

ASIAN DEVELOPMENT BANK

**REGIONAL TECHNICAL ASSISTANCE
TA NO: 5795-REG
INSOLVENCY LAW REFORM**

**SUPPLEMENTARY REPORT ON
PHILIPPINES**

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A. Insolvency Process

- (a) **corporations whose financial affairs have been or are being handled under the relevant process, framework or agreement governing informal corporate debt restructuring [the numbers should be from the date that the process, framework or agreement was established to facilitate informal restructuring; details of the corporations should relate to size, industry type, debt level]**

As no formal reporting or filing system is in place for informal restructuring, we are not in a position to give statistics or data on this matter. However, as there are reports in the newspapers from time to time of agreements having been reached between debtors and their bank creditors, the public in general is aware that there have been a number of informal corporate debt restructurings. Indeed, our firm has been involved in several restructurings involving debts exceeding One Billion Philippine Pesos (PP=1,000,000,000).

- (b) **corporations which have been placed in formal liquidation under the relevant insolvency law [numbers and details should be from January 1999].**

Based on available statistics coming from the Philippine Securities Exchange Commission (the "SEC") for the period of January to end of July 1999, no corporation has been placed in formal liquidation during the said period by the SEC under Presidential Decree No. 902-A. With respect to insolvency cases filed under Act No. 1956, as amended, otherwise known as "The Insolvency Law", there is no way to determine the number of corporations that have been placed in formal liquidation by the various Regional Trial Courts around the Philippines unless such decision is contested and reaches the Supreme Court.

- (c) **corporations whose financial affairs have been or are being handled under the relevant insolvency law governing reorganization [numbers and details as in (b)].**

Based on a list we obtained from the SEC of cases for suspension of payments filed from 1 April 1982 to 30 October 1998 and from 1 January to 31 July 1999 with the SEC, the following are the relevant numbers of corporate insolvency cases or administrations in the Philippines:

Year	Number of Cases Filed
1982	1
1983	0
1984	2
1985	0
1986	0
1987	0
1988	0
1989	0
1990	1
1992	4
1993	5
1994	2
1995	10

Year	Number of Cases Filed
1996	9
1997	20
1998	32
1999	11

1.	Number of cases dismissed	30
	• due to failure to comply with requirements	18
	• due to other reasons	12
2.	Companies going through rehabilitation	4
3.	Cases with on-going hearings	22
4.	Number of:	
	a) Manufacturing Companies	35
	b) Realty Companies	20
	c) Sugar Milling Companies	4
	d) Steel Fabrication Companies	3
	e) Construction Companies	3
	f) Retail Companies	3
	g) Towing Companies	2
	h) Hotel and Resort Companies	2
	i) Garments/Fabrics Companies	2
	j) Others	32
5.	Value of total assets involved in the cases filed from April 1982 to 30 October 1998	P135,393,187,921.32
6.	Value of total assets involved in the cases filed from 1995 to 30 October 1998	P127,009,242,491.00
7.	Value of total assets involved in the cases filed from 1 January to 31 July 1999	P41,224,155,935.41
8.	Value of total liabilities involved in the cases filed from April 1982 to 30 October 1998	P 209,969,677,315.25
9.	Value of total liabilities involved in the cases filed from 1995 to 30 October 1998	P202,632,629,651.00
10.	Value of total liabilities involved in the cases filed from 1 January to 31 July 1999	P 19,071,597,384.14

Among the well publicized petitions for a suspension of payments were the following companies: Philippine Airlines, Inc., Victoria's Milling Co., Inc., the Uniwide Group of Companies, and the EYCO Group of Companies.

In the case of Philippine Airlines, Inc. ("PAL"), as of 19 June 1998, it declared that it had assets totalling P90,642,933,919.00 and liabilities in the total amount of P85,109,075,351.00. The SEC has approved the rehabilitation plan of PAL.

As for Victorias Milling Co., Inc. (“VMC”), on 4 July 1997, it declared that it had assets totalling P7,124,933,698.00 and liabilities in the total amount of P5,068,870,236.00. Sometime in June 1999, the SEC approved a plan aimed at bringing VMC back on its feet almost two years after it sought the suspension of payment of its P5 Billion debt.

For the Uniwide Group of Companies (comprised of Uniwide Sales, Inc., Uniwide Holdings, Inc., Naic Resources and Development Corp., Uniwide Sales and Resources Corp., First Paragon Corp., and Uniwide Sales Warehouse Club, Inc. which are engaged in either the real estate or retailing business) (“Uniwide”), records have indicated that it has a combined liability amounting to Eleven Billion One Hundred Million Philippine Pesos (PP=11,100,000.00) and had total assets amounting to Nineteen Billion Eighty Six Million Philippine Pesos (PP=19,086,000.00). A three-man interim receiver was appointed to verify the accuracy of Uniwide’s petition, including its annexes such as the schedule of debts and liabilities, and to ascertain the causes of its problems including possible fraud, misconduct or mismanagement. The receiver was also directed to monitor Uniwide’s operations, immediately report any material adverse change in its business, evaluate the possibility of a restructuring, and take custody of existing assets and liabilities. The interim receiver was given two months from 29 July 1999 to come up with its recommendations. Uniwide blames its massive land-banking and its ill-timed venture into real estate development for its severe financial strain and its inability to meet its maturing debt obligations.

With respect to the EYCO Group of Companies (comprised of Nikon Industrial Corp., Nikolite Industrial Corp., Trade Hope Industrial Corp., First Unibrands Food Corp., Integral Steel Corp., Eycos Properties, Inc., and Thames Phils., Inc.) (the “EYCO Group”), according to its financial statement for 1997, its total assets amounted to Four Billion Seven Hundred Million Philippine Pesos (PP=4,700,000.00) while its liabilities amounted to Six Billion Eight Hundred Million Philippine Pesos (PP=6,800,000.00). On 14 September 1999, the SEC, finding the EYCO Group to be insolvent with a capital deficiency of more than Two Billion Philippine Pesos (PP=2,000,000,000.00), dismissed EYCO Group’s petition for suspension of payment and ordered the latter’s immediate liquidation and dissolution. The rehabilitation plan proposed by the EYCO Group called for the development of a condominium complex. This was rejected by the SEC due to the illiquid and unstable real estate market.

2. Provide details and copies of any published comments, opinions or statements describing how the above processes are working and the level of success or otherwise.

The following are the published articles of Francis Ed. Lim, one of the senior partners of Abello Concepcion Regala & Cruz Law Offices (ACCRA) that have appeared in a daily newspaper, The Philippine Star:

- a. Voting on Rehabilitation Plans for Distressed Companies (3 August 1999),
- b. Some Jurisdictional Questions on Rehabilitation Cases Before the SEC (29 June 1999),
- c. Abuse of Creditors’ Rights by Financially Distressed Companies (20 July 1999),
- d. Suspension of Claims Under the Presidential Decree No. 902-A, as amended,
- e. Personal Liability for Debts of Company Seeking Rehabilitation (26 January 1999),
- f. Corporate Rehabilitation for Distressed Companies (13 October 1998),

Summaries of the paper “Corporate Rehabilitation: The Philippine Experience” delivered by SEC Associate Commissioner Danilo L. Concepcion before a group of economists and businessmen were reported in several newspapers.

B. Insolvency Reforms

1. Provide details of any reforms that have occurred in relation to insolvency law and practice and related areas (such as corporate governance, secured transaction and so forth) since January 1999.

The SEC on July 1999 released for comments and public hearing the draft “Rules of Procedure on Corporate Recovery” (the “Draft Rules”). During the public hearings held on 2 and 10 August 1999, the Chairman of the SEC announced that the Draft Rules were expected to be adopted and approved by the SEC before the end of August and to be effective by mid-September. To this date, the SEC has not yet adopted and finalized the Draft Rules.

The Draft Rules governs the procedure to be followed by the SEC on petitions for: (1) suspension of payment where the debtor possesses sufficient property to cover all its debts but foresees the impossibility of meeting them when they respectively fall due because of some temporary economic or liquidity problems; (2) rehabilitation where the insolvent company may still be rehabilitated through the institution of some changes in its management, organization, policies, strategies, operations, or finances; and (3) in case of termination of the two preceding proceedings for a reason other than the success thereof, dissolution and liquidation of the debtor-company.

2. Provide details of any proposed reforms as above.

The Draft Rules have the following salient features:

(a) Rule I (General Provisions)

Rule I defines terms such as: “Affidavit of General Financial Condition”, “Board of Directors”, “Claim”, “Creditor”, “Commission”, “Commissioner”, “Debtor”, and “Stockholder”.

(b) Rule II (Common Provisions)

Rule II identifies the parties in interest, gives the venue of hearings, allows permissive intervention and provides that any order issued by the SEC under the Draft Rules is immediately executory. Section 5 enumerates the instances when a receiver, liquidator or member of a management committee shall be deemed to have a conflict of interest while Section 6 provides that a receiver or member of the management committee may be removed by the SEC, upon motion or motu proprio on account of conflict of interest or on grounds for removing a trustee under the general principles of trusts.

(c) Rule III (Suspension of Payments)

Rule III provides for the filing of a simple petition for suspension of payments which may be filed by a debtor possessing sufficient property to cover all its debts but foresees the impossibility of meeting them when they respectively fall due because of some temporary economic or liquidity problems. Rule III prescribes the contents of the petition (Sec. 2) and the effect of failure to submit attachments thereto (Sec. 3). Upon filing of the petition, the SEC shall issue an order staying all actions to enforce payment of all claims for thirty days, which may be extended provided such extension does not exceed six months (Sec. 4). A suspension order shall be issued by the SEC, which in no case shall exceed two (2) years from the filing of the petition (Sec. 8). An Oversight Committee composed of representatives of secured and unsecured creditors and the SEC may be appointed by the SEC to oversee the operations of the company, which, however, shall remain in the hands of the incumbent management. (Secs. 9-11).

If the inability of the company to pay will last for more than two years or the company has become actually or technically insolvent, the SEC, upon motion or motu proprio, may treat the petition for suspension of payments as one for rehabilitation and proceed with it in accordance with Rule IV (Sec.12-13).

The SEC, by motion or motu proprio, may create a Management Committee composed of three (3) members from the private sector if there is imminent danger of dissipation, loss, wastage or destruction of assets or other properties or paralyzation of business operations of the company which may be prejudicial to the interest of those concerned (Sec.14-15).

(d) Rule IV (Rehabilitation)

An insolvent company which may still be rehabilitated through the institution of some changes in its management, organization, policies, strategies, operations, or finances, or any of its creditors or stockholders, may petition the SEC to be placed under rehabilitation (Sec.1). The petition must be verified and shall include the required documents, including the rehabilitation plan and at least three nominees for Interim Receiver. If the debtor filed the petition, it must be accompanied by an Affidavit of General Condition. (Sec.2) Upon filing of the petition, an order for a period of sixty (60) days suspending all actions to enforce claims against the company shall be issued by the SEC. Such suspension may go beyond one hundred eighty (180) days if there is convincing evidence that there is a good chance for a successful rehabilitation. (Sec.9)

(e) Rule V (Dissolution and Liquidation)

In case of termination of the proceedings under Rules III and IV for a reason other than the success thereof, the SEC may, upon motion or motu proprio, order the dissolution and liquidation of the company (Sec. 1).

During the public hearings, concerns were raised that the different sectors whose interests will be affected by the Draft Rules were not accorded sufficient time to study and comment on the same. The SEC Chairman explained that as the Draft Rules were prepared pursuant to certain undertakings by the Republic of the Philippines to the World Bank and other multilateral institutions to adopt a set of rules and procedures for the speedy resolution of debt relief proceedings filed before the SEC, a tight deadline has to be met.

The SEC received comments on the Draft Rules from the different law firms. The threshold issue raised in these comments is the authority of the SEC to include matters in the Draft Rules which should properly be the subject of legislation. Under Philippine law, the SEC, like any administrative body, could wield only such powers as are specifically granted by law. Thus, some argued the Draft Rules should not go beyond the provisions of the Insolvency Law and Presidential Decree No. 902-A ("PD 902-A"), as amended (i.e., the two laws applicable for debt relief proceedings) and that the SEC should not create, divest or add new rights or proceedings not found in the said laws. The law practitioners said that the SEC did exactly the opposite when it promulgated the Draft Rules.

Some criticisms raised against the Draft Rules were:

- (a) Rule III recognizes a petition for suspension of payment but does not follow the procedure prescribed by the Insolvency Law. Instead the Draft Rules created its own procedure for suspension of payments. Many lawyers are of the view that a petition for suspension of payments should comply with the procedures prescribed by the Insolvency Law while others believe that a petition for suspension of payments with a request for the appointment of a

rehabilitation receiver removes the proceeding from the ambit of the Insolvency Law. This issue has not been settled by the Draft Rules.

- (b) An order suspending all actions and proceedings to enforce payment of all claims against the petitioner for a period of thirty days shall be issued by the SEC upon filing of the petition (Sec. 7, Rule III). This contravenes existing jurisprudence which states that the mere filing of a petition for suspension of payments does not ipso facto stop actions and procedures for claims.
- (c) Actions for the recovery of property being used by, but not belonging to, the petitioner in a suspension of payments proceeding are among those actions covered by a suspension order (Sec. 8, Rule III). This in effect favors the debtor in a suspension proceedings over the owner of the property such as a lessor, an unpaid vendor holding title by way of security or a beneficiary or property held in trust.
- (d) The suspension order is approved by the SEC and not the creditors (Sec. 8, Rule III). The Insolvency Law requires approval of the creditors.
- (e) The suspension order may extend up to a period of two (2) years from the filing of the petition (Sec. 8, Rule III). There is no mention of such a suspension period in the Insolvency Law and PD 902-A.
- (f) Incumbent management will continue to manage the corporation even after the filing of suspension of payments but the Draft Rules authorize the creation of an Oversight Committee to oversee the day to day operations of the corporation. (Sec. 9-10, Rule III).
- (g) Considering that actions for claims will be suspended over a period of time, the Draft Rules does not contain provisions which give adequate protection to the interests of creditors.
- (h) There appears to be no legal basis for the Draft Rules to bar all claims not filed with the liquidator at the end of the specified period for the filing of claims against the debtor (Sec. 5, Rule V).
- (i) There appears to be no legal basis for the Draft Rules to order the confiscation of payments due to claimants which are not collected by them within one year from date of tender (Sec. 12, Rule V).

In view of the gap in the laws on debt-relief proceedings, a comment was made that the SEC should not have prepared the Draft Rules but should have waited instead for the enactment of a new insolvency law. Indeed, a new insolvency law would have been the ideal solution; except that Congress has not yet began to act on the matter. Indeed, it will probably take many more years before new legislation can be enacted. The SEC appears to have opted for the next best thing - promulgate a set of rules for the debt relief proceedings filed before it. In doing so, there is a danger that portions of the Draft Rules which creates, divests or adds new rights or proceedings not found in the Insolvency Law and/or PD 902-A may be adjudged unconstitutional.

C. Corporations

- 1. Identify and detail the areas in which it is considered that relevant accounting practice or regulation is weak and could be strengthened [for example, accounting and financial information; projections of income/expenditure; valuation of assets; debtor and creditor control]**

The following areas in relevant accounting practice and regulation have been identified as weak and could be considerably strengthened:

(a) Significant Variances Between Philippine Generally Accepted Accounting Principles and the United States' Generally Accepted Accounting Principles

One striking difference is that of allowing appraised value of assets to be reflected in the financial statements of the company. This accepted accounting practice facilitates the claim made by companies filing for debt-relief with the SEC that they have sufficient assets to meet their liabilities.

(b) Accepted Practice of Keeping of Different Sets of Accounting Records

Concerns have been raised on the reliability of audited financial statements submitted by prospective borrowers when they apply for a loan with a bank as small, medium and even some large privately-held corporations are generally viewed to keep more than one set of accounting records. The accounting records used as basis for the audited financial statements and income tax return submitted to the Bureau of Internal Revenue generally present a significantly lower income/assets for the corporation.

(c) Low Regard for Professional Ethics and Responsibility

Concerns have likewise been expressed that some accountants sign audited financial statements without actually conducting an audit of the company. Thus, there is the perception by some quarters that an audited financial statement does not really reflect the actual financial condition of the company as the accountant did not conduct an audit. Some have even expressed the view that, unlike the members of the large and reputable auditing firms, some accountants seem to have lost their integrity due to a lack of appreciation of what their signature stands for. In multi-million financing arrangements, it is normal for financial institutions to require that the financial statements be prepared by an accounting firm affiliated with one of the large international accounting firms. It should be noted though that the integrity of the financial statements of two publicly-held companies prepared by a large local auditing firm affiliated with one of the largest international accounting firms were placed in serious doubt after the two companies started having difficulties servicing their debts. These two incidents appear to be isolated, however, as they involved possible fraudulent acts of the officers of the publicly-held companies to hide mounting losses.

A suggestion that has been proposed is to enact laws to bring about the reforms needed to meet the foregoing concerns. Such laws should address areas such as a more stringent code of professional responsibility for accountants.

2. Identify and detail areas of weakness in corporate governance by reference to such factors as director's duties and their performance; financial management and responsibility; the interests of shareholders and creditors. If possible, provide specific example of cases in which examples of such weaknesses have been found to exist.

Although the Board of Directors exercises all the corporate powers of the corporation and conducts its business and control its properties, directors are not generally held liable for the debts of the corporation. Of course, if the director guarantees the debts, or knowingly assents to, patently unlawful acts of the corporation, or is guilty of gross negligence or bad faith in managing the affairs of the corporation, such director becomes jointly and severally liable for damages caused to third persons, including creditors.

Not a few have observed that among the corporations which file for debt-relief are those which may be considered to be managed by a controlling individual stockholder and which has experienced tremendous growth and expansion in recent years. Accusations that

the controlling individual stockholder siphoned off the funds of the corporation abroad or that the financial difficulties of the corporation were caused by the extravagant lifestyle of the controlling individual stockholder are not uncommon.

This raises the issue of whether the directors prudently and diligently exercised and performed their powers and functions under the Corporation Code which provides that “the corporate powers of [the] corporation ...shall be exercised, all business conducted and all property...controlled and held by the board of directors.” For some, the board of directors merely rubber-stamps the decisions of the controlling stockholder in running the company. In many of these companies, the controlling individual stockholder may be said to be responsible for the growth and expansion of the company and this is probably the reason why directors, many of whom were selected by him, give him a free hand in running the company.

Another problem that has been observed on companies that are managed by a controlling individual stockholder and that have experienced rapid growth in recent years is the over-centralization of the decision-making process. Most, if not all, corporate actions must be approved by the controlling individual stockholder. In some instances, all vouchers and checks issued by the corporation must be signed and approved by him or trusted family members or friends involved in the operation of the business. This leads some people to observe that the controlling individual stockholder has retained a “sari-sari store” (small retailers found in almost every corner in the Philippines) mentality where the owner is active in all the aspects of the business. It has been observed that this is not conducive to the development of professional managers willing to make management decisions with the corresponding responsibility for making said decisions.

In the debt relief proceedings of PAL, the creditors considered the engagement of professional advisers as an essential element for the rehabilitation of the distressed airline. The creditors in effect contended that if the controlling individual shareholder, Philippine businessman Mr. Lucio Tan, was allowed to continue managing the airline, without the required professional expertise, the airline could never become profitable. Although the creditors do not doubt the business acumen of Mr. Tan, who is one of the most successful businessmen in the Philippines, the creditors believe that Mr. Tan’s management style is not suited in the airline industry, which requires sophisticated know-how and skills. It appears that the SEC appreciated this position as the engagement of professional consultants was one of the requirements for the approval of the rehabilitation plan of PAL.

3. Identify and detail areas of concern regarding political, government or commercial links with corporations, by reference to such factors as “cronyism”, “patronage” and corruption.

Recent newspaper articles have raised the fear that cronyism is becoming rampant under the current presidency. This is brought about by the following incidents reported in the media:

- (a) the return to positions of power and influence of the Marcos family and their business associates;
- (b) lucrative deals with government owned or controlled corporations favor those who are well connected to the present administration. Some quarters have attacked the grant without public bidding by the state-run Philippine Gaming Corporation of exclusive franchises to operate bingo and spanish pelota betting stations to those groups identified with the current administration; and
- (c) rumors circulating in the business circles that the biggest deals in the country are brokered by powerful individuals close to the President.

The newspapers recently reported that the International Monetary Fund has expressed concerns over the comeback of cronyism in the Philippines.

4. Identify and detail areas of concern regarding the size and power of corporations, corporate group or conglomerates.

There is generally no manifest concern over the size and power of corporations, corporate group or conglomerates in the Philippines. Recently, however, concerns have been raised by some sectors on what they perceived as cartel-like behavior of the three biggest oil companies in the country, particularly in the price-fixing mechanism for gasoline and oil products.

5. Is it practical and might it be of benefit to introduce legal guidelines on director duties and responsibilities and to provide sanctions or penalties for breach or non-observance of such duties? If so, outline the areas to be covered and the nature of any sanctions.

Yes. This should specially hold true for directors in the financial and banking sector. A government official has recently expressed the view that the Bangko Sentral should have stricter supervision and control over officers and directors of financial institutions and banks as in not a few instances of bank failures, the officers who caused the collapse of the bank can be said to have little knowledge of the banking business. The predecessor of the Bangko Sentral, the Central Bank of the Philippines, came out in 1976 with a pamphlet entitled "Directors' Duties, Liabilities and Responsibilities". Based on the then relevant laws, banking regulations and jurisprudence, the pamphlet discusses in detail the (1) the statutory and regulatory requirements, (2) the responsibilities and duties, and (3) the liabilities, of directors of banks and non-bank financial intermediaries performing quasi-banking functions. As an initial step in making corporate directors, in particular, and the public, in general, familiar with directors' duties, responsibilities and liabilities, it is highly recommended that the SEC publish a similar pamphlet based on existing laws, rules and regulations, and jurisprudence.

While we understand that in certain countries directors of certain corporations that have become insolvent are disqualified from becoming directors of other corporations, there is no similar restriction under Philippine law. The idea of penalizing either by imprisonment or the imposition of a hefty fine directors guilty of gross negligence has likewise been raised.

6. Would directors of corporations benefit from education and training on such areas such as financial management and responsibility, negotiation of a financial restructure, informal work out techniques? If so, detail the areas and the type of program.

Yes. Senior officers should also be included as they are the ones involved in the day-to-day management of the business.

Many note that a significant number of corporations which filed for debt-relief with the SEC faced financial difficulties after recklessly diversifying into areas completely separate and distinct from their core business. Directors can benefit from education and training on financial responsibility and management to lessen, if not avoid, such reckless diversification.

While directors will benefit from education and training on the conduct of negotiations of a financial restructuring and on informal work out techniques, such efforts are hampered by the lack of a proper legal structure for financial restructuring and informal work outs.

D. Banks/Finance Providers

1. Identify and detail the areas in which it is considered that the lending practices of domestic banks are weak and might be improved or strengthened.

There is some concern on the reliability of audited financial statements submitted by prospective borrowers. Where the financial statements and income tax returns submitted to the bank do not justify the grant of a credit line, there are apparently other means (e.g., a second set of book of account) pertaining to the financial condition of the prospective borrower that may lead the banks' lending officers to approve the credit line. Another set of documents may indicate that these borrowers have a greater earning capacity/assets than those indicated in the documents officially submitted.

A view has likewise been expressed that before the onset of the region-wide Asian economic crisis (i.e., middle of 1997) when the Philippine economy was experiencing steady growth, banks were under some form of pressure to lend without sufficient collateral and/or documentation for fear that if they do not do so another bank will get the business. However, since the start of the Asian economic crisis, banks, under the watchful eye of the Bangko Sentral ng Pilipinas (BSP) have become stricter. Many have in fact observed that banks are now reluctant to lend and that the BSP have initiated several measures to encourage banks to start lending again.

As a result of the economic slowdown, the BSP has tightened enforcement of banking regulations pertaining to documentation of bank loans and has issued several circulars on this regard. Essentially these circulars provide that if during the course of the BSP's audit of the bank, there are loan accounts which are considered deficient based on the financial capacity of the borrower to pay, as indicated by the supporting documents (i.e., audited financial statements, income tax return), the bank would be required to provide reserves for those loans. In some instances, such an audit by the BSP will result in the cancellation of the credit line by the bank unless sufficient and adequate documentation are provided by the borrower. Some noted however that the bank and the borrower have made arrangements that in case the BSP would notice these violations, the borrower should just be charged an additional interest as compensation to the bank for the reserves being required by the BSP. One banker has stated that some banks are beginning to encourage their borrower-clients to produce appropriate documentation, including the audited financial statements showing the actual condition of the business.

Although large foreign banks are generally considered to have more stringent standards (e.g., documentation) than local banks in giving out loans, an observation has been made that not a few foreign banks have relaxed their standards to become competitive with the local banks. These foreign banks end up getting their share of bad and/or non-performing loans.

The following areas were likewise identified as requiring improvement:

- a) **Documentation.** Complete and proper loan documentation (e.g. the loan agreement, Collateral Trust Agreement, Joint and Several Suretyship) will leave banks adequately secured in the event loans extended become past due.
- b) **Loan Administration/Monitoring Policies.** Most banks are remiss on their duty to regularly monitor its borrowers to see how their businesses are doing. Banks should periodically check on the business of their borrowers as well as its surrounding business environment to ascertain and anticipate any difficulties such borrowers can expect in the future. Banks can then take such action as may be necessary or

pertinent to protect their interests and/or help such borrowers if they determine that the borrowers can ride out the expected difficulties.

- c) **Remedial Management.** Banks should have personnel with sufficient experience in handling formal insolvency cases or informal work outs. These people should have the ability to make sound decisions as well as the authority to make such decisions quickly without having to wait for the appropriate board approval.

An observation was made that before the onset of the Asian crisis, officers and employees of banks and other financial institutions were getting training and education through various programs instituted by the Bankers Association of the Philippines with an affiliated business school. After the onset of the Asian crisis, the budget of banks and other financial institutions for such training and education were slashed. It has been suggested that such education and training should be required, which we understand is the case in other east Asian countries.

2. Identify and detail areas of concern regarding the involvement of banks with corporations (for example, through equity holding, long term relationship, government association).

In the Philippines, there are rules governing the investment of banks in the equity of any enterprise. Banks may invest in the equities of allied undertakings, whether financial or non-financial, or non-allied undertakings as defined in the Manual of Regulations for Banks. Universal banks frequently invest in non-allied undertakings in the endeavor to achieve greater profits.

Before the onset of the Asian crisis, the Bangko Sentral issued numerous banking licenses which caused many people to cry in alarm that the Philippines is becoming "overbank". Although the Bangko Sentral has since stopped issuing banking licenses, some say that the widespread issuance of banking licenses has resulted in some individuals controlling banks simply to meet the financial needs of their own businesses. These individuals use the banks for their personal business so much so that when their core businesses face financial difficulties the bank that they control likewise suffers. Several bank failures since the onset of the Asian crisis were caused by the controlling stockholder lending the bank's resources to his business. This happened notwithstanding stringent rules and regulations of the Bangko Sentral on loans to a bank's directors, officers, stockholders and related interests. In one case, a bank was subsequently ordered liquidated by the BSP due to financial difficulties which were widely perceived to have been brought about by loans to the controlling stockholder to finance the latter's aggressive expansion into the real estate business.

Areas of concern regarding the involvement of banks with corporations likewise include: possible lack of proper monitoring of loans extended to enterprises wherein the bank has equity investment, possible lowering of lending criteria to such enterprises to avoid loss of investment.

Although the government has gradually sold its holdings in one of the country's largest universal banks through a series of public offerings, the government still controls the management and directly holds approximately thirty percent (30%) of the outstanding capital stock of the bank. This bank has one of the highest, if not the highest, portfolio of non-performing loans among the local banks. Many perceive that this is due not on the lack of appreciation of the business risks of the borrowers but on the constraints brought by political pressure to lend to businessmen friendly to high ranking government officials. Fears have been expressed that the days when financial institutions were used to finance the businesses of close associates of high ranking government officials are returning, similar to

the 1980s when government financial institutions were saddled by huge amounts of bad debts, most of which were incurred by individuals who were well connected with the government at the time.

3. Would officers/employees of banks/finance institutions benefit from education and training on such areas as lending practices, formal insolvency practices, informal work out techniques and practices? If so, detail the area and the type of program.

Education concerning lending practices would definitely benefit banks and financial institutions as this would help its officers/employees in implementing the philosophy of their own bank when it comes to extending credit. The following have been identified as possible areas for a training program for officers and employees of banks:

- (a) **Target Marketing.** Inform the employees/officers of the policies of the banks with respect to extending credit. Point out what kind of market/industry would the bank want to capture. Included in this should be the risk acceptance criteria of banks (eg. up to what amount is the bank willing to extend credit on an unsecured basis; the types of security that are acceptable to the bank).
- (b) **List of Target Clients.** - disseminate a list of prospective clients that the bank would like to obtain or a certain criteria that prospective clients should have.
- (c) **Marketing.** Educate employees/officers on how to go about promoting the products of the banks and the manner in which to attract its target clients. At the same time, the employees/officers of the bank should be informed how to find out more about the manner in which its target clients conduct their business while they go around conducting their marketing activities. The more information regarding the target client that can be obtained by the bank's employees/officers will later on help the bank in deciding as to whether or not to actually extend credit and up to how much.
- (d) **Documentation.** The importance of documentation should be stressed. This can be done by showing how good documentation can help protect the bank in the event a loan becomes past due.
- (e) **Loan Administration.** Employees/officers should be instructed on how to conduct the monitoring of the accounts they are handling (e.g. basic factors that should be considered and closely examined when monitoring accounts).
- (f) **Informal Work Outs and Insolvency.** Although it is conceded that the best training for bank officers and employees on insolvency practices and informal work out techniques and practices is actual on-the-job training, it is advisable to give training and education on the legal and regulatory framework for such practices.

E. Property Law

1. To what extent might the law relating to ownership, mortgages and the creation of other security interests in land and other property be improved/reformed to enable secured transactions to be transacted more efficiently?

The law relating to the following may be reformed or improved to enable secured transactions to be transacted more efficiently:

- (a) **Assignment of Incorporeal Rights as Security.** Incorporeal rights that are included here are receivables, credits and such other contractual rights which may be the object of an assignment by way of security. Under existing laws, the nature of such assignments is not clear and it is uncertain if such assignment by way of security creates a lien in favor of the assignee. This places the assignee's security position at great risk once the debtor is in default. Also, there is no system of registration for such assignments. The creation of a centralized and computerized registry for future receivables subject to a security arrangement is also desirable.
- (b) **Inefficient and Unreliable Registries of Chattel Mortgages.** At present, there are no efficient and reliable registries for chattel mortgages. Chattels subject to a mortgage do not have central registries rendering it difficult to ascertain whether or not a particular chattel is already the subject of an existing encumbrance.
- (c) **Overturn Principles of Chattel Mortgage.** Another possible area of reform is to overturn two principles applicable to chattel mortgages which often create problems for creditors. These are: (1) a chattel mortgage cannot be executed over future property not yet in existence at the time the chattel mortgage is executed; and (2) a chattel mortgage may not be executed to secure future obligations.
- (d) **Prohibition of Pactum Comissorium and Equitable Mortgage Should Be Clarified.** Under existing law, a mortgagee or pledgee may not appropriate (i.e., pactum comissorium) the things given by way of pledge or mortgage. Any stipulation to the contrary is void. Under Article 1602 of the Civil Code, a contract of sale shall be presumed to be a mortgage if any of the circumstances mentioned therein exists. When a transaction is deemed to be an equitable mortgage, the debtor is given the right to reform the contract. The reason for these restrictions appear to be based on the need to protect mortgagors, especially the owners of small parcels of land, from unscrupulous creditors. In financing arrangements involving large amounts and with complicated security arrangements, such restrictions can be a hindrance in coming out with the appropriate transactional structure.
- (e) **Registration Fees and Taxes.** Relatively high taxes and other registration fees impede or restrict the creation of security. These fees and taxes are normally based on a percentage of the amount of the obligation secured or on the purchase price during the foreclosure sale.

Legislation would generally be required to effect the reforms in the areas identified above.

2. Are there particular commercial or other practices (as distinct from formal laws) associated with the laws relating to property and secured transactions which impede or restrict the latter?

Relatively high taxes and other registration fees impede or restrict secured transactions. Many of these fees are determined base on a percentage of the amount of the obligation secured.

Another major impediment are the inefficient registries of real and chattel mortgages. At present, there are no centralized registries for chattel mortgages. Unless governed by special laws requiring registration (i.e., vehicles), the absence of a central registration system makes it difficult to ascertain whether or not a particular chattel is already the subject of an existing encumbrance.

F. Secured Transactions

1. What are the major impediments to the enforcement of security rights over property?

The following may be considered as major impediments to the enforcement of security rights over property:

- (a) **Chattel Mortgage.** Under existing laws, a chattel mortgagee may not foreclose if the chattel is not in his possession. An unscrupulous mortgagor may hide the chattel from the creditor to prevent foreclosure, although this will subject him to penal sanctions.
- (b) **Right of Redemption Given to Debtors of Banks or Credit Institutions.** Under existing laws, the mortgagor or debtor whose real property has been extrajudicially foreclosed for the full or partial payment of an obligation to any bank, banking or credit institution shall have the right, within one (1) year after the sale of the real estate, to redeem the property. Only banks and credit institutions are covered by this rule.
- (c) **Pledge.** Under the Civil Code, if the price of the sale of the thing pledged is more than the amount due the creditor, the debtor is not entitled to the excess unless the contrary is provided. In the same way, if the price of the sale is less, neither is the creditor entitled to recover the deficiency and any stipulation to the contrary is void. In determining the property to be pledged, the creditor must ensure that the value of the property that was pledged does not diminish so that at the time the pledge is enforced the creditor is still sufficiently secured. This creates possible complications especially if shares of stock are pledged as it is difficult to ascertain the value of the shares, unless the shares are listed in the exchange, in which case the market value thereof may easily be determined.
- (d) **Foreclosure of Real Estate Mortgage on Land by Foreign Banks or Financial Institutions.** Foreign banks cannot easily foreclose mortgaged lands which secure outstanding obligations as foreign banks are not allowed to make a bid during the foreclosure sale. Under existing law, foreign banks may foreclose the mortgage but may hold the land for a limited period pending the foreclosure sale.
- (e) **Inefficient Judicial System.** An inefficient judicial system is a great and major impediment to the enforcement of security rights over property.

2. How might these impediment be overcome? Outline what improvements might be made.

The following improvements are proposed:

- (a) **Registration Fees and Taxes.** Legislation would be required to reduce the taxes and some of the fees.
- (b) **Chattel Mortgage.** A centralized registry for chattel mortgage can reduce attempts of debtors to hide the chattel.
- (c) **Right of Redemption Given to Debtors of Banks or Credit Institutions.** Enabling legislation would be required to effect the change.
- (d) **Pledge.** Enabling legislation would be required to effect the change.

G. Insolvency Law

1. **What are the major substantive defects in the corporate insolvency law viewed from the respective positions of:**
 - (a) **banks/financial providers**
 - (b) **secured creditors**
 - (c) **unsecured creditors**
 - (d) **employees**
 - (e) **corporations**
 - (f) **directors**
 - (g) **shareholders?**

(a) Banks/Financial Providers

The banks and financial providers will not be able to enforce their security if a stay is issued by the SEC. As the SEC order is not time-bound, recovery of the debt and enforcement of the security might take a long time.

(b) Secured Creditors

Secured creditors will not be able to enforce their security as this is stayed by the SEC.

(c) Unsecured Creditors

The present SEC procedure is to bar enforcement for an indefinite period of secured and unsecured claims after filing of the debt relief proceeding. To the extent that the claims of secured creditors are barred, unsecured creditors are benefitted. However, in the event that SEC dismisses the debt relief proceeding and the suspension to enforce claims is lifted, then the unsecured creditors may enforce their claim on the assets of the debtor subject to the preferential lien of the secured creditors.

Recently, the SEC was faced with the issue of whether or not suppliers of a corporation which has filed for debt-relief with the SEC can be compelled to continue delivering supplies in the light of the constitutional provision against involuntary servitude. The SEC decided to nevertheless require suppliers to continue making deliveries to the debtor company as the SEC believes that cutting off the supplies would be detrimental to the survival of the company.

(d) Employees

Under existing laws, unpaid wages and other monetary claims of workers enjoy preference over all other claims, including taxes due the government. However, the Supreme Court has ruled that this preference in favor of the laborers applies only if an insolvency or other liquidation proceeding takes place. As a practical matter, the laborers are usually placed at a disadvantage notwithstanding such preference because the insolvency or liquidation proceedings take years to terminate while they are unemployed in the meantime.

(e) Corporations

There is no discharge for corporations under the Insolvency Law.

(f) Directors

The directors are allowed to continue holding office but their powers may be severely restricted once the SEC appoints the rehabilitation receiver or the management committee.

(g) Shareholders

The interests of the shareholders are also taken into account by the SEC in debt-relief proceedings filed before it.

2. What are the major practical defects in the application of the insolvency law viewed from the respective positions of:

- (a) corporations**
- (b) creditors?**

(a) Corporations

Many are of the view that current SEC practice and procedure favor the debtor corporation. The procedures are neither speedy nor time-bound while the payments to and actions for claim of creditors are suspended.

(b) Creditors

There is a perception that the SEC has too much discretion in debt relief proceedings which normally result in the interests of creditors not being adequately protected.

H. Judicial System

1. Has there been any discernible improvement or change in the operation of the judicial system in relation to the conduct of:

- (a) debt collection/recovery processes;**
- (b) enforcement processes in respect of secured property rights**
- (c) recovery or enforcement processes in respect of leased property;**
- (d) formal corporate insolvency processes?**

If possible, provide some detail of cases in which any such change or improvement has been made apparent.

(a) Debt Collection/Recovery Processes

None.

(b) Enforcement Processes in Respect of Secured Property Rights

None.

(c) Recovery or Enforcement Processes in Respect of Leased Property

None.

(d) Formal Corporate Insolvency Processes

See discussion on B, *infra*.

2. **What reforms, if any, have been made to improve the operation of the judicial system in relation to the above 4 areas?**

None.

3. **Are there any identifiable proposals for reforms in these areas?**

See discussion on B, infra.

4. **What are the main problems or difficulties regarding the operation and application of the corporate insolvency law through the court system?**

See discussion on B, infra.

5. **What practical improvements might be made to overcome these problems/difficulties?**

The enactment of definitive and time bound insolvency rules or laws will be the first step towards insolvency law reform.

I. Informal Work Out Techniques

1. **Provide detailed examples of some cases of successful informal work outs and also cases of genuine attempts at informal work outs which have not been successful.**

Case A

A corporation and its wholly-owned subsidiary (the "Companies") accumulated debts to twenty four different creditor banks in the amount of roughly Two Billion Six Hundred Million Philippine Pesos (PP=2,600,000.00). The assets of the Companies however amounted to over Three Billion Philippine Pesos (PP=3,000,000,000.00) although a majority of the assets were in the form of raw undeveloped land, some of which were subject to a joint venture agreement with two other developers. Out of the twenty four creditor banks, only three were fully secured. The rest of the creditor banks were either unsecured or only partially secured (the "Unsecured Banks"). The Companies, hoping to reduce their level of debts which will allow them to continue their operations and at the same time service their loans, made the following proposal to their creditor banks: the Companies would enter into dacion en pago¹ arrangements over their unencumbered real estate properties with their creditor banks and restructure the remaining debts with the Unsecured Banks. At a creditors' meeting called by the Companies, they offered to enter into a collateral trust agreement in which the Companies would create a first mortgage over their unencumbered real estate properties and chattels and a second mortgage over its previously encumbered real estate properties and chattels. The principal stockholders of the corporation were also to execute a joint and several suretyship in favor of the Unsecured Banks. While the terms of the agreement between the Companies and the Unsecured Banks were to be negotiated, the Unsecured Banks were not to bring any suit against the Companies for defaulting on their loans. A Memorandum of Agreement to refrain from filing suit was distributed to the Unsecured Creditors.

¹ Dacion in payment, whereby property is alienated to the creditor in satisfaction of a debt in money, is recognized as a mode of payment in Philippine law. see Article 1245, Civil Code of the Philippines.

Only eight banks from the Unsecured Banks (the "Consortium") signified their intention to restructure the Companies debts in exchange for security to their unsecured or undersecured loans. Protracted negotiations ensued between the Companies and the Consortium to come up with a mutually acceptable Term Sheet. Some of the terms agreed upon by the parties was that the restructured loans were to have a term of seven years with a two year grace period on the principal repayment. There will also be a two year grace period on the interest.

The Consortium engaged the services of external counsel to draft the documentation of an omnibus agreement which contained the restructuring of the loans, the collateral trust agreement, and the joint and several suretyship agreement, among others, which was subsequently reviewed by the legal counsel of the Companies.

A significant feature of the omnibus agreement is that it allowed any of the other Unsecured banks who were not members of the Consortium to adhere to the terms of the agreement within a certain period of time from the signing of the omnibus agreement.

The Companies and the Consortium eventually signed the omnibus agreement. However, to date, the Consortium has not been able to annotate the mortgage created in the appropriate Register of Deeds because the parties cannot agree on the valuation to be used for the properties which shall secure the obligations of the Companies.

Case B

A publicly-held corporation accumulated debts in the form of short term loans in the amount of roughly Three Billion Pesos (PP=3,000,000,000.00) with around twelve (12) creditor banks, all of which were unsecured. The company experienced some liquidity problems and was thus unable to pay the loans as they became due. The company and the creditor banks executed a Memorandum of Agreement wherein it was agreed that the company was to execute a mortgage trust indenture in favor of the creditor banks and that for a period of one year, the creditor banks would not bring suit against the company for collection of its loans.

During the one year period, the company presented a rehabilitation plan to the said creditor banks. The company and the creditor banks agreed on the terms of the rehabilitation plan and eventually executed an omnibus agreement. Some of the features of the omnibus agreement are that some of the short term loans of the company were converted into long term loans while others were made into convertible loans with a ten year maturity. Interest on these convertible loans would also be paid only upon maturity. For the long term loans there was a moratorium of interest for the first two years. Further, a grace period on principal of three (3) years was agreed upon by the parties.

The whole process took over a year and a half to complete. However, two of the creditor banks who had signed the memorandum of agreement refused to sign the omnibus agreement and have threatened to file a collection suit against the company. The total exposure of these two creditor banks amounts to about two percent of the total loans of the company.

Case C

In an informal work-out involving one of the Philippines' biggest mining companies, a business plan was worked out by the debtor with its creditors composed of local and foreign banks. During the work-out the creditors were advised of certain weaknesses in their security and were thus given additional security by the debtor. In this work-out, the local banks appeared to be more receptive than the foreign banks to the work-out which was

believed to have been brought about by the inadequate loan-loss provisioning of these local banks.

Banks generally are receptive to work outs as there are viewed as the best way to clean the books of bad loan. This is normally done by way of a dacion en pago whereby the debtor assigns an asset as payment for his obligation. Some sectors view this technique with disfavor as the bank would end up with an asset instead of being paid the amount due in money. However, in cases where the possibility of recovering payment from the debtor is close to nil then dacion en pago may be viewed as an adequate remedy to collect from the debtor. One attraction of a dacion en pago is that the arrangement enables the bank to reduce its past due loans.

2. In practice, are such technique/s operating efficiently and successfully?

These techniques are generally operating efficiently and successfully.

3. What are the major problems in the application of these technique/s?

A major problem in dacion en pago is the proper valuation of the asset being offered as payment of a past due debt. Moreover, as the debtor-owner of the property is in financial distress, there is frequently a cash out from the creditor who has to advance the payment for capital gains tax of the debtor, costs of transfer and registration fees. Where the property offered for dacion is already the subject of a mortgage in favor of a bank, one advantage from the bank's viewpoint is that the dacion is treated as a sale and the property is no longer subject to the one-year redemption period, as it would have been in the case of a foreclosure. A view has been expressed that in certain instances frequent resort by a bank to dacion arrangements can result in a misrepresentation in the true financial condition of the bank.

4. Is it considered that training and education in the operation of these technique/s would be valuable and, if so, in what areas and to whom should the training be directed?

Training and education of bank officers and other professionals including lawyers and accountants would be valuable. At present, there are very few individuals who are considered to be capable of handling work outs. An observation has been made that professionals are not willing to engage in such practice in view of the unclear legal structure. Presumably, they are afraid of potential liabilities arising from handling informal work outs which might eventually be adjudged to be contrary to law or existing rules and regulations. The passage of a new insolvency law would go a long way in making clear how the work outs may proceed and in identifying the areas of training and education for the practitioners in this field.

J. Insolvency Administration System

1. Comment on the extent of development, expertise and efficiency regarding both public and private sector administration of formal cases of:

- (a) corporate liquidation; and**
- (b) corporate reorganization**

(a) Corporate Liquidation

The SEC is the government agency with primary jurisdiction over the liquidation of corporations, except for entities which under special laws are subject to regulation by particular government agencies (i.e., the Bangko Sentral ng Pilipinas for banks, the

Insurance Commission for insurance companies). Its ability to efficiently and promptly settle these cases is greatly hampered by the lack of trained and experienced personnel. In cases involving corporations with huge liabilities, a Commissioner of the SEC normally chairs a hearing panel or the SEC en banc itself handles the proceeding. Considering that the SEC has many functions and responsibilities (i.e., regulating the capital market, pre-need industry) and that a debt-relief proceeding requires significant time and attention, it is difficult to imagine how the proceedings pending with the SEC can be speedy and efficient. It has been observed that such proceedings have normally dragged on for years without any clear indication to its outcome, with the creditors uncertain whether or not they will be paid.

There is a perception that it is difficult to appoint private individuals to act as receivers or members of rehabilitation committees either because of lack of training or because of inadequate compensation for serving as such. At present, there is no system of accreditation or organization for these private individuals so that it becomes more difficult for the SEC or the other interested parties to identify who can be appointed as receivers or members of the management committee. In the PAL proceeding pending with the SEC, the members of the interim rehabilitation receiver were perceived to be a continuation of the management for the reason that the majority were officers of PAL. Recently, the SEC appointed the members of the regular rehabilitation receiver, all of whom were not connected with PAL.

(b) Corporate Reorganization

The SEC is generally not involved in corporate reorganization. There is however a procedure known as quasi-reorganization where a corporation's assets are written up following an appraisal indicating an appraisal surplus which is utilized to wipe-out a deficit in the equity account. Quasi-reorganizations require the approval of the SEC.

2. Is it considered that education and training in these areas would be valuable and, if so, in what areas?

Yes. Education and training in the area of corporate liquidation and corporate reorganization would be valuable.

3. Is it considered desirable to introduce more formal structures of both public and private sector administration of insolvency cases?

For insolvency law reform to be completed, a new law should be enacted creating not only a new insolvency regime but also a specialized body charged to implement such law. Many have observed that the SEC has far too many functions than it can effectively handle and that removing its jurisdiction over debt-relief proceedings would be a significant step towards insolvency reform. The involvement of the private sector in insolvency proceedings should also be identified. This involvement may be in the form of a body which shall accredit professionals who may be appointed as receivers or liquidators.

K. Information & Statistics

1. **Is it desirable to establish systems to gather information concerning:**
 - **Incidence and results of formal insolvency cases under the insolvency law**
 - **Incidence and results of informal work out cases**
 - **Statistics of value of assets and liabilities**
 - **Causes of financial failure, main area/s of business?**

Yes.

2. **If so, how best might such system/s be established?**

The Investment and Research Department of the SEC makes a compilation of debt-relief petitions filed with the SEC. The compilation includes the amount of the assets and liabilities involved, as well as the status of the case. The causes of financial failure, however, is not mentioned. Information and statistics on informal work out cases might be difficult to obtain as there is no regulatory requirement for making a disclosure. While most corporations which went through an informal work out make announcements to the press, such announcements do not normally set out detailed information and statistics.

With respect to insolvency proceedings filed before the trial courts, the latter should be required to file periodic reports to the Supreme Court indicating thereon such pertinent data on the pending insolvency proceedings. Said reports should indicate the amount of assets and liabilities involved, as well as the status of the proceedings.

L. General Insolvency Information and Developments

1. **Provide details of any other relevant information or developments since January 1999 in regard to such issues as the effect of insolvency law policies on areas such as employment, fiscal/revenue debts, detection and recovery of corporate fraud, domestic and foreign investment and etc.**

Not a few have expressed the view that one reason for the continuing reluctance of banks to lend is the unclear insolvency regime existing in the country at present. They point out that banks would not want to lend as they are not certain if they can recover payment and enforce their security. However, we are not aware of any formal study that has been conducted recently to validate this view.

There have also been reports that due to the difficulties being encountered by foreign export credit agencies in the debt-relief petition of Philippine Airlines, export credit agencies are not inclined to extend credit to Philippine companies for fear that recovery of machineries and equipments object of the credit may be difficult once a petition for suspension of payments or other similar proceedings is filed before the SEC.

2. **Is there any evidence of a change in attitudes (such as social/commercial stigma, aversion to strict legal processes, fear of loss of control) toward the use of:**
- (a) formal insolvency processes; and**
 - (b) informal insolvency processes?**

In respect of corporations in financial difficulty or insolvent corporations? If possible, provide details of any specific cases which might reflect evidence of change.

None.