Article

CORPORATE REHABILITATION: FILLING THE GAPS OF DISCRETION (SETTING THE STANDARDS ON WHETHER TO REHABILITATE AND WHEN)

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I. INTRODUCTION

The new millennium has arrived and has brought with it a host of complexities to baffle and to challenge the modern Filipino. Chief among these complexities is the looming crisis at the economic and financial front. The unpredictable fluctuation of currencies, the enigmatic transition toward a world economy, and the seeming inability of the government to cope with the situation, among others, have left most policymakers and the country's leaders in a confused and bewildered state.

Speaking from a technical standpoint, this translates to a sagging economy, high inflation rate, and low investments. From a layman's perspective, this translates to low public confidence, high prices, unemployment, and a refusal to part with hard-earned money. The inevitable result of all these factors, coupled with extrinsic problems from politics and from law enforcement, is the series of business collapses that have recently plagued the country. It is with this situation in mind that this paper is written.

The Chinese word for crisis is composed of two characters: one signifying danger and the other signifying opportunity. Unfortunately, in a crisis, most people tend to see only the danger, and not the opportunity. This frame of mind has often led to indiscriminate and irrational reactions from the business community, especially among creditors. Instead of fostering calm, creditors add to the panic by tightening terms, increasing interest rates, and stringently enforcing collections, thus forcing several corporations towards their untimely demise. Corporations that can be saved are forced to fold up due to the relentless pressure from the creditors to pay their obligations.

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Needless to say, no one truly wants to see a viable business close down. In certain instances, the continuing flow of income from a company that is a going concern is more beneficial for the investors and creditors than the proceeds derived from liquidating the assets. This does not even take into account the societal impact of continuing business operations on the country's labor situation. In view of the importance of keeping companies alive, there is thus a preference for rehabilitation as opposed to closure.

Although not a new concept, corporate rehabilitation is a relatively unexplored field. There are no hard and fast rules, equations, or tests to determine which corporations deserve to be rehabilitated and which do not. Financial ratios may be of aid, but only to a limited extent. The law itself provides little insight in resolving this dilemma. To further complicate matters, the jurisdiction to hear corporate rehabilitation petitions has been transferred from the Securities and Exchange Commission to the Regional Trial Courts. Judges who are less familiar in finance and management and who have limited dealings with corporate affairs are now thrust into the unenviable role of determining the fate of distressed corporations. In resolving a petition for corporate rehabilitation, the judge is basically given unfettered discretion. The rules governing corporate rehabilitation do not provide definite standards to assist the judge in making a judicious determination of the matter.

This paper seeks to provide standards that will aid a judge in the exercise of his/her discretion. To this end, a determination will be made as to when rehabilitation may be allowed. There will be a discussion on the parts of the financial statements that are relevant and on the financial ratios that are essential to the resolution of the question regarding the viability of a corporation. A discussion will also be made on the analytical tools that can be utilized by a judge in reaching his/her decision. The different interests to be considered by the judge will be elaborated on, and the conflicts among these interests will be identified and reconciled. Hopefully, this paper will provide new insights on the attitude toward, and on the treatment of, corporate rehabilitation.

II. BACKGROUND AND A SURVEY OF RELEVANT LAWS

Rehabilitation is a fairly recent development in dealing with insolvent or financially distressed persons. To highlight the importance of this development, it is important to look into the past. A trip down memory lane may provide the proper perspective in evaluating a corporation in need of rehabilitation. It is imperative that the reason for the evolution of the laws be understood for a better insight in the study and analysis of corporate rehabilitation.

The Philippines passed its own insolvency law, Act No. 1956, on May 20, 1909. This law has two major divisions: Suspension of Payments and Insolvency Proceedings. Suspension of Payments is Spanish in origin, copied from the provisions of the Code of Commerce.[1] Under Act No. 1956, otherwise known as the Insolvency Law, jurisdiction over proceedings for suspension of payments, voluntary and involuntary insolvency is exclusively vested in the regular courts.[2]

On March 11, 1976, Presidential Decree No. 902-A was passed which granted additional powers to the Securities and Exchange Commission (SEC). The SEC, under the Decree, was granted powers to pursue the management or rehabilitation of private corporations through the appointment of a management committee or a rehabilitation receiver.[3] Further increasing the functions and powers of the SEC, Presidential Decree No. 1758, issued in 1981, transferred jurisdiction over most cases involving the Insolvency Law from the regular courts to the SEC.

However, this trend of increasing the functions of the SEC was completely reversed upon the passage of the Republic Act No. 8799 or the Securities Regulation Code, which was approved on July 19, 2000. Under Republic Act No. 8799, the jurisdiction over cases involving the Insolvency Act and rehabilitation cases was transferred from the SEC to the Regional Trial Courts (RTC). Pursuant to these developments, the Supreme Court promulgated the Interim Rules of Procedure on Corporate Rehabilitation, which took effect on December 15, 2000. However, the Interim Rules of Procedure on Corporate Rehabilitation did not contain any provision for the appointment of a management committee, but only allowed the appointment of a rehabilitation receiver. To remedy this situation, the Supreme Court subsequently issued the Interim Rules of Procedure for Intra-Corporate Controversies, which took effect on April 1, 2001. Under Section 1 of Rule 9 of the Interim Rules of Procedure for Intra-Corporate Controversies, a party may apply for the appointment of a management committee for the corporation, partnership, or association as an incident to any of the cases filed under the Interim Rules on Corporate Rehabilitation.

One of the most satisfying trends in the job of a receiver over the past few decades has been the shift in emphasis from simply liquidating the assets of a failed

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[1] C. VILLANUEVA, COMMERCIAL LAW REVIEW 1184 (2002).

[2] Ching v. Land Bank, 201 SCRA 190 [1991]

[3] C. VILLANUEVA, PHILIPPINE CORPORATE LAW 641 (2001).

company and winding it up to the more constructive approach of trying to rescue the company as much as possible and seeing it live on as a going concern. The receiver today is, and much prefers it to be, a doctor; he is only an undertaker when the company has failed beyond recall.[4]

While relatively a recent development, corporate rehabilitation is not a new concept in Philippine law. Under Section 5(d) of PD 902-A, as amended by PD 1758, the SEC has the power to suspend payments in cases where the corporation, partnership, or association has no sufficient assets to cover its liabilities, but is under the management of a rehabilitation receiver or management committee. Section 6 (d) and (e) of PD 902-A, as amended by PD 1799, also provides for the appointment of rehabilitation receivers or a management committee by the SEC.

However, Section 5.2 of Republic Act 8799 or the Securities Regulation Code states that the Commission's jurisdiction over all cases enumerated under Section 5 of Presidential Decree No. 902-A is thereby transferred to the courts of general jurisdiction or the appropriate Regional Trial Court, provided that the Commission shall retain jurisdiction over pending suspension of payments or rehabilitation cases filed as of 30 June 2000 until final disposal. Pursuant to this legislation, the jurisdiction of the SEC over corporate suspension of payments proceedings and corporate rehabilitation proceedings has been transferred to the Regional Trial Courts.

The Supreme Court issued the Interim Rules of Procedure on Corporate Rehabilitation (2000) to address the vacuum in the Rules of Court on how to deal with corporate rehabilitation proceedings. Section 1 of Rule 3 of the Interim Rules provides that the proceedings shall be considered *in rem*. The same section also mandates that the proceedings be summary and non-adversarial in nature.

Rule 4 of the Interim Rules allows any debtor who foresees the impossibility of meeting its debts when they respectively fall due, or any creditor or creditor holding at least twenty-five percent (25%) of the debtor's total liabilities, to petition the proper Regional Trial Court to have the debtor placed under rehabilitation. The petition must be verified and must be accompanied by documents like the audited financial statements, schedule of debts and liabilities, inventory of assets, and rehabilitation plan, among others. The rehabilitation plan must contain the desired business targets or goals, terms and conditions of such rehabilitation, material financial commitments, means for the execution of the rehabilitation plan, liquidation analysis, and such other relevant information to

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[4] J. ARGENTI, CORPORATE COLLAPSE: THE CAUSES AND SYMPTOMS 31 (1976).

enable a reasonable investor to make an informed decision on the feasibility of the rehabilitation plan.

Under the Interim Rules, the court is called to decide on seven matters. The first matter is the stay order. Section 6 of Rule 4 of the Interim Rules provides that, if the court finds the petition to be sufficient in form and substance, it shall issue a stay order not later than five (5) days from the filing of the petition. The court, through the stay order, will appoint a rehabilitation receiver, fix the bond, stay enforcement of all claims, and fix the initial hearing.

The second matter involves the determination of whether the court will give due course to the petition. The second paragraph of Section 9 of Rule 4 of the Interim Rules states that if, after the initial hearing, the court is satisfied that there is merit in the petition, it shall give due course to the petition and immediately refer the petition to the rehabilitation receiver who will evaluate the rehabilitation plan and submit his recommendations to the court not later than one hundred twenty (120) days from the date of initial hearing.

The third matter requires a ruling on whether an extension for the approval of the rehabilitation plan should be granted. Otherwise, the petition for rehabilitation shall be dismissed. The second paragraph of Section 11 of Rule 4 of the Interim Rules mandates that the petition shall be dismissed if no rehabilitation plan is approved by the court upon the lapse of one hundred eighty (180) days from the date of the initial hearing. The court may grant an extension beyond this period only if it appears by convincing and compelling evidence that the debtor may successfully be rehabilitated. However, in no case shall the period for approving or disapproving a rehabilitation plan exceed eighteen (18) months from the date of filing of the petition.

The fourth matter is with regard to the relief for a modification or termination of the stay order. Under Section 12 of Rule 4 of the Interim Rules, the court may, on motion or *motu proprio*, terminate, modify, or set conditions for the continuance of the stay order, or relieve a claim from the coverage thereof upon showing that (a) any allegation 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 the property securing its claim; (c) the debtor's secured obligation is more than the fair market value of the property subject of the stay order and such property is not necessary for the rehabilitation of the debtor. A creditor shall be deemed to lack adequate protection if it can be shown that the debtor fails or refuses to honor a pre-existing agreement to keep the property insured, the debtor fails or refuses to take commercially reasonable steps to maintain the property, or the property has depreciated to an extent that the creditor is undersecured.

The fifth matter involves the approval of the rehabilitation plan. Section 23 of Rule 4 of the Interim Rules provides that the court may approve a rehabilitation plan even over the opposition of creditors holding a majority of the total liabilities of the debtor if, in its judgment, the rehabilitation of the debtor is feasible and the opposition of the creditors is manifestly unreasonable. The opposition of the creditors is manifestly unreasonable when the plan would likely provide the objecting class of creditors with compensation greater than that which they would have been received if the assets of the debtor were sold by a liquidator within a three-month period, when the shareholders or owners of the debtor lose at least their controlling interest as a result of the plan, or when the rehabilitation receiver has recommended approval of the plan. Upon approval of the rehabilitation plan, the court shall issue necessary orders or processes for its immediate and successful implementation. The rehabilitation plan may still be revoked within ninety (90) days from approval, on motion or *motu proprio*, on the ground that its approval was secured through fraud.

The sixth matter is with regard to the alteration or modification of the rehabilitation plan. Under Section 26 of Rule 4 of the Interim Rules, an approved rehabilitation plan may, on motion, be altered or modified if, in the judgment of the court, such alteration or modification is necessary to achieve the desired targets or goals set forth therein.

The seventh matter deals with the termination of the proceedings. Section 27 of Rule 4 of the Interim Rules states that in case of failure of the debtor to submit the rehabilitation plan, or the disapproval thereof by the court, or the failure of the rehabilitation of the debtor because of failure to achieve the desired targets or goals as set forth therein, or the failure of the said debtor to perform its obligations under the said plan, or a determination that the rehabilitation plan may no longer be implemented in accordance with its terms, conditions, restrictions, or assumptions, the court shall, upon motion, *motu proprio*, or upon recommendation of the rehabilitation receiver, terminate the proceedings. The proceedings shall also terminate upon the successful implementation of the rehabilitation plan.

Aside from the rehabilitation receiver, a management committee may also be created to rehabilitate a corporation. Under Section 1 of Rule 9 of the Interim Rules of Procedure for Intra-Corporate Controversies, a party may apply for the appointment of a management committee for the corporation, partnership or association as an incident to any of the cases filed under these Rules or the Interim

Rules on Corporate Rehabilitation, when there is imminent danger of dissipation, loss, wastage or destruction of assets or other properties, and paralysis of its business operations, which may be prejudicial to the interest of the minority stockholders, parties-litigants, or the general public. The management committee shall be composed of three (3) members chosen by the court.

This winds up the recent legal developments in the field of corporate rehabilitation, but in no way should this survey be considered as the last word on the matter. Due to the recent transfer of jurisdiction over corporate rehabilitation proceedings from the SEC to the courts, there has been a renewed interest in this field. The Supreme Court has been conducting studies, and is poised to make amendments and supplements to the Interim Rules of Procedure on Corporate Rehabilitation.

III. CORPORATE REHABILITATION: WHEN TO AVAIL

The petition for corporate rehabilitation may be filed by the debtor or by the creditor holding at least twenty-five (25%) of the debtor's total liabilities when they foresee the impossibility of meeting the debtor's debts when they respectively fall due.[5] This standard provided by the Supreme Court as to when the petition can be filed, however, is not clear. A host of questions arises. Should the standard be considered as a minimum requirement or as an exclusive requirement? Should the petition be filed only when the debtor cannot pay its debts as they fall due or is insolvent? Can the petition be filed even if the corporation is bankrupt, not just insolvent? Can the petition be filed when the corporation is bankrupt but still able to pay its current liabilities? These questions face the court at the outset of the proceedings.

In trying to resolve this matter, Atty. Marcial Balgos stated, "[a] corporation seeking for rehabilitation is not insolvent, but merely illiquid. It has sufficient assets and properties, but could not convert them into cash at the maturity of the obligations. It could not, however, muster 3/5 of its liabilities and 2/3 of the number of its creditors to act favorably on its intention to delay payments."[6] Obviously, Atty. Balgos sees the standard mentioned in the immediately preceding paragraph as an exclusive requirement. He takes the phrase

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[5] Interim Rules of Procedure on Corporate Rehabilitation SC Adm. Mem. No. 00-8-10-SC (2000), Rule 4, sec. 1.

[6] M. Balgos, *Effects of the Interim Rules on Corporate Rehabilitation*, THE LAWYER'S REVIEW 8 (2001).

"the impossibility of meeting the debtor's debts when they respectively fall due" at its literal meaning, and considers this as applicable only to illiquid corporations.

The writers of this paper submit a different view from that presented by Atty. Balgos. First of all, while illiquidity and insolvency are different concepts in accounting, the Philippine insolvency law makes no distinction between them. Both terms refer to a situation when the debtor cannot meet its obligations as they fall due. Perhaps, Atty. Balgos, in referring to an illiquid corporation, was actually referring to a debtor under Section 2 of Act 1956 or the Insolvency Law, who possessing sufficient property to cover all his debts foresees the impossibility of meeting them when they respectively fall due. Such debtor may petition that he be declared in the state of suspension of payments. He differentiated this from an insolvent debtor under Section 14 of the Insolvency Law who may apply from voluntary insolvency. This distinction flies out of the window when we consider that Section 1 of the Insolvency Law permits the insolvent debtor to suspend payments or be discharged from his debts and liabilities. In other words, the Insolvency Law considers both the "illiquid" debtor under Section 2 and the "insolvent" debtor under Section 14 as both insolvent debtors. Secondly, the Insolvency Law does not make a distinction between bankruptcy and insolvency even though these two are also entirely different accounting concepts. Neither does the Interim Rules of Procedure on Corporate Rehabilitation make such a distinction. In fact, by definition, a bankrupt corporation also cannot pay its debts as they fall due.

For the sake of argument, let us assume that there is a distinction in the legal treatment of a bankrupt corporation vis-à-vis an insolvent one. It is true that in America, a bankrupt corporation is liquidated, not rehabilitated. One author stated that:

> Should the corporation be insolvent in the bankruptcy sense, the shareholders were not allowed to retain any interest in the reorganized corporation. On the other hand, the stockholders were included in the plan of reorganization if the corporation was insolvent only in the equity sense. Voluntarily to begin liquidation under prior law, the debtor did not need to be insolvent in any manner. *For creditors to begin liquidation proceedings against the debtor, insolvency in the bankruptcy sense was necessary for the filing of a petition after the commission of an act of bankruptcy.*[7] [Emphasis supplied]

[7] G. NEWTON, BANKRUPTCY AND INSOLVENCY ACCOUNTING: PRACTICE AND PROCEDURE 61 (3rd ed., 1985).

However, this treatment of bankrupt corporations cannot find application in the Philippines. The events that unfolded beginning with the financial crisis in 1997 until the present militate against such application.

The backdrop of the passage of the Interim Rules of Procedure on Corporate Rehabilitation must be brought to mind and explained. As early as 1997, there was a worldwide recession resulting in the devaluation of currencies and in the plunge of the prices at the stock and securities markets. Interest rates soared, some doubling and some tripling. Aggravating the situation was the enforcement of some of the provisions of the World Trade Agreement, and this resulted in the loss of tariff protection and in the increase of foreign competition. It is no wonder that some financially sound corporations became bankrupt in the years that followed. The corporations' sales were not only pulled down, but their liabilities ballooned to twice or thrice their previous amounts through no fault of theirs. Most affected among these corporations were those that pegged their debts to the dollar. The peso-dollar exchange rate changed from Php 26: US$1 to Php 50: US$1. The value of the peso vis-à-vis the dollar was cut in half. Debtors had to pay twice or thrice as much to meet their obligations. This was compounded further by the earlier stated meteoric rise in interest rates. Creditors shamelessly increased their interest rates, and no one could stop them since the law prohibiting the application of usurious rates was effectively suspended. Predictably, many corporations found it difficult to meet their obligations as they fell due. Against this background, it is safe to say that some of the corporations petitioning for rehabilitation are merely the victims of the exigencies of time. It is not that the corporations stopped becoming profitable, but that their profits were just eaten away or were just not enough to hurdle the extraordinary events that unexpectedly came about.

After considering the law on the matter and other factors, a strong case can be made supporting the argument that bankrupt corporations are eligible for corporate rehabilitation. The standard set by the Supreme Court in the Interim Rules of Procedure on Corporate Rehabilitation, requiring the petitioner to foresee the impossibility of the debtor meeting its debts as they fall due, should be considered as a *minimum* requirement for filing a petition for corporate rehabilitation, thus allowing illiquid, insolvent, and bankrupt corporations to be subjects of corporate rehabilitation.

To take the matter a little further, even a bankrupt corporation that is able to pay current liabilities but is unable to pay its long-term liabilities can be subjected to rehabilitation. The situation contemplated here is that of a corporation that is liquid, but already insolvent. The rules clearly state that the petition can be filed when the debtor or creditor foresees the impossibility of meeting debtor's debts when they respectively fall due. The term "foresees" implies the anticipation of a future event. A debtor or a creditor need not wait for the corporation to actually be unable to pay its liabilities before filing a petition for rehabilitation. A petition can be filed *in anticipation* of the impossibility of the debtor in meeting its debts when they respectively fall due. Hence, the standard for determining when to file a petition for corporate rehabilitation is not limited to the failure to pay current liabilities, but also includes failure to pay long-term liabilities.

IV. CORPORATE REHABILITATION: A CONFLICT OF VIEWS

One of the biggest problems placed before the judge in a corporate rehabilitation case is whose interest he or she will give preference to in granting or denying rehabilitation to a corporation. Among the interests to be considered are those of the creditors, of the investors or stakeholders, of the general public, of the workers, and of the State. To better understand these interests, a discussion will be made on the different perspectives, views, decision-making tools, and objectives of the parties involved.

A. From A Creditor's Perspective

When accountants recommended by creditors meet the debtor for the first time, they try to set the debtor's mind at ease by describing the accounting function as a helpful one. Basically, they have three objectives. First, they have to determine the debtor's financial condition with reasonable accuracy, short of conducting an audit. Second, they have to find the underlying cause, or causes, of the debtor's financial difficulty, and are expected to monitor the debtor's business activities. In this light, they are free to suggest strategies and improvements that might help the debtor survive the crisis. Third, creditors' accountants intend to investigate the debtor's actions prior to the inception of the insolvency to ascertain if acts were committed which would bar the debtor's discharge in bankruptcy. Such acts include fraud, concealment of assets, the solicitation of credit based on false financial statements, and other deceptive conduct.[8]

The creditor is primarily interested in the balance sheet of the corporation. By studying the amount and kinds of assets in relation to the amount and payment

[8] R. WIENER AND R.CHRISTIAN, INSOLVENCY ACCOUNTING 34-35 (1977).

dates of the liabilities, a creditor can form an opinion as to the ability of the business to pay its debts promptly. The creditor gives particular attention to the amount of cash and of other assets which will soon be converted into cash and compares them with the amount of liabilities falling due in the near future.[9]

Important as it is for helping all parties concerned in arriving at a realistic assessment of the debtor's worth, either as a going concern or under the auctioneer's hammer, the balance sheet does not normally reveal much about how the debtor arrived at the present predicament. Far more valuable in this connection are comparative financial statements, which should be prepared in great detail for at least two years preceding plus the short accounting period immediately before the commencement of the insolvency proceeding.[10]

Generally, the information of most value and interest is that regarding the debtor's activities during the twelve months preceding the filing of the petition or the initiation of the out-of-court negotiations. The inquiry, therefore, is initially confined to this period, although extraordinary developments occasionally warrant a wider probe. In addition, summary data from prior periods should be included in the examining accountant's report, as they often prove helpful, particularly for comparative analysis.[11]

These comparative financial statements often include entries that suggest further review. A drastic change in the gross profit on sales, for instance, or in any significant expense category, obviously warrants a closer look. One purpose of this comparative analysis is to detect and investigate any marked changes in the conduct of the debtor's business. It is not unusual, unfortunately, to find a substantial number of large purchases in the months immediately preceding the petition date, coupled with a concurrent reduction of payments to creditors. This indicates bad faith on the part of a debtor who is secretly but fully aware of serious trouble ahead.[12]

The creditor is also deeply interested in the liquidation values or the value of the corporation if the corporation decides to cease operation and sell its assets. Liquidation values do not necessarily mean the amount that would be obtained in a forced sale but most likely refer to the amount that could be obtained in an orderly liquidation. The liquidation values will be, in most cases, much less than going

[9] R. MEIGS AND W. MEIGS. ACCOUNTING: THE BASIS FOR BUSINESS DECISIONS 26 (8th ed., 1991).

[10] *Id.* at 61.

[11] R. MEIGS AND W. MEIGS, *op. cit. supra* note 9 at 52.

[12] *Id.* at 61-62.

concern values.[13] Case law indicates that, in determining "fair valuation" for the insolvency test, a debtor's property should not be given a "distress" valuation. Fair value refers to what a willing owner not compelled to sell would take and a willing purchase would pay when not compelled to buy.

In the Andrew Johnson Properties, Inc. case, the court defined "fair valuation" as the fair market value of the property between willing buyers and sellers or the value that can be made available to creditors within a reasonable amount of time. Widely varying elements may be considered in appraising real property, including physical characteristics, type of business for which the premises are designed, age, condition, original costs, and past and prospective earnings. In Johnson Properties, the court went on to state that if the bankrupt is a going concern at the time of the transfer of assets, the property must be valued as a going concern.[14]

To determine the size of the payment that could be expected upon liquidation, the accountant must establish the value of all assets that remained. Accountants use several methods for determining the immediate market price of assets. The accountant may have another client in the same type of business who may be able to supply information about the values of the assets, especially the inventory. The accountant may be able to reasonably estimate the values of the assets through previous experience with companies in the same industry. In order to determine the value of plant and equipment, the accountant may contact the manufacturer or a used-equipment dealer. It is often necessary for the court or the creditors' committee to employ an auctioneer or appraiser to evaluate the assets. The assets listed will include not only the property on hand but also whatever may be recovered, such as assets concealed by the debtor, voidable preferences, any questionable transactions involving payments to creditors, returns of merchandise to vendors, sales of fixed assets, and repayment of loans to owners.[15]

To guide the creditor, there are several financial ratios that have proven to be of good use in predicting when a corporation will become insolvent or bankrupt and in assessing if a corporation is in financial distress. These financial ratios are:

1. Altman's Z. As a company enters the final stages prior to failure, a pattern may develop in terms of a changing financial profile. Although bankruptcy or insolvency cannot be predicted with certainty, several financial ratios have proven to be useful indicators of impending disaster. A study by Altman developed

[13] G. NEWTON, *op. cit. supra* note 7 at 402.
[14] G. NEWTON, *op. cit. supra* note 7 at 394.
[15] *Id.* at 402-403.

a statistical model that found the financial ratios best predicting bankruptcy. Based on Altman's sample of bankrupt firms, the study yielded an equation that used five ratios to predict bankruptcy:

$$Z = 1.2X_1 + 1.4\,X_2 + 3.3X_3 + .6X_4 + .999X_5$$

where Z = bankruptcy score
X_1 = (net working capital ÷ total assets)
X_2 = (retained earnings ÷ total assets)
X_3 = (earnings before interest and taxes ÷ total assets)
X_4 = (total market value of stock ÷ book value of total debt)
X_5 = (sales ÷ total assets)[16]

We may conclude that a potentially failing corporation begins to invest less in current assets (X_1). Because X_2 is a cumulative indicator of profitability relative to time, the finding suggests that younger companies have a greater chance of falling into bankruptcy. Variable X_3 reflects the firm's general earning power. Deterioration in this factor is the best single indicator that bankruptcy may be forthcoming. Variable X_4 depicts the firm's financial leverage position. Finally, X_5, the asset turnover ratio, measures management's ability to generate sales from the firm's assets.[17]

With this equation, the criterion for separating firms with a strong likelihood of bankruptcy from those that probably will not fail should be as follows: if the score exceeds 2.99, no concern for bankruptcy should exist. On the other hand, a score less than 1.81suggests that the firm is a likely candidate for failure. Values between 1.81 and 2.99 are difficult to classify. However, although a firm in this "gray area" can easily be misclassified in terms of the final outcome, the best way to set up a dividing line is to predict that a company will fail if its score is less than 2.675. Alternatively, a score exceeding 2.675 may be used as an indicator that success is more likely to happen than failure.[18]

Based on the results of his research, Altman suggests that the bankruptcy prediction model is an accurate forecaster of failure up to two years prior to bankruptcy and that the accuracy diminishes substantially as the lead time increases.[19]

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[16] J. PETTY, A. KEOWN, D. SCOTT, JR. AND J. MARTIN, BASIC FINANCIAL MANAGEMENT 829(6th ed., 1993).

[17] J. PETTY, et al., *op. cit. supra* note 43 at 829-830.

[18] *Id.* at 829.

[19] G. NEWTON, *op. cit. supra* note 7 at 40.

2. Current Ratio. The current ratio or current assets divided by current liabilities may show how readily the company could meet its short-term debts. Many companies like to see a ratio of 2:1 or better.[20]

3. Quick Ratio. The quick ratio or cash plus debtors/current liabilities more stringently tests the company's ability to meet its short-term debts because, unlike current ratio, it leaves out stocks which might take some time to liquidate. It is often known as the acid test ratio and many firms like it at 1:1 or better.[21]

4. Margin. Margin of profit divided by sales shows whether a company's profits are protected against a rise in costs or a fall in selling prices which often cause a profit squeeze in times of economic downturn.[22]

5. Sales/Fixed Assets. This ratio may indicate the extent to which the company is using its assets to generate turnover. However, note that the sales will be in the current year's value while fixed assets may be in the value of many years ago. Inflation will severely distort this figure if one is not careful to compensate for this error.[23]

6. Stocks+debtors-creditors/long-term capital. This is a useful test of liquidity in times of inflation. If this ratio rises, it would indicate that the company would have to either raise new finance or increase its dividend cover by retaining a higher proportion of profits.[24]

7. Long-term loans+equity capital/fixed assets. This one shows whether the company's fixed assets, upon which its long-term future depends, are financed by equally long-term capital. A 1:1 ratio is prudent.[25]

8. Price/earnings Ratio. The stock market capitalization divided by total after tax earnings gives the P/E ratio and reveals the stock market's opinion on the company's future prospects.[26]

9. Share price/share index. Movements of a company's share price relative to the movement of the stock market as a whole may also indicate how the market currently views the company's prospects.[27]

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[20] J. ARGENTI, *op. cit. supra* note 4 at 138.
[21] *Id.* at 138-139.
[22] *Id.* at 139.
[23] *Ibid.*
[24] *Ibid.*
[25] *Ibid.*
[26] J. ARGENTI, *op. cit. supra* note 4 at 139.

While financial ratios are useful indicators to creditors, these ratios have limitations. In general, these ratios only consider business factors that can be reduced to monetary terms. Qualitative factors such as management, competition, and industry are left out. In particular, there are three very serious doubts as to the usefulness of the ratios in the study of corporate collapse. First, while these ratios may show that there is something wrong and while a sequence of them over time may show that it is getting worse, it is doubtful whether one could predict the collapse or failure of a business on the evidence of these ratios alone. Hence, they may present as a symptom of something wrong, but not as a symptom of impending failure. Second, their value has been severely eroded by inflation. Figures that appear to show an improvement may conceal deterioration in reality. A ratio is essentially the comparison of one figure with another, and unless both figures are subject to the same rate of inflation, any comparison over time is invalid. Third, as soon as the managers know that all is not well with their company, they will start creative accounting, thus hiding the tell-tale symptoms from everyone (perhaps even from themselves).[28]

In summary, the creditor will consider such information as necessary to determine if rehabilitation is feasible. Outwardly, the creditor will cooperate with the corporation's attempts to steer the corporation out of financial trouble, and might even extend some aid to the distressed corporation. The bottom line, however, is whether or not the corporation can pay its debts. To make this assessment, the creditor will send his/her accountant to the corporation to study the corporation's financial condition, the underlying causes of the corporation's financial difficulties, and the corporation's recent activities, though this will be done in the guise of helping the corporation.

The true interest of the creditor is to find out if the corporation can meet its obligations as they fall due. The balance sheet will provide the creditor with information on the ability of the assets of the corporation to cover its liabilities. The comparative financial statements will provide the creditor with, among others, information on any acts of bad faith on the part of the corporation that are inimical to the interest of the creditor or that can be construed as acts to renege on its obligations. The creditor will also be interested in liquidation values in the event that the rehabilitation of the corporation is found to be not feasible. Financial ratios that mainly interest the creditor are those that indicate signs of trouble and possibly of failure. However, these financial ratios have several limitations that detract from their usefulness and reliability in the study of corporate collapse and corporate rehabilitation.

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[27] *Ibid.*

[28] J. ARGENTI, *op. cit. supra* note 4 at 138.

B. From An Investor's Perspective

In trying to determine the value of a business, The U.S. Supreme Court ruled in *Consolidated Rock Products Company vs. DuBois*:

> A prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record and all circumstances which indicate whether or not that record is a reliable criterion of future performance.[29]

Thus, the proper method of valuation of the business as a going concern is the assessment based on future earnings, rather than the utilization of a procedure based on either the market value of outstanding stocks and bonds or on book value of the corporation's assets. The two factors through which the going concern value is derived are the prospective future earnings of the company and the appropriate rate of capitalization.[30]

Prospective Future Earnings

The benefits gained from projection of future operations go beyond simply determining if the plan of reorganization is feasible. These projections are necessary to develop an effective business plan and are crucial in determining the future viability of the company. These projections are used to determine the value of the business as a going concern and to help determine the interest creditors and stockholders have in the reorganized company.[31] No universal formula exists for a certain and accurate estimate of future earnings. Thus, the courts have concluded that "valuation must be determined on a case-by-case basis, and all relevant factors must be taken into consideration in each case in determining going concern values."[32] A survey of the literature and case law, however, reveals recurring factors that, though incapable of statement in concise formula fashion, will nevertheless prove instrumental in establishing valuation guidelines.[33]

The logical first step to determine prospective future earnings is to evaluate "projected future sales and the estimate profit margin on those sales."[34] This

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[29] 312 U.S. 510, 526 (1941)

[30] G. NEWTON, *op. cit. supra* note 7 at 403-404.

[31] *Id.* at 344.

[32] Moulded Products, Inc v. Barry, 474 F.2d 220, 226 (8th Cir. 1973).

[33] G. NEWTON, *op. cit. supra* note 7 at 410.

[34] In re Muskegon Motor Specialties, 366 F. 2d 522, 526 (6th Cir. 1966).

valuation of future sales may well be accomplished by means of a detailed analysis of the debtor's past operating history, a piece of information which may be of particular relevance to the court in its consideration of a reorganization plan. Of course, past history is relevant only insofar as it is indicative of the future earning power of the corporation. If it is shown that the record of past earnings is an unreliable criterion for future performance, the court must form an estimate of future performance by inquiring into all foreseeable factors that may affect future prospects.[35]

Past records of earnings must be adjusted or weighted to take into account unusual past conditions and reasonably foreseeable changes in the future. As an example, adjustments have been made for expected surges of new business from customers who had previously been unwilling to deal with a debtor whose past operating losses failed to inspire confidence. Other examples of unusual conditions for which adjustment must be made are: the stability and prospects of the industry, the rate of obsolescence of assets due to technical developments in the industry, the efficiency and integrity of future management, the increased expenses and the possible alteration in competition within the debtor's industry.[36]

Closely allied to the problem of the weight to be assigned to past earnings is the difficulty in determining what year's earnings should be used as the base period. The SEC, in its analysis of corporate reorganization plans, has usually been inclined to eliminate — rather than adjust – abnormal years in the industry and it has preferred to use earning trends instead of earning averages. Likewise, courts have steadfastly rejected estimates of future earnings based on unusual occurrences of prior years.[37]

Appropriate Capitalization Rate

In general, deciding the appropriate rate of capitalization of future earnings and predicting future earnings face the same problem: lack of mathematical certainty. Nevertheless, even though no precise formula has been developed to determine the rate, a general agreement exists concerning the basic principles on choosing an appropriate rate. Virtually all would agree that the capitalization rate should reflect the market free-interest rate (based upon long-term government paper), to which is added an interest component that reflects the risk inherent in the enterprise and the industry.[38]

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[35] *Ibid.*

[36] *Ibid.*

[37] G. NEWTON, *op. cit. supra* note 7 at 410-411.

[38] *Id.* at 412.

As in forecasting future expected earnings, setting the rate of capitalization is best determined on a case-by-case basis, and any factors that appear relevant to a specific company's risk evaluation may be utilized to determine the rate of capitalization. Thus, when determining the appropriate rate of capitalization, courts have considered the cyclical nature of the industry, the number and character of the debtor's customers, the possible uncertainties in management, expenses and operations, the age and condition of the debtor's plant and equipment, and the rate of technological progress in the industry.[39]

Courts have also displayed a tendency to utilize in their calculation figures obtained from other companies within the industry, provided these companies are similar in nature to the debtor corporation. However, where the debtor has been compared to other concerns substantially differing in character, the courts have rejected the rate of capitalization so determined.[40]

Determining Value

Once the capitalization rate and average projected earnings have been determined, the value is assigned as follows:

$$V = \frac{E}{R}$$

Where V = going concern value of business
E = average projected earnings for an indefinite time period
R = capitalization rate[41]

Discounting Cash Receipts

While the courts and the SEC have consistently valued companies by estimating the average earnings and multiplying them with a capitalization rate, a strong argument can be made that the discounting of future earnings would be a better approach. The current approach can place a larger value on the company than is justified if the average earnings value used is much higher than the earnings

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[39] G. NEWTON, *op. cit. supra* note 7 at 412.
[40] *Ibid.*
[41] *Id.* at 413.

in the first several years subsequent to the reorganization, as is typically the case. At other times the value based on the capitalization of earnings approach can be too low.[42]

One method frequently suggested as a viable approach to ascertain the value of a firm in bankruptcy is to discount future receipts. To use this method, reasonable estimates of future cash receipts must be obtained along with the liquidation or residual value at the end of the investment period, or alternatively, a stable cash flow must be expected indefinitely. Under certain conditions, it may be reasonable to substitute profits for cash flows. For many companies, the cash inflows will be less than earnings during growth periods and toward the end of the life cycle cash inflows would exceed the reported profits.[43]

The valuation process can be described as follows: it is assigning value to an asset by calculating the present value of its expected future cash flows using the investor's required rate of return as the discount rate. The investor's required rate of return, R, is determined by the level of the risk-free rate of interest and the risk premium that the investor feels is necessary to compensate for the risks assumed in owning the asset. Therefore, the basic security valuation model can be defined mathematically as follows:

$$V = \frac{C_1}{(1+R)^1} + \frac{C_2}{(1+R)^2} + \frac{C_n}{(1+R)^n}$$

or

$$V = \sum_{t=1}^{n} \frac{C_t}{(1+R)^t}$$

Where C_t = cash flow to be received in year t

V = the intrinsic value or present value of an asset producing expected cash flows, C_n in years 1 through n

R = the investor's required rate of return.[44]

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[42] G. NEWTON, *op. cit supra* note 7 at 413.

[43] G. NEWTON, *op. cit. supra* note 7 at 418.

[44] J. PETTY, et. al., *op. cit. supra* note 16 at 138-139.

In Equity Funding Corporation of America,[45] the court allowed the use of discounted future profit flows as a basis to appraise part of the company on the argument that special factors may make the usual approach using past earnings reports and future sales and expense projections an unreliable guide. The court concluded that since the insurance companies reported their earnings on the basis of statutory accounting as prescribed by state insurance departments, these records were particularly unreliable indicators of future earning expectancy because both companies had substantially increased their new business production and had made significant changes in the nature of their operations and types of insurance sold during the administration of the estate.[46]

Price Earnings Ratio (PER) valuation

The use of the price earnings ratio (PER) valuation approach has the advantage of being easily explained to those in court who are not well trained in finance. There are several problems associated with its use. For most firms in bankruptcy, prior ratios are often not a valid indication of future ratios. This is true for several reasons. Recent past years are not appropriate because the business sustained losses during the time period. Also, many business and operational changes may have been made resulting in a differing type of operation, or major segments of the business may have been eliminated.[47]

The bankruptcy courts have consistently used the PER of comparable companies. The net result is an average rate that may have little value.[48] There is no indication that the business emerging from bankruptcy will have the characteristics to cause the PER to be the average of that of other companies. The assumption is also made that these firms are properly priced. These ratios may contain temporary increases or decreases in earnings that distort the results. The PER for companies with the same type of operations and debt structure may differ because of the accounting methods used to report income. In pricing the stock, the market takes into consideration these accounting differences. Yet when the court simply uses the average PER, it is ignoring the adjustments made by the market.[49]

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[45] 416 F. Supp. 132 (1975).
[46] G. NEWTON, *op. cit. supra* note 7 at 418.
[47] *Id.* at 419-420
[48] *Id.* at 420.
[49] *Ibid.*

Margin of Safety

The past ability to earn in excess of interest requirements constitutes the margin of safety that is counted on to protect the investor against loss or discomfiture in the event of some future decline in net income.[50] The investor does not expect future average earnings to work out the same as in the past. If he were sure of that, the margin demanded might be small. Nor does he rely to any controlling extent on his judgment as to whether future earnings will be materially better or poorer than in the past. If he did that, he would have to measure his margin in terms of a carefully projected income account, instead of emphasizing the margin shown in the past record. Here, the function of the margin of safety is, in essence, that of rendering unnecessary an accurate estimate of the future. If the margin is a large one, then it is safe to assume that future earnings will not fall far below those of the past so that an investor will feel sufficiently protected against the vicissitudes of time.[51]

In summary, an investor values a corporation either as a going concern or an entity that earns. The proper valuation of a corporation, according to an investor, are by determining its future earnings and by factoring or discounting these earnings with an appropriate capitalization or discounting rate. There are other methods such as the price earnings ratio, but these methods have less reliability in valuing a corporation in distress. In determining the capitalization or discounting rate, a margin of safety must be included. It should be remembered that good investment is defined as one that promises safety of principal and a satisfactory return. It would be a poor investment indeed if the return fails to reach the satisfactory level.

C. An Illustration

To provide a clearer picture of the valuation techniques and ratios mentioned in the previous two sections, the writers have taken the liberty of conjuring a fictitious corporation for illustration purposes. To simplify matters, the capital stock of the corporation as stated in its balance sheet is assumed to also be the market value of its stocks.

This fictitious corporation, Triple V Auto Services, Inc., has the following financial statements:

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[50] B. GRAHAM, THE INTELLIGENT INVESTOR 20 (4th rev. ed., 1997).

[51] B. GRAHAM, *op. cit. supra* note 50 at 20-21.

Triple V Auto Services, Inc.
Balance Sheet As of December 31, 2000

Assets			**Liabilities**		
Cash	P	100,000	Accounts Payable	P	400,000
AccountsReceivables		200,000	Notes Payable		100,000
Inventory		300,000	Total Liabilities		500,000
Other Assets		400,000			
			Stockholder's Equity		
			Capital Stock	P	300,000
			Retained Earnings		200,000
			Total Stockholder's Equity		500,000
Total Assets	P	1,000,000	Total Liab & SHE	P	1,000,000

Triple V Auto Services, Inc.
Income Statement
For the year ended December 31, 2000

Sales	P	100,000
Cost of Services		(50,000)
Gross Profit	P	50,000
General & Admin Exp		(100,000)
Earnings Before Interest & Taxes	P	(50,000)

Triple V Auto Services, Inc. suffered several setbacks in its business operations during year 2000. Its employees went on strike for one month. Even after the strike, the employees continued to be belligerent, and several cases of intentional sabotage of job orders and of machinery were observed. As a result, the corporation's sales plummeted from an average of Php500,000 to a measly Php100,000. On top of this, its current liabilities were steadily accumulating. Due to the slippage in sales, inventory turnover was at its all time low, thus the corporation had trouble paying its suppliers. Fortunately, by the end of the year, the labor problems of the corporation were solved largely due to the spirit of forgiveness and generosity fostered by the Yuletide season. However, sensing that the creditors wanted the corporation to be declared bankrupt and to be liquidated, the board of directors of the corporation decided to preempt them and directed the filing with the Regional Trial Court a petition for corporate rehabilitation with a prayer for the issuance of a stay order.

The creditors opposed the granting of the petition and the issuance of the stay order. In support of their opposition, they argued that the corporation was clearly on its way to bankruptcy. Utilizing Altman's Z-score bankruptcy predictor model, the creditors were able to come up with the following figures:

X_1 = net working capital ÷ total assets
Where networking capital = [current assets(e.g. cash + accounts receivable + inventory) - current liabilities (e.g. accounts payable)]
= [(100,000+200,000+300,000) - 400,000] ÷ 1,000,000 = **0.20**

X_2 = retained earnings ÷ total assets = 200,000 ÷ 1,000,000 = **0.20**

X_3 = earnings before interest and taxes ÷ total assets
= -50,000 ÷ 1,000,000 = **-0.05**

X_4 = total market value of stock ÷ book value of total debt
= 300,000 ÷ 500,000 = **0.60**

X_5 = sales ÷ total assets = 100,000 ÷ 1,000,000 = **0.10**

$$\begin{aligned} \mathbf{Z} &= 1.2X_1 + 1.4\,X_2 + 3.3X_3 + .6X_4 + .999X_5 \\ &= 1.2\,(0.20) + 1.4\,(0.20) + 3.3\,(-0.05) + .6\,(0.60) + .999\,(0.10) \\ &= 0.24 + 0.28 - 0.165 + 0.36 + 0.0999 = \underline{\mathbf{0.8149}} \end{aligned}$$

As mentioned earlier, a corporation with a Z score less than 1.81 is a likely candidate for business failure. Triple V Auto Services, Inc.'s Z score of 0.8149, way below the acceptable score of 1.81, was an obvious indication that it was headed for bankruptcy.

The creditors also pointed out that the corporation was unable to readily meet its short-term debts. Looking at the corporation's current ratio, the creditors computed it as follows:

Current Ratio = Current Assets ÷ Current Liabilities
= (100,000 + 200,000 + 300,000) ÷ 400,000 = **1.50**

Finding the current ratio of the corporation to be 1.50:1 that was below the generally acceptable level of 2:1, the creditors claimed that the corporation would not be able to pay the debts when they fall due. To further emphasize the point, the creditors used the more stringent test of the Quick Ratio, and came up with the following figure:

Quick Ratio = Quick Assets (e.g. Cash, Accounts Receivable) ÷ Current Liabilities
= (100,000 + 200,000) ÷ 400,000 = **0.75**

Since the Quick Ratio of the corporation of 0.75:1 was below the acceptable level of 1:1, the creditors argued that there was no way for the corporation to meet its short-term debts.

On the other hand, the petitioner countered that the best way to value the worth of a corporation was by determining its prospective future earnings and discounting these future earnings with an appropriate rate of capitalization. The petitioner submitted the following schedule of forecasted earnings:

Projected Future Earnings:

Year	Gross Sales	Net Cash Flow
2001	P 500,000	P 300,000
2002	500,000	300,000
2003	500,000	300,000

In support of these projected future earnings, the petitioner argued that since its average sales during normal years was Php500,000, this should be the figure used. The petitioner explained that the sales figure for year 2000 should not be used in projecting sales and income because of the unusual and non-recurring conditions surrounding the corporation's operations during that year.

The petitioner posited that the appropriate capitalization rate to be used should be 20%, computed as follows:

Appropriate Capitalization Rate

Risk Free Rate	5%
Required Profit & Interest Rate	10%
Margin of Safety	5%
Capitalization Rate	**20%**

Having determined the prospective future earnings and the appropriate capitalization rate, the petitioner discounted the cash receipts to determine the present value of the corporation, and came up with the following figure:

$$V = \frac{C_1}{(1+R)^1} + \frac{C_2}{(1+R)^2} + \frac{C_n}{(1+R)^n}$$

$$= \frac{300{,}000}{(1+.20)^1} + \frac{300{,}000}{(1+.20)^2} + \frac{300{,}000}{(1+.20)^3}$$

= **Php 631,944.44**

The petitioner postulated that the present value of the corporation to an investor was certainly higher than the total liabilities of the corporation, and would most likely be higher than the liquidation values of the corporation's assets. The petitioner asserted that the company is worth more as a going concern than it would be if liquidated. At this point, it is evident that there is a conflict of interests between the creditors and the distressed corporation. This conflict of interests and its reconciliation will be addressed in further detail later in the discussion.

D. Other Interests Involved

The general public has an interest in the rehabilitation of corporations. The Supreme Court itself admitted such when it stated that "the rehabilitation of a financially distressed corporation benefits its employees, creditors, stockholders and, in a larger sense, the general public."[52] Though the interest of the general public cannot be easily put into monetary terms, their interest, nonetheless, is as important or even more important than that of the creditors or of the investors. The continued operation of some corporations is indispensable to the smooth performance of the day-to-day functions of the general public. Corporations engaged in electricity distribution, transport, communications, and banking play such a crucial role that closure of even one of these corporations will result in massive disruption in everyone's life.

Other corporations that are crucial to a healthy GNP and GDP like local manufacturers and exporters play a primary role in attracting investments. The benefits of investments to the general public include the construction of basic

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[52] Rubberworld (Phils.), Inc. v. NLRC, 305 SCRA 721, 728-729, (1999).

facilities and infrastructure, the creation of more jobs, and the infusion of more money to the economy, thus paving the way for expansion and development. The closure of these corporations will result not only in the loss of opportunity to attract future investments, but also in the loss of existing investments due to a lack of confidence in the country's economy and ability for sustainable growth. Furthermore, some corporations provide healthy and much-needed competition, the benefits of which are lower prices and better quality of services. Closure of these corporations will place the general public at the mercy of monopolies.

The laborers and employees also have an interest in the rehabilitation of corporations. This is evident since the laborers and employees rely on these financially distressed corporations for their livelihood. Some of these laborers and employees are even willing to receive cutbacks in their payroll for prolonged periods, so that the financially distressed corporation can be rehabilitated. In the case of Rivera vs Espiritu[53], a union of the employees of the beleaguered Philippine Air Lines, faced with the closure of the operations of PAL, offered a 10-year moratorium on strikes and similar actions, and a waiver of some of the economic benefits, but management rejected this offer. The union and PAL eventually agreed to a suspension of the collective bargaining agreement for a period of ten years provided that some safeguards were in place. Although not mentioned outright, one of the greatest concerns that the court will face involves the welfare of the laborers and employees who will be displaced if the corporation is not rehabilitated. It is just not possible to assess a corporate rehabilitation case without considering this human factor. In fact the Philippine Constitution itself provides that labor is a primary social economic force and that the rights of workers shall be protected and their welfare promoted.[54]

The State also has interest in the rehabilitation of corporations. Corporations provide jobs, and the State is mandated by the Constitution to promote full employment.[55] By ensuring that corporations continue to operate properly, the State can prevent unemployment and displacement of workers in compliance with the mandate of the Constitution. Also, the State recognizes the indispensable role of the private sector, encourages private enterprises, and provides incentives to needed investments.[56] The private sector is recognized by the Constitution as holding the key to the development of the country. It behooves the State to support rehabilitation when possible, so that the private sector may develop and expand. It should also be noted that the private sector provides competition so

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[53] G.R. No. 135547, January 23,2002.
[54] CONST. Art. II, sec. 18.
[55] CONST.. Art II, sec. 9.
[56] CONST.. Art II, sec. 20.

that goods and services will be efficiently and effectively provided to the public at minimal cost.

The Philippine Constitution provides that "the State shall regulate or prohibit monopolies when the public interest so requires. No combinations in restraint of trade or unfair competition shall be allowed."[57] In some instances, the closure of a financially distressed corporation will result in the survival of only one other corporation or in the creation of a monopoly. In these instances, the option of rehabilitating the financially distressed corporation becomes imperative.

E. Where The Conflict Lies

The conflict basically lies in the issue of whether to rehabilitate or liquidate. The creditor is interested mainly in the ability of the corporation to pay its debts. on the contrary, the investor is interested in the ability of the corporation to operate profitably. The interest of the public, workers, and the State is in the ability of the corporation to supply its much-needed goods and services and to provide jobs. The interests of the investor, the public, workers, and the State are thus not conflicting since they all want the corporation to continue to operate. However, it is different with the creditor. The creditor will agree to the rehabilitation of the corporation if there is a determination that the value the creditor will get during and after rehabilitation is more than the liquidation value. Otherwise, the creditor will demand liquidation. The court is now tasked to balance these interests.

The Supreme Court stated in a case that "...in considering whether to rehabilitate or not, the SEC gives preference to the interest of creditors, including employees. The reason is that shareholders can recover their investments only upon liquidation of the corporation, and only if there are assets remaining after all corporate creditors are paid."[58]

However, in the same case, the Court in discussing the suspension of the claims in rehabilitation proceedings stated that "(s)uch suspension is intended to give enough breathing space for the management committee or rehabilitation receiver to make the business viable again, without having to divert attention and resources to litigations in various fora."[59] In other words, from the start, there is a tendency to treat the corporation as a going concern, not as a group of assets to be liquidated.

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[57] CONST. Art XII, sec 19.

[58] Rubberworld (Phils.), Inc. vs NLRC, *supra* at 729.

[59] Rubberworld (Phils.), Inc. vs NLRC, *supra* at 724.

Moreover, in enumerating the contents of a rehabilitation plan, the Rules of Procedure on Corporate Rehabilitation includes such other relevant information to enable a *reasonable investor to make an informed decision on the feasibility of the rehabilitation plan.*[60] It can be argued that since the rehabilitation plan requires investor's information, the assessment of such rehabilitation plan must be done from an investor's perspective.

It is clear from the foregoing that both the creditor and the investor can present strong arguments to support their respective interests.

F. Reconciling The Interests

An American author wrote:

> The decision as to whether rehabilitation or liquidation is best also depends upon the amount to be realized from each alternative. The method resulting in the greatest return to the creditors and stockholders shall be chosen. The amount to be received from liquidation depends on the resale value of the firm's assets minus the costs of dismantling and legal expenses. The value of the firm after rehabilitation must be determined (net of costs of achieving the remedy). The alternative leading to the highest value should be followed.[61]

The Regional Trial Court of Cebu, 7th Judicial Region, Branch 11, wrote the following in its decision regarding the petition for Rehabilitation of Shemberg Biotech Corp.:

> At this point, it is noteworthy to state that, aside from seeing the petitioner being rehabilitated, the Court's primary concern is the protection of the rights and interests of its creditors. This concern stems from the highest level of public interest to promote initiatives and efforts to resuscitate distressed corporation so that it can continue to be an on-going business concern. Given this impetus, the Court is driven by the highest sense of responsibility to see to it that the petitioner be afforded a program of rehabilitation which will enable it to satisfy its outstanding obligations. A plan for rehabilitation, to the mind of this Court, is always premised on a desire to save a corporation from liquidation and to continue its operation. The law giving the court the power to approve rehabilitation plans must have been enacted precisely to help distressed corporations because a distressed corporation, after all, may be worth more as a going concern than being liquidated (Jordan and Warren, Bankruptcy, p. 680) for the simple

[60] Interim Rules of Procedure on Corporate Rehabilitation SC Adm. Mem. No. 00-8-10-SC (2000), Rule 4, sec. 5.

[61] G. NEWTON, *op. cit. supra* note 7 at 9.

> reason that assets used for production in the industry for which they were designated are actually more valuable than if sold for scrap (Poorman, Bankruptcy Reform Act of 1978, Oklahoma Law Review, Volume 32, 583 p. 617).[62]

It can be gleaned from these quoted statements that there is a balancing of interests involved in resolving a petition for rehabilitation. In some cases where the liquidation value of the corporation is disproportionately higher than the value of the corporation as a going-concern, the interest of the creditor must be given more weight, and the corporation must be liquidated. If the situation were reversed, the investor's interest must be upheld, and the corporation must continue in operation. However, petitions for rehabilitation are rarely that simple and clear-cut. In many cases, both liquidation values and going-concern values are evenly balanced. During these instances, the interests of the investor, general public, workers, and the State should tilt the scale in favor of maintaining the corporation as a going-concern.

The reason for favoring the interest of investors in evenly balanced cases or doubtful cases can be found, after a careful perusal and appreciation, in the Interim Rules of Procedure on Corporate Rehabilitation. The rules require investor's information to be included in the rehabilitation plan. As mentioned earlier, Section 5 of Rule 4 of the Interim Rules mandates the inclusion of such other relevant information to enable a reasonable investor to make an informed decision on the feasibility of the rehabilitation plan. If the rehabilitation receiver, after assessing this information, finds the rehabilitation plan to be feasible, the court may approve the rehabilitation plan even over the opposition of the creditors.[63] The procedure thus subordinates the interest of the creditor to the findings of the rehabilitation receiver. It should be reiterated that the findings of the rehabilitation receiver is based on investor's information contained in the rehabilitation plan. Accordingly, the rehabilitation receiver is impliedly tasked to appraise the corporation as an investor. And like any investor, the rehabilitation receiver must give more emphasis on assessing the corporation as a going concern.

Going back to the illustrative hypothetical example of Triple V Auto Services, Inc., a balancing of interests will have to be made with regard to the conflicting claims of the creditors and of the debtor-petitioner. On one hand, the creditors claim that the petitioner is well on its way to bankruptcy and that there is a near impossibility for the petitioner to meet its current liabilities. On the other

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[62] In the Matter of Petition for Approval of Rehabilitation Plan and Appointment of Rehabilitation Receiver of Shemberg Biotech Corp., Civil Case No. CEB-26481-SRC.

[63] Interim Rules of Procedure on Corporate Rehabilitation, SC AM No. 00-8-10-SC (2000), Rule 4, sec. 23.

hand, the petitioner claims that the corporation is more valuable if it is allowed to continue to operate, rather than if it is liquidated. The adverse parties both present compelling arguments to support their claims. A conscientious judge will certainly be hard put to resolve this dilemma.

In cases where the interests of adverse parties are almost evenly balanced, the court should be guided primarily by the valuation of the corporation as a going concern. In the above-mentioned illustration, the present value of the corporation as a going concern is Php631,944.44. This value is higher than the market price of the capital stock of the corporation which is only Php200,000. It is also higher than the total stockholder's equity of Php500,000. Furthermore, this value is even higher than the combined amount of the current liabilities (Php400,000) and long-term liabilities (Php100,000) of the petitioner corporation. Moreover, it should also be noted that the financial woes of the corporation originated from a cause that is extraordinary and non-recurring. The labor problems that wreaked havoc on the corporation's sales and cost occurred only in Year 2000, and have already been resolved. Thus, there is no reason to close down the operation of the corporation and liquidate its assets. There is no indication that the operation of the corporation will continue in its downward spiral. In fact, the evidence presented support the view that the corporation's operation will return to normal in the succeeding years, and that the sales will go back to its usual levels. In light of this assessment, the court should grant the petition for corporate rehabilitation and issue a stay order.

The only remaining obstacle to a complete resolution of this matter is the Supreme Court ruling in the Rubberworld case stating that in considering whether to rehabilitate or not, the interest of creditors, including employees, shall be given preference. This statement by the Supreme Court should be considered as referring to the order of preference of credits, not as referring to the standard for determining whether or not to rehabilitate. This should be the interpretation since the main and entire issue of the Rubberworld case involved the order of preference of credits, and since the case discussed rehabilitation only incidentally. This interpretation finds support in the next sentence of the decision which stated that the *reason* for the preference of the interest of creditors, including employees, was that shareholders could recover their investments only upon liquidation of the corporation, and only if there were assets remaining after all corporate creditors were paid. This next sentence removes any doubt on the matter and clarifies what the Supreme Court was referring to. The ponencia was clearly discussing the order of preference of credits. It is a basic accounting concept that shareholders recover their investment only upon liquidation, and after the creditors have been paid. Creditors have priority in the order of payment of claims over shareholders. When the Court wrote that the interest of the creditors should be given preference, it was referring to the preference in the collection of the creditor's claims over the shareholder's claims. Even assuming that the Court was referring to the standard for determining whether or not to grant the petition for rehabilitation, the contentious statement of the Supreme Court in the Rubberworld case should, at most, be considered as *obiter dictum*, since it was not necessary for the disposition of the case. As such. the related statements lack the force of adjudication and have no binding effect.

V. CONCLUSION

It is truly interesting to note the trend on how mankind deals with the financially distressed debtor. The shift in approach -- helping save the debtor instead of closing his shop -- reflects not only a more humane attitude but also reflects a change in the appreciation of the value of a rescued debtor as opposed to a dead or broken down debtor. This is particularly significant in these modern times characterized by dynamic and ever-changing economic, financial, and social landscapes, where more and more are finding themselves in financial crisis due to the failure to adapt or to cope with the changes. While the stigma associated with bankruptcy will always be attached to a financially distressed debtor, the experience need not be as harrowing or as heartwrenching as in the past. The debtor need not, as a poet once put it, "watch the things you gave your life to, broken, and stoop and build 'em up with worn-out tools."

Corporate rehabilitation recognizes the value of a corporation as a going concern. Insolvent or bankrupt corporations can still make sufficient earnings so long as they retain their assets and command the loyalty and patronage of their markets. In many instances, the value of a financially distressed corporation as a going concern is greater than its liquidation value. Of course, there are conflicts as to the accuracy of these valuations. But this only highlights the importance of setting a definite and uniform standard for valuing corporations.

The writers do not presume to possess neither the knowledge nor the expertise to set the best and most accurate standards. This we will leave to those who are more knowledgeable, wiser, and more experienced. However, we have cited some methods of valuation that may aid in the resolution of a corporate rehabilitation proceeding. More importantly, we have presented a way of thinking essential to a proper attitude and approach towards rehabilitation.

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