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**EVOLVING CORPORATE REORGANIZATION IN THE PHILIPPINES,
IN TANDEM WITH AND POTENTIALLY AHEAD OF THE US MODEL**

by
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1. A system with a uniquely strong US connection

Business insolvency and rehabilitation in the Republic of the Philippines has a uniquely American heritage, and it has transformed over the past 98 years, as US insolvency law and practice evolved. The Philippine system has not been the subject of extensive commentary, other than by academics in the Philippines and international finance agencies seeking to promote their goals. The purpose of this article is to provide an overview from a foreign comparative-law perspective.

Many nations have modeled their insolvency laws in part on features of the US system. The Philippine system is unique, however, as it is based, in its most fundamental part, on laws that were enacted while the United States governed the Philippines as a territory (from 1898 to 1946). Indeed, all three branches of the U.S. government had approval powers over legal matters in the Philippines during that period.

Like businesses in the US, few large companies in the Philippines used its laws to attempt a rehabilitation in the early decades after adoption of its insolvency statute. Even after corporate reorganization became more commonplace in the US, however, very few financially distressed Philippine corporations found its laws an attractive mechanism, so corporate reorganization practice developed its details and evolved more slowly in the Philippines.

That process accelerated noticeably once Philippine Airlines (“PAL”), Asia’s oldest airline, commenced its proceeding in 1998.¹ Moreover, in recent years, the Philippine government and corporate sectors have been highly focused on adopting “best practices” in various areas, and may soon adopt a corporate rehabilitation law that would arguably be the world’s most modern and innovative.

2. The early phase: very limited rehabilitation possibilities

In 1909, the Philippines enacted the Insolvency Law, often referred to in the Philippines as “Act No. 1956.” It created two types of proceedings: (a) suspension of payments and (b) insolvency. The former was derived from the Spanish Code of Commerce, and the latter was modeled after similar provisions in the US Bankruptcy Act of 1898 and the Insolvency Act of California of 1895.

To avail itself of a suspension-of-payments proceeding, a company had to be balance-sheet solvent, but cash-flow insolvent, so filings were not plentiful. Another deterrent to its use was that, although the moratorium on payments was on terms proposed by the debtor, it had to be acceptable to a large majority of unsecured creditors. Holders of at least three-fifths of the unsecured debt in amount had to attend the meeting of creditors and two-thirds of those present had to vote to approve. Moreover, secured debt and wage claims were not affected. Claim enforcement was stayed, and transactions out of the ordinary course of business required court approval.

Insolvency proceedings, on the other hand, were straightforward US-style liquidations by receivers or assignees chosen by the creditors. In addition to the close similarity to US legislation, in *Mitsui Bussan Kaisha v. Hongkong & Shanghai Bank*, 36 P.R. 27 (1917), the Philippine Supreme Court noted in this early decision that, with respect to certain sections of the Insolvency Law, the Philippine legislature intended to establish “the essential features of the American system of bankruptcy” and directed that the courts look to the decisions of the US for guidance.

3. The second phase: regulatory control of expanded rehabilitation potential

Prior to 1976, all petitions under the Insolvency Law, including petitions for the suspension of payments, were handled by the Regional Trial Courts. In 1976, then-President Ferdinand Marcos issued Presidential Decree 902-A, consisting of three and a half typewritten pages, and typically referred to as “PD 902-A.” Pursuant to that decree, the Philippines Securities and Exchange Commission (the “PSEC”) became vested with original and exclusive jurisdiction over corporations (and other business associations registered with the PSEC) seeking to be declared in the state of suspension of payments. The corporation must possess property to cover all of its debts, but foresee the impossibility of meeting them when they respectively fall due. But now also corporations that lack sufficient assets to cover their liabilities, but are under a “management committee” could seek such relief. And the

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management committee itself could be appointed by the PSEC pursuant to the decree, with essentially the same limited powers as a receiver, as described below. PD 902-A §§ 5(d), 6(d).

PD 902-A was viewed as thereby adding rehabilitation as a viable option for balance-sheet insolvent corporations, as an alternative to dissolution as a form of proceeding to deal with general financial distress. This, of course, greatly expanded the number of entities that could reorganize.

It is unclear whether rehabilitation is a *type* of suspension-of-payments proceedings, created by and therefore requiring application of the Insolvency Act, or is an entirely different remedy. As a result, while PD 902-A did not expressly incorporate the Insolvency Law, or any other Philippine statute, the Philippine courts and the PSEC in some instances expressly adopted sections of the Insolvency Law and in other instances used the Insolvency Law only for guidance in reaching its decisions.

All claim enforcement is stayed, *including* secured claims. PD 902-A §§ 6(c), 6(d). *Rizal Commercial Banking Corp. v. Intermediate Appellate Court*, 213 S.C.R.A. 830, 838 (1992); *Bank of the Philippine Islands v. Court of Appeals*, 229 S.C.R.A. 221, 228 (1994). A special order is usually issued, staying enforcement of pre-petition claims, prohibiting transactions out of the ordinary course of business (unless first approved by the PSEC), authorizing post-filing debts to be paid, and staying termination of executory contracts or utility service. The stay is subject to being lifted by PSEC order. Creditors who seek relief from the stay are entitled, under the PSEC's rules, to file motions with the PSEC and argue that cause exists to lift the stay, accompanied by supporting affidavits and other papers.

An interim receiver or "management committee" evaluates operations and reorganization and liquidation alternatives, and submits a proposed plan to creditors and the PSEC – within 30 days or as extended. There is no clear limit on the length of the payment program. The PSEC often appointed persons, sometimes groups of persons, as receivers and management committees, whom the PSEC appears to believe are best able to solve the debtor's problems because they are familiar with the debtor. Creditors and others have complained at times that this creates a conflict of interest.

If and when a plan is approved, the receiver becomes a "permanent" rehabilitation receiver, who oversees and reports to the PSEC, generally until the last payment is made under the plan. If the rehabilitation effort fails, the corporation is dissolved, under the guidance of the PSEC.

If a creditor believes that a petitioner is not eligible to seek a suspension of payments or corporate rehabilitation (and therefore the PSEC lacked jurisdiction) or that there are other grounds to seek the dismissal of the petition, that creditor may file a motion to dismiss. Creditors are given by the debtors ample information to mount such a battle, at the outset of the proceeding. Under the policies and procedures of the PSEC, the following supporting documents must accompany the petition and be served on all creditors: (a) *audited* financial statements as of the end of its last fiscal year; (b) interim financial statements as of the end of the month prior to the filing of the petition; (c) a list of the petitioner's creditors, indicating the name and address of each creditor, the amount of the claim, including principal and interest

due as of the date of filing, and whether the claim is admitted, contingent, unliquidated or disputed; (d) a list of the petitioner's equity holders, showing the name of the security holder and the kind of interest registered in the name of each holder; (e) a list of the petitioner's assets stating the specific nature, book value, market value, location, and certificates of ownership; and (f) a certification of the Bureau of Internal Revenue as to the petitioner's tax liability. When submitted, the petition and its annexes must also be served on each creditor.

Decisions of the PSEC under PD 902-A are appealable to the Philippine Supreme Court. Its important rulings include that the provisions of the Philippine Civil Code governing priority of claims, entitled "Concurrence and Preference of Credits," apply in suspension-of-payments and rehabilitation proceedings under PD 902-A. *State Investment House, Inc. v. Court of Appeals*, 277 S.C.R.A. 209, 211 (1997).

There is no exclusivity period during which only the debtor may submit a plan. Executory contracts may be revoked. *Figuroa v. Securities and Exchange Commission*, 162 S.C.R.A. 689 (1988).

PD 902-A rehabilitation proceedings under the jurisdiction of the PSEC were therefore similar to chapter 11 cases under the US Bankruptcy Code, even though chapter 11 was not enacted until three years *after* PD 902-A. PD 902-A did not leave the debtor literally "in possession," but it did not impose a truly independent trustee either, as was required under Chapter X under the US Bankruptcy Act of 1898, the predecessor to chapter 11.

The tradition of relying on US precedent continued under PD 902-A. For example, in *Finasia Investments and Finance Corp. v. Court of Appeals*, 237 S.C.R.A. 446, 450 (1994), the Philippine Supreme Court adopted *verbatim* the definition of "claim" contained in the current US Bankruptcy Code. In another instance, *BF Homes, Inc. v. Court of Appeals*, 190 S.C.R.A. 262, 270 (1990), the court relied on and cited 28 U.S.C. § 1479(a) and a discussion of bankruptcy in American Jurisprudence 2d for assistance in addressing an issue relating to an attachment lien in bankruptcy.

Controversy around PD 902-A cases often centered on the lack of creditor veto over a rehabilitation plan. PD 902-A does not contain explicit guidelines for voting on plans. Nevertheless, the PSEC, in practice, generally *did* require at least a majority of the creditors to accept the plan before it would be approved.

The PSEC always solicited creditor input, but generally found that a plan could be approved in the PSEC's discretion. Some academics in the Philippines and intentional finance agencies have posited that this may have caused financial institutions to be reluctant to lend to Philippine corporations.

An example of how carefully the PSEC used the voting requirements of the Insolvency Act as a guide can, however, be found in the record of *Mauritius Pulp and Packaging Corp.*, SEC Case No. 02-97-5553. The PSEC issued an order that described what transpired:

On June 17, 1997 a Creditors' Meeting was held in this office for the consideration of the petitioners' Proposed Compromise Agreement and Proposed Rehabilitation Plan. In the

said meeting, the petitioners and the creditors acknowledged that the presence of at least three-fifths of the liabilities as required by Section 8 of the Insolvency Law for the purpose of holding the meeting had been complied with.

After much debate and discussion, the parties in this case agreed to put the petitioners' proposal to a vote. The vote was conducted by a call of names. The said votation resulted in the rejection of the petitioners' proposals for having failed to muster the required two-thirds vote as required by Section 8 of the Insolvency Law.

Pursuant to what transpired in the meeting of June 17, 1997, the Order of Suspension of Payments issued by this Office dated February 25, 1997, is hereby lifted effective June 17, 1997.

Few US companies have been so severely subjected to the will of their creditors or seen that will carried out so swiftly.

4. The *Philippine Airlines* case tests the system: it passes

PD 902-A was used by few corporations until the Asian financial crisis of 1997, which led to a very substantial devaluation of the Philippine peso and high interest rates on loans denominated in foreign currencies.

PAL commenced a "suspension of payments and corporate rehabilitation" proceeding in 1998, listing US \$2.3 billion of assets and US \$2.1 billion of debt, having reflected shortly before the financial crisis. Labor strife at PAL was intense at this time, as it transitioned away from being government-owned and the influence of the unions had diminished as a consequence. The drop in ridership caused by the general financial crisis, together with the continuing need to provide air service to many islands, required a new business plan, as well as a restructuring of debt payments, to coincide with new collective bargaining agreements.

Not only was this case thus uniquely large and complex for a Philippine proceeding, it remains among the largest transnational rehabilitations of a non-bank entity with substantial ongoing operations in the U.S. And it had, of course, extremely valuable assets that were highly mobile.

PAL's capital sources were also truly global. It had borrowed from banks in the US, the UK, Germany and France, and had securitized its credit card receivables through a transaction in Hong Kong. But its US trade creditors presented the greatest challenges. PAL had not closed a purchase of several Boeing 747's, a purchaser of other aircraft was in litigation with PAL in U.S. District Court in New York, and GE's Aircraft Engines Division claimed a large past-due amount for maintenance, secured by US possessory liens.

PAL therefore filed an ancillary bankruptcy proceeding in the US to seek an injunction that would assure that its aircraft were not seized as they landed in San Francisco and Los Angeles every day, flying PAL's most profitable routes. Other creditors' particular issues, as

was typical in ancillary proceedings under old Bankruptcy Code § 304, were carved out from the US injunction. The US Export-Import Bank, whose largest problem credit was PAL, and most others were thereby placated. But Boeing, GE and the aircraft purchaser objected to comity being extended to the PSEC proceedings.

One aspect of PD 902-A that would likely be viewed as important with regard to recognition in many ancillary proceedings *outside* the US would be the lack of complete independence of the receiver/administrator. The PSEC had appointed an interim rehabilitation receiver, also deemed to be a management committee, which at times included senior officers of PAL and others with ties to the corporation. Probably due to the strong presumption in US reorganization law that a debtor-in-possession is usually preferable to a truly independent fiduciary, little was made in the US proceeding of these ties between the multi-person receiver and PAL's management.

The objectors complained that under PD 902-A the PSEC was essentially unconstrained by legal principles and argued that moving rehabilitation proceedings to an administrative agency, subject to executive influence, made the Philippine system not worth of international recognition.

In a multi-day trial, PAL argued and presented evidence that the PSEC had, in practice, conformed quite closely to US norms. The bankruptcy judge noted the historic ties between US and Philippine insolvency and rehabilitation law.

PAL argued that US comity decisions through that time had focused on how the tribunal *performs*. Denial of comity by a US court is likely only when a foreign proceeding is, in actual *practice*, devoid of legal standards, notice and practicability. *See, e.g. Hourani*, 185 B.R. 58 (S.D.N.Y. 1995); *Finanz*, 1998 U.S. Dist. LEXIS 5902 (S.D.N.Y.). Most decisions applying comity standards look for “fundamental fairness.” *See Allstate v. Linter*, 994 F.2d 996 (2nd Cir. 1993). Courts espouse a “worthy-unworthy” binary approach. But, based on what is actually occurring in the foreign proceeding, US courts have found the laws of such nations as Canada (*Toga Manufacturing*, 28 B.R. 165 (E.D. Mich. 1983)), Australia (*Interpool, Ltd.*, 102 B.R. 373 (D.N.J. 1988)) and Spain (*Papelinas Reunidas*, 92 B.R. 584 (E.D.N.Y. 1988); *New Line Int'l Releasing*, 140 B.R. 342 (S.D.N.Y. 1988)) to be worthy and unworthy in different cases.

The PAL ancillary proceeding presented an additional challenge for the judge. Nearly all US ancillary bankruptcy proceedings are assistance to *liquidators*, and there was then almost no guidance on what were the most important features in *rehabilitation* cases worthy of comity.

Bankruptcy Judge Thomas Carlson reasoned that the PSEC's actions, guided by various relevant laws and bound by others, and with frequent reference to US law, rather than the PSEC's *theoretical* freedom to be arbitrary, was compelling. He concluded that the PSEC “is not at all the lawless agency objecting creditors portray it to be,” and made the US injunction coterminous with the PSEC's stay.

That, of course, did not resolve objections of various creditors pending before the

PSEC. Also, the labor strife that had been instrumental in causing the filing continued, resulting in a complete – and apparently permanent – shutdown for a time. That led to the US Bankruptcy Judge allowing aircraft to be seized in California. When the airline resumed operations, some secured creditors in the US, with the support of the US Justice Department on behalf of the Export-Import Bank of the United States, resisted turning the seized aircraft back to PAL, and asserted the US court had no jurisdiction over a plane on the ground in Hong Kong, but leased to PAL by a lender in Utah. Judge Carlson ordered that all planes being held on behalf of US-based entities, wherever those planes were located throughout the world, must be turned over to PAL.

A majority of creditors opposed PAL's initial rehabilitation plan in the PSEC proceeding. The plan was amended, majority consent of creditors (and the receiver) was obtained, and the PSEC approved the amended rehabilitation plan. PAL quickly returned to profitability and, despite soaring energy costs, impacts of 9/11 and other challenges to the airline industry worldwide, it appears to be on track to making every payment as promised in the plan.

5. The third phase: all rehabilitation proceedings nevertheless back to the courts

Despite the generally smooth operation of PD 902-A proceedings, including PAL's (smooth at least if one considers its enormous complexity), and the expertise gained by the PSEC in handling those proceedings, once the Asian financial crisis of the late 1990's calmed down, the Philippine government, apparently to accommodate international doubts about corporate reorganizations being handled by an administrative agency, in July, 2000 transferred jurisdiction for corporate suspension-of-payments and rehabilitation cases from the PSEC back to the Regional Trial Courts, as part its adoption of a new Securities Regulation Code. Ironically (at least), non-performing assets of Philippine banks grew from four percent of all assets in 1997, much lower than most other Asian nations, to fourteen percent in 2005, the highest in Asia.

In December, 2000, the Philippine Supreme Court issued Interim Rules on Corporate Rehabilitation (the "Interim Rules") in much the same manner that the U.S. Supreme Court adopted rules of bankruptcy in the early 1970's, several years before the Bankruptcy Code was enacted, to add very substantial detail to the procedural predictability of matters under PD 902-A. The Interim Rules, as did the PSEC's rules adopted a year earlier, are geared toward expediting rehabilitation cases, and they still preserve in the tribunal a large amount of discretion over the approval of plans, as well as other matters.

The Interim Rules also clarify the courts' subject-matter jurisdiction as *in rem* and personal jurisdiction over "all those affected" as acquired by publication in a Philippine newspaper. The proceedings are directed to be "non-adversarial in nature," prohibiting most types of pleadings that would be aimed at attacking or complicating the proceedings. Rule 3 § 1.

A rehabilitation petition may be filed by any business debtor that foresees the "impossibility" of meeting its debts when they come due, or by creditors holding at least 25%

of the debtor's total liabilities. There is no balance-sheet solvency requirement. Rule 4 § 1.

A proposed plan must be filed with the petition initiating the proceeding, together with detailed and audited financial information in a voluntary case. Rule 4 § 2.4. If the court finds the petition sufficient, a stay is ordered and a receiver is appointed. Rule 4 § 6.

One significant change is that the receiver is now likely to be more independent of the debtor. The receiver cannot be a creditor, shareholder, or competitor, or, within the past two years, have been an officer, director, or employee of the debtor or of any of its creditors, or be an underwriter, auditor or accountant for the debtor, among other qualifications. Rule 4 § 13. It is now clarified that the receiver does not manage or control the debtor, "but shall closely oversee and monitor the operations of the debtor." Rule 4 § 14. The receiver primarily looks for the "best way to rehabilitate the debtor" and, among other things, objects to claims and makes various reports to the court. Rule 4 § 14.

The stay can be modified, on grounds that include a lack of adequate protection of collateral. Rule 4 § 11.

The debtor has only eighteen months to obtain court approval of the plan, subject to extensions that cannot exceed an additional eighteen months. Rule 4 § 11. The receiver and creditors comment on the debtor's proposed plan, but creditors still do not have veto power. Rule 4 §§ 9, 20. The court can approve a plan over the objections by even a majority of the creditors if the plan is feasible and creditor opposition is "manifestly unreasonable." In making that determination, the court is to consider whether the objecting creditors will likely receive more than they would receive in a prompt liquidation, the shareholders are giving up at least control, and the receiver is recommending approval.

If a plan is not approved by the deadline, the petition is dismissed. Rule 4 § 11. There is no provision for converting the proceeding to a liquidation, even though the PSEC supervised the liquidation of failed rehabilitation cases. The Supreme Court is considering rules for such matters, and bills pending before the legislature would do likewise.

There is widespread applause for the Interim Rules, which may, among other things, eliminate meaningful challenges to recognition of Philippine rehabilitation receivers in foreign ancillary proceedings. All parties have, though, lost the expertise that had developed in the PSEC, as the proceedings are now heard by generalist trial judges who seldom see such matters. Sixty branches of the Regional Trial Courts have been selected to hear rehabilitation proceedings, as "Special Commercial Courts," and the judges of those courts are given specialized training by the Philippine Judicial Academy. But those judges continue to have diverse caseloads.

The courts have approved rehabilitation plans that appear to adopt some of the more controversial US chapter 11 practices, stretching them beyond the limits that would likely be imposed in US Bankruptcy Courts. Distribution of non-cash assets has been approved. Secured creditors have seen interest rates on their claims stretched on as much as a seventeen-year period, at a rate lower than the lender's cost of funds. The courts have been inconsistent in their rulings on substantive consolidation. Appeals have been commonplace and many are

unresolved.

6. A potential leap forward: pending legislation

Despite the development of articulated standards for plan approval and independence of receivers, there appears to be a consensus growing in the Philippines that the Insolvency Law and Civil Code provisions on lien priorities are so out of date, and P.D. 902-A is so skeletal and ambiguous, that, even when embellished substantially by the Interim Rules, major revisions are needed in the law governing corporate reorganization. The transfer of jurisdiction for rehabilitations to the Regional Trial Courts is generally seen as a positive development in assuring foreign recognition of Philippine proceedings, but more modern procedural rules and specialized judges are widely viewed as desirable.

For the past few years, multiple bills have been pending before the Committee of Banks and Financial Intermediaries of the Congress of the Republic of the Philippines, each of which, if enacted, would greatly revise insolvency and rehabilitation proceedings. The “Corporate Recovery and Liquidation Act” would give veto power to creditors with regard to the plan and appointment of the receiver. It would provide for – and require – conversion of the proceeding to liquidation by an independent party if a plan is not approved within eighteen months. The debtor would essentially remain in possession in most circumstances, but there would be a receiver with limited oversight and reporting responsibilities.

A more intriguing and bold proposal is the “Corporate Recovery Act,” which would create a menu of innovative proceedings to expedite resolution of financial distress. It would create proceedings called “pre-negotiated rehabilitation,” “fast track rehabilitation,” “court-supervised rehabilitation,” and “dissolution-liquidation.”

A pre-negotiated rehabilitation would enable a corporate debtor that has persuaded a majority of its creditors to agree to a workout to bind dissident creditors by a court process expected to take merely *weeks* to complete. An alternate fast-track rehabilitation would be a very creative device, allowing a debtor that lacks a consensus with a majority of its creditors to drop its assets into a debt-free subsidiary and then auction off the stock issued by the sub, with creditors and shareholders having preferred bidding rights. Court-supervised rehabilitation would involve a “conservator” appointed by the court to have custody of the assets, but leave plan formulation to the shareholders, in negotiation with creditors. If a majority of creditors oppose the plan, the case would be converted to a liquidation. Dissolution-liquidation would continue as a standard liquidation proceeding, but with a reform of the Civil Code’s complex ranking of claim priorities and a cementing of the priorities.

These pending bills are part of a wide and concerted effort in the Philippines to adopt best practices for corporate governance and capital market regulation and to thereby attract investment and promote capital formation. Without specialized judges and a large contingent of professionals who limit their practice to such corporate reorganizations, however, statutorily authorized fast-track cases could present numerous challenges. Without numerous financial professionals focused on trading in distressed assets and the stock of corporations that are in distress, extremely rapid procedures might not generate fair value for all constituents.

These reforms would, though, if adopted, indisputably transform the Philippines into a world leader in the arena of corporate reorganization law and procedure.