

## The International Scene



# The Philippines Establishes New Rehabilitation Rules, Designates Insolvency Law Courts

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The Asian financial crisis spurred a host of efforts in various Southeast Asian countries to re-engineer their bankruptcy law regimes. Thailand and Indonesia, for instance, recently established specialized bankruptcy courts and updated their laws on insolvency and rehabilitation.

However, as reported in this column in February 1999, the Philippines has lagged behind its neighbors in reforming its bankruptcy laws. Observers have attributed this to a combination of factors. Perhaps most importantly, the Philippines weathered the early blows of the Asian crisis better than its neighbors. The Philippine banking industry's level of non-performing loans has remained significantly below the levels in Indonesia and Thailand.

Further, unlike its neighbors, the Philippines had an established bankruptcy court operating under the Philippine Securities and Exchange Commission (SEC) and a legal mechanism for resolving debt relief cases—the Insolvency Law (Republic Act No. 1956), enacted in 1909. The Insolvency Law set forth detailed procedural rules for declaring individuals and companies in suspension of payments.<sup>2</sup> It also allowed for liquidations of companies under the guidance of an assignee following a voluntary or involuntary declaration of insolvency.<sup>3</sup>

But times have changed quickly. During the past year, new legislation intended to

improve the core regulatory functions of the SEC transferred the jurisdiction over corporate debt relief cases from the Philippine SEC back to the trial courts. In response, the Philippine Supreme Court designated specific courts to hear these cases and established a set of procedures that are separate and apart from the suspension of payment procedures found in the Insolvency Law.

These reforms are likely to be tested soon. Economic troubles connected to slowing export markets, rising fiscal deficits and political uncertainty may prompt many Philippine companies that weathered the Asian crisis to seek protection from creditors under the new rules and the new forum in 2001.

This article will trace these developments and offer some opinions on the likely direction of insolvency law reform in the Philippines over the upcoming months and years.

## The End of a 20-Year Experiment in Resolving Debt Relief Cases Under the SEC

Up through 1981, corporate debt relief cases in the Philippines were handled by the trial courts. This changed with the issuance of Presidential Decree No. 902-A, as amended (PD 902-A). The decree vested in the SEC original and exclusive jurisdiction to hear and decide on a petition of a corporation, partnership or association that was seeking to be declared in a "state of suspension of payments" where it had sufficient "property to cover all its debts, but foresees the impossibility of meeting them when they fall due."<sup>4</sup> PD 902-A also gave the SEC jurisdiction over petitions for suspension of payments where a "corporation, partnership or association has no sufficient assets to cover its liabilities, but is under the Management Committee created pursuant to this decree."<sup>5</sup> Apart from debt-relief cases, the decree gave the SEC jurisdiction over cases involving intra-corporate disputes.

In addition to transferring jurisdiction over these cases to the SEC, PD 902-A formally recognized the power of the SEC to appoint a rehabilitation receiver or management committee "to restructure and rehabilitate" distressed companies "if determined to be feasible by the Commission."<sup>6</sup> For nearly the next 20 years, the SEC accepted and heard evidence on approximately 100 debt-relief petitions, the majority being filed in the past five years. The SEC's record for resolving petitions for debt relief was mixed. A study sponsored by

the Asian Development Bank noted that only a small handful of companies have been successfully rehabilitated or reorganized under the SEC.<sup>7</sup>

Still, the specialization forum that the SEC offered, as well as its less-formalized procedures, remained a somewhat appealing model. In a separate report, the Asian Development Bank characterized the Philippine approach as a "model that should not be dismissed or overlooked."<sup>8</sup> Much hope was placed in a more detailed set of procedural rules that the SEC adopted in December 1999, which provided for greater participation by creditors regarding whether to approve a rehabilitation plan.<sup>9</sup> The SEC also reformed its internal procedures, clarifying the way its bankruptcy hearing panels were formed and prohibiting *ex parte* contacts with SEC hearing officers.<sup>10</sup>

But while the SEC was attempting to reform its bankruptcy hearing unit, lawmakers in the Philippine Congress were becoming increasingly concerned that the SEC's bankruptcy functions were hampering its ability to regulate the securities markets effectively. Thus, when the Philippine Congress passed comprehensive legislation reforming securities market regulation in August 2000, it included a provision that transferred the SEC's jurisdiction over debt-relief cases back to the regional trial courts.<sup>11</sup> Under the new Securities Regulation Code (Republic Act No. 8799), corporate debt-relief cases filed after June 30, 2000, would be processed by the regional trial courts.

## Back to Bankruptcy for the Philippine Regional Trial Courts

The transfer of jurisdiction of debt relief cases from the SEC was a somewhat sudden and unexpected development. The clause that transferred the jurisdiction was found in neither the original House or Senate bills that formed the basis for the final legislation. Although the Philippine Congress had been considering separate legislation that called for a transfer of the jurisdiction back to the courts, most observers did not expect that legislation to be passed before the end of 2001.

<sup>7</sup> T. Regala, *Report on the Philippines (Part 2)*, at 3. Another report, this time by the International Monetary Fund, cited a case in which the claims of secured creditor had been stayed for more than 14 years "as a result of, among other things, a dispute between the majority shareholder group and the minority group over whose rehabilitation plan should be approved." International Monetary Fund, *Managing Corporate Distress in the Philippines: Some Policy Recommendations (1998)*, at 20.

<sup>8</sup> Asian Development Bank, *Insolvency and Law Reforms in the Asian and Pacific Region, in Law and Policy Reform at the Asian Development Bank* (2000 ed., Vol. 1) at 78.

<sup>9</sup> SEC Rules of Procedure on Corporate Recovery (December 1999).

<sup>10</sup> See SEC Revised Rules of Procedure (June 2000).

<sup>11</sup> The Securities Regulation Code (Republic Act No. 8799), §5.2 (2000).

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<sup>2</sup> Insolvency Law, Chapter II.

<sup>3</sup> *Id.*, Chapters III and IV.

<sup>4</sup> PD 902-A, §5(d).

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*, §6(d).

The Philippine Supreme Court, which oversees the administration of the regional trial courts in the Philippines, had to react quickly to this development. To facilitate training and specialization of judges to hear these cases, it designated courts in Manila and several other larger Philippine cities as "special commercial courts"<sup>12</sup> and began efforts to provide these judges with a "crash course" in legal principles regarding the laws of bankruptcy and corporations.<sup>13</sup> It also created a committee of jurists and practitioners to establish procedural rules pertaining to "suspension of payments, rehabilitation, constitution of management committees, and dissolution and liquidation of corporations."<sup>14</sup>

The committee developed the "Interim Rules of Procedure on Corporate Rehabilitation" by mid-November 2000. With slight modification, the Supreme Court voted *en banc* to adopt them on Nov. 21. The rules came into legal effect on Dec. 15.

### The Philippine Interim Rules of Procedure on Corporate Rehabilitation

Due to the abbreviated schedule under which the rules committee and the Supreme Court labored, the Interim Rules of Procedure on Corporate Rehabilitation (Interim Rules) are narrowly focused. They do not address issues regarding suspension of payments procedures under the Insolvency Law, nor do they address how to treat companies that are slated for liquidation. Rather, the Interim Rules provide a framework for treating companies that request "rehabilitation." A summary of the major aspects of the Interim Rules is provided below:

**Availability:** The proceedings established under the Interim Rules are available to any corporation, partnership or association that "foresees the impossibility of meeting its debts when they respectively fall due." They are also available to creditors of such entities, where the creditor, either singularly or jointly with other creditors, holds at least 25 percent of the debtor's liabilities.<sup>15</sup> The Interim Rules establish a checklist of required information and

attachments to initiate the proceedings.<sup>16</sup> One of these documents is a rehabilitation plan that has been formulated according to the minimal requirements of the Interim Rules.<sup>17</sup>

**Issuance of a Stay Order:** The court is required to act on the petition no later than five days from the date of its filing. If it finds the petition on its face to be legally sufficient, the court issues a stay order that, among other things, fixes a date for an initial hearing no later than 60 days from the date the petition was filed. The petitioner is required to publish the order in a newspaper of general circulation.

**Scope of a Stay Order:** The stay order suspends all legal actions against the debtor, including foreclosure actions by secured creditors. This is a deviation from the Philippine Insolvency Law, which exempted secured creditors and other preferred creditors from the stay. Concurrently, the order initiating the case is required to enjoin the debtor from disposing of assets outside the ordinary course of business and making any payments on liabilities outstanding as of the date when the petition was filed.<sup>18</sup>

**Appointment and Role of the Rehabilitation Receiver:** The Interim Rules require the court to appoint a rehabilitation receiver as part of its stay order. The receiver is required to meet the standards of competence and expertise set forth in the Interim Rules and should be free of any conflicts of interest.<sup>19</sup> Considered to be an officer of the court, the receiver is "tasked to study the best way to rehabilitate the debtor and to ensure that the value of the debtor's property is reasonably maintained pending the determination of whether or not the debtor should be rehabilitated."<sup>20</sup> But rather than replacing the management of the debtor, the Interim Rules call on the receiver to oversee and monitor the debtor's operations. To this end, the Interim Rules endow the receiver with unfettered access to the debtor's "employees, premises, books, records and financial documents..."<sup>21</sup>

**Initial Hearing:** The first opportunity for creditors and interested parties to formally participate in the proceeding is at the initial hearing. The rules contemplate the initial hearing as an opportunity for creditors and other interested parties to have the petition dismissed for failure to comply with the rules. Such right is dependent on the interested party filing a written opposition with the court no later than 10 days before

the date of the initial hearing.<sup>22</sup> If the petition survives the initial hearing, the court is required to submit the petition and proposed rehabilitation plan to the rehabilitation receiver.

**Administrative Expenses and Post-Petition Financing:** The Interim Rules specifically require the debtor to make payments for administrative expenses,<sup>23</sup> which are defined as "expenses incurred in the ordinary course of business after the issuance of the stay order, excluding interest payable to creditors."<sup>24</sup> The Interim Rules, however, do not provide for any super-priority for creditors offering post-petition financing. Further, a prohibition against encumbering assets outside the ordinary course of business in the Interim Rules would appear to preclude new financing secured by collateral of the debtor.

**Voidability of Fraudulent Transfers and Preferences:** The Interim Rules specifically allow the court to unwind transactions or preferences made by the debtor in violation of the stay order.<sup>25</sup> However, the rules are silent as to the right of the court to unwind transactions or preferences made before the imposition of the stay.

**Adequate Protection for Secured Creditors:** The Interim Rules provide a secured creditor with specific remedies should depreciation or neglect threaten the value of its collateral. In such instances, the rehabilitation receiver is required to intervene in order to protect the collateral—for instance, making insurance payments current or providing for property's maintenance or safekeeping. Alternatively, the receiver may be ordered to "make payments or otherwise provide additional or replacement security such that the obligation is fully secured."<sup>26</sup> If such arrangements are not feasible, the court is required to lift the stay against the secured creditor.

**Exception to Adequate Protection when it Jeopardizes a Rehabilitation:** Although the Interim Rules establish a coherent framework for providing secured creditors with adequate protection, they nonetheless deny the remedies set forth in the Rules when "such remedies would prevent the continuation of the debtor as a going concern or otherwise prevent the approval and implementation of a rehabilitation plan."<sup>27</sup> The Rules are silent as to the alternative remedies that would be available to a secured creditor under such circumstances.

**Contents of the Rehabilitation Plan:** The Interim Rules provide an outline of what a

<sup>12</sup> Resolution Designating Certain Branches of Regional Trial Courts to Try and Decide Cases Formerly Cognizable by the Securities and Exchange Commission, Supreme Court Administrative Memorandum No. 00-11-03-SC (Nov. 21, 2000).

<sup>13</sup> "Supreme Court Prepares to Create New Special Court," *Philippine Business World* (Sept. 14, 2000).

<sup>14</sup> Resolution Regarding the Transfer of Cases from the Securities and Exchange Commission to the Regional Trial Courts, Supreme Court Administrative Memorandum No. 00-8-10-SC (Sept. 12, 2000).

<sup>15</sup> Interim Rules, Rule IV, §1. Although not made explicit in the rules, a petitioning creditor would likely have to allege and prove that the debtor was not able to meet its obligations as they came due in order to initiate a case.

<sup>16</sup> *Id.*, Rule IV, §2.

<sup>17</sup> *Id.*, Rule IV, §2(e).

<sup>18</sup> *Id.*, Rule IV, §6.

<sup>19</sup> *Id.*, Rule IV, §13.

<sup>20</sup> *Id.*, Rule IV, §14.

<sup>21</sup> *Id.*, Rule IV, §14(p).

<sup>22</sup> *Id.*, Rule IV, §10.

<sup>23</sup> *Id.*, Rule IV, §6.

<sup>24</sup> *Id.*, Rule II, §1(a).

<sup>25</sup> *Id.*, Rule IV, §8.

<sup>26</sup> *Id.*, Rule IV, §12.

<sup>27</sup> *Id.*

plan should entail. The plan should provide "desired business targets...and the duration and coverage of the rehabilitation." It should also disclose how the plan will be implemented "giving due regard to the interests of secured creditors." For purposes of assisting creditors in deciding to support the plan, the Interim Rules require that the plan contain a liquidation analysis that would estimate the dividend "creditors and shareholders would receive if the debtor's properties were liquidated" and other "relevant information to enable a reasonable investor to make an informed decision" on the plan's feasibility.<sup>28</sup>

*Creditor and Shareholder Participation in Plan Formulation:* The Interim Rules allow interested parties to provide input on the plan both through court filings and discussions with the debtor and rehabilitation receiver. Interested parties may file a comment or opposition with the court within 120 days from the date of the initial hearing. Further, the Rules specifically contemplate the rehabilitation receiver meeting with creditors to discuss the plan.

*Submission of the Rehabilitation Plan for Court Approval:* Upon expiration of the comment period by the receiver and interested parties, the debtor has the choice of moving for court approval of the plan or to submit a modified or substitute plan for final approval. The deadline for submission of a substitute plan is one year from the date of the initial hearing.<sup>29</sup>

*Creditor Objection and Possibility of Cram Down:* If creditors holding a majority of the total liabilities of the debtor oppose the plan, the Interim Rules implicitly suggest that the court has the right and duty to disapprove the plan, lift the stay order and dismiss the proceedings. Nonetheless, the Interim Rules allow the court to approve the plan despite the objections of a majority of creditors if it deems that the opposition is "manifestly unreasonable." For guidance in this determination, the Interim Rules provide the courts with the following criteria. A plan may be crammed down if:

1. it provides the creditors with compensation greater than they would have received if the debtor were liquidated;
2. the shareholders or owners of the debtor lose at least their controlling interest as a result of the plan; and
3. the rehabilitation receiver has recommended approval.

The rules appear to require the court to make such a finding as part of any order to

<sup>28</sup> *Id.*, Rule IV, §5.  
<sup>29</sup> *Id.*, Rule IV, §22.

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approve the plan over the objections of the creditors.

**Effect of Plan Approval:** The Interim Rules resolve a contentious issue that has plagued efforts to rehabilitate companies in the Philippines for the past several years: the power of a court to unilaterally alter the contractual rights of the debtor with its creditors. Under the Rules, the terms of an approved plan "shall be binding upon the debtor and all persons who may be affected by it, including the creditors, whether or not such persons have participated in the proceedings or opposed the plan, or whether or not their claims have been scheduled."<sup>30</sup> Further, these alterations are irreversible, even if the plan fails: "Any compromises on amounts or rescheduling of timing of payments by the debtor shall be binding on creditors regardless of whether or not the plan is successfully implemented."<sup>31</sup>

### The Impact of the Interim Rules on Philippine Bankruptcy Practice

Although intended as a temporary measure, the Interim Rules will have a long-lasting effect on the way Philippine companies are rehabilitated. The Rules lay to rest the controversy over the application of the procedures under the Insolvency Law to rehabilitation cases. Although the SEC had been reluctant to apply the Insolvency Law to cases before it, this was a controversial policy that had yet to be affirmed by the Supreme Court. This long-standing dispute was the key issue in the §304 proceeding regarding Philippine Airlines (*see* The International Scene, February 1999). With the Interim Rules, the Supreme Court has unequivocally established that the Insolvency Law does not apply to petitions for rehabilitation.

With the establishment of an alternative set of rules for rehabilitation, few, if any, companies are likely to file petitions for suspension of payments under the Insolvency Law, as the latter provides procedures that are far less debtor-friendly. For instance, the approval of a debt restructuring plan under the Insolvency Law requires the approval of two thirds of the creditors holding three fifths of the debtor's liabilities.<sup>32</sup> Secured creditors that choose not to participate in the proceedings under the Insolvency Law are free to enforce their claims against the debtor notwithstanding the stay order.<sup>33</sup> By contrast, under the Interim

<sup>30</sup> *Id.*, Rule IV, §24(a).

<sup>31</sup> *Id.*, Rule IV, §24(e).

<sup>32</sup> Insolvency Law, §8.

<sup>33</sup> *Id.*, §9.

Rules, a stay order applies to all creditors, and a plan may be approved so long as a majority of creditors do not object to it.

The Interim Rules also establish that a duly approved rehabilitation plan may alter the creditors' contractual rights against the debtor regardless of their consent to the plan. Previously, provisions in the Philippine Civil Code on the sanctity of contract, and the non-impairment clause in the Philippine Constitution, had given dissenting creditors much fodder for arguing that their contractual rights against the debtor withstood the approval of a rehabilitation plan. This in turn lead the SEC to use its power to issue stay orders indefinitely—until the creditors voluntarily consented to the plan, or payments were made in full, or until the debtor no longer had assets worth pursuing.

The authority of a court under the Interim Rules to amend contracts thus resembles, in effect, the discharge provisions in chapter 11 proceedings in the United States. By permanently altering contracts in accordance with a plan, the Rules provide the debtor with a genuine fresh start free from claims other than those defined in the rehabilitation plan.

### Future Directions for Philippine Bankruptcy Law

As their name suggests, the Interim Rules were written with the notion that they

would serve as a stopgap measure until new legislation takes the place of the Insolvency Law. One such bill, the Corporate Recovery Act (House Bill No. 11867), was filed in Congress soon after the Securities Regulation Code transferred jurisdiction over debt relief cases to the regional trial courts. The Corporate Recovery Act, which establishes a comprehensive framework for rehabilitation and, when applicable, liquidation of financially distressed corporations, is currently under review by various public- and private-sector groups. Although the congressional elections in the first half of 2001 make passage of the Corporate Recovery Act extremely unlikely in the current session, the measure is likely to be taken up again when Congress reconvenes in July.

In the meantime, the regional trial courts that have been slated to hear petitions for corporate rehabilitation have a challenge before them in addressing the concerns of critics of the decision to transfer these cases out of the SEC. Although not perfect, the Interim Rules give the courts a chance to prove these critics wrong.

**Author's Note:** Copies of the documents referred to in this article may be obtained from Daniel Fitzpatrick at fitzjdj@aol.com. ■

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