with rather sketchy provisions on key areas, lead to problems, including the following:

- (a) Abuse of discretion on the part of the SEC to ram-down desired results, either by petitioner debtor or the unsecured creditors;
- (b) Subjected SEC hearing officers to corrupt offers;
- (c) Employment of the process to obtain the automatic stay umbrella to coerce other parties to compromise, or at the very least to obtain delay through series of appellate judicial process to lay-down doctrinal rulings on various aspects not specific under the Decree.

### **8. Positive Developments**

The designation of SEC, an administrative agency with expertise and institutional thrust in corporate and partnership matters, to have exclusive jurisdiction over rehabilitation proceedings, contributed to the following positive developments:

- (a) Development, tedious though, of a body of rules and regulations and doctrinal pronouncements, of a body of specialized rules and policy of corporate insolvency; and
- (b) The appointment of rehabilitation receivers or management committees, as the legal triggering point of the automatic stay, allow the development of a pool of professional managers/rehabilitation receivers, to with expertise on corporate and partnership rehabilitation schemes.

Shortly after the SEC finally adopted the detailed Rules of Procedure on Corporate Recovery in January, 2000, unfortunately, it was stripped of all its *quasi*-judicial powers.

### **C. RECENT DEVELOPMENTS: THE SECURITIES REGULATION CODE**

As a reaction to the stock scam at the Philippine Stock Exchange (the “BW Resources” scandal), Philippine Congress fast-track the passage of the Securities Regulation Code<sup>14</sup> stripping the SEC of all *quasi*-judicial powers to allow it to concentrate on its main role to administer and monitor the Philippine capital market.

#### **1. Relevant Features of the Code**

- (a) Merely transferred quasi-judicial powers of the SEC on corporate suspension of payments and rehabilitation to the regular trial courts (RTC);
- (b) Does not contain provisions relating to corporate rehabilitation.

Consequently, all forms of insolvency proceedings, including corporate/partnership rehabilitation proceedings, have been unified within the jurisdiction of the RTC.

#### **2. Disadvantages of the Designation of the RTCs**

The unification of all types of suspension of payments proceeding, rehabilitation proceedings and insolvency proceedings in the regular trial courts presents the following problems:

- (a) Since RTC are courts of general jurisdiction, the hearing judges essentially do not have the requisite expertise on the intricacies of corporate/partnership rehabilitation and insolvency issues, nor do they have

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<sup>14</sup>Republic Act No. 8799, August (2000).

the “feel” for the complexities of the various hierarchical, proprietary and valuation claims of the various stakeholders;

- (b) With heavy case-loads on other types of cases, and since the system of trial in the Philippines is episodic and not the continuous trial system, RTC judges would not have the time to develop the necessary expertise, nor to grant the speedy remedies essential in rehabilitation proceedings necessary to preserve the value of the enterprise and those of the claims of various stakeholders;
- (c) Since Philippine courts do not have common-law jurisdiction, and unlike administrative quasi-judicial agencies which have the power to adopt internal rules of procedure to cover matters not provided for in the enabling statute, the RTC could only act on the basis of rules of procedure promulgated by the Supreme Court and on the language of substantive law, and could not make substantive rules to achieve equity and justice.

### 3. Rules on Corporate Rehabilitation

In November, 2000, Supreme Court’s approved the “Interim Rules on Corporate Rehabilitation,” which have the following salient features:

- (a) The automatic stay order<sup>15</sup> covers both secured and unsecured creditors,<sup>16</sup> The Interim Rules provide for the following basic steps for rehabilitation:
- (b) Treated rehabilitation proceedings as *in rem* in nature and required publication thereof;<sup>17</sup>
- (c) Provided specific periods for hearing the petition;<sup>18</sup> referral of the rehabilitation plan for recommendation to the rehabilitation receiver;<sup>19</sup> meeting and approval by the creditors of such plan;<sup>20</sup> and submission of a final rehabilitation plan to the court for its approval;<sup>21</sup>
- (d) Provides for dismissal of the Petition (which results into the automatic lifting of the stay order unless otherwise order by the court) if no rehabilitation plan is approved after one-hundred-eighty (180) days from the date of the initial hearing;<sup>22</sup>

### 4. Effectiveness of Set-up

- (a) RTC, as a general rule, because they exercise general jurisdiction, do not have the competence nor the quick-response mechanism, to handle corporate insolvency/rehabilitation proceedings.

The solution has been for the Supreme Court to designate particular branches of the RTC in each region as rehabilitation courts, and whose trial judges are given training through the Philippine Judicial Academy (PHILJA).

- (a) There are still no substantive legal basis for corporate rehabilitation, and much of the basis of powers, specially coercive powers, would have to be based on jurisprudential rulings on PD 902-A when such cases where still within the SEC jurisdiction.

Nevertheless, RTC cannot be "productive" since they are court of laws, unlike the SEC, which was an administrative agency vested with much leeway.

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<sup>15</sup>Sec. 4-6, Interim Rules on Corporate Rehabilitation.

<sup>16</sup>The stay order covers both secured and unsecured creditors, in line with the principle of “equality is equity” doctrine in rehabilitation proceedings since allowing the secured creditors to enforce their liens may hinder or prevent the rescue of the corporate debtor. See *B.F. Homes, Inc. v. Court of Appeals*, 190 SCRA 262 (1990); *Alemar’s Sibal & Sons, Inc. v. Elbinias*, 186 SCRA 94 (1990); and *Bank of the Philippine Islands v. Court of Appeals*, 229 SCRA 223 (1994).

<sup>17</sup>Sec. 4-6, Interim Rules on Corporate Rehabilitation.

<sup>18</sup>Sec. 4-6, *ibid.*

<sup>19</sup>Sec. 4-9, *ibid.*

<sup>20</sup>Sec. 4-21 *ibid.*

<sup>21</sup>Sec. 4-22, *ibid.*

<sup>22</sup>Sec. 4-11, *ibid.*

## CONCLUSIONS

### **A. WHAT ARE THE BENEFITS OF THE ESTABLISHMENT OF A SPECIALIZED COURT SYSTEM?**

1. A specialized court system in a given jurisdiction allows a systematic and well-focused development and evolution of both procedural and substantive components of insolvency proceedings.
2. Encourages the various stakeholders in the enterprise to more properly evaluate the various alternatives available to them.
3. Encourages the development of auxiliary support systems that would allow a more efficient approach to insolvency proceedings.

### **B. UNDER WHAT CONDITIONS IS SUCH A SYSTEM MOST EFFECTIVE?**

### **C. DO WE RECOMMEND TO ASIAN COUNTRIES TO INTRODUCE THE SYSTEM?**

The historical developments in the Philippines show how both the substantive basis insolvency law and the court system designated to handle such system, would prove critical in involving a truly responsive and efficient insolvency system. Thus —

1. There must be a reasonable comprehensive substantive statutory basis (i.e., a comprehensive Bankruptcy Code) underpinning the bankruptcy system of a given jurisdiction, and laying-down the jurisdiction and powers of the specialized court.
2. There must also be accompanying or integrated remedial or procedural provisions governing such proceedings law setting-up the procedure and requirements for insolvency proceedings
3. There must be in place a system of professional managers and pool of experts as auxiliary supports to such specialized court system.

### **D. WHAT ARE THE MAJOR CHALLENGES IN INTRODUCING AND OPERATING A SPECIALIZED COURT SYSTEM? HOW COULD THESE CHALLENGES BE OVERCOME?**

1. State commitment to use its various department to enact a responsive Bankruptcy Code.
2. The hefty financial costs involved in setting-up a specialized court system, and hiring competent judges/hearing officers;
3. Stage of development of commercial law system in a given jurisdiction;
4. Appropriate orientation or re-orientation of community to such a system vis-à-vis cultural settings.