

**WHEN “EQUALITY” IS NOT “EQUITY”:  
A COMPARATIVE LEGAL AND ECONOMIC PERSPECTIVE FOR  
JUDICIAL REVIEW OF THE STATUS OF SECURED CREDITORS IN  
PHILIPPINE CORPORATE REHABILITATION PROCEEDINGS**

*Diane A. Desierto\**

*Rehabilitation contemplates a continuance of corporate life and activities in an effort to restore and reinstate the corporation to its former position of successful operation and solvency. When a distressed company is placed under rehabilitation, the appointment of a management committee follows to avoid collusion between the previous management and creditors it might favor, to the prejudice of the other creditors. All assets of a corporation under rehabilitation receivership are held in trust for the equal benefit of all creditors to preclude one from obtaining an advantage or preference over another by the expediency of attachment, execution or otherwise. As between the creditors, the key phrase is equality in equity. Once the corporation threatened by bankruptcy is taken over by a receiver, all the creditors ought to stand on equal footing. Not any one of them should be paid ahead of the others. This is precisely the reason for suspending all pending claims against the corporation under receivership.*

- Ruby Industrial Corporation et al. v. Court of Appeals  
G.R. Nos. 124185-87, 20 January 1998  
Supreme Court Second Division

*Sec.5. Rehabilitation Plan. – The rehabilitation plan shall include ~~xxx xxx~~ (b) the terms and conditions of such rehabilitation, which shall include the manner of its implementation, giving due regard to the interests of secured creditors; ~~xxx~~*

- Interim Rules of Procedure on Corporate Rehabilitation  
(A.M. No. 00-8-10-SC)

---

\* Law Reform Specialist, Institute of International Legal Studies (IILS), University of the Philippines Law Center; Professorial Lecturer in Legal History and Agency & Partnership Law, University of the Philippines College of Law; Professorial Lecturer in Public International Law and Administrative Law, Lyceum of the Philippines College of Law; B.S. Economics, *summa cum laude*, School of Economics, University of the Philippines; LL.B., *cum laude*, College of Law, University of the Philippines.

## INTRODUCTION

Since the Supreme Court's promulgation of the Interim Rules of Procedure on Corporate Rehabilitation in 2000 ("Interim Rules"), unsecured creditors have latched on to the oft-cited *Ruby Industrial* dictum<sup>1</sup> to assert a status of equality with secured creditors with respect to rehabilitation plan payments. This raises several threshold questions. Does giving "due regard" (as mandated in Rule IV, Section 5(b) of the Interim Rules) to the interests of secured creditors contemplate a prohibition against the use or distribution of the property constituting the security under the terms of a court-approved rehabilitation plan? If the use or distribution of the property constituting the security is permitted, could secured creditors be "adequately protected", as contemplated in the Interim Rules, against the erosion of their security interests? If so, what modes of judicial action are permissible to abate or mitigate such erosion?

The extreme interpretation of the *Ruby Industrial* dictum can lead to unsecured creditors claiming that "all assets" of the corporation under rehabilitation form part of the entire corpus of assets from which rehabilitation plan payments are made. All of these assets are purportedly "held in trust for the equal benefit of all creditors to preclude one from obtaining an advantage or preference over another by the expediency of attachment, execution or otherwise". Relying on the *Ruby Industrial* dictum's claim of "equality is equity", unsecured creditors therefore insist on their "equal" status with secured creditors for any payments to be made under court-approved rehabilitation plans. Whether payments are to be sourced from properties comprising security or other assets of the corporation, unsecured creditors maintain that all such properties (secured or unsecured) form part of the "distributable assets" of a corporation in a rehabilitation proceeding.

The result of this "extreme" interpretation of perceived "equality" under the *Ruby Industrial* dictum is that secured creditors can end up losing the property/ies subject of their security to the distribution scheme approved under the rehabilitation plan. Unsecured creditors can end up recovering their claims even from the disposition of (or income from) secured assets – a pool of corporate assets unsecured creditors would ordinarily not have had access to without corporate rehabilitation proceedings. In the meantime, due to the Stay Order<sup>2</sup> in force during rehabilitation, secured creditors will be unable to foreclose over their security. The net effect of the "extreme" interpretation of the *Ruby Industrial* dictum is that

---

<sup>1</sup> Other recent citations of the *Ruby Industrial* dictum include: Metropolitan Bank & Trust Company v. ASB Holdings Inc. et al., G.R. No. 166197, February 27, 2007; New Frontier Sugar Corporation v. Regional Trial Court, Branch 39, Iloilo City, et al., G.R. No. 165001, January 31, 2007; Spouses Sobrejuanite v. ASB Development Corporation, G.R. No. 165675, September 30, 2005.

<sup>2</sup> See Rule IV, Section 6 of the Interim Rules.

unsecured creditors could also profit from a distribution or payment scheme involving secured assets, reinforced by the suspension of enforcement of secured creditors' foreclosure rights. At its worst, the "extreme" interpretation of "equality" the *Ruby Industrial* dictum could be basis for rehabilitation courts to approve rehabilitation plans that dispose of secured assets (without corresponding replacement) and transmit the proceeds of disposition to all creditors, secured or unsecured. Since courts are authorized under the Interim Rules to a "cramdown" of the rehabilitation plan even over the objections of creditors,<sup>3</sup> there is no guarantee that secured creditors' security interests could be preserved during rehabilitation. By the time rehabilitation has terminated, there could be no property (if any) over which secured creditors could exercise their foreclosure right.

Secured creditors can expectedly object to the decimation of their security under a court-approved payments distribution to all creditors (secured or unsecured) in the rehabilitation plan. Arguing from the standpoint of both policy and law, secured creditors foreseeably can insist on the protection of their security interests even during corporate rehabilitation.<sup>4</sup> Otherwise, the perceived destruction of security interests in corporate rehabilitation proceedings will ultimately incentivize secured creditors to immediately initiate insolvency proceedings against the subject corporation, in order to enable secured creditors to maximize recovery on their loans to the corporation and the security intended to guarantee such loans.

Clearly, the interpretation and application of the *Ruby Industrial* dictum is a pivotal case for judicial balancing of interests,<sup>5</sup> and an opportunity for courts to review the relative status of secured and unsecured creditors in corporate rehabilitations under the Interim Rules. Part I of this paper examines the jurisprudential antecedents of the *Ruby Industrial* dictum in relation to the content

---

<sup>3</sup> Interim Rules, Rule IV, Section 23.

<sup>4</sup> See Villanueva, Cesar L. *Judicial Activism in Commercial Laws*, at p. 8 found at: <http://www.deanclv.net/newsdata/13/object/judicialactivism.doc> (last visited 5 January 2008):

"Perhaps the more controversial areas of the Interim Rules are those that have constitutional repercussion, thus:

- (a) Lumping together both secured and unsecured creditors and making their vote to the adoption of the rehabilitation plan a condition precedent; and
- (b) Non-protection of the property value of secured creditors under the rehabilitation plan with the cramdown power of the Regional Trial Courts

xxx xxx xxx

As the argument goes, secured creditors have property rights under their existing security arrangements with the debtor that cannot be put asunder without their consent or unless in exchange for valuable consideration that preserves at least the value of their property rights."

<sup>5</sup> See Kahn, Peter L. *The Politics of Unregulation: Public Choice and the Limits of Government*, 75 CORNELL L. REV. 280 (January 1990).

and purpose of the "due regard" provision of the Interim Rules (and comparable provisions in the former SEC Interim Rules on Corporate Recovery). In Part II, the scope of the "due regard" provision is also explored from comparative international best practices on corporate rehabilitations and/or reorganizations to determine the relative status of secured and unsecured creditors in these types of proceedings. As will be later shown, there appears to be a heavy legal preponderance in favor of maintaining and preserving security interests to accomplish the objects and purposes of corporate rehabilitations. Both international practice and Philippine jurisprudence affirm that security interests should not be destroyed in corporate rehabilitation.

Part III of this paper then uses a basic efficiency allocation model for courts to consider before approving rehabilitation plans that call for distribution of properties comprising security in order to pay off all of the corporation's creditors, secured or unsecured. The question of distribution is ultimately one of efficiency in the allocation of corporate resources for creditor payments and corporate expenses – how best to derive the optimal distribution of corporate assets in payment to creditors (secured or unsecured) that most feasibly ensures the corporation's restoration to financial and operational viability. The Pareto efficient allocation for courts to consider in the payment distribution under a rehabilitation plan is clearly the allocation when "there is no way to make some individual better off without making someone else worse off".<sup>6</sup>

As will be subsequently shown, however, the Interim Rules (specifically the "due regard" and "adequate protection" clauses in Rule 4, Section 5(b) and Rule 4, Section 12 of the Interim Rules) create an in-built constraint that forces courts to choose a Pareto-efficient allocation in the interior of the Pareto set or contract curve, and not at the origin (where one set of creditors enjoys full recovery from secured assets to the complete exclusion of the other set of creditors). The courts, as the virtual "auctioneer" in the "exchange" between secured and unsecured creditors (best exemplified in the creditors' meetings with the rehabilitation receiver), can set the "relative prices" for creditor recovery on their claims – through court approval of valuation of corporate assets, court approval of the estimated debt burden of the corporation under rehabilitation, and, among others, court-sanctioned 'transaction costs' that make it incrementally difficult for creditors to recover the full amount of their claim from the corporation. While Pareto efficiency can theoretically contemplate a situation where one set of creditors (unsecured creditors) are able to recover the full amount of their claim from both secured and unsecured assets of the corporation while secured assets can be exhausted under the payment scheme in the rehabilitation plan, the Interim Rules prevent this situation by prohibiting the destruction of security interests.

Thus, as will be seen from international best practices, Philippine jurisprudence, and economic efficiency analysis, rehabilitation courts cannot

---

<sup>6</sup> See VARIAN, HAL R. *INTERMEDIATE MICROECONOMICS*, (2<sup>nd</sup> ed., 1990.), at 480.

interpret the *Ruby Industrial* dictum in a manner that permits the obliteration or destruction of assets comprising the security, without requiring the corporation subject of rehabilitation to replace such assets with others comparable in value. The "equality is equity" dictum in *Ruby Industrial* simply contemplates a stay in the enforcement of claims of all creditors, whether secured or unsecured. It cannot authorize the distribution of secured assets to all creditors (secured or unsecured) without a corresponding and appropriate replacement of such assets. Rehabilitation does not intend the destruction of security interests.

**I. RETRACING THE *RUBY INDUSTRIAL* DICTUM: FROM  
SEC CORPORATE RECOVERY RULES AND *ALEMAR'S SIBAL & SONS*,  
TO THE INTERIM RULES AND *NEW FRONTIER***

*Ruby Industrial Corp. et al. v. Court of Appeals et al.*, (hereafter, *Ruby Industrial*)<sup>7</sup> was decided by the Second Division of the Supreme Court two (2) years before its promulgation of the Interim Rules of Procedure on Corporate Rehabilitations. The case originated from a Petition for Suspension of Payments filed by Ruby Industrial with the Securities and Exchange Commission (SEC) in 1983. When the SEC declared Ruby Industrial under suspension of payments, Ruby Industrial was enjoined, pending hearing on the Petition, from disposing of its properties or from making payments outside of the necessary or legitimate expenses of its business.

After the SEC Hearing Panel approved the rehabilitation plan proposed by Ruby Industrial's majority stockholders ("Benhar/Ruby plan"), the minority stockholders appealed. The SEC en banc then issued a writ of preliminary injunction against the enforcement of the Benhar/Ruby plan. The Supreme Court later upheld the injunction.

Problems arose when it was discovered that Ruby Industrial had partly implemented the Benhar/Ruby plan before its approval by the SEC Hearing Panel. One of Ruby Industrial's secured creditors (Far East Bank & Trust Company, or FEBTC) had been paid off, and FEBTC had executed a deed of assignment in favor of the majority stockholder, Benhar. Despite the injunction, Benhar paid off Ruby Industrial's other secured creditors who later assigned their credits to Benhar. Upon motion of Ruby Industrial's unsecured creditors, the SEC nullified the deeds of assignment to Benhar. The SEC's orders were affirmed by the Court of Appeals, and thereafter, the Supreme Court.

Ruby Industrial then submitted a revised rehabilitation plan to the SEC, which provided for reimbursement to Benhar for payments it had made to Ruby

---

<sup>7</sup> G.R. Nos. 124185-87, January 20, 1998.

Industrial's secured creditors. Ruby Industrial's creditors objected, claiming that the revised plan would legitimize the entry of Benhar as the new (and biggest) creditor of Ruby, and the revised plan would put Ruby's assets beyond the reach of unsecured creditors and the minority stockholders.

The SEC approved this revised plan. The Court of Appeals reversed, stating that the revised plan circumvented its earlier decision nullifying the deeds of assignment executed by Ruby's secured creditors in favor of Benhar.

The Supreme Court affirmed the Court of Appeals' decision, anchoring its reasoning on the final declaration of nullity of the deeds of assignment. Such assignments being entirely void, Benhar could not derive rights as against Ruby Industrial as to entitle Benhar to payments as a 'creditor'. Otherwise stated, the Court affirmed that Benhar could not assert any entitlement to repayment from Ruby Industrial for Benhar's void act of paying off Ruby's secured creditors while an injunction against such dispositions was subsisting. The Court then admonished, in its now oft-cited dictum, that:

"Rehabilitation contemplates a continuance of corporate life and activities in an effort to restore and reinstate the corporation to its former position of successful operation and solvency. (citing *New York Title and Mortgage Co., vs. Friedman*, 276 N.Y.S. 72, 153, Misc. 697) When a distressed company is placed under rehabilitation, the appointment of a management committee follows to avoid collusion between the previous management and creditors it might favor, to the prejudice of the other creditors. All assets of a corporation under rehabilitation receivership are held in trust for the equal benefit of all creditors to preclude one from obtaining an advantage or preference over another by the expediency of attachment, execution or otherwise. As between the creditors, the key phrase is equality in equity. Once the corporation threatened by bankruptcy is taken over by a receiver, all the creditors ought to stand on equal footing. Not any one of them should be paid ahead of the others. This is precisely the reason for suspending all pending claims against the corporation under receivership. (citing *Araneta vs. Court of Appeals*, G.R. No. 95253, July 10, 1992, 211 SCRA 390; *Rizal Commercial Banking Corporation vs. IAC and BF Homes, Inc.*, G.R. No. 74851, September 14, 1992, 213 SCRA 830)."

Thus, as clearly seen from *Ruby Industrial*, the Supreme Court simply affirmed the prohibition against disposition of corporate assets in favor of one class of creditors (secured creditors) before approval of the rehabilitation plan. The *Ruby Industrial* dictum precisely affirms that what is suspended is the enforcement of claims against the corporation, and thus, "not any one of [the creditors] should be paid ahead of the others". The *Ruby Industrial* dictum did not destroy the distinction between the claims of secured creditors and unsecured creditors.

The prohibition against the mere enforcement of claims is further affirmed from the cases cited by the Supreme Court in the *Ruby Industrial* dictum:

### 1) *Araneta v. Court of Appeals*<sup>8</sup>

*Araneta* involved a claim arising from Philfinance's sale of a security (promissory note) to the Aranetas. The security was under the custodianship of Pilipinas Bank. When the Aranetas sought to recover the security from Pilipinas Bank, the bank maintained that the security forms part of the assets of Philfinance which have been frozen by the SEC upon declaring Philfinance under suspension of payments and receivership. In affirming the bank's refusal to turn over the security to the Aranetas, the Supreme Court held that the declaration of suspension of payments upon Philfinance was a 'supervening' event, and that the Aranetas should properly file their claim under the SEC proceedings. The Supreme Court noted its decision in *Aleman's Sibal & Sons Inc. v. Elbinias*,<sup>9</sup> to explain the rationale for placing a corporation in a state of suspension of payments and receivership:

"It must be stressed that the SEC had earlier ordered the suspension of all actions for claims against Alemar's in order that all the assets of said petitioner could be inventoried and kept intact for the purpose of ascertaining an equitable scheme of distribution among its creditors.

During rehabilitation receivership, the assets are held in trust for the equal benefit of all creditors to preclude one from obtaining an advantage or preference over another by the expediency of an attachment, execution or otherwise. For what would prevent an alert creditor, upon learning of the receivership, from rushing posthaste to the courts to secure judgments for the satisfaction of its claims to the prejudice of the less alert creditors.

As between creditors, the key phrase is 'equality is equity (Central Bank vs. Morfe, 63 SCRA 114, citing *Ramisch vs. Fulton*, 41 Ohio App. 443, 180 N.E. 735).' When a corporation threatened by bankruptcy is taken over by a receiver, all the creditors should stand on an equal footing. Not anyone of them should be given any preference by paying one or some of them ahead of the others. This is precisely the reason for the suspension of all pending claims against the corporation under receivership. Instead of creditors vexing the courts with suits against the distressed firm, they are directed to file their claims with the receiver who is a duly appointed officer of the SEC."

As seen from the foregoing, what the Supreme Court simply intended in stating that "all creditors should stand on equal footing" is the establishment of "equality" based on an across-the-board prohibition against any enforcement of claim by any creditor, secured or unsecured. Thus, this reasoning should infuse judicial appreciation of the *Ruby Industrial* dictum. The *Ruby Industrial* dictum should not be read as having destroyed security interests in corporate rehabilitation, or

---

<sup>8</sup> G.R. No. 95253, July 10, 1992.

<sup>9</sup> G.R. No. 75414, June 4, 1990. Emphasis and underscoring supplied.

vesting unsecured creditors with the same corpus of rights over secured assets as secured creditors.

**2) *Rizal Commercial Banking Corporation (RCBC) v. Intermediate Appellate Court (IAC) et al.*<sup>10</sup>**

RCBC likewise affirms the same prohibition against enforcement of claims by any creditor where a corporation is declared under suspension of payments. In this case, BF Homes filed a Petition for Rehabilitation and for Declaration and Suspension of Payments with the SEC. One of its creditors was RCBC. Before the petition could be heard by the SEC, RCBC extrajudicially foreclosed on the properties subject of BF Homes' real estate mortgage with RCBC. The properties were auctioned off at a public sale, on the sheriffs' claim that the SEC had not yet issued any injunction at the time of the sale. RCBC filed a petition for mandamus to compel the delivery of the Certificate of Sale of the auctioned properties. The trial court granted RCBC's petition. Thereafter, upon BF Homes' complaint with the IAC for annulment of the trial court's judgment, the IAC set aside the writ of mandamus issued and suspended issuance of new titles to RCBC pending resolution of the rehabilitation petition with the SEC.

The Supreme Court denied RCBC's petition seeking annulment of the IAC decision. The Supreme Court affirmed the prohibition on the enforcement (or foreclosure) of the claim over the security pending rehabilitation:

"While it is recognized that RCBC is a preferred creditor and likewise the highest bidder at the auction sale, We have however stated that whenever a distressed corporation asks the SEC for rehabilitation and suspension of payments, preferred creditors may no longer assert such preference, but as earlier stated, stand on equal footing with other creditors. Foreclosure shall be disallowed so as not to prejudice other creditors, or cause discrimination among them. If foreclosure is undertaken despite the fact that a petition for rehabilitation has been filed, the certificate of sale shall not be delivered pending rehabilitation. Likewise, if this has also been done, no transfer of title shall be effected also, within the period of rehabilitation. The rationale behind PD 902-A, as amended, is to effect a feasible and viable rehabilitation. This cannot be achieved if one creditor is preferred over the others.

In this connection, the prohibition against foreclosure attaches as soon as a petition for rehabilitation is filed. Were it otherwise, what is to prevent the petitioner from delaying the creation of the Management Committee and in the meantime dissipate all its assets. The sooner the SEC takes over and imposes a freeze on all the assets, the better for all concerned."<sup>11</sup>

---

<sup>10</sup> G.R. No. 74851, September 14, 1992 (en banc).

<sup>11</sup> Emphasis and underscoring supplied.



Clearly, the 'equality of footing' contemplated (between secured and unsecured creditors) is hinged on the uniform prohibition against the enforcement of claims against the corporation pending rehabilitation. Read alongside its jurisprudential antecedents in *Alemar's Sibal & Sons Inc.*, *Araneta*, and *RCBC*, the *Ruby Industrial* dictum should be understood simply as a prohibition against any creditor's enforcement of a claim against the corporation pending rehabilitation (and approval of a rehabilitation plan). None of these cases collapsed the distinction between secured creditors and unsecured creditors. The rights of secured creditors to foreclose over secured assets of the corporation (to the exclusion) of unsecured creditors, remain intact, but are simply rendered 'unenforceable' during the pendency of corporate rehabilitation.

The foregoing interpretation is also consistent with the SEC Rules of Procedure on Corporate Recovery ("SEC Corporate Recovery Rules"),<sup>12</sup> which antedated the Interim Rules. The SEC Corporate Recovery Rules were promulgated "to carry out the objectives of Presidential Decree No. 902-A<sup>13</sup> and to assist the parties in obtaining a just, expeditious, and inexpensive settlement of cases".<sup>14</sup> Section 2-10 of the SEC Corporate Recovery Rules expressly classifies creditors into secured and unsecured creditors.

Rule IV of the SEC Corporate Recovery Rules provides for the remedy of rehabilitation. Rehabilitation can be initiated by the debtor corporation, its creditors, or stockholders, so long as it is shown that the debtor corporation is "insolvent because its assets are not sufficient to cover its liabilities, or [which is] technically insolvent under Section 3-12 of these Rules, but which may still be rescued or revived through the institution of some changes in its management, organization, policies, strategies, operations, or finances."<sup>15</sup> While the SEC Corporate Recovery Rules does not carry a similar "due regard" provision for secured creditors as indicated in the Interim Rules,<sup>16</sup> the same SEC Corporate Recovery Rules recognize

<sup>12</sup> SEC Rules of Procedure on Corporate Recovery, December 21, 1999.

<sup>13</sup> Presidential Decree No. 902-A ("REORGANIZATION OF THE SECURITIES AND EXCHANGE COMMISSION WITH ADDITIONAL POWERS AND PLACING THE SAID AGENCY UNDER THE ADMINISTRATIVE SUPERVISION OF THE OFFICE OF THE PRESIDENT"), March 11, 1976, as amended.

<sup>14</sup> SEC Rules of Procedure on Corporate Recovery, Rule I, Section 1-2.

<sup>15</sup> *Ibid.*, at Rule IV, Section 4-1.

<sup>16</sup> See Interim Rules, Rule IV, Section 5(b) alongside Rule IV, Section 4-18 of the SEC Rules of Procedure on Corporate Recovery.

that a secured creditor is entitled to "adequate protection over property securing its claim."<sup>17</sup>

<p>Section 5. <i>Rehabilitation Plan.</i> – The rehabilitation plan shall include: a) the desired business targets or goals and the duration and coverage of the rehabilitation; b) the terms and conditions of such rehabilitation <b>which shall include the manner of its implementation, giving due regard to the interests of secured creditors</b>; (c) the material financial</p>	<p>Section 4-18. <i>Rehabilitation Plan.</i> – The petitioner shall attach to the petition the proposed rehabilitation plan. If not so attached, the petitioner shall submit it within such time as the Commission may allow serving notice to each creditor of record that the Rehabilitation Plan has been filed with the Commission and that a copy thereof served on</p>
<p>commitments to support the rehabilitation plan; (d) the means for the execution of the rehabilitation plan, which may include conversion of the debts or any portion thereof to equity, restructuring of the debts, <i>dacion en pago</i>, or sale of assets or of the controlling interest; (e) a liquidation analysis that estimates the proportion of the claims that the creditors and shareholders would receive if the debtor's properties were liquidated; and (f) such other relevant information to enable a reasonable investor to make an informed decision on the feasibility of the rehabilitation plan. (Emphasis supplied.)</p>	<p>the Interim Receiver is available for examination and reproduction. The Rehabilitation Plan shall include (a) the desired business targets or goals and the duration and coverage of the rehabilitation, (b) the terms and conditions of such rehabilitation which shall include the manner of its implementation, (c) the material financial commitments to support the Rehabilitation Plan, (d) a repayment plan for all debts and liabilities including the source of repayment, (e) the means for the execution of the Rehabilitation Plan, which may include conversion of the debts or any portion thereof to equity, restructuring of the debts, <i>dacion en pago</i>, or sale of the assets or of the controlling interest; and (f) such other relevant information to enable a reasonable investor to make an informed decision on the feasibility of the Rehabilitation Plan.</p>

<sup>17</sup> See Rule IV, Section 4-10 of the SEC Rules of Procedure on Corporate Recovery:

"Section 4-10. *Relief from, modification or termination of Suspension Order.* – The Commission may, on motion or *motu proprio*, terminate, modify, or set conditions for the continuance of the suspension order, or relieve a claim from the coverage thereof upon showing that (a) any of the allegations in the petition, or any of the contents of any attachment, or the verification thereof has ceased to be true; (b) **a creditor does not have adequate protection over property securing its claim**; or (c) the debtor's secured obligation is more than the fair market value of the property subject of the stay and such property is not necessary for the rehabilitation of the debtor.

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

- a. the debtor is not honoring pre-existing agreement with the creditor to keep the property insured;
- b. the debtor is failing to take commercially reasonable steps to maintain the property; or

Significantly, the SEC Corporate Recovery Rules (in conjunction with Presidential Decree No. 902-A) also appear to affirm the preservation of security interests during rehabilitation:

“May encumbered assets be disposed of?

In almost all rehabilitation proceedings, infusion of additional capital is an indispensable ingredient of the rehabilitation strategy. However, it is next to impossibility to find a bank willing to lend that additional capital. An investor may become interested but, as demonstrated in the case of PAL, that situation is rare.

Faced with the formidable predicament, the corporation may have no choice but to dispose of some assets and use the proceeds to operate the business. There will be no problem if the assets are unencumbered. But complications will develop if they are. May the Commission allow the disposition of encumbered assets?

I believe that the Commission has the authority to allow the lifting of the lien from an encumbered asset but only when a substitute security is given to the creditor. Rehabilitation, as a rule, merely postpones the right of the creditors to foreclose on the security. It does not work to remove the lien altogether.”<sup>18</sup>

---

c. depreciation of the property is increasing to the extent that the creditor is undersecured.

Upon showing of a lack of adequate protection, the Commission shall order the debtor to (a) make arrangements to provide for the insurance or maintenance of the property, (b) to make payments or otherwise provide an additional or replacement lien to the creditor to offset the extent that the depreciation of the property is increasing to the extent that the creditor is undersecured. Provided, however, that the Commission may deny the creditor the remedies in this paragraph if such remedies would prevent the continuation of the debtor as a going concern or otherwise prevent the approval and implementation of a Rehabilitation Plan.”

<sup>18</sup> Concepcion, Danilo L. *Corporate Rehabilitation: The Philippine Experience*, found at: <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/LAWANDJUSTICE/GILD/0,contentMDK:20154076~menuPK:146222~pagePK:64065425~piPK:162156~theSitePK:215006.0.html>. (last visited 15 January 2008) (Emphasis and underscoring supplied.).

See also Villanueva, Cesar L. *Revisiting the Philippine “Laws” on Corporate Rehabilitation*, Professorial Chair Paper for the JUSTICE CARMELO ALVENDIA CHAIR IN COMMERCIAL LAW for School Year 1998-1999:

“What may be clearly implied from the rulings of the Supreme Court is that the whole issue of “equality” among the creditors, both secured and unsecured, during the process of rehabilitation, should pertain only to the non-availment of actions on claims against the petitioning creditor during the period that rehabilitation is being pursued. But it cannot mean an actual treatment of the claims as “equal” to forgo the existence of contractual security rights in favor of secured creditors. A rehabilitation plan that “impairs” or destroys such security rights cannot be affirmed without the consent of the individual secured creditors; otherwise it would be a constitutional violation of due process and non-impairment clause.”

Likewise, the destruction of security interests (or any collapse in the distinction between secured and unsecured creditors) does not appear to be consistent with the express provisions of the Interim Rules, mandating that rehabilitation plans must give 'due regard' to the interests of secured creditors, and providing for adequate protection for secured creditors thus:

"Sec. 5. *Rehabilitation Plan.* – The rehabilitation plan shall include: a) the desired business targets or goals and the duration and coverage of the rehabilitation; b) the terms and conditions of such rehabilitation which shall include the manner of its implementation, giving due regard to the interests of secured creditors; (c) the material financial commitments to support the rehabilitation plan; (d) the means for the execution of the rehabilitation plan, which may include conversion of the debts or any portion thereof to equity, restructuring of the debts, *dacion en pago*, or sale of assets or of the controlling interest; (e) a liquidation analysis that estimates the proportion of the claims that the creditors and shareholders would receive if the debtor's properties were liquidated; and (f) such other relevant information to enable a reasonable investor to make an informed decision on the feasibility of the rehabilitation plan.

xxx xxx xxx

Sec.12. *Relief from, Modification, or Termination of Stay Order.* – 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 of the allegations in the petition, or any of the contents of any attachment, or the verification thereof has ceased to be true; (b) a creditor does not have adequate protection over property securing its claim; or (c) the debtor's secured obligation is more than the fair market value of the property subject of the stay and such property is not necessary for the rehabilitation of the debtor.

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

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

Upon showing of a lack of adequate protection, the court shall order the rehabilitation receiver to (a) make arrangements to provide for the insurance or maintenance of the property, or (b) to make payments or otherwise provide additional or replacement security such that the obligation is fully secured. If such arrangements are not feasible, the court shall modify.

---

the stay order to allow the secured creditor lacking adequate protection to enforce its claim against the debtor; *Provided, however*, That the court may deny the creditor the remedies in this paragraph if such remedies would prevent the continuation of the debtor as a going concern or otherwise prevent the approval and implementation of a rehabilitation plan.”<sup>19</sup>

The Supreme Court has not had occasion yet to interpret the foregoing “due regard” and “adequate protection” clauses of the Interim Rules. The Court, however, has consistently upheld the preferred status of secured creditors over unsecured creditors in relation to properties subject of security, clarifying that what is merely suspended during rehabilitation proceedings is the enforcement of the claim over the property constituting the security.<sup>20</sup> As the Court clarified in *Metropolitan Bank & Trust Company v. ASB Holdings Inc. et al.*,<sup>21</sup> mortgage liens are retained in corporate rehabilitations, and what is only suspended is the creditor’s enforcement of such preference:

“We are not convinced that the approval of the Rehabilitation Plan impairs petitioner bank’s lien over the mortgaged properties. Section 6(c) of P.D. No. 902-A provides that ‘*upon appointment of a management committee, rehabilitation receiver, board or body, pursuant to this Decree, all actions for claims against corporations, partnerships or associations under management or receivership pending before any court, tribunal, board or body shall be suspended.*’”

By that statutory provision, it is clear that the approval of the Rehabilitation Plan and the appointment of a rehabilitation receiver merely suspend the actions for claims against respondent corporations. Petitioner bank’s preferred status over the unsecured creditors relative to the mortgage liens is retained, but the enforcement of such preference is suspended. The loan agreements between the parties have not been set aside and petitioner bank may still enforce its preference when the assets of ASB Group of Companies will be liquidated. Considering that the provisions of the loan agreements are merely suspended, there is no impairment of contracts, specifically its lien in the mortgaged properties.

As we stressed in *Rizal Commercial Banking Corporation v. Intermediate Appellate Court*, such suspension “shall not prejudice or render ineffective the status of a secured creditor as compared to a totally unsecured creditor”, for what P.D. No. 902-A merely provides is that all actions for claims against the distressed corporation, partnership or association shall be suspended. This arrangement provided by law is intended to give the receiver a chance to rehabilitate the corporation if there should still be a possibility for doing so, without being unnecessarily disturbed by the creditors’ actions against the distressed corporation. However, in the event that rehabilitation is no longer feasible and the claims against the distressed corporation would eventually have to be settled, the secured

---

<sup>19</sup> Interim Rules, Rule IV, Sections 5 and 12. Emphasis supplied.

<sup>20</sup> See *Philippine Airlines Inc. et al. v. Zamora*, G.R. No. 166996, February 6, 2007; *Philippine Airlines Inc. v. Philippine Airlines Employees Association*, G.R. No. 142399, June 19, 2007.

<sup>21</sup> G.R. No. 166197, February 27, 2007.

creditors, like petitioner bank, shall enjoy preference over the unsecured creditors.”<sup>22</sup>

Notably, the Supreme Court held in *Metrobank* that there was no impairment of security interests under the approved rehabilitation plan, since the *dacion en pago* therein contemplates obtaining the consent of the secured creditors to the disposition of the mortgaged properties. Since the *dacion en pago* transactions would be based on “mutually agreed upon terms” between the debtor-corporation and secured creditors, the rehabilitation plan did not *per se* appear to indicate impairment of the secured creditors’ property and/or contractual rights. (Clearly, this was not even an instance involving a “cramdown” upon secured creditors of a payment distribution scheme calling for disposition of the corporation’s mortgaged properties.)

Finally, under the Interim Rules, the suspension of enforcement of creditor claims comes into effect from the issuance of the Stay Order appointing a rehabilitation receiver. As the Court explained in *New Frontier Sugar Corporation v. Regional Trial Court of Iloilo City, Branch 39, et al.*,<sup>23</sup> (a case whose original incidents were already covered by the Interim Rules), the suspension of enforcement of creditor claims applies to both secured and unsecured creditors:

“Rehabilitation contemplates a continuance of corporate life and activities in an effort to restore and reinstate the corporation to its former position of successful operation and solvency ( *citing Ruby Industrial Corporation v. Court of Appeals, 348 Phil. 480, 497 (1998)*). Presently, the applicable law on rehabilitation petitions filed by corporations, partnerships or associations, including rehabilitation cases transferred from the Securities and Exchange Commission to the RTCs pursuant to Republic Act No. 8799 or the Securities Regulation Code, is the Interim Rules of Procedure on Corporate Rehabilitation (2000).

Under the Interim Rules, the RTC, within five (5) days from the filing of the petition for rehabilitation and after finding that the petition is sufficient in form and substance, shall issue a Stay Order appointing a Rehabilitation Receiver, suspending enforcement of all claims, prohibiting transfers or encumbrances of the debtor’s properties, prohibiting payment of outstanding liabilities, and prohibiting the withholding of supply of goods and services from the debtor. Any transfer of property or any other conveyance, sale, payment, or agreement made in violation of the Stay Order or in violation of the Rules may be declared void by the court upon motion or *motu proprio*.

Further, the Stay Order is effective both against secured and unsecured creditors. This is in harmony with the principle of “equality is equity” first enunciated in *Alema’s Sibal & Sons, Inc. v. Elbinias*, thus:

---

<sup>22</sup> Emphasis and italics in the original.

<sup>23</sup> G.R. No. 165001, January 31, 2007.

During rehabilitation receivership, the assets are held in trust for the equal benefit of all creditors to preclude one from obtaining an advantage or preference over another by the expediency of an attachment, execution or otherwise. For what would prevent an alert creditor, upon learning of the receivership, from rushing posthaste to the courts to secure judgments for the satisfaction of its claims to the prejudice of the less alert creditors.

As between creditors, the key phrase is "equality is equity." When a corporation threatened by bankruptcy is taken over by a receiver, all the creditors should stand on an equal footing. Not anyone of them should be given any preference by paying one or some of them ahead of the others. This is precisely the reason for the suspension of all pending claims against the corporation under receivership. Instead of creditors vexing the courts with suits against the distressed firm, they are directed to file their claims with the receiver who is a duly appointed officer of the SEC. (Emphasis supplied)

Nevertheless, the suspension of the enforcement of all claims against the corporation is subject to the rule that it shall commence only from the time the Rehabilitation Receiver is appointed. Thus, in *Rizal Commercial Banking Corporation v. Intermediate Appellate Court*, the Court upheld the right of RCBC to extrajudicially foreclose the mortgage on some of BPI Homes' properties, and reinstated the trial court's judgment ordering the sheriff to execute and deliver to RCBC the certificate of auction sale involving the properties. The Court vacated its previous Decision rendered on September 14, 1992 in the same case, finding that RCBC can rightfully move for the extrajudicial foreclosure of the mortgage since it was done on October 16, 1984, while the management committee was appointed only on March 18, 1985. The Court also took note of the SEC's denial of the petitioner's consolidated motion to cite the sheriff and RCBC for contempt and to annul the auction proceedings and sale."

As seen from the foregoing recent clarification by the Supreme Court, it appears clear that the "equality is equity" dictum in *Ruby Industrial* (traceable to *Alemar's Sibal & Sons*) only refers to the stay order, or the suspension of enforcement of claims against the corporation. It should not be construed as having destroyed the distinction between the rights of secured creditors vis-à-vis unsecured creditors.

Thus, as seen from the jurisprudential antecedents of the *Ruby Industrial* dictum, the SEC Rules on Corporate Recovery, the express provisions of the Interim Rules, and recent jurisprudence, there is no basis for an "extreme" interpretation of the *Ruby Industrial* dictum by rehabilitation courts. The perceived "equality" of secured and unsecured creditors in rehabilitation proceedings stems from the uniform suspension of enforcement of claims of all creditors. This "equality" does not extend to the use and disposition of secured assets (and without replacement or comparable substitution of the assets) to pay off all creditors under the rehabilitation plan, whether secured or unsecured. Security interests must still be respected and preserved during corporate rehabilitation.

## II. INTERNATIONAL BEST PRACTICES ON CORPORATE REHABILITATIONS/REORGANIZATIONS: RECONCILING THE 'PARI PASSU' DOCTRINE WITH THE *RUBY INDUSTRIAL* DICTUM

The "extreme" interpretation of "equality" between creditors classes (secured and unsecured) in the *Ruby Industrial* dictum has led to the argument that such "equality" permits the distribution of all corporate assets (including secured assets) for indiscriminate payment to all creditors (secured or unsecured). It has been argued that this "equality" is, in reality, consistent with the doctrine of *pari passu* treatment of creditors.

As internationally applied and understood in corporate restructuring proceedings, however, the *pari passu* doctrine contemplates equality only for classes of creditors that are similarly situated. The *pari passu* clause is a basic financial covenant which, in modern cross-border credit instruments, typically states that the loan (to which the clause is attached) will rank equally in right of payment with all other similarly situated loans of the borrower.<sup>24</sup>

"In a corporate context, this [*pari passu*] clause is a statement that on a forced insolvency, debts are, by law, paid ratably. It does not mean that one debt cannot be paid before another in time.

In the state context, the meaning of the clause is uncertain because there is no hierarchy of payment which is legally enforced under a bankruptcy regime. Probably the clause means that on a de facto inability to pay external debt as it falls due, one creditor will not be preferred by virtue of an allocation of international monetary assets achieved by a method going beyond contract; and (perhaps) that there will be no discrimination between creditors of the same class in the event of insolvency."<sup>25</sup>

Clearly, the *pari passu* clause does not mandate uniform payment treatment for what are obviously different creditor classes (secured and unsecured creditors). In devising a payment scheme during corporate restructuring, clear distinctions must be drawn between secured creditors and unsecured creditors, who not only

---

<sup>24</sup> Buchheit, Lee C. and Jeremiah S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, found at <http://www.law.georgetown.edu/international/documents/Pam.pdf> (last visited on 31 March 2005); See also WOOD, PHILIP R. LAW AND PRACTICE OF INTERNATIONAL FINANCE (1980), at Sec. 6.3(2), pp. 155-156: "In the context of a corporate loan, the undertaking [*pari passu clause*] is to be construed as a commitment or a warranty that on an insolvent liquidation or a forced distribution of assets unsecured creditors will be entitled to pro rata payment, and also that, on the occasion of judicial compromises or agreed debt settlements, the bondholders will not be discriminated against." (Underscoring supplied.)

<sup>25</sup> WOOD, PHILIP R., LAW AND PRACTICE OF INTERNATIONAL FINANCE: PROJECT FINANCE, SUBORDINATED DEBT & STATE LOANS (1995), at Sec. 16-12, p. 165. (Underscoring supplied.)



bear radically different legal rights and creditor status, but are also motivated by disparate interests.<sup>26</sup> As such, the *pari passu* clause is intended to address only borrower actions having the effect of changing the legal ranking of the debt or perhaps the earmarking of assets or revenue streams to benefit specific creditors.<sup>27</sup> Notably, the 2004 United Nations Commission on International Trade Law (UNCITRAL) Legislative Guide on Insolvency Law (which includes the concept of corporate reorganization/restructuring/rehabilitation), defines the *pari passu* clause as “the principle according to which similarly situated creditors are treated and satisfied proportionately to their claim out of the assets of the estate available for distribution to creditors of their rank.”<sup>28</sup>

The importance of the distinction between the rights of secured and unsecured creditors has constitutional dimensions. As recently argued by scholars and encapsulated in United States Supreme Court decisions, secured creditors have a property right in “hav[ing] the value of the collateral applied for payment of the secured creditor’s claim.”<sup>29</sup> Where there is an impairment of this property right in a corporate reorganization plan that jeopardizes such property right (e.g. through a ‘most egregious’ delay in the enforcement of a stay against a secured creditor during corporate reorganization, for example), it has been argued that there is a violation of the Takings Clause.<sup>30</sup>

---

<sup>26</sup> WOOD, PHILIP R., *LAW AND PRACTICE OF INTERNATIONAL FINANCE: PRINCIPLES OF INTERNATIONAL INSOLVENCY* (1995 ed.), Secs. 1-15-1-44, pp. 10-26.

<sup>27</sup> *Ibid.*, at p.5; See also distinctions between classes of creditors in corporate reorganizations (or rehabilitations) in FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS (2000 ed.), Volume 15A, Chapter 63, Sections 7634.27 to 7634.42. See also SCOTT, HAL S., *INTERNATIONAL FINANCE: TRANSACTIONS, POLICY AND REGULATION* (Foundation Press, 13<sup>th</sup> ed., 2006), at pp. 840-843.

<sup>28</sup> *UNCITRAL Legislative Guide on Insolvency Law*, p. 6. Found at: [http://www.iiiglobal.org/organizations/uncitral/UNCITRAL Legislative Guide Insolvency Law.pdf](http://www.iiiglobal.org/organizations/uncitral/UNCITRAL%20Legislative%20Guide%20Insolvency%20Law.pdf) (last visited 15 January 2008)

<sup>29</sup> Forrester, Julia Patterson. *Bankruptcy Takings*, 51 FLA. L. REV. 851 (December 1999), at 877. This paper provides a comprehensive and updated refutation of the claim that security interests could be completely invalidated in a bankruptcy or corporate reorganization setting, which claim was discussed in the landmark article of Rogers, James Steven, *The Impairment of Secured Creditors’ Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 973 (1983).

<sup>30</sup> *Ibid.*, at 911:

“Current bankruptcy law for the most part protects property rights, including the rights of secured creditors. Secured creditors do experience delay in bankruptcy in their ability to realize upon their security. However, only the most egregious case of delay could present a successful takings claim. Security interests are subject to avoidance in bankruptcy, but only in limited circumstances that for various reasons do not present a takings problem.

Scholars have suggested that prospective legislation that invalidates security interests in bankruptcy would not create a takings problem. However, the constitutionality of this invalidation proposal is doubtful. All property owners would be affected by legislation that invalidated security interests in bankruptcy because they would not be able to create a security interest that could

It should be noted further that international practices on corporate rehabilitations, restructuring, or reorganizations collectively affirm that the distinction between creditor classes (secured and unsecured) must be preserved in any court-approved payment distribution scheme.<sup>31</sup> In the United States, corporate

---

survive a bankruptcy filing. **The right to convey a security interest may be a sufficiently important strand in the bundle of property rights that its abrogation would constitute an impermissible taking.** If, because of limitations on the availability of secured credit, the invalidation proposal substantially interfered with the right of an owner to transfer land, it would most certainly be an unconstitutional taking. **In addition, the invalidation proposal may be unconstitutional from the point of view of the secured creditor.** Because the proposal would appropriate the secured creditor's property rights rather than regulate them, a court could find the proposal unconstitutional without reaching the ad hoc test of Penn Central. Even if the ad hoc test is applicable, a court could find a taking. The extent of the secured creditor's reasonable investment-backed expectations would be limited, but prior notice should not eliminate investment-backed expectations altogether where the secured creditor is not taking the security interest in order to create a takings claim and has no ability to avoid the possibility of loss. Furthermore, the economic impact of the proposal could be substantial, and the character of the regulation, destruction of the secured creditor's property rights, would be extraordinary. As a result, the constitutionality of the invalidation proposal is doubtful.

Although other proposals are not as onerous in affecting the property rights of owners and secured parties, they do still raise substantial constitutional questions. The takings formula is too fact dependent and takings law is still in too much of a muddle to make certain predictions about its application. Scholars making these proposals are ignoring significant and complex takings issues that may make their proposals unconstitutional. Since Professor Rogers' 1983 article, courts and scholars have made assumptions about the bankruptcy takings problem, most of which are based on his conclusions. However, their assumptions are not correct. The Takings Clause does limit the power of Congress to pass new bankruptcy legislation, even legislation that is prospective. Security interests are interests in property, and new bankruptcy legislation cannot redefine the property interest of a secured creditor. Changes in the treatment of secured creditors in bankruptcy do affect property owners as well as secured creditors, and their rights must be considered in assessing the constitutionality of new bankruptcy legislation. Finally, because the takings formula, in the absence of a categorical taking, requires the application of a fact intensive ad hoc test, the constitutionality of current limitations on the rights of secured creditors does not mean that different limitations would also pass constitutional muster. When the correct assumptions are made, the bankruptcy takings problem becomes much more complex and cannot be dismissed with a short paragraph of current bankruptcy limitations on secured creditors. The bankruptcy takings problem is still very much alive and must not be ignored." (Emphasis supplied.)

<sup>31</sup> See Phelan, Robin E. and W. Everett. *The Wretched Refuse -- Leading the Foreign Corporation to a Fresh Start in the United States*, 59 CONSUMER FIN. L. Q. REP. 23 (Spring-Summer, 2005), at 36:

"The district court in *Singer*, discussed above, granted comity to the courts on the other side of the Atlantic. Across the Pacific, the 1990s Asian financial crisis spurred interest in insolvency and reorganization proceedings for Asian companies, and an increasing number of bankruptcy opinions here are recognizing foreign proceedings over there. **For example, Bankruptcy Judge Thomas E. Carlson recently recognized the Philippine rehabilitation law as worthy of comity, in an unpublished opinion ("In re Ancillary Petition regarding Philippine Airlines Inc., a Philippine Corporation, No. 98-3-2705-TC (Bankr. N.D. Cal. 1998). Philippine Airlines Inc. (PAL), the national airline of the Republic of the Philippines, filed a petition for suspension of payments and corporate rehabilitation with the Philippine**

reorganizations expressly require a specification of creditor classes in the formulation of corporate reorganization plans:

“§7634.30 Designation of classes of claims

A plan of reorganization is required to designate classes of claims and classes of interests. A claim or interest may be placed in a particular class only if it is substantially similar to the other claims or interests in the class. The plan may, however, designate a separate class of claims consisting of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience.

Certain sorts of claims need not be designated, such as administrative expenses, claims arising after the filing of an involuntary petition and before the appointment of a trustee or the entry of an order for relief, and certain claims for taxes and custom duties.

§ 7634.33 Designation of classes of interests

The reorganization plan must designate classes of interests. Although the term “interest” is not defined in the Bankruptcy Code, it is used to describe an ownership interest.

An interest may be placed in a particular class only if it is substantially similar to the other interests in the class. The plan must also specify any classes of interests which are not impaired under the plan, and specify the treatment of any class of interests which is impaired.

§ 7634.36 Specification of claims or interests impaired

A reorganization must specify any class of claims or interests which is not impaired under the plan, and specify the treatment of any class of claims or interests which is impaired. The plan may impair or leave unimpaired any class of claims, whether secured or unsecured, or any class of interests.

**Securities and Exchange Commission (PSEC).** Thereafter, the foreign representative of PAI, filed a section 304 petition in the Northern District of California, obtaining a preliminary injunction prohibiting actions against PAI, and its property in the United States. Objecting creditors noted a 1981 presidential decree of President Marcos that transferred jurisdiction over suspension-of-payments proceedings from the Philippine courts to the PSEC. According to the objecting creditors, the suspension-of-payments proceeding was not subject to Philippine insolvency law, and thus not worthy of comity under section 304.

**The Philippines Airline court disagreed, noting first that Philippine insolvency law provides creditors procedures and protections similar to those found under the U.S. Bankruptcy Code, including priority of claims, appellate review, a first meeting of creditors, an automatic stay, voting on plan confirmation, and recovery of preferences and fraudulent transfers. xxx** (Emphasis and underscoring supplied.)

Each claim or interest of a particular class must receive the same treatment under the plan, unless the holder of a particular claim or interest agrees to a less favorable treatment. A plan may designate a separate class of claims consisting only of unsecured claims less than a specified amount, or reduced to an amount which the court finds reasonable and necessary for administrative convenience. Therefore, small and unsecured claims may be placed in a separate class and need not be accorded the same treatment as large unsecured claims.

#### § 7634.39 Priority claims

Claims for administrative expenses and claims arising during the gap period must be paid in full on the effective date of the plan, unless the holder of the claim agrees to a less favorable treatment. Tax claims may be paid over a period of time, as may employee benefit claims, wage, salary and commission claims, and claims for deposits on consumer purchases, under prescribed conditions.

It is fundamental that creditors take priority over stockholders. Even defrauded stockholders' claims are subordinate to the claims of general unsecured creditors."<sup>32</sup>

More importantly, international practice emphasizes that corporate reorganizations or rehabilitations should not cause 'excessive interference' with the security as to altogether deprive the secured creditors of benefit from such security.<sup>33</sup>

"If there is a stay on the enforcement of security, the main points to be considered are the period of the stay and whether the stay is limited to assets essential to the continuing business which are idiosyncratic (not securities, cash or ordinary commodities). The alleged object of the stay is to keep the business together while the rehabilitation is allowed to work, e.g. by preventing the mortgagee sale of the main factory, computer equipment, or an essential patent or unfinished inventory. But the effect of excessive interference in the security is to deprive the creditor of the benefit of the security: the whole purpose of security is that it should be available on the insolvency of the debtor and therefore, if the jurisdiction destroys the security when it is most needed, the value and utility of security itself is demoted. Accordingly jurisdictions have to decide whether they desire the advantages of security or whether they prefer the draconian rehabilitation procedure, although middle courses are possible, e.g. a stay on enforcement for a limited period.

The stay causes problems for perishable assets; volatile assets, such as securities, commodities, and foreign currency deposits, especially margin

---

<sup>32</sup> FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS, (1995 ed.) Vol. 15A, p. 603, § 7634.30 to § 7634.39. Emphasis and underscoring supplied.

<sup>33</sup> See also Norton Jr., William L. § 110:9 *Treatment of Holders of Secured Claims*, 5 NORTON BANKR. L. & PRAC. 2d § 110:9 (October 2007).

collateral for market dealings; ships, aircraft and other assets which are in need of special protection or which could attract an "assets" bankruptcy jurisdiction just because they happen to be there or which can be spirited away to avoid a surprise attachment; liens covering small assets not essential to the business; income-earning assets if the debtor can use the income, e.g. rent from land and equipment leases, dividends and interest on securities, recoveries on receivables, royalties and intellectual property rights (the income may have been essential to service the creditors' interest); and possessory pledges and liens since the security is lost if possession must be surrendered.

Other factors are: (1) a stay results in the erosion of security if it falls in value or if interest continues to pile up – the period of the stay is germane; (2) whether the debtor can use the secured assets for the purpose of the continuing business and the powers which the creditor has to preserve the asset; (3) whether the debtor can substitute alternative secured assets in order to retain some essential asset; (4) whether a plan can bind dissentient secured creditors to an extension of the maturity of the debt or a reduction in amounts or a change of currency; (5) whether the security is primed by the costs of the administration (liabilities incurred in continuing the business, super-priority loans, employees, taxes) so that the creditor's security is eroded and its value highly unpredictable; (6) whether security expressed to cover after-acquired property such as a floating charge over all present and future assets or an aircraft mortgage over engines subsequently replaced can catch assets acquired by the debtor post-commencement; (7) the degree of protection given to secured creditors against unfair prejudice; (8) whether cash collateral can be taken away in the interests of financing the business; and (9) whether post-commencement interest continues to run and can be added to the secured debt. A common problem is whether a creditor who has security over investments or receivables violates a stay if he receives payment on the assets from the third party and applies it to the secured debt: this would be a violation of the US stay in *BC 1978* s 362.<sup>34</sup>

---

<sup>34</sup> WOOD, PHILIP R., *COMPARATIVE LAW OF SECURITY AND GUARANTEES* (1995 ed.), Chapter 11 ("Security and Rehabilitation Proceedings"), at pp. 152-153; *See* WOOD, PHILIP R., *PRINCIPLES OF INTERNATIONAL INSOLVENCY* (1995 ed.), at Chapter 11 ("Corporate Rehabilitation Proceedings: England, France, Japan, United States) p. 186-187.

#### **"Grounds for petition and ease of entry**

**11-7 General** The key issue here is the ease of entry into the proceedings – ease of entry prioritizes the formal proceedings over private work-outs. Factors are:

- whether the debtor must show actual insolvency or the likelihood of insolvency, whether he is not required to prove insolvency at all, and whether insolvency is a balance sheet test or a liquidity test or both. If the objective of early rehabilitation is to be achieved before it is too late, the debtor should not be required to show actual insolvency, but rather the probability of an impending insolvency;

Where there is an erosion of the security interest under the reorganization/rehabilitation plan, there must be 'adequate protection' given to the affected (secured) creditor through corresponding liens or cash payments:

"11-12 Adequate protection Rather than allowing relief from the stay, the court may order the creditor to be given adequate protection of its security interest, e.g. additional liens or cash payments to match the fall in value. The basic protection given to secured creditors is that they must receive indubitably adequate protection for their security.

The House Report indicated that the concept of adequate protection is derived from the Fifth Amendment protection of property interests and from a policy that secured creditors should not be deprived of the benefit of their bargain, so that if the secured creditor does not get the exact collateral (because, like a factory, it is needed for the debtor's business), he must get the equivalent in value. Case law shows that the creditor has adequate protection if he is over-secured (to the extent of the cushion) or has a recoverable guarantee from a third party, but not usually if the guarantee is unsecured. The US Supreme Court established in the *Timbers* case above that, if the creditor is under-secured, the creditor is entitled to cash payments (or the equivalent) if his collateral is decreasing in value, that he is not entitled to compensation for loss of the ability to reinvest proceeds from a foreclosure, and that the creditor should be granted relief from the stay if the property is not necessary for an effective reorganization which is feasible and in prospect."<sup>35</sup>

It is internationally recognized that judicial rehabilitations result in "increased complication, confrontation, delay and cost". The heavy involvement of professionals – lawyers, accountants and consultants – and the "confrontations and litigation caused by a rigid statutory framework, by the compulsory quelling or divestment of creditor rights" makes formal proceedings in judicial rehabilitations

---

- whether the debtor must show that survival is feasible so as to avoid abuse of the process;

- whether entry is by court order or by unilateral initiation by the debtor (Australia, but not Britain or the US). Judicial approval increases cost but controls abuse and discourages an over-easy entry with a view to promoting a work-out, i.e. the proceeding is a last resort. (Underscoring supplied.)

<sup>35</sup> *Ibid.* at pp. 156-157. Emphasis supplied. See Japanese practice in Tanaka, Wataru. *Extinguishing Security Interests: Secured Claims in Japanese Business Reorganization Law and Some Policy Implications for U.S. Law*, 22 EMORY BANKR. DEV. J. 427 (Spring 2006), at 428-435. In Japan, a debtor can cancel security interests in any property necessary for continuation of its business by paying the secured creditors the liquidation value of such property.

See also GROCHAL, ALAN M. AND MEGAN K. MECHAK, PRACTICE MANUAL FOR THE MARYLAND LAWYER, 3rd ed. with 2006 Update, Volume I, Chapter 4 ("**Bankruptcy**"), (2006 ed.), at Part IV.G. (summary on Chapter 11 proceedings in the United States)."

costly for all stakeholders.<sup>36</sup> These inherent costs only make it all the more imperative that distinctions between secured and unsecured creditors should be built into the court's approval of the rehabilitation or reorganization plan. To do otherwise would only invite further delay and cement opposition between creditor classes – a situation prohibitive to the goal of expeditious, efficient, and non-adversarial rehabilitation envisioned in the Interim Rules.

### III. REHABILITATION COURTS AS 'AUCTIONEERS' IN THE 'CREDITOR' EXCHANGE OF DEMANDS: HOW THE PARETO-EFFICIENT SET OF ALLOCATIONS OF CORPORATE ASSETS BETWEEN SECURED AND UNSECURED CREDITORS ARE CONSTRAINED BY THE INTERIM RULES

Rehabilitation courts assume a more "interventionist" role in rehabilitation proceedings than in traditional civil or criminal litigation. In corporate rehabilitations, courts are mandated to approve rehabilitation plans that will most feasibly restore the corporation to financial viability. This task calls for a calibration of competing interests in the mode and manner of distribution of corporate assets: 1) the corporation's need for a sustainable supply of resources to support business operations, generate profits, and improve shareholder value; 2) secured creditors' demand for repayment of their loans, and in the interim (before full repayment), the maintenance or preservation of their security interests; and 3) unsecured creditors' demand for repayment of their loans. Clearly, this is not a pure system of "private bargaining", which as envisioned under the Coase Theorem, should be the most appropriate means of allocating resources when transactions costs are low.<sup>37</sup> Instead, what transpires is a hybrid between private bargaining and public regulation (through the rehabilitation court's approval and implementation of the rehabilitation plan and the Interim Rules).

Certainly bargaining does take place in corporate rehabilitation, perhaps even more so than most traditional litigation contexts. Under the Interim Rules, the Rehabilitation Receiver may (and before submission of his evaluation of the rehabilitation plan to the rehabilitation court) meet with the debtor, the creditors, or any interested party "to discuss the plan with a view to clarifying or resolving any matter connected therewith".<sup>38</sup> Prior to the court's final approval of the rehabilitation plan, revisions can be submitted by creditors, any interested party, as

---

<sup>36</sup> See also WOOD, PHILIP R. PRINCIPLES OF INTERNATIONAL INSOLVENCY/PRINCIPLES OF INTERNATIONAL INSOLVENCY. (1995 ed.), at Chapter 11 ("Corporate Rehabilitation Proceedings: England, France, Japan, United States"), pp. 302-303.

<sup>37</sup> See COOTER, R. & THOMAS ULEN. LAW AND ECONOMICS (Pearson Addison Wesley 2004, 4<sup>th</sup> ed.), at p. 89.

<sup>38</sup> Interim Rules, Rule IV, Section 21.

well as the debtor corporation.<sup>39</sup> Such "bargaining", therefore, occurs in a setting institutionally-mandated under the Interim Rules. (As discussed elsewhere by other scholars, such institutionally-mandated bargaining under corporate reorganization is based on the social desirability of coordinating debt collection activities, as well as a cost-reduction motivation to mitigate or prevent creditor conflict.<sup>40</sup>)

The bargaining process entails the resolution of several issues of valuation (e.g. how much is the corporation's total debt burden; how much of the total debt burden is owed to each creditor class; how much is the corporation's total assets; and how much is the corporation's needed annual operational and capital expenses to reach the targeted level of financial solvency as would take the corporation out of rehabilitation). Parties' options for restructuring corporate debt can range from debt cancellation or reduction, debt satisfaction (for less than the full amount, or with "haircuts" borne by creditors), debt-for-debt exchanges, debt modification, debt-for-equity exchanges, or capital contribution of debt.<sup>41</sup> Given limited resources to service corporate debt, creditors can foreseeably bring their own valuations to the bargaining table, including the maximum portion of their credit that they are willing to "retire" (or, as in some cases, convert to equity in the corporation) for the sake of corporate rehabilitation. Following the Rehabilitation Receiver's submission of his proposed rehabilitation plan and creditors' comments and/or revisions to such plan, it is then the task of the rehabilitation court to

---

<sup>39</sup> *Ibid.* at Rule IV, Section 22.

<sup>40</sup> Longhofer, Stanley D. and Stephen R. Peters, *Protection for Whom? Creditor Conflict and Bankruptcy*, 6 AM. L. & ECON. REV. 249 (Fall 2004), at 273-274:

"xxx But, in the absence of an automatic stay on the unsecured creditor's debt-collection efforts, it may be difficult after the fact to trace the line between the disposal of the assets serving as collateral and the payments made to the unsecured creditors. **Thus, even collateralized claims depend on the basic elements of a bankruptcy system -- the automatic stay and preference provisions -- to ensure effective protection for the secured creditor.**

There are private actions a secured creditor might take to protect its interests, even in the absence of a bankruptcy system with these provisions. For example, it may impose restrictive covenants on the firm's use of any assets serving as collateral, requiring prior approval before they may be liquidated. Restrictions such as these, however, may prove more costly than they are worth. By limiting the firm's ability to misuse the assets, the creditor may also hamper the firm's ability to redirect these assets to their highest-valued use. In other words, the very restrictions the creditor may require to protect its own interests may limit the firm's ability to maximize its profits. Furthermore, covenants restricting the use of collateralized assets must be monitored if they are to be effective in protecting the secured creditor's interests. Consequently, secured debt may be no more effective in reducing the costs of coordination than seniority and coordination covenants.

All of this suggests that, although collateral may effect coordination in some cases, it cannot serve as a general replacement for a bankruptcy system that mandates creditor coordination. Thus, our primary conclusion is reconfirmed: **A mandatory bankruptcy law that ensures all creditors will coordinate their liquidation activities ex post improves social welfare better than private contracting solutions.**" (Emphasis and underscoring supplied.)

<sup>41</sup> Zarlenga, Lisa M. *Restructuring Troubled Corporations*, 789 PLI/Tax 769 (October-November 2007), at 780-786.



ascertain how to most efficiently allocate corporate resources (between debt servicing and financing corporate expenses) towards the goal of rehabilitation.

"Efficient" public regulation (through the rehabilitation court's enforcement of the Interim Rules) should therefore reduce the costs of enforcing and implementing the eventual "agreement" between creditors (spanning secured creditors, unsecured creditors, and suppliers) and the debtor corporation under the rehabilitation plan.<sup>42</sup> As the "public regulator", courts conceivably appear as the most critical actors in the rehabilitation process. How rehabilitation courts will decide on the sensitive issue of corporate asset/resource allocation between creditor classes (and without sacrificing rehabilitation goals) is a veritable test case for modeling judicial methodology and reasoning.<sup>43</sup>

Intuitively, an "effective" corporate rehabilitation should be "capable of swift implementation, as uncomplicated and inexpensive as possible, and flexible, providing alternative terms of dealing with the financial affairs of the company."<sup>44</sup> These intuitive generalities, however, are hardly informative for rehabilitation courts tasked to ascertain what "efficiency" is in the allocation of corporate resources during rehabilitation. Does "efficiency" embrace the extreme interpretation of the *Ruby Industrial* dictum, which is that secured and unsecured creditors are on "equal footing" with respect to the pool of resources from which their debts will be serviced? Alternatively, does an "efficient" allocation mean that unsecured creditors can, along with secured creditors, be paid from the proceeds of sales or dispositions of secured assets, without the debtor corporation having to replace such properties comprising the security?

### A. THE CONCEPT OF ECONOMIC EFFICIENCY

Answers to the foregoing questions depend on how rehabilitation courts appreciate the concept of efficiency. Economic efficiency is described as "the best use of limited resources given people's tastes."<sup>45</sup> Intuitively, the optimal quantity of any good, *ceteris paribus*, is that "at which the value placed by society on the marginal unit equals its marginal social cost."<sup>46</sup> There is Pareto efficiency (also known as

---

<sup>42</sup> See Ulen, Thomas S. *Courts, Legislatures, and the General Theory of Second Best in Law and Economics*, 73 CHU-KENT L. REV. 189 (1998), at 198.

<sup>43</sup> For an interesting model proposing cognitive reflection as the schema for judicial decision-making, see Guthrie, C. et al. *Blinking on the Bench: How Judges Decide Cases*, 93 CORNELL L. REV. 1 (November 2007).

<sup>44</sup> Fisher, Richard. *Rehabilitating Large and Complex Enterprises in Financial Difficulties*, DISCUSSION PAPER BY THE CHAIRMAN OF PARTNERS OF BLAKE DAWSON WALDRON, Sydney, Australia, 8 April 2004 found at [http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFSubmissions/\\$file/BDW.pdf](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFSubmissions/$file/BDW.pdf) (last visited 27 December 2007).

<sup>45</sup> BARR, NICHOLAS. *THE ECONOMICS OF THE WELFARE STATE* (Oxford University Press, 3<sup>rd</sup> ed., 1998), at 70.

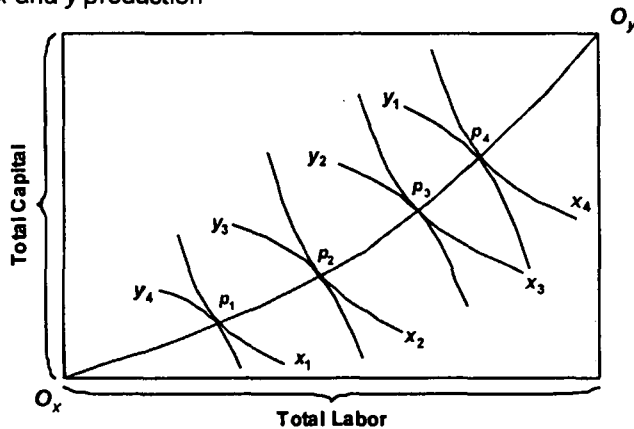
<sup>46</sup> *Ibid.*

Pareto optimality or allocative efficiency) when resources cannot be allocated or distributed in any other way without making someone else worse off.<sup>47</sup> In a market of exchange, a “general equilibrium” exists when three (3) conditions simultaneously hold: 1) *productive efficiency* (where maximum output is achieved from a given set of inputs); 2) *efficiency in the product mix* (the optimal combination of goods that should be produced given existing production technology and consumer tastes); and 3) *efficiency in consumption* (consumers allocate their income in a way that maximizes their utility, given their incomes and the prices of goods).

Economic efficiency is best illustrated by the Edgeworth Box Diagram<sup>48</sup> in microeconomics:

## Edgeworth Box Diagram

At each efficient point, the *RTS* (of *k* for *l*) is equal in both *x* and *y* production



The diagram shows the allocation of resources (in this case, capital and labor) between two (2) persons,  $O_x$  and  $O_y$ . The diagram maps out the set of indifference curves of each person. (An indifference curve is a graphical representation of the individual's set of consumption preferences, or as in this case, a set of preferences for consuming a bundle including capital and labor.) The indifference curves of  $O_x$  are represented in the diagram above by the X-set of

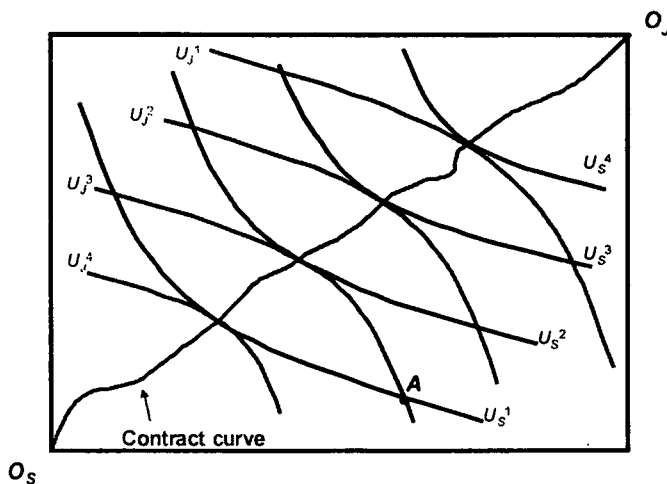
<sup>47</sup> VARIAN, *op.cit.* Note 7 at p. 480.

<sup>48</sup> Illustration found at [http://ihome.ust.hk/~tanjim/econ200/econ200\\_ch12.ppt#11](http://ihome.ust.hk/~tanjim/econ200/econ200_ch12.ppt#11) (last visited 15 January 2008).

convex curves ( $X_1, X_2, X_3, X_4$ ). The indifference curves of  $O_y$  are represented by the Y-set of convex (from  $O_y$ 's orientation) curves ( $Y_1, Y_2, Y_3, Y_4$ ).

The set of Pareto efficient allocations is seen from the diagonal line traversing the origin at  $O_x$ , across points where  $O_x$ 's indifference curves do not intersect  $O_y$ 's indifference curves, to the origin at  $O_y$ . (Otherwise stated, the set of bundles preferred by  $O_x$  does not intersect  $O_y$ 's preferred bundles of resources.) This line is known as the Pareto set or contract curve. There is a Pareto efficient allocation at any point of this curve because there is no way to make  $O_x$  better off without making  $O_y$  worse off, and vice-versa. In this situation, all of the gains from trade have been exhausted, such that there is no mutually advantageous exchange of goods (capital and labor) that can still be made between the two individuals  $O_x$  and  $O_y$ .<sup>49</sup>

## Contract Curve



58

This mode of exchange (or allocation between resources) is a system of "pure exchange", where the allocation of resources (capital and labor) between  $O_x$

<sup>49</sup> *Ibid.*

and  $O_y$  are made based largely on the preferences of  $O_x$  and  $O_y$  as shown in their indifference curves.

### B. CREDITOR EXCHANGE UNDER REHABILITATION WITH COURTS AS "AUCTIONEERS"

Let us transpose the Edgeworth box diagram as an analytical tool for dissecting the system of creditor exchange in corporate rehabilitations. What kind of "exchange" occurs, who are the persons involved, and what "resources" are subject of allocation?

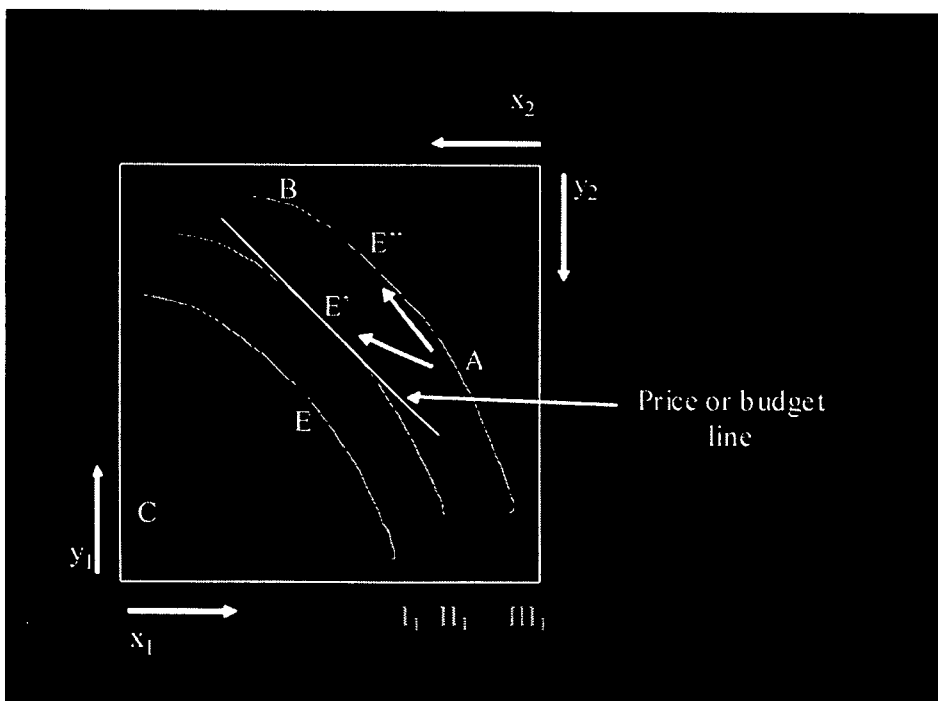
As previously discussed, in a corporate rehabilitation, there is a finite set of corporate assets that may be used to defray corporate expenses and pay off creditors in order to give the corporation the "breathing space" to generate profits and return to financial solvency. We will distinguish corporate assets only as to whether they are secured or unsecured assets. The allocation problem facing courts is to ascertain how much of secured assets and how much of unsecured assets will be allocated to pay off secured and unsecured creditors, as would permit continued operation of the corporation towards full rehabilitation?

Clearly, this situation does not involve a system of "pure exchange" as described in the previous subsection. Due to its authority to approve valuations (of corporate assets, corporate debt, and corporate expenses), and its mandate to ensure the feasible rehabilitation of the corporation, courts act as proverbial "auctioneers" who set "prices" (or costs, as it were)  $P_1$  and  $P_2$ . Both creditor classes of secured and unsecured creditors receive this set of prices (from either the Rehabilitation Receiver's valuation, or the court-approved valuation). In turn, the court's fixing of these prices affects how much of each type of corporate asset (secured and unsecured) can be allocated to pay off each group of creditors (secured creditors vis-à-vis unsecured creditors) under the approved rehabilitation plan.

Creditors' respective demands for repayment of its loan obligation from the corporation's secured and unsecured assets will be influenced by the "prices" they receive from the rehabilitation court. A creditor class can expectedly adjust their demand for repayment from the pool of secured assets and the pool of unsecured assets upon receiving the Rehabilitation Receiver's valuation of the total fair market value of corporate assets. Corollarily, the extent of a "haircut" a creditor class is willing to absorb out of their loan receivable would depend on the valuation of total corporate assets. The level of debt that a creditor class would accept for conversion to equity in the corporation – thereby foregoing repayment of the loan obligation in cash or other similar liquid forms – will likewise be affected by the court's valuations of corporate assets, corporate debt, and corporate expenses. A creditor class could therefore accept "haircuts" or debt conversion at the bargaining process during rehabilitation when the creditor class sees that this is the highest

possible recovery it could make on its loan receivable, even by comparison with liquidation values in insolvency proceedings.

Thus, the “bargaining process” in corporate rehabilitation does not simulate a system of pure exchange. The “prices” set by rehabilitation courts as “auctioneers” generates a “budget constraint” on the allocation of resources. When rehabilitation courts approve valuations of corporate debt, assets, and expenses and implement the provisions of the Interim Rules (especially the “due regard” and “adequate protection” clauses for secured creditors), the efficient allocation of the corporation’s secured and unsecured assets can only be made subject to the budget constraint.<sup>50</sup>



Due to the “due regard” and “adequate protection” provisions of the Interim Rules guaranteeing against impairment of secured creditors’ security interests, rehabilitation courts can never set “prices” or a budget constraint where unsecured creditors are fully and indiscriminately repaid from secured and unsecured corporate assets, to the exclusion of secured creditors. Simply put, there can be no allocation which grants unsecured creditors repayment from all the secured assets (whether from income or the disposition of such assets), while

<sup>50</sup>Modified illustration. Original illustration found at: <http://www.agecon.ksu.edu/abircr/For%20Web%20505/Exchange%20and%20the%20Edgeworth%20Box%20Nov%2019%202002.ppt#25> (last visited 15 January 2008).

secured assets do not receive any repayment from the secured assets. (In the pure exchange analysis previously discussed, this could still be a Pareto-efficient allocation if the contract curve commences from the origin. Intuitively, an allocation that repays unsecured creditors with 100% of secured assets while secured creditors are not repaid with any of the secured assets would appear to be Pareto-efficient. At this point, there is no other allocation that would make secured creditors better off without making unsecured creditors worse off.) The budget constraint militates against the argument that a court-approved allocation could contemplate a situation when security interests are destroyed, as when secured assets are disposed of to repay unsecured creditors and no corresponding replacement is provided for by the rehabilitation court.

The important result is that rehabilitation courts do not have free rein over their choice of Pareto-efficient allocations. Due to the constraint generated by the Interim Rules mandating “due regard” to the interests of secured creditors, and requiring “adequate protection” for secured creditors with respect to properties comprising the security, courts would have to approve allocations along the interior of the Pareto set or contract curve. This means that, in any court-approved allocation of corporate assets (for debt servicing and corporate assets during rehabilitation), secured creditors could never be deprived of repayment from secured assets, even if such secured creditors are induced to accept “haircuts”, debt-equity conversion, or egregious deferments in repayment (as when the court approves a long repayment term). The rationale of economic efficiency adds weight to the proposition that security interests cannot be destroyed or invalidated in corporate rehabilitation.

### C. ECONOMIC EFFICIENCY AND THE RUBY INDUSTRIAL DICTUM

Courts, as “auctioneers” in the rehabilitation bargaining process, therefore have a vital role to play in setting “prices” or costs on creditors’ recovery from corporate assets. The extreme interpretation of the *Ruby Industrial* dictum (putting secured and unsecured creditors on terms of “equality” as to the corpus of assets from which repayments can be sourced) does not make economic sense. An economically efficient-allocation recognizes the in-built constraint institutionally established under the Interim Rules, through the “due regard” and “adequate protection” provisions protecting secured creditors.

Obviously, it is not the First Theorem of Welfare Economics (“First Welfare Theorem”) that is implicated in judicial “auctioneering” in corporate rehabilitations. The First Welfare Theorem states that “any competitive equilibrium is Pareto-efficient.”<sup>51</sup> In a pure exchange situation where secured creditors and unsecured creditors only care about their own consumption of corporate resources

---

<sup>51</sup> VARIAN *op. cit.* Note 7 at p. 499.

(or the satisfaction of their loan obligations from corporate assets), the extreme interpretation of the *Ruby Industrial* dictum could result in the destruction of security interests that could still be deemed "Pareto-efficient". However, this exchange situation presupposes that each group of creditors (secured and unsecured) truly behaves competitively and takes prices as given (or are unable to influence such prices). As observed by law and economics scholars, however, this "first-best" notion is largely inconsistent with reality:

"x x x That is, all our prescriptions for allocative efficiency are best only in the constrained sense that we are fully aware that we are leaving something out—namely, the distributional consequences of a different endowment. There is a sense in which this constraint should not be so troubling. It embodies the post-modern notion that everything is highly contextualized. First-best and uniquely optimal results are classroom exercises, not guides to the real world. History, political possibility, geography, custom, and all the other details matter too much to be ignored. There is no need to speculate on how things might have been if we had been able to start with a clean slate."<sup>52</sup>

What should better reorient judicial perspective in corporate rehabilitations is the Second Theorem of Welfare Economics ("If all agents have convex preferences, then there will always be a set of prices such that each Pareto efficient allocation is a market equilibrium for an appropriate assignment of endowments").<sup>53</sup> The Second Welfare Theorem recognizes that prices can have roles that are both allocative (in this case, the relative scarcity of corporate assets), and distributive (how much of secured and unsecured assets will creditors be permitted to avail of in the exchange) in nature. A truly efficient allocation by rehabilitation courts should therefore take into account the true social cost of asset allocation in approving rehabilitation plans. This includes the cost of preserving security interests — if secured creditors perceive that the corporate rehabilitation environment in the Philippines is simply a process that countenances the destruction of security interests (and worse, without any empirical projection of how and when the debtor corporation will reach full rehabilitation), secured creditors would be incentivized to "jump the gun", and file a petition for insolvency against the corporation way ahead of the filing of any debtor or creditor-initiated petition for rehabilitation. At that juncture, secured creditors would be well-justified in thinking that loan recovery from liquidation values of corporate assets (especially from secured assets where their preferences rank higher than any other creditor) is a far better option than participating in a long drawn-out and illusory corporate rehabilitation where the probability of loan recovery is minimal.

Significantly, economic literature has also accepted the concept of "egalitarian-equivalence" in resource allocations:

---

<sup>52</sup> *Id.* Note 42, at 196.

<sup>53</sup> VARIAN *op.cit.* Note 7 at p. 495.

"Pazner and Schmeidler formulated the concept of egalitarian-equivalence to avoid a difficulty they perceived in fairness, a concept of equity that, like egalitarian equivalence, is ordinal and does not require interpersonal welfare comparisons. In what follows, an agent who would prefer another agent's bundle of goods to his own will be said to *envy* the other agent. An allocation at which no agent envies another will be a *fair* allocation."<sup>54</sup>

By recognizing the need for egalitarian-equivalence in deriving Pareto-efficient allocations, economics scholars have also devised a set of empirical tools that can be used to derive the Pareto-efficient egalitarian-equivalent allocation.<sup>55</sup> This model could also be applied in corporate rehabilitations. It contains the procedure for forecasting allocations only involving a few actors who know each other well (as in the case of secured and unsecured creditors). Clearly, this is more compatible with conceptions of fairness in a rehabilitation setting. With its helpful theoretical underpinning to public choice, the model could also be employed by rehabilitation courts.

Finally, the foregoing analysis does not intend to prop up efficiency analysis as the primary criterion for evaluating legal rules (or as in this case, the extreme interpretation of the *Ruby Industrial* dictum). There are law and economics scholars who argue that legal rules *per se* are "not the proper place to pursue distributional objectives", thus preferring to resolve economic inequality through income redistribution under direct (and indirect) taxation.<sup>56</sup> While there is ample room for normative debate on the appropriate mode of economic evaluation of legal rules, the analysis undertaken here is a simplified presentation of the economic dimensions of interpreting the *Ruby Industrial* dictum. The conceptual tools could vary for as many mathematical methods available.<sup>57</sup>

## CONCLUSION

As seen from the triage of jurisprudential and legal history, international best practices, and economic efficiency analysis, "equality" is not "equity" in corporate rehabilitations --- at least, not in the sense of the extreme interpretation of the *Ruby Industrial* dictum favored by unsecured creditors. The legal framework and genesis of the Interim Rules does not support the destruction of security interests --- especially where destruction leads to a windfall (inadvertent or deliberate) for unsecured creditors. While the Supreme Court has admittedly not

---

<sup>54</sup> Crawford, Vincent P. *A Procedure for Generating Pareto-Efficient Egalitarian-Equivalence Allocations*, *ECONOMETRICA*, Vol. 47, No. 1 (January 1979), at 49.

<sup>55</sup> *Ibid.*

<sup>56</sup> Sanchirico, Chris William. *Deconstructing the New Efficiency Rationale*, 86 *CORNELL L. REV.* 1003 (July 2001), at 1007.

<sup>57</sup> See DANA O. ROLANDO A. *MATHEMATICAL METHODS IN ECONOMICS AND BUSINESS* (University of the Philippines Press, 2007).



yet had occasion to interpret the “due regard” and “adequate protection” clauses of the Interim Rules, this is certainly not license for unrestrained interpretation by rehabilitation courts. As critical “auctioneers” who set prices (as well as transaction costs) in the exchange of creditor demands in the rehabilitation process, courts must be vigilant in observing the inbuilt constraints of the Interim Rules. Court-approved allocations of corporate assets, while ultimately designed to lead debtor corporations to financial health and restoration, should not result in the extreme externality of depriving creditors of the legal benefits from their security.

Neither can courts ignore the broader moral hazard of driving out secured creditors from the rehabilitation bargaining process. Rehabilitation courts, while admittedly vested with considerable powers under the Interim Rules, must likewise be conscious of the consequences of judicial policy-setting in their interpretation of the Interim Rules. Particularly since the Supreme Court has not yet issued its final rules of procedure on corporate rehabilitations, rehabilitation courts must observe caution in the kind of precedents they generate (especially with respect to the interpretation of the “due regard” and “adequate protection” clauses for secured creditors). Perceptions of increased credit risk (due to rehabilitation courts’ manipulation of “prices” or costs of recovery by secured and unsecured creditors) could crowd out secured creditors from the macroeconomy, and cause such vital sources of credit to redirect their valuable assets elsewhere.

## ANNEX

*(a) Equilibrium in the "exchange"*

Let:

$A$  = Unsecured creditors

$B$  = Secured creditors

Good 1 = Pool of SECURED ASSETS of debtor corporation

Good 2 = Pool of UNSECURED ASSETS of debtor corporation

Initial Endowment ( $W^1, W^2$ )  $\square$  creditors' claims from each type of assets before rehabilitation proceedings were initiated. Creditors rely on their own valuation of each asset group.

$P_1$  = price of obtaining recovery from the corporation's pool of unsecured assets (due to legal expenses, transaction costs, time lags in recovery causing depreciation)

$P_2$  = price of obtaining recovery from the corporation's pool of secured assets (due to legal expenses, transactions costs, depreciation, etc.)

REHABILITATION COURT, as "auctioneer", can endogenously determine prices (e.g. valuation of the total corporate debt burden, percentages of secured and unsecured assets, and total corporate assets available for debt servicing imposition of documentation requirement for creditor class to prove entitlement to claim, delay in proceedings, etc.)

See creditors' respective demand functions:

UNSECURED CREDITORS

$$x_A^1(P_1, P_2)$$

$$x_A^2(P_1, P_2)$$

SECURED CREDITORS

$$x_B^1(P_1, P_2)$$

$$x_B^2(P_1, P_2)$$

At equilibrium: court should set prices ( $P_1^*$ ,  $P_2^*$ ) to equate each set of creditors' demands with the total entitlement to the supply of each type of corporate asset (secured or unsecured asset).

$$x_A^1(P_1^*, P_2^*) + x_B^1(P_1^*, P_2^*) = W_A^1 + W_B^1$$

$$x_A^2(P_1^*, P_2^*) + x_B^2(P_1^*, P_2^*) = W_A^2 + W_B^2$$

*Due to the "due regard" and "adequate protection" clauses in the Interim Rules,  $x_A^1(P_1^*, P_2^*) \neq 0$*

Point at origin of contact curve: Court cannot choose  $P_1^*$ ,  $P_2^*$  where  $x_B^1(P_1^*, P_2^*) = W_A^1 + W_B^1$

Creditors' optimal choice given budget constraint ( $P_1$  and  $P_2$  set by the rehabilitation court)

Assume Cobb-Douglas utility function (convex ICs)

$$u(x_1, x_2) = x_1^c x_2^d$$

Each creditor class must then maximize recovery given the constraint:

$$\max c \ln x_1 + d \ln x_2 \longrightarrow \text{log form}$$

$$\text{such that } P_1 X_1 + P_2 X_2 = m \longrightarrow \text{budget constraint (cost of recovery of each type of asset equals total amount } m \text{ that creditor can spend to recover payment from corporate assets)}$$

Setting up the Lagrangian:

$$L = [c \ln x_1 + d \ln x_2] - [\lambda (P_1 X_1 + P_2 X_2 - m)] \longrightarrow \lambda \text{ as the Lagrangian multiplier}$$

Differentiating (for  $x_1, x_2$ , and  $\lambda$ )

or:  $c = \lambda P_1 X_1$

$\frac{\delta L}{\delta x_2} = \frac{d}{x_2} - \lambda P_2 = 0$

or:  $d = \lambda P_2 X_2$

$\frac{\delta L}{\delta \lambda} = P_1 X_1 + P_2 X_2 - m = 0$

$$\frac{c}{x_1} - \lambda P_1 = \frac{d}{x_2} - \lambda P_2$$

since:

$$c = \lambda P_1 X_1$$

$$d = \lambda P_2 X_2$$

then:

$$\lambda = \frac{c + d}{m}$$

- o0o -