CONCURRENCE AND PREFERENCE OF CREDITS AND THE INSOLVENT'S CREDITORS

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"Running into debt isn't so bad.
It's running into creditors that hurts."
JACOB M. BRAUDE

The hold of an owner over his property is perhaps weakest when such property takes the form of a credit. Not only is such property intangible, but its owner usually exercises little physical control over the actual and tangible evidences of the credit since these evidences, be it money, a movable or an immovable, are usually in the hands of another. The situation deteriorates when the properties from which the credits are to be satisfied become insufficient, and there are several creditors to a single debtor. Here a mad scramble for the assets of the debtor ensues among the creditors and naturally there will be some, if not all, creditors who will be deeply disappointed with what they would finally receive to satisfy their credits.

The ancient Romans have an interesting solution to such a problem, in an action known as *actio per manus injectionem* or an action of "laying on of hand." Here, a judgment creditor can arrest the judgment debtor who cannot legally resist the arrest except by paying the debt. Where the debtor fails to tender payment, the judgment creditor can bound him in chains and take him home, keeping said debtor for a number of days. At its final stage, this action could result in the sale of the debtor as a slave or the debtor could be put to death.[1] Where there are several creditors, they were permitted to cut and divide the body of the debtor into parts and each creditors shall have a proper share in the body of the debtor.[2]

Fortunately for defaulting debtors, the remedies available to creditors under Philippine law are not as radical. Under the present state of the law, this situation is governed under two basic laws. These are the Insolvency Law[3] and Title XIX of Book IV of the Civil Code on Preferences and Concurrences of Credits. Under the Insolvency Law, a debtor who does not have sufficient assets to meet his debts may be the subject of insolvency

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1 As provided in the Twelve Tables of Justinian, the creditor shall hold the debtor in bond for sixty days. During this time the debtor shall be brought to the magistrate for three successive market days and the amount of his debt publicly declared. It is after the third market day that the debtor can be thus sold or put to death.

2 WILLIAM L. BURDICK, THE PRINCIPLES OF ROMAN LAW IN RELATION TO MODERN LAW 632-633 (1938).

3 Act No. 1956 (1909).

proceedings either by his own volition[4] or upon petition of his creditors.[5] Such a proceeding has for its ends the equitable distribution of the debtor's assets, insufficient as they are, among the creditors.[6] This however, is somewhat modified by the creation of preferences and concurrences of credits provided by civil law in favor of certain types of creditors. These preferences and concurrences in relation to cases of insolvency is the subject matter in this paper.

THE DEVELOPMENT OF LEGAL PREFERENCES IN RELATION TO INSOLVENCY

The list of preferred credits found in Articles 2241,[7] 2242,[8] and 2244,[9] were taken from Articles 1922,[10] 1923,[11] and 1924[12] of the Spanish Civil Code.[13] With the occupation of the Americans of the Philippines, these

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[4] *I.e.*, voluntary insolvency, Act No. 1956 (1909), ch. III.

[5] *I.e.*, involuntary insolvency, Act No. 1956 (1909), ch. IV.

[6] Uy Tong v. Silva, 132 S.C.R.A. 448, 451 (1984), *accord* Central Bank of the Philippines v. Morfe, 63 S.C.R.A. 114 (1975); Rohry v. Fulton, 18 O.N.E. 735, 736.

[7] "Art. 2241. With reference to specific movable property of the debtor, the following claims or liens shall be preferred:

(1) Duties, taxes and fees due thereon to the State or any subdivision thereof;

(2) Claims arising from misappropriation, breach of trust, or malfeasance by public officials committed in the performance of their duties, on the movables, money or securities obtained by them;

(3) Claims for the unpaid price of movables sold, on said movables, so long as they are in the possession of the debtor, up to the value of the same and if the movables has been resold by the debtor and the price is still unpaid, the lien may be enforced on the price; this right is not lost by the immobilization of the thing by destination, provided it has not lost its form, substance and identity; neither is the right lost by the sale of the thing together with other property for a lump sum, when the price thereof can be determined proportionally;

(4) Credits guaranteed with a pledge so long as the things pledged are in the hands of the creditor, or those guaranteed by a chattel mortgage, upon the things pledged or mortgaged, up to the value thereof;

(5) Credits for the making, repair, safekeeping or preservation of personal property, on the movable thus made, repaired, kept or possessed;

(6) Claims for laborers' wages, on the goods manufactured or the work done;

(7) For expenses of salvage, upon the goods salvaged;

(8) Credits between the landlord and the tenant, arising from the contract of tenancy on shares, on the shares of each in the fruits or harvest;

(9) Credits for the transportation, upon the goods carried ,for the price of the contract and incidental expenses, until their delivery and for thirty days thereafter;

(10) Credits for lodging and supplies usually furnished to travellers by hotel keepers, on the movable belonging to the guest as long as such movables are in the hotel, but not for money loaned to the guests;

(11) Credits for seeds and expenses for cultivation and harvest advanced to the debtor, upon the fruits harvested;

(12) Credits for rent for one year, upon the personal property of the lessee existing on the immovable leased and on the fruits of the same, but not on money or instruments of credit;

(13) Claims in favor of the depositor if the depository has wrongfully sold the thing deposited, upon the price of the sale.

In the foregoing cases, if the movables to which the lien or preference attaches have been wrongfully taken, the creditor may demand them from any possessor within thirty days from the unlawful seizure (1922a)."

[8] "Art. 2242. With reference to specific immovable property and real rights of the debtor, the following claims, mortgages and liens shall be preferred, and shall constitute an encumbrance on the immovable or real right:

(1) Taxes due upon the land or building;
(2) For the unpaid price of real property sold, upon the immovable sold;
(3) Claims of laborers, masons, mechanics and other workmen, as well as of architects, engineers and contractors, engaged in the construction, reconstruction or repair of buildings, canals or other works, upon said buildings, canals or other works;
(4) Claims of furnishers of materials used in the construction, reconstruction, or repair of buildings, canals or other works, upon said buildings, canals or other works;
(5) Mortgage credits recorded in the Registry of Property, upon the real estate mortgaged;
(6) Expenses for the preservation or improvement of real property when the law authorizes reimbursement, upon the immovable preserved or improved;
(7) Credits annotated in the Registry of Property, in virtue of a judicial order, by attachments or executions, upon the property affected, and only as to later credits;
(8) Claims of co-heirs for warranty in the partition of an immovable among them, upon the real property thus divided;
(9) Claims of donors of real property for pecuniary charges or other conditions imposed upon the donee, upon the immovable donated;
(10) Credits of insurers, upon the property insured, for the insurance premium for two years. (1923a).

[9] "Art. 2244. With reference to other property, real and personal of the debtor, the following claims or credits shall be preferred in the order named:
(1) Proper funeral expenses for the debtor, or children under his or her parental authority who have no property of their own, when approved by the court.
(2) Credits for services rendered the insolvent by employees, laborers, or household helpers for one year preceding the commencement of the proceedings in insolvency;
(3) Expenses during the last illness of the debtor or his or her spouse and children under his or her parental authority, if they have no property of their own;
(4) Compensation due the laborers or their dependents under laws providing for indemnity for damages in cases of labor accident, or illness resulting from the nature of the employment;
(5) Credits and advancements made to the debtor for support of himself or herself, and family, during the last year preceding the insolvency;
(6) Support during the insolvency proceedings, and for three months thereafter;
(7) Fines and civil indemnification arising from a criminal offense;
(8) Legal expenses, and expenses incurred in the administration of the insolvent's estate for the common interest of the creditors, then properly authorized and approved by the court;
(9) Taxes and assessments due the national government, other than those mentioned in articles 2241, No. 1, and 2242, No. 1;
(10) Taxed and assessments due any province, other than those referred to in articles 2241, No. 1, and 2242, No. 1;
(11) Taxes and assessments due any city or municipality, other than those indicated in articles 2241, No. 1 and 2242, No. 1;
(12) Damages for death or personal injuries caused by a quasi-delict;
(13) Gifts due to public and private institutions of charity or deneficence;
(14) Credits which, without special privilege, appear in (a) a public instrument; or (b) in a final judgement, if they have been the subject of litigation. These credits shall have preference among themselves in the order of priority of the dates of the instruments and of the judgments, respectively. (1924a)."

[10] "Article 1922. Con relacion a determinador bienes muebles del deudor: gozan de preferencia
1. ° Los Créditos por contrucción, reparación, conservación o precio de venta de bienes muebles que estén en poder del beudor, hasta donde alcance el valor los mismos.
2. ° Los garantizados con prenda que se halle en poder del acreedor, sobre la cosa empenada y hasta donde alcance su valor.
3. ° Los garantizados con fianza de efectos o valores, constituida en establecimento púublico o mercantil sobre la fianza y for el valor de los efectos de la misma.
4.° Los creditos por transporte, sobre los efectos transportados, por el precio del mismo, gastos y derecho sde conduecion y conservación, hasta la entrega y durante treinto dias después de ésta.
5. ° Los de hospedage sobre los muebles del deudor existences en la porada.

civil law provisions acquired a rough and tumble legal past. Since the turn of the century and from the very first volume of the Philippine Reports, our Supreme Court seems to have vacilated on the issue of whether or not to apply these provisions. It was clear that section 524 of the Code of Civil Procedure[14] repealed all existing laws with respect to insolvency and bankruptcy and the Insolvency Law enacted thereafter had its own list of preferred claims[15] rendering the civil law preferences ineffective.[16] But despite these,

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6. ° Los créditos por semillas y gastos de cultivo y recolección anticipados al deudor sobre los frutos de la cosecha para que sirvieron.

7. ° Los creditos por alquileres y rentas de un ano, sobre los bienes muebles del arrendatario existentes en la finca arrendada y sobre los frutos de la misma.

Si los bienes muebles sobre que recae la preferencia hubiesen side custraidos, el acreedor podrá reclamarlos de qwen los turiese, dentro del término de trenta dias contados desde que ocurió la sustracción."

11 "Articulo 1923. Con relación a determinados bienes immuebles y derechos reales del deudos, gozan de preferencia:

1. ° Los créditos a favor del Estado, sore bienes de los contribuyentes, por el importe de la última anualidad, vencida y no pagada, de los impuestos que granitez sobre ellos.

2. ° Los creditor de los a segura dores, sobre los bienes asegurados, por los premios del seguro de dos amos, y, si fuere el seguro muituo por los dos últimos dividendos que se hubiesen repartudi.

3. ° Los créditos hipotecarios y los refaccionarios, anotados e insonitos en el Registro de la propiedad, sobre los bienes lupotecados o que hubiesen sido objeto de la refacción.

4. ° Los créditos preventiramente anotados en el Registrado de la propriedad, en virtual de mandamiento judicial, por embargos, secuestros o ejecucion de sentencias, sobre los bienes anotados, y sólo en euanto a creditos posteriores.

5. ° Los refaccionarios no anotados ni inscritos sobre los immuebles a que la refacción se refiera, y sólo respecto a otroo creitos destuitos de los expresados en los cuatro numeros anteriores."

12 "Articulo 1924. Con relación a los demos bienes muebles e immuebles del deudor, gozan de preferencia.

1. ° Los créitos a favor de la provincia o del Municipio, por los impuestos de la ultima anualidad uenuda y mo pagada, no comprendidos en el articulo 1923, numero 1.°

2. ° Los derengados:

A. Por gastos justicia y de administracion del concurro en interés común de los acreedores, heckos con la debida autor, zacion a aprobación.

B. Por los funerales del deudor, segun el uso de lugar, y tambien los de su miyer y los de sus hiyos constitutuidos bajo su partria postestad, si no truesen bienes propios.

C. Pos gastos de la última enfermedad de las mismas persones causados en el último ano, contado hasta el dia del fallecimiento.

D. Por jornales y salarios de dependientes y creados domesticos correspondientes al último ano.

E. Por anticipaciones heclias al deudor, para si y su familia constituida bajo su autoridad, en comestibles vestido o calzado, en el mismo perio do de tiempo.

F. Por pensiones alimentecias durante el juico de concurso, a no ser que se funden en un titulo de mera libedalidad.

3. ° Los creditos que sin privelegio especial consten.

A. En escritura pública.

B. Por sentencia ferme, si hubiesen sido objeto de litigio.

Estos créditos tendrén preferencia entre si por el orden de antiguedad de las fechas de las escrituras y de las sentencias.

13 5 A. TOLENTINO, COMMENTARIES ON THE CIVIL CODE OF THE PHILIPPINES 565, 569, and 571 (1959).

14 Act No. 190 (1901).

15 Act No. 1956 (1909), Ch. VI.

16 *See* Philippine Trust & Co. v. Mitchell, 50 Phil. 30 (1933); Ingersoll v. National Bank, 43 Phil. 303 (1922); Justice opinions in Kuenzle and Streiff Ltd. v. Villanueva,

the Court was reluctant to abandon the system of preferences provided in the Spanish Civil Code. This was made apparent when it ruled time and again for its application. This line of decisions began with the ruling finding application for civil preferences in "judicial proceedings other than formal bankruptcy."[17] This was repeated in several non-insolvency cases[18] until the Court found this doctrine to be infallible that it could only be overturned by legislative action.[19] In the end, the Court ruled for the application of civil law preferences even in insolvency cases reasoning that these preferences had the legal force and effect of a "lien" as the term was used in Section 59 of the Insolvency Law.[20] Meanwhile, the Court intermittently asserted that the civil law preferences were no longer applicable[21] and this view seem to have been the last word on the issue before Republic Act 386 was enacted.[22]

The enactment of the New Civil Code in 1950 struck a death blow to this latter view and transformed the Supreme Court's infatuation with civil law preferences into law. The new code retained the general scheme of the Spanish Civil Code in that it classified credits into three classes, that is, specific movables, specific immovables, and preferred credits over the free property of the debtor. The credits of the first two classes being specially privileged credits of the third class, though enjoying preference among themselves, are inferior to those of the first two classes.[23] However, the Republic Act did introduce some radical changes. First, with respect to preferences covering determinate property, the Spanish Civil Code prescribes a certain order of preferences among the various claims. This ranking was done away with by Articles 2247[24] and 2249[25] of the new code. Such liens and encumbrances must now be paid *pro rata*[26] except that taxes due on specific property must be paid first. However, the order of preferences over the free property of the debtor was preserved. Second, new liens and claims were added to the existing lists, to wit: with respect to specific

41 Phil. 611 (1916) and Smith Bell & Co., Ltd. v. Estate of Maronilla, 41 Phil. 557 (1916); Peterson v. Newberry, 6 Phil. 260 (1906).

17 Martinez v. Holliday, Wise & Co., 1 Phil. 194 (1902).

18 *See,* e.g., Pena v. Mitchell, 9 Phil. 587 (1908); Soler v. Alzona, 8 Phil. 539 (1907); Gochuico v. Ocampo, 7 Phil. 15 (1906); Olivarez v. Hoskyn & Co. 2 Phil. 689 (1903).

19 Alzua and Arnalot v. Johnson, 21 Phil. 308 (1912).

20 Tec Bi & Co. v. Chartered Bank of India, Australia and China, 41 Phil. 819 (1917). *Accord.* O'Brien v. China Banking Corp., 55 Phil. 353 (1930); Roman v. Herridge, 47 Phil. 98 (1924); Vielgelmann & Co. v. Perez, 37 Phil. 678 (1918).

21 *See* cases cited *supra* note 16.

22 The last Supreme Court ruling o nthis issue is in the 1933 decision of Philippine Trust & Co. v. Mitchell, 59 Phil. 30 (1933).

23 National Bank v. Viuda de Angel Jesus, 63 Phil. 814, 822 (1936).

24 Article 2247. If ther eare two or more credits with respect to the same specific movable property, they shall be satisfied *pro rata,* after the payment of duties, taxes and fees due the State or any subdivision thereof. (1926a).

25 Article 2249. If there are two or more credits with respect to the same specific real rights, they shall be satisfied *pro rata.* After the payment of the taxes and assessments upon the immovable property or real right. (1927a).

26 See *supra* note 13 at 574, 575; *See also* Carried Lumber Co. v. ACCPA, 63 S.C.R.A. 411, 416-417 (1975).

personal property the preferred claims were increased from seven to thirteen; with respect to specific real property the preferences were increased from five to ten; and as to those over free property, the seven preferred claims in Section 50[27] of the Insolvency Law was increased by the Code Commission to fourteen. Thus, it would seem conclusive that, the Code Commission intended to remove the incompatibility between the civil law preferences and the preferences found in the Insolvency Law. This is more so when we consider that Article 2243[28] of the Civil Code was introduced by the Commission to harmonize the preferences of specific property with the Insolvency Law.[29] Thus, it would seem conclusive that, the Code Commission intended to supplant section 50 of the Insolvency Law with Title XIX on Concurrences and Preferences in the new code.[30] Nevertheless, there was still some uncertainty as to how to apply the new rules of preferences especially in relation to insolvency. In the landmark case of *Barretto v. Villanueva,* the Supreme Court, ruled that the civil law rules on preferences apply not only to cases of insolvency, but to all or any creditor-debtor relationships as well.[32] Thus in this decision, a third party claim for a vendor's lien was pro-rated with a mortgage lien in a foreclosure sale. Twenty-three months after that decision, the Supreme Court reversed itself in a resolution deciding a motion of reconsideration filed by the mortgagee.[33] In the resolution, no

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[27] Sec. 50. The following are the preferred claims which shall be paid in the order named:

(a) Necessary funeral expenses of the debtor, or of his wife or children who are under their parental authority and have no property of their own, when approved by the court;

(b) Debts due for personal services rendered the insolvent by employees, laborers, or domestic servants immediately preceding the commencement of proceedings in insolvency;

(c) Compensation due the laborers or their dependents under the provisions of Act Numbered Thirty-four hundred and twenty-eight, known as the Workmen's Compensation Act, as amended by Act Numbered Eighteen hundred and seventy-four, known as the Employee's Liability Act, and of other laws providing for payment of indemnity for damages in cases of labor-accident;

(d) Legal expenses incurred in the administration of the insolvent's estate for the common interest of the creditors, when properly authorized and approved by the court;

(e) Debts, taxes, and assessments due the Insular Government;

(f) Debts, taxes, and assessments due to any province or provinces of the Philippine Islands;

(g) Debts, taxes, and assessments due to any municipality or municipalities of the Philippine Islands;

All other creditors shall be paid *pro rata.*

[28] Article 2243. The claims or credits enumerated in the two preceding articles shall be considered as mortgages or pledges of real or personal property, or liens within the purview of legal provisions governing insolvency. Taxes mentioned in No. 1, Article 2241, and No. 1, Article 2242, shall first be satisfied. (n)

[29] PHIL. CODE COMMISSION, REPORT ON THE PROPOSED CIVIL CODE 162-165 (1948).

[30] *See* Feliciano, *Classification and Preference of Credits in Insolvency,* 26 PHIL. L. J. 98, 107 (1951).

[31] 1 S.C.R.A. 288 (1961).

[32] *Supra* at 294.

[33] *Supra* at 294-300. Also in 6 S.C.R.A. 928 (1962).

less than Justice J.B.L. Reyes, one of the drafters of the present code, noted that the "previous decision failed to take fully into account the radical changes introduced by the Civil Code of 1889."[34] In refusing to apply the civil law preferences to this case, the famous civilist wrote that for pro-rating[35] in Article 2242 to be effective, the preferred creditors enumerated therein must necessarily be convened and the imports of their claims ascertained. There must, in other words be some proceeding where the claims of all the preferred creditors may be bindingly adjudicated, such as insolvency, settlement of a decedent's estate or some other similar proceeding. Thus, in the case before it, Justice J.B.L. Reyes concluded that

> . . . one preferred creditor's third party claim to the proceeds of a foreclosure sale . . . is not the proceeding contemplated by law for the enforcement of preferences under Art. 2242, unless the claimant were enforcing a credit for taxes that enjoy absolute priority. If none of the claims is for taxes, a dispute between two creditors will not enable the Court to ascertain the *pro rata* dividend corresponding to each, because the rights of the other creditors likewise enjoying preference under Article 2242 cannot be ascertained. . . .[36]

The doctrine laid down by the Barretto case that the applicability of the rules on preferences to some proceedings where all creditors must be convened was reiterated by Supreme Court six years later in *Pacific Farms Inc. v. Esguerra.*[37] Here the Supreme Court argues that "it is a matter of necessity and logic that the question of preferences should arise only where the debtor cannot pay his debts in full." The Court then posed this now oft-quoted rhetorical question: "If debtor A is able in full to pay all his three creditors, B, C, and D, how can the need arise for determining which of the three creditors shall be paid first or whether they shall be paid out of the proceeds of a specific property?"[38]

It is unfortunate however, that in a 1975 ruling of the Supreme Court[39] the *Barretto* ruling was somewhat corrupted. In that case, the Court argued that the *Barretto* ruling was predicated on the assumption that such an insolvency proceeding or similar proceeding is necessary in order to enable the court to ascertain the *pro-rata* shares corresponding to each of the creditors in the classification of credits found in Article 2242 and such proceedings are unnecessary where it "appears" that there are no other creditors other than the two claimants[40] in this case. In a subsequent case,[41] this argument was echoed by a party claiming a contractor's lien over an immovable. This party's writ of execution of a judgment in his favor was returned unsatisfied and hence he proceeded to sue the mortgagee of the

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[34] *Supra* at 295.
[35] That is, after taxes.
[36] *Supra* note 31 at 297.
[37] 30 S.C.R.A. 684 (1969).
[38] *Supra* at 688.
[39] Carried Lumber Co. v. ACCFA, 63 S.C.R.A. 411 (1975).
[40] A claim for a mortgage lien and a claim for a materialman's lien.

same immovable who had in the meantime foreclosed on the real property. When the case reached the Supreme Court, this party claiming a contractor's lien maintained that the proceedings had before the lower court can qualify as a general liquidation of the estate of the debtor because the only existing property of said debtor is the specific real property subject matter of the litigation. This contention was rejected by the Supreme Court which restored the *Barretto* ruling in full. Quoting liberally from Justice J. B. L. Reyes' decision, the high court reasserted the need for some proceeding *in rem* so that whatever title in satisfaction of a preferred creditor's claim obtained in the proceeding shall be indefeasible and can not be questioned later by another preferred creditor who has not presented his claim in the proceeding. In the case at bar, the lower court's finding that there were no other creditors other than the two claimants herein cannot be conclusive as it does not bar other preferred creditors from later showing up to present their claims. The *Barretto* case, the Court declared, does not sanction the instability to the titles of preferred creditors that would result as a consequence of upholding the contention of the lower court and the creditor claiming a contractor's lien in herein case.

Raison D'etre OF PREFERRED CREDITS

We come now to the question of why there should be preferences in the first place. The demand for a *raison de'etre* becomes even more pressing when one considers that in the light of the foregoing discussion it would seem that the preferences in the Civil Code was primarily intended to apply to a situation where the debtor has insufficient assets to meet various credits. The law on obligations and contracts has for its basis the assumption that the obligor must comply with his obligations exactly as they are constituted. Ordinarily, failure to do so will give rise to a right of indemnity in favor of the obligee and demandable from the obligor,[42] and if there exists several creditors, all these creditors can have the same rights enforced. Thus, it has been said that it is a matter of sound principle that all credits must be equal and deserve the same consideration with respect to collection. Where the debtor's obligations exceeds his property, this principle of equity would theoretically require that the assets of the debtor be distributed among the creditors in proportion to their credits whatever the nature or character of these credits.[43] Thus, the considerable number of priorities found in the Civil Code interferes with the operation of ratable distribution and strans the principles of equity.

Strangely, it is asserted that the interference of these priorities is precisely to minimize the resulting clash of rights among several creditors over the inadequate property of the debtor.[44] Manresa, for one, contends that

[41] Philippine Savings Bank v. Lantin, 124 S.C.R.A. 476 (1983).
[42] *Supra* note 30 at 98.
[43] V. J. FRANCISCO, 2 CREDIT TRANSACTIONS 1087 (1953).
[44] *Supra* note 42.

in the realm of positive law, the situation where the debtor's property is insufficient to meet his credits is one which does not permit him to faithfully perform his moral and juridical duty of satisfying all of his obligations, without distinction as to class or category. This consideration imposes, according to Manresa, the necessity of establishing a determined order in accordance with which the satisfaction of pending claims has to be made. Manresa further maintains that there is nothing unjust in this since the classification and order of corresponding preferences had been established beforehand, one who enters into a contract is aware that the form in which the contract is made will determine the preferences of the credit to ensure that he is placed in better situation in relation to other creditors of the debtor, so that in case of insolvency of the debtor each of the creditors will find themselves in a situation which they created for themselves out of their own volition when contracting with the debtor. If being in a position to bring about the imposition of conditions that would result in a special preference in his favor, the creditor, instead does not do so, the consequences must be imputed only to him and fault shall be with no person other than the creditor who finds his credit postponed after those others who were more cautious and exacting than he.[45]

Aside from the preceding arguments of Manresa, there is really very little given by way of explanation for the retention or addition of credits as preferred. The Code Commission merely pointed out that the new liens added to the list of specific personal property were added as a matter of public policy. These are taxes due thereon, funds misappropriated by public officials and price of things deposited sold by a depository.[46] Other new liens over specific movables; that is, wages for work done or goods manufactured, salvaged goods, and those out of contracts of tenancy, were added due to public policy. With regard specific real property the commission stated that the new liens were "demanded by considerations of justice." Those liens are the unpaid price of an immovable sold; mechanic's, contractor's, or refectionary liens; expenses for preservation or improvement of an immovable; so-heirs' claims for warranty in partition; and donor's liens on immovables donated.[48] As to preferred credits over the free property of the debtor the added ones refer to support,[49] fines and civil indemnification arising from a criminal offense,[50] damages for death or personal injuries caused by quasi-delict,[51] gifts due to charitable institutions,[52] and credits appearing in a public instrument or final judgement.[53] The Code Commission

[45] *Supra* note 43 at 1087-1088.
[46] Article 2241, No. (1), (2), (3) respectively.
[47] Article 2241, nos. (6), (7), (8) respectively.
[48] Article 2242, nos. (2), (3), (6), (8), (9) respectively.
[49] Article 2244, nos. (3), (5), (6).
[50] Article 2244(7).
[51] Article 2244 (12).
[52] Article 2244 (13).
[53] Article 2244 (14).

justified the preferences of these credits in that it is "but right" that they should receive priority as they are of "special importance."[54]

Other explanations have been given. The preference given to credits guaranteed by a pledge or mortgage over specific property[55] were said to be necessary due to the "desirability of maintaining established juridical forms."[56] Generally speaking liens as a charge or encumberance upon determinate real or personal property is an inchoate right where the title is in someone else other than a lienholder.[57] A lien then, can in justice be preferred as in reality they are not part of the debtor's property to which the general creditor is entitled to.[58] Preferences as to credits due to the state, such as taxes or money's misappropriated by public officers may be said to be necessary for the protection of public revenue for the public good.[59] Finally, the automatic first lien for laborer's wages over the assets of an employer's business undergoing liquidation a bankruptcy now provided in the Labor Code[60] is because labor "as human beings must be treated over and above chattels, machineries and other kinds of properties and the interests of the employer who can afford and survive the hardships of life better than their workers." This lien is mandated by the universal sense of human justice, as well as by the Constitutional guarantee of social justice and protection to labor.[61]

SUMMARY AND CONCLUDING REMARKS

The theory and purpose of insolvency systems is the equitable distribution of the insolvent's estate among his creditors.[62] As the predominant policy of the insolvency law is intended to secure equality among creditors through the ratable distribution of the debtor's assets,[63] a system of preferences must necessarily be supported by values which are over and above

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[54] *Supra* note 29 at 164.

[55] Article 2241 (4) and Article 2242 (5).

[56] *Supra* note 30 at 98-99.

[57] *See* Columbia R. Gas & E. Co. v. Jones, 112 SE 267; Assembly of God v. Samgster, 260P2d1057; U.S. Phillips (CA5 Tex) 267F2d374; Olsen v. Kidman, 235P2d 510; Maman v. Bitting 52 ALR 698; Tim Aircraft Corp. v. Byram 213 P2d 715; Fallon v. Worthington 22 P2d 260; Dysat v. State Dept. Public Health and Welfare (Mo. App), 361 SW 2d347; Swanson v. Graham, 179 P2d 288.

[58] *See* Porterfield v. Farmers Exch. Bank 37SW 2d 936, 82ALR 22.

[59] *See* U.S. Fidelity & G. Co. v. Bramwell, 217 P332, 32 ALR 829; People ex rel. Nelson v. Wiersema Stale Bank, 197 NE 237, 101 ALR 501; National Surety Co. v. Morres 241 P2063, 42 ALR1290.

[60] LABOR CODE, Art. 110: "In the event of bankruptcy a liquidation of an employer's business, his workers shall enjoy first preference as regards wages due them for services rendered during the period prior to the bankruptcy or liquidation, any provision of law to the contrary notwithstanding. Unpaid wages shall be paid in full before other creditors may establish any claim to a share in the assets of the employer."

[61] Philippine Commercial and Industrial Bank v. National Mines and Allied Workers Union (NAMAWU-MIF), 115 S.C.R.A. 873, 880-881 (1982).

[62] Uy Tong v. Silva, 132 S.C.R.A. 448, 451 (1984). See 42 Am. Jur. 2d. 1249.

[63] *See* Rohr v. Stanton Trust & Savings Bank, 245 P. 947, 949; Roberts v. Edie, 36 A. 820. 822. Accord Central Bank of the Philippines v. Morfe, 63 S.C.R.A. 114, 120-121 (1975).

the basic purpose for which an insolvency law is established. By its very nature, a system of preference contradicts the policy of law and tends to frustrate equality among creditors and thus disturbs the very policy which lies at the very root of all insolvent laws."[64] The creation of preferences, generally speaking, should therefore be discouraged except in cases where the right thereto is clearly established.[65] Mere arguments of justice and equity for the institution of preferences, such as those advanced by the Code Commission, will not suffice. After all, justice and equity, as a catch-all clause may be invoked in favor of any and every contention, including an injustice. The supposed greater sacredness of a particular credit must, in addition to arguments of equity, be founded on some agreement or the relation of the credit to an assigned property.[66]

In this connection, Manresa's assertion is of some significance. As mentioned earlier in this paper, this assertion is to the effect that a creditor who took pains to place his credit on a preferred basis, the preference having been established beforehand by law, can rightly be favored at the expense of those other creditors who could have done the same, but failed to do so. Such an argument however, is valid only where the creditor has done some act, other than simply extending or granting the credit, to ensure the satisfaction of the same, such as securing or registering his credit. Among the preferred credits provided in the Civil Code, only three can qualify under this category, to wit: pledge or chattel mortgage on a specific movable,[67] a registered mortgage on an immovable[68] and lastly, executions and attachements over an immovable annotated in the Registry of Property.[69] Outside of this enumeration are credits whose preferences arises merely from their nature or character. Between these two groups of credits,[70] there is again another contradiction. This is where the creditor who secures and registers his credit, precisely to guard against the day when the debtor shall become insolvent, will find instead that the debtor's property which was reserved to satisfy the full amount of the debt must be pro-rated with the credits of others, or worse be used to satisfy the taxes due thereon first before his credit.

As a matter of practicality, this should be cause for concern. Modern commercial transaction rely a great deal on the systems of credit and the accompanying laws that protect the rights of the parties affected. In this regard, it is important that the number and extent of preferred claims be ascertainable by any creditor who should know that any security he may

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[64] Roberts v. Edie, *supra*.

[65] Cavin v. Gleason, 11 N.E. 504, 506.

[66] *See* Ramisch v. Fulton, 180 N.E. 735, 736. Accord Cavin v. Gleason, *supra;* Central Bank of the Philippines v. Morfe, *supra*.

[67] Article 2241 (4).

[68] Article 2242 (5).

[69] Article 2242 (7).

[70] *Id est*: those which are preferred because they were secured and/or registered; and those which are preferrd only bcause of their nature or character.

take cannot be jeopardized by further preferential claims that may arise in the future and enjoy priority over his or rank *pari passu* with his. The long list of preferred claims is both exhaustive and to a certain extent, defensible. But it forces the secured financier to face the danger that future preferred claims which he cannot forsee will be entitled to be paid *pro rata* with his and certain claims for taxes will enjoy priority. Under such circumstances the valuation of a collateral will not always be attended with accuracy. This could result in conservative valuations of property offered for collateral and the obstruction of free flow of available credit and finance especially where foreign banking institutions are involved.[71] This is hardly a desirable situation for a developing country such as the Philippines.

In sum, the present system of preferences and concurrences can be criticized on two grounds. First as a system constructed primarily to apply to circumstances of insolvency it undermines the very essence of all insolvency proceedings, proceedings which call for the marshalling of all the debtor's assets to be ratably distributed among the creditors. In this regard the particular credits preferred under the law do not seem to be well-justified. Second, preferred claims present a security problem, and where the need for development financing from the outside is felt, legal preferences can create an obstacle to such necessary supports.[72] Indeed, the present classification of preferred claims can stymie local financing.

This is not to say that preferred claims should be done away with. It is respectfully submitted, however, that an intelligent review of the present classification of credits is in order. Preferences should not be based solely on the character of nature of the credit. Neither should preferences arise *ipso facto* because a credit falls under some classification created by law. At most the list of credits listed in Title XIX of Book IV of the Civil Code may constitute only an inchoate right to preference. The operative act that shall constitute a preferential right should, instead, be registration. This is because preferences by their very essence affects persons who are not parties to the relationship of creditor and debtor and basic legal wisdom dictates that there should be registration of a right arising from a relationship before the same right can affect third persons.

In closing, it is suggested in this paper that a procedure for registration of preferential claims be provided for by law. This procedure should be sufficient in form as to constitute adequate notice to third persons of the preferential right. It is further suggested that such a system of registration of preferences should not only admit legal preferences but

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[71] S.T.J. DE GUSMAN JR., D.E. ALLAN, M.E. HISCOCK, & DEREK ROEBUCK, CREDIT AND SECURITY IN THE PHILIPPINES: THE LEGAL PROBLEM OF DEVELOPMENT FINANCE 109 (1974).

[72] D.E. ALLAN, M.E. HISCOCK, D. ROEBUCK, CREDIT AND SECURITY: THE LEGAL PROBLEMS OF DEVELOPMENT FINANCE 64 (1974).

consensual preferences as well, such as the negative pledges[73] so much in vogue in international financing today. Lastly, registration being the operative act that shall constitute the preference, and order of preference should be based on the dates of registration[74] rather than any *pro rata* sharing or the characters of the credits.

[73] A negative pledge is a covenant whereby the borrower promises not to create "any security over any or all of his assets ranking in priority over the claims of the lender and usually acknowledges that if he attempts to do so a preferential charge will immediately arise over those assets in favor of the lender with whom the covenant is made. It is in fact an extension of the clause frequently formed in loan agreements, restricting the power of the borrower to create any securities ranking in priority to or *parri passu* with the ight of the lender. . . ."*Supra* at 70.

[74] See *supra* note 71.