

# Equality in Equity: Equal Footing of Secured and Unsecured Creditors in Suspension of Payments and Rehabilitation Proceedings

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## I. INTRODUCTION

*Corporate Rehabilitation* was initially a term relatively unknown to Philippine Courts. Corporate rehabilitation was not considered a remedy allowed within its jurisdiction. Rather, the Insolvency Law<sup>1</sup> provided that distressed corporations may either file for suspension of payments or petition the Courts to have the corporation declared as insolvent. The first remedy was taken from the Spanish Code of Commerce while the latter was based on

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1. Insolvency Law of the Philippines, Act No. 1956 (1909).

the California Insolvency Act of 1895.<sup>2</sup> Under suspension of payments, a debtor, who, possessing sufficient property to cover his debts, but foresees the impossibility of meeting them when they respectively fall due, may petition that he be declared in a state of suspension of payments by the courts.<sup>3</sup> Since suspension of payments was reserved for solvent debtors, this option was not available to insolvent corporations. The remedy for such corporations was to set forth a petition, stating among other things 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 that it is applying to be adjudged an insolvent.<sup>4</sup> Because of the inadequacy of these two remedies, Presidential Decree 902-A<sup>5</sup> was promulgated, modifying suspension of payments provided for in the earlier law and expanding the options of financially distressed corporations to include corporate rehabilitation and dissolution. "These remedies are regulator-driven or SEC-controlled inasmuch as in the exercise of this exclusive jurisdiction, the SEC [Securities and Exchange Commission] has taken the position that the provisions of Act Number 1956 are not applicable to these remedies."<sup>6</sup>

The remedies were limited to insolvency proceedings; there were no rules governing corporate rehabilitation. The only guide corporations had were internal rules promulgated by the Securities and Exchange Commission (SEC). The passage of the Securities Regulation Code,<sup>7</sup> which transferred the jurisdiction over rehabilitation and insolvency cases from the SEC to the regular trial courts and the Interim Rules of Procedure on Corporate Rehabilitation,<sup>8</sup> did not change anything. Despite their promulgation, it can be said that the available rules or statutes regarding corporate rehabilitation are insufficient for its effective implementation.

The current absence of comprehensive legislation regarding the rehabilitation of financially distressed corporations in the Philippines has encouraged jurisprudence to develop and respond to this need. The result is

2. Danilo L. Concepcion, *Insolvency Systems in Asia*, available at <http://www.oecd.org/dataoecd/4/11/1897335.pdf> (last accessed August 25, 2004) [hereinafter Concepcion].

3. Act No. 1956, § 2.

4. Concepcion, *supra* note 2, at 1.

5. Reorganization of the Securities and Exchange Commission with Additional Powers and Placing the Said Agency Under the Administrative Supervision of the Office of the President, Presidential Decree 902-A (1976).

6. Concepcion, *supra* note 1, at 1.

7. The Securities Regulation Code, Republic Act No. 8799 (2000).

8. Interim Rules of Procedure on Corporate Rehabilitation, A.M. No. 00-8-10-SC (2000) [INTERIM RULES OF PROCEDURE ON CORPORATE REHABILITATION].

a principle anchored primarily on equitable considerations placing financially distressed corporations back on its feet and at the same time treating both secured and unsecured creditors fairly and impartially.

This article will focus on the "equality in equity principle" placing secured and unsecured creditors on equal footing or *in pari passu* with each other during rehabilitation proceedings. It will also discuss how secured creditors retain the advantages and benefits under their security arrangements despite the application of this principle. Part I will trace the jurisprudential roots of the "equality in equity" principle. Part II will analyze the intent of the Rules on Corporate Rehabilitation. Part III will examine the advantages that secured creditors possess over unsecured creditors. Finally, Part IV will distinguish rehabilitation from insolvency. This is how the author aims to present this Note.

## II. TRACING JURISPRUDENTIAL ROOTS

The seed of "equality in equity principle" placing the secured and unsecured creditors on equal footing in corporate rehabilitation proceedings and suspension of payments did not germinate and grow overnight. It was a consequence of years of fine-tuning by the Supreme Court.

### A. Preferential Right of Secured Creditors in Both Insolvency Proceedings and Suspension of Payments

Initially, in the 1989 case of *Philippine Commercial and International Bank v. Court of Appeals*,<sup>9</sup> the prevailing doctrine enunciated by the Supreme Court was that "suspension of payments could only be applied to claims of unsecured creditors. Such order cannot extend to creditors holding a mortgage, pledge or any lien."<sup>10</sup> It followed the former rule providing that suspension of payments cannot extend to a creditor holding a mortgage, pledge or lien on the property unless they give up the property security or lien in favor of all creditors.<sup>11</sup> Thus, the Court held that the preferential rights of secured creditors over that of unsecured creditors apply not only to insolvency proceedings, but also in case of suspension of payments. This doctrine was later on abrogated in the cases of *Alemar's Sibal and Sons v.*

9. *Philippine Commercial and International Bank v. Court of Appeals*, 172 SCRA 436 (1989).

10. *Id.* at 440.

11. HECTOR S. DE LEON, COMMENTS AND CASES ON CREDIT TRANSACTIONS 586 (2002 ed.) (citing *Philippine Commercial and International Bank v. Intermediate Appellate Court*, 172 SCRA 436 (1989)) [hereinafter DE LEON].

*Elbinias*,<sup>12</sup> *BF Homes Inc. v. Court of Appeals*,<sup>13</sup> *Araneta v. Court of Appeals*,<sup>14</sup> and *Rizal Commercial Banking Corporation v. Intermediate Appellate Court*.<sup>15</sup>

In *Philippine Commercial and International Bank*, petitioner Philippine Commercial and International Bank, PCIB for brevity, entered into a pledge agreement with the Philippine Underwriters Finance Corporation (Philfinance) involving certain shares of stocks and bonds to secure Philfinance's outstanding obligation. Subsequently, the SEC placed Philfinance under suspension of payments and appointed a receivership committee, which recommended that Philfinance be dissolved and liquidated. SEC then ordered the dissolution and liquidation of Philfinance. Meanwhile, PCIB sought to foreclose on the pledge due to Philfinance's failure to satisfy its outstanding obligation. The case found its way to the Supreme Court when the appellate court decided to enjoin the foreclosure sale decreed by the trial court on the ground that the receivership of Philfinance has not yet terminated. The Supreme Court upheld the rights of PCIB as a secured creditor and maintained that "the rights of a preferred creditor remain to be respected and recognized in every existing situation."<sup>16</sup> Furthermore, the Court ruled that there is "no substantial difference between the suspension of actions in the instant case and that under the Insolvency Law."<sup>17</sup>

### B. Legal Consequences of Receivership

However, in the 1990 case of *Alemar's Sibal and Sons v. Elbinias*,<sup>18</sup> the Supreme Court, citing *Central Bank v. Morfe*,<sup>19</sup> which in turn cited *Ramsich v. Fulton*,<sup>20</sup> applied the "equality in equity principle" to a company placed under rehabilitation receivership by the SEC. The Court held that "as between creditors, the key phrase is equality in equity. When a corporation threatened by bankruptcy is taken over by a receiver, all the creditors should stand on equal footing."<sup>21</sup>

12. *Alemar's Sibal and Sons v. Elbinias*, 186 SCRA 94 (1990).

13. *BF Homes Inc. v. Court of Appeals*, 190 SCRA 262 (1990).

14. *Araneta v. Court of Appeals*, 211 SCRA 390 (1992).

15. *Rizal Commercial Banking Corporation v. Intermediate Appellate Court*, 213 SCRA 830 (1992).

16. *Philippine Commercial and International Bank v. Court of Appeals*, 172 SCRA 436, 441 (1989).

17. *Id.*

18. 186 SCRA 94 (1990).

19. *Central Bank v. Morfe*, 63 SCRA 114 (1975).

20. *Ramsich v. Fulton*, 41 Ohio App. 443, 180 N.E. 735.

21. *Alemar's*, 186 SCRA at 99.

In the *Alemar's* case, the bone of contention was whether the execution of a final decision for the payment of a sum of money can be had despite the fact the judgment debtor has been placed under receivership. The Regional Trial Court had rendered judgment ordering Alemar's Bookstore, a business entity owned and managed by petitioner Alemar's Sibal and Sons, Inc., to pay its creditor G.A. Yupangco and Co., Inc. Subsequently, the SEC placed Alemar's under rehabilitation receivership and ordered that all actions against it be suspended in order to ensure the orderly payment of claims. Although as a general rule the lower court's judgment is final and executory, its "stay of execution is warranted by the fact that Alemar's has been placed under rehabilitation receivership."<sup>22</sup> The Supreme Court then enunciated that the legal consequences of a receivership include: (1) suspending claims against the corporation under receivership, and (2) holding its assets in trust for the creditors. The rationale behind is to "preclude [creditors] from obtaining undue advantage or preference over another"<sup>23</sup> and to prevent creditors from "rushing posthaste to the courts to secure judgments for the satisfaction of their claims."<sup>24</sup> In such case, the proper course of action for the creditors would be, not to go to court to secure judgment against the distressed firm, but "to file their claims with the receiver who is a duly appointed officer of the SEC."<sup>25</sup>

### C. Suspension, When Effected

The "equality in equity principle" was reiterated during the same year in the case of *BF Homes Inc. v. Court of Appeals*,<sup>26</sup> wherein the creditors also filed a collection suit despite the fact that BF Homes was placed under rehabilitation receivership. The appellate court suspended the proceedings of the civil action in the trial court based on the wrong supposition that the management committee should be permitted to be substituted for BF Homes as party defendant. It reasoned that the resumption of the civil action is necessary to determine BF Home's liability to the creditors who filed suit. "The flaw in this theory is that even if such liability is determined, it still cannot be enforced by the trial court as long as BF Homes is under receivership."<sup>27</sup> Thus, civil actions against a distressed corporation under rehabilitation receivership are suspended, not because the management committee or rehabilitation receiver has to be substituted for the corporation,

22. *Id.* at 98.

23. *Id.* at 99.

24. *Id.*

25. *Id.* at 99-100.

26. *BF Homes Inc.*, 190 SCRA 262 (1990).

27. *Id.* at 268.

but because of the pending implementation of the rehabilitation plan. This doctrine is further refined by the Supreme Court in 1999 by ruling that the "suspension of actions for claims commences only from the time a management committee or receiver is appointed by the SEC"<sup>28</sup> and not upon the filing of the application for rehabilitation with the SEC.

### D. Rationale for Placing Secured and Unsecured Creditors on Equal Footing

In 1992, the Supreme Court once again affirmed the equality in equity doctrine in the case of *Araneta v. Court of Appeals*.<sup>29</sup> The Supreme Court reiterated that "during rehabilitation receivership, the assets are held in trust for the equal benefit of all creditors to preclude one from obtaining an advantage over another."<sup>30</sup> During the same year, *Rizal Commercial Banking Corporation v. Intermediate Appellate Court*<sup>31</sup> affirmed what was said in *Araneta*, and further held that "whenever a distressed corporation asks the SEC for rehabilitation and suspension of payments, preferred creditors may no longer assert such preference, but as earlier stated, stand on equal footing with other creditors."<sup>32</sup>

In 1994, in the case of *Bank of the Philippine Islands v. Court of Appeals*,<sup>33</sup> the Supreme Court explicitly stated that it has abrogated the doctrine in the *PCIB v. Court of Appeals*<sup>34</sup> case. It ruled that the suspension of preferred creditors' claims against a distressed corporation placed under rehabilitation "will enable the management committee or rehabilitation receiver to effectively exercise his/its powers free from any judicial or extrajudicial interference that might unduly hinder the rescue of the distressed company."<sup>35</sup>

In 1998, the Supreme Court in *Ruby Industrial Corporation v. Court of Appeals*,<sup>36</sup> nullified the rehabilitation plan approved by the Securities and Exchange Commission which gave undue preference to Ruby Industrial's secured creditors over unsecured creditors, with the following reasoning:

28. *Rizal Commercial Banking v. Intermediate Appellate Court*, 320 SCRA 279, 293-294 (1999).

29. *Araneta v. Court of Appeals*, 211 SCRA 390 (1992).

30. *Id.* at 398-99.

31. *Rizal Commercial Banking Corporation v. Intermediate Appellate Court*, 213 SCRA 830 (1992).

32. *Id.* at 837.

33. *Bank of the Philippine Islands v. Court of Appeals*, 229 SCRA 223 (1994).

34. *Philippine Commercial and International Bank v. Court of Appeals*, 172 SCRA 436 (1989).

35. *Rizal Commercial Banking Corporation*, 213 SCRA at 228.

36. *Ruby Industrial Corporation v. Court of Appeals*, 284 SCRA 445 (1998).

All assets of a corporation under rehabilitation receivership are held in trust for the equal benefit of all creditors to preclude one from obtaining an advantage or preference over another by the expediency of attachment, execution or otherwise. As between the creditors, the key phrase is equality in equity. Once the corporation threatened by bankruptcy is taken over by a receiver, all the creditors ought to stand on equal footing. Not any one of them should be paid ahead of the others. This is precisely the reason for suspending all pending claims against the corporation under receivership.<sup>37</sup>

#### E: Rules of Thumb

In 1999, the case of *Rizal Commercial Banking Corporation v. Intermediate Appellate Court*<sup>38</sup> traced the jurisprudential rulings placing the secured and unsecured creditors on equal footing in suspension of payments and rehabilitation proceedings and laid down the following rules of thumb:

*First*, all claims against corporations, partnerships or associations that are pending before any court, without distinction as to whether or not a creditor is secured or unsecured, shall be suspended upon the appointment of a management committee, rehabilitation receiver, board or body in accordance with Presidential Decree No. 902-A.<sup>39</sup>

*Second*, secured creditors shall retain their preference over unsecured creditors. However, the enforcement of such preference is equally suspended upon the appointment of a management committee, rehabilitation receiver, board or body. In case the assets of the corporation, partnership or association are finally liquidated, secured and preferred credits under the applicable provisions of the Civil Code will definitely have preference over unsecured ones.<sup>40</sup>

Thus, once a management committee, rehabilitation receiver, board or body is appointed pursuant to P.D. 902-A, all actions for claims against a distressed corporation pending before any court, tribunal, board or body shall be suspended accordingly. The suspension, however, shall not prejudice or render ineffective the status of a secured creditor as compared to a totally unsecured creditor. P.D. 902-A does not state anything to this effect since it merely provides that all actions for claims against the corporation, partnership or association shall be suspended. This should give the receiver a chance to

37. *Id.* at 460.

38. *Rizal Commercial Banking v. Intermediate Appellate Court*, 320 SCRA 279 (1999).

39. *Id.* at 293.

40. *Id.*

rehabilitate the corporation if there should still be a possibility for doing so. This will be in consonance with the ruling in *Alemar's, BF Homes, Araneta and Rizal Commercial Banking Corporation* insofar as the enforcement of preferred creditors' liens.<sup>41</sup> However, if rehabilitation is no longer feasible and claims against the distressed corporation would have to be settled, the secured creditors shall enjoy preference over the unsecured creditors following the ruling in *Philippine Commercial and International Bank* but subject to the provisions of the Civil Code on concurrence and preference of credit.<sup>42</sup> As further stated by the Supreme Court:

The majority ruling in our 1992 decision that preferred creditors of distressed corporations shall, in a way, stand on equal footing with all creditors, must be read and understood in the light of the foregoing rulings. All claims of both a secured and unsecured creditor, without distinction on this score, are suspended once a management committee is appointed. Secured creditors, in the meantime, shall not be allowed to assert such preference before the Securities and Exchange Commission. It may be stressed, however, that this shall only take effect upon the appointment of a management committee, rehabilitation receiver, board, or body, as opined in the dissent.<sup>43</sup>

The rationale underlying this rule is to enable the management committee or the rehabilitation receiver to effectively exercise its/his powers free from any judicial or extrajudicial interference that that might unduly hinder or prevent the *rescue* of the debtor company. "To allow such other actions to continue would only add to the burden of the management committee or rehabilitation receiver, whose time, effort and resources would be wasted in defending claims against the corporation instead of being directed towards its restructuring and rehabilitation."<sup>44</sup>

It can be said that based on the abovementioned rulings, the rule now is "equality in equity." This finds application in the example that if a property is mortgaged, the secured creditor may not foreclose the property so as not to prejudice other creditors or cause discrimination among them. "If foreclosure is undertaken despite the fact that a petition for rehabilitation has been filed, the certificate of sale shall not be delivered pending rehabilitation. If this has already been done, no transfer certificate of title shall likewise be affected within the period for rehabilitation."<sup>45</sup>

41. *Id.* at 294.

42. *Id.* (citing *State Investment House, Inc. v. Court of Appeals*, 277 SCRA 209 (1997)).

43. *Id.*

44. *Rubberworld Philippines Incorporated v. National Labor Relations Commission*, 305 SCRA 772 (1999).

45. DE LEON, *supra* note 11, at 567.

### III. DETERMINING THE INTENT OF THE RULES OF PROCEDURE ON CORPORATE REHABILITATION

Although the foregoing jurisprudence were decided prior to the transfer of jurisdiction over rehabilitation proceedings from the Securities and Exchange Regulation to the regular courts, they are still applicable even after such transfer. This is expressly stated by the Supreme Court Committee on Securities and Exchange Commission Cases in its Memorandum<sup>46</sup> dated 17 November 2000, explaining the Interim Rules of Procedure on Corporate Rehabilitation.

The Proposed Rules contemplate that the stay order will be effective both against the secured and unsecured creditors. This is consistent with the 'equality in equity' principle in rehabilitation proceedings because allowing the secured creditors to enforce their liens might unduly hinder or prevent the 'rescue' of the debtor or prevent a feasible and viable rehabilitation of the debtor.<sup>47</sup> The proposed rules do not destroy their security position and in the event that the debtor's assets are finally liquidated, the preference of secured creditors will be respected under the applicable provisions of the Civil Code.<sup>48</sup>

The distinction between secured and unsecured creditors has been removed pursuant to the ruling of this Court in rehabilitation proceedings that during rehabilitation receivership, the assets of the debtor are held in trust for the equal benefit of all creditors who all stand on equal footing during rehabilitation.<sup>49</sup>

The above explanation is further clarified by the Minutes<sup>50</sup> of the Committee deliberations during its 17 November 2000 meeting, as follows:

Justice Vitug informed the Committee that the Court wanted guidelines on how to induce the secured creditors [to] agree to a rehabilitation plan

during the proceedings for rehabilitation. The Chairman asked if this can be done by extending a favored treatment to the secured creditors.

Atty. Orendain commented that the matter involves a substantive issue as the (P.D. No. 902-A) does not distinguish between secured and unsecured creditors. He explained that while the secured creditors get some advantage in practice (i.e. subordination of unsecured creditors as regards the issuance of participation certificates), it would be difficult to put the preference in a rule, as it would be counter productive.

Atty. Balgos said that it is different to set a distinction between secured and unsecured creditors during rehabilitation.

After discussion, the Chairman suggested to put a general statement in the Rules to the effect that the rehabilitation plan should give due consideration to the rights of secured creditors consistent with the purpose of rehabilitation. Justice Vitug explained that a general statement will provide flexibility in the formulation of the rehabilitation plan. After fine-tuning, the Committee resolved to add the phrase 'giving due regard to the interests of the secured creditors' in Sec. 4-5.<sup>51</sup>

In sum, rescuing a distressed corporation by placing it under rehabilitation receivership does not endanger the security of the preferred creditors. On the contrary, the operation of the "equality in equity principle" upon appointment of a management committee or a rehabilitation receiver ensures that their claims will be paid. In rehabilitating a firm, the goal is to implement a feasible and viable rehabilitation plan sans any judicial or extrajudicial interference. In effect, the secured and unsecured creditors are thus placed on equal footing such that the secured creditors cannot assert their preferential right over the unsecured creditors pending implementation of the rehabilitation plan. Should the plan fail, the "equality in equity doctrine" ceases to operate and the secured creditors cease to be on equal footing with the unsecured creditors. At that point, the security of the secured creditors may be enforced.

### IV. ADVANTAGES OF SECURED CREDITORS OVER UNSECURED CREDITORS

Since the rule is "equality in equity", many secured creditors and investors have become concerned with whether or not the present rule respects the *non-impairment clause*<sup>52</sup> and *due process clause*<sup>53</sup> found under the Philippine

51. *Id.* (emphasis supplied).

52. PHIL. CONST. art 3, § 10 ("No law impairing the obligation of contracts shall be passed.").

53. PHIL. CONST. art 3, § 1 ("No person shall be deprived of life, liberty or property without due process of law, nor shall any person be denied equal protection of the laws.").

46. Memorandum from the Supreme Court Committee on Security and Exchange Commission Cases (Nov. 17, 2000) (on file with author).

47. *Id.* (citing B.F. Homes Inc. v. CA, 190 SCRA 262 (1990); Alemar's Sibal and Sons Inc. v. Elbinias, 186 SCRA 94 (1990); Bank of the Philippine Islands v. CA, 229 SCRA 223 (1994)).

48. *Id.* (citing Rizal Commercial Banking v. Intermediate Appellate Court, 320 SCRA 279 (1999)).

49. Memorandum from the Supreme Court Committee on Security and Exchange Commission Cases (Nov. 17, 2000) (on file with author) (emphasis supplied).

50. Minutes of the Supreme Court Committee on Security and Exchange Commission Cases (Nov. 17, 2000) (on file with author) (citing Alemar's Sibal and Sons Inc. v. Elbinias, 186 SCRA 94 (1990); Bank of the Philippine Islands v. CA, 229 SCRA 223 (1994)).

Constitution and whether or not it allows for protection of contractual rights found under the Civil Code.<sup>54</sup> Basically, their anxiety stem from the fact that since secured and unsecured creditors stand on equal footing, there is no purpose for requiring security for debts since a secured creditor will also be relegated to the status as that of an unsecured creditor, therefore removing any advantage or preference over other creditors. This statement however, is not accurate. This is because although they stand on equal footing, the advantages and benefits of secured creditors are maintained *vis-à-vis* unsecured creditors.

Secured creditors enjoy property rights over their collaterals, rights *in rem* which are constitutionally protected. This is illustrated in the case of *NDC v. Philippine Veterans Bank*,<sup>55</sup> where the Supreme Court nullified a decreed corporate rehabilitation which provided for the extinguishment of mortgages and other charges of secured creditors for being unconstitutional and void as it abridged the obligatory force of contracts.

Although a rehabilitation plan cannot destroy the property rights of a secured creditor, all assets of a corporation under rehabilitation or receivership are held in trust for the equal benefit of all creditors to preclude any of them from obtaining an advantage or preference over another by the expediency of attachment or execution. This is in line with the Trust Fund Doctrine, held sacred by the Corporation Code<sup>56</sup> and accepted by civil and common-law jurisdictions as early as in 1921. It is widely accepted that a corporation which is insolvent or is, in dealing with its funds in contemplation of insolvency and not in the ordinary course of business, has no power to prefer particular creditors.<sup>57</sup> This rule is founded upon the doctrine that "the assets of a corporation constitute in equity a trust fund pledged to the payment of all its debts which must be construed as meaning pledged to the payment of all debts ratably and equally without preferences

54. Cesar Villanueva, *The Philippine Experience: Specialized Court System for Insolvency Proceedings*, available at <http://www.oecd.org/dataoecd/7/43/1874140.pdf> (last accessed Aug. 25, 2004). This article provides that there are concerns regarding the following contract provisions of the Civil Code: a) freedom to contract and stipulate the terms and conditions, b) the binding effect of contracts on both parties in any form perfected and that contracting parties are mandated to comply with all the consequences thereof, and c) contracts creating real rights over property bind the world who take possession of the property.

55. *National Development Corporation v. Philippine Veterans Bank*, 192 SCRA 257 (1990).

56. *The Corporation Code of the Philippines*, Batas Pambansa Blg. 68 (1980), art. 122.

57. 14-A CORPUS JURIS, *Insolvency and Receivers*, § 3074-77 (1921).

among creditors of the same class."<sup>58</sup> This is also consistent with the current jurisprudential rulings in the Philippines on corporate rehabilitation that, as between creditors, the key phrase is "equality in equity". Once the corporation threatened by bankruptcy is taken over by a receiver, all the creditors ought to stand on equal footing. *Not any one of them should be paid ahead of the others.* This is precisely the reason for suspending all pending claims against the corporation under receivership. The rationale is to effect a feasible and viable rehabilitation which cannot be achieved if one creditor is preferred over the others. If a secured creditor is allowed to be paid his claim from a distressed corporation while a rehabilitation plan is being implemented, it is likely that the debtor's remaining assets will be compromised.

All financial creditors composed of secured and unsecured creditors, excluding trade creditors, are to be repaid *pari passu* under the rehabilitation plan using the principle of "equality in equity." But if a creditor has security, he may enjoy priority in the event of liquidation or default of the corporation under the rehabilitation plan. Following this, the proper interpretation of the phrase "giving due regard to the interests of secured creditors" found under Section 5 of the Interim Rules of Procedure on Corporate Rehabilitation<sup>59</sup> is to give *adequate protection* to the secured creditors.

The right of the secured creditors must be balanced with the policy of the law to preserve the debtor's estate and salvage and rehabilitate its business as a going concern. The secured creditor is entitled to constitutional protection to the extent of the value of his collateral. Such adequate protection may take the following forms: (1) the debtor honoring a pre-existing agreement with the creditor to keep the property insured, (2) the debtor taking commercially reasonable steps to maintain the property, and (3) preventing the depreciation of the creditor's collateral or compensating him for such depreciation to avoid under-security.<sup>60</sup> These measures of adequate protection should apply to safeguard secured creditors during the implementation of the rehabilitation plan. Failure to observe these measures will allow the secured creditor to cause the lifting of the stay order for enforcement of claims against the ailing corporation.<sup>61</sup>

58. *Id.*

59. INTERIM RULES OF PROCEDURE ON CORPORATE REHABILITATION, RULE 4, § 5.

60. *Id.* § 12

61. INTERIM RULES OF PROCEDURE ON CORPORATE REHABILITATION, RULE 4, § 12. The provision provides in full:

The court may, on motion or *motu proprio*, terminate, modify, or set conditions for the continuance of the stay order, or relieve a claim

### V. DISTINGUISHING REHABILITATION FROM INSOLVENCY

To fully appreciate the principle of "equality in equity", distinction must be made between insolvency proceedings under the Insolvency Law and corporate rehabilitation under Presidential Decree 902-A.

Insolvency denotes the state of a person whose liabilities are more than his assets. It is the "relative condition of a person's or entity's assets and liabilities that the former, if all made immediately available, would not be sufficient to discharge the latter."<sup>62</sup> Insolvency proceedings may be commenced by the debtor or by three or more creditors whose credit extended to the debtor exceeds P1,000. Once adjudged insolvent, the corporation must surrender all its properties to an assignee. The assignee cannot continue the management of the corporation because cessation of

from the coverage thereof upon showing that: (a) any of the allegations in the petition, or any of the contents of any attachment, or the verification thereof has ceased to be true; (b) a creditor does not have adequate protection over property securing its claim; or (c) the debtor's secured obligation is more than the fair market value of the property subject of the stay and such property is not necessary for the rehabilitation of the debtor.

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

- a. the debtor fails or refuses to honor a pre-existing agreement with the creditor to keep the property insured;
- b. the debtor fails or refuses to take commercially reasonable steps to maintain the property; or
- c. the property has depreciated to an extent that the creditor is undersecured.

Upon showing of a lack of adequate protection, the court shall order the rehabilitation receiver to (a) make arrangements to provide for the insurance or maintenance of the property, or (b) to make payments or otherwise provide additional or replacement security such that the obligation is fully secured. If such arrangements are not feasible, the court shall modify the stay order to allow the secured creditor lacking adequate protection to enforce its claim against the debtor; *Provided, however*, That the court may deny the creditor the remedies in this paragraph if such remedies would prevent the continuation of the debtor as a going concern or otherwise prevent the approval and implementation of a rehabilitation plan.

corporate life is contemplated. Thus, the assignee is simply tasked to preserve the assets of the distressed corporation and create an effective distribution plan for the liquidation of such assets. Secured creditors can enforce their security by foreclosing mortgaged property. Insolvency proceedings aim "to conserve all the remaining assets of the insolvent for distribution to the creditors after payment of taxes."<sup>63</sup>

Rehabilitation, on the other hand, is a remedy available to an insolvent corporation which may still be rehabilitated through the institution of some changes in the corporation's management, policies, strategies and organization. Under PD 902-A, corporations may petition to be placed under rehabilitation. The same law however, does not provide for the mechanics under which the remedy may be availed of. Unlike insolvency proceedings, rehabilitation contemplates a continuance of corporate life in an effort to restore and reinstate the corporation to its former position of successful operation and solvency. In undertaking rehabilitation, the idea is to put the distressed corporation back into a state of viability, a condition which benefits not only the corporation and its stockholders but also its creditors who are thereby assured of being paid. Rehabilitation enables the company to gain a new lease on life thereby allowing the claims of its creditors to be paid from its earnings. Parenthetically, the rehabilitation of a financially distressed corporation benefits its employees, creditors, stockholders, and in a large sense, the general public.

The aim in rehabilitation proceedings is to resuscitate an ailing corporation and enable it to be a money-making enterprise; not to drain its coffers dry just to adhere to the preference accorded to some creditors. The creditors are presumed to know the risks involved when they lent their credit to the corporation under receivership, and, therefore, the rehabilitation must take precedence over their preferred status.

Because of this purpose, the credit preferences provided for by law are not applicable in rehabilitation proceedings. The preferred creditors may only invoke their right of preference upon the institution of insolvency or other liquidation proceedings which contemplate the cessation of corporate life. Well-settled is the rule that a declaration of bankruptcy or a judicial liquidation must be present before preferences over various money claims may be enforced. The preferences established by law in favor of secured creditors become material only when rehabilitation is no longer feasible. In such cases, secured creditors would enjoy preference over unsecured creditors during the settlement of claims. The logic lies in the fact that since the creditor's security is assured of protection, there is no reason why he should not be relegated to the same footing as that of other unsecured creditors during rehabilitation.

62. BLACK'S LAW DICTIONARY 797 (6d ed. 1991).

63. *Araneta*, 211 SCRA at 399.