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Alternative Coping Mechanisms for Corporate Insolvency

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INTRODUCTION

Generally, operations of a business may continue even after a loss. But sooner or later, this kind of operation may result in bankruptcy or insolvency. The usual meaning of insolvency is that the liabilities of the business exceed its assets, but the term is also used in many cases to characterize a concern which is unable to meet its ordinary debts as they mature because its assets, though greater than its liabilities, are frozen and hence unavailable for payment of debts.[1]

There are two classes of corporate insolvency, namely (1) where the corporation owes more money than its assets can ever be made to pay, which is an "absolute insolvency" or insolvency in its popular sense; and (2) where the corporation does not possess available resources to meet its present need which is "technical insolvency".[2]

To distinguish it from bankruptcy, a "bankrupt" person is a person (natural or artificial) who has been formally declared to be subject to bankruptcy laws and proceedings by a court.[3] Bankruptcy indicates the particular legal status to be entertained and declared by a judicial decree, and is only one of the methods of dealing with business failure and corporate insolvency.[4]

INTRA-CORPORATE ACTIONS

At the initial stage of corporate deficit existence, certain management policies must be implemented in order to maintain the business as a going concern. More often than not, it may be suffering from excessive salaries, mismanagement or other ailments which can be cured. By rearranging the capital structure, scaling down creditors' claims, effecting economies in operations and other steps, the corporate business continues. Thus, the following internal programs can be implemented, namely:[5]

(1) *Re-capitalization* by any of the three alternatives which include conversion of par value shares, reduction of the par value of the outstanding shares by reducing the capital stock without decreasing the number of shares issued and quasi-reorganization;

(2) *Quasi-reorganization* is a procedure recognized in accounting by which the accounts of a corporation may be restated to the same extent as they would be if a new corporation were created and a new basis for accountability of assets, liabilities and capital is established; usually effected by decreasing the capital stock and offsetting such decrease against the deficit;[6]

(3) *Conversion* of outstanding preferred shares into debt instruments either by redemption of these shares as treasury shares or recall of all these outstanding preferred issues by a reduction of the capital stock to totally wipe them out;[7]

(4) *Dividend distribution* only out of free and unobligated surplus resulting from actual profits earned by the corporation during the current year or accumulations thereof through the years.[8]

CORPORATE REORGANIZATIONS

Once a corporation becomes aware of the limitations imposed by intra-corporate devices, it has to turn to other corporations for a solution.

One of these remedial measures is corporate reorganization. It is the process constitutive of changes in debt or capital structure, modification of creditors' rights or claims, shareholders' earnings of assets, their relative rights resulting from the acquisition of new assets, or liabilities through merger or consolidation.[9]

A *merger* is effected when one of the old existing corporations absorbs the businesses of the other old existing corporations by buying their assets and assuming their liabilities, and issuing shares of stock equal to the net value transferred as payment therefore; while *consolidation* is effected when an entirely new corporation is organized for the purpose of taking over the business of one (or more) old existing corporation.[10]

Financially weak companies, when pooled together, can result in a financially stronger and bigger company. It is for this reason that mergers and consolidations are favored, even required, by the government as in the case of banks and insurance companies in order to attain a healthier and more stable economy.

Merger has been consistently viewed as a capital raising or expansion operation on the part of the absorbing corporation, and a salvage-device for the insolvency of the absorbed corporation.[11] In a majority of cases of mergers or consolidations presented for approval by the Securities and Exchange Commission, at least one of the several parties to the plan has an existing deficit or is operating under losses.

In short, the essence of a corporate reorganization plan is to bring before the court/commission all interested parties of all classes including bondholders, general creditors and stockholders to obtain their consent to an arrangement to rehabilitate the corporation and to compel dissenting minorities of each group to accept new securities issued under a plan agreed to by the majority of each group and approved of by the court/commission after hearing.[12] This may well be viewed as "compromise agreement"[13], whereby all classes of security holders, whether of equity or debt, make some sacrifices, scaling down their interests in order to keep the corporation in operation because it is worth more as a going concern than as a dissolved and liquidated company.

BANKRUPTCY/INSOLVENCY PROCEEDINGS

Another option for an insolvent corporation is to petition the courts for voluntary insolvency through bankruptcy proceedings. The general underlying objective in bankruptcy proceedings is the equitable distribution of the debtor's unencumbered assets to general unsecured creditors.[14]

The Philippine Bankruptcy Law was enacted by the Philippine Legislature under the authority of the United States on May 20, 1909 as Act No. 1956 otherwise known as "The Insolvency Law". Its substantive provisions have not yet been modified, except for the applicability of Articles 2241 and 2242 of the New Civil Code to insolvency cases.[15]

A petition for voluntary insolvency by an insolvent corporation to be adjudged by the court should be accompanied by an exhibition of a vote of the directors or trustees, or the consent in writing of a majority of them.[16] The petition must set forth the following items:[17] the debtor's place of residence; his inability to pay all his debts in full; his willingness to surrender all his property, estate and effects not exempt from execution for the benefit of his creditors; and an application to be adjudged insolvent. Annexed thereto are schedules of debts and inventory of assets.

Once a corporation is declared insolvent, its property and assets shall be distributed to the creditors but no discharge shall be granted to the corporation.[18]

Some temporary relief in the forms of suspension of payments and composition of debts can also be availed of by the corporate debtor.

In suspension of payment, the corporation has sufficient properties to cover all its debts, but foresees the impossibility of meeting them when they respectively fall due. Suspension of payment affords the corporate debtor an extension of his debts.

On the other hand, in composition of debts, the corporate debtor of its own motion offers to pay to its creditors a certain percentage of their claims in exchange for a release from its liabilities. Approval of the composition plan will depend upon the giving of a *deposit* for the corporate debt or as a consideration to be paid to its creditors.[19]

The Philippine government in the past played an active, interventionist role of rescue

Except to a very limited extent, the Philippine Insolvency Act does not have provisions for the rehabilitation and reorganization of debtors in financial distress and consequently has no provision on the use of the collateral necessary for the continuation of the business.[20]

FORMS OF GOVERNMENT INTERVENTION IN THE TASk OF CORPORATE REHABILITATION

The Philippine government in the past played an active, interventionist role of rescue or rehabilitation of corporations rocked by financial debacle. In January 1981, the financial troubles were triggered by the disappearance of Mr. Dewey Dee, a textile magnate, who left his company with debts of $78 million.[21] Key government offices and instrumentalities like the Securities and Exchange Commission, the Central Bank and the state-owned Philippine National Bank and Development Bank of the Philippines had been substantially involved in this task of corporate bail-out. Their supervisory powers had been further strengthened and more financial resources had been pumped into them. A short discussion of their individual participative roles is made.

THE S.E.C. SOLUTION

The modern trend is progressively towards rehabilitation of distressed corporations through a more liberal system of reorganization, better administration of creditors' and stockholders' rights and a more considerate treatment of debtor relief.[22] The latest decrees governing the Securities and Exchange Commission of the Philippines had clothed it with ample powers to handle ailing corporations and assist in its rehabilitation process. These powers are as follows:[23]

1) To appoint a rehabilitation receiver of corporations, partnership or other associations;
2) To create and appoint a management committee, board or body upon petition or motu propio to undertake the management of corporations, partnerships or other associations;
3) Such rehabilitation receiver or management committee shall have the power to take custody of, and control over, all existing assets and property of such entities; to evaluate the existing assets and liabilities, earnings and operations; to determine the best way to salvage and protect the interest of investors and creditors; and to study, review and evaluate the feasibility of continuing operations and restructuring and rehabilitating such entities; and
4) It may order, on the basis of the findings thereon, the dissolution of such corporation entity and its remaining assets liquidated accordingly.

The Commission's power of supervision over the corporations are exercised through the regular issuance of circulars, rules and regulations, opinions on queries on corporate re-structuring, quasi-organization and receivership as well as guidelines on the implementation of these corporate moves.

Among the regular SEC circulars which aim to control and check on the financial dealing and records of corporations are the following:

1. SEC Circular No. 3, series of 1982 which prescribes "Penalties for Late Filing of Reportorial Requirements" (April 13, 1982);
2. Circular addressed to All Certified Public Accountants regarding "Submission of All Financial Statements to SEC to be Accompanied by an Affidavit of Representation" (October 28, 1981);
3. Memorandum Circular No. 1, Commercial Paper Series of 1981 regarding "Rules Requiring Non Stock Corporations to Keep Accounting Records and to Submit Annual Financial Statements" (November 20, 1980); and
4. Rules and Regulations Prescribing Penalties for Issuance of Shares Without Prior Permit (October 17, 1978).

These circulars and regulations served as preventive and not curative measures to future corporate financial fiascos.

ROLE OF CB AND OTHER STATE-OWNED BANKS

The Central Bank of the Philippines has the primary responsibility to "maintain internal and external monetary credit and exchange conditions conducive to a balanced and sustainable growth of the economy".[24]

Exercising its power of supervision over the banking institutions and non-bank financial intermediaries performing quasi-banking functions, the Central Bank issues certificates of authority to corporations which are deemed licensed to engage in banking activities. In the event that the Monetary Board finds that a bank or a quasi-bank is in a "state of continuing inability or unwillingness to maintain a condition of solvency and liquidity deemed adequate to protect the interest of depositors and creditors,"[25] it shall appoint a conservator to take charge of the assets, liabilities and the management of that institution, collect all monies and debts due to said institution and exercise all powers necessary to preserve the assets of the institution, reorganize the management thereof, and restore its viability.[26]

Furthermore, the conservator has the power to overrule or revoke the actions of the previous management and board of directors of the bank or quasi-bank. If after the period of conservatorship the findings still show that the continuance in business of the institutions would cause probable loss to its depositors or creditors, the Monetary Board shall designate a receiver to immediately take charge of its assets and liabilities as expeditiously as possible, collect and gather all assets and administer the same for the benefit of the creditors.[27]

After a period of 60 days, the Board shall determine whether the bank or quasi-bank may be reorganized so as to permit it to resume business with safety to its depositors and creditors and the general public, or it shall be subjected to liquidation proceedings due to its insolvent condition.[28] The liquidator shall convert the assets of the institution to money or sell, assign or otherwise dispose of the same to the creditors and other parties for the purpose of paying the debts of such institutions.[29]

Other monetary instruments which control and regulate the financial resources of the banks and non-bank financial intermediaries performing quasi-banking functions include the imposition of reserve requirements against deposit liabilities, interest rate, ceiling on equity investment in allied and non-allied undertakings, and net worth to risk assets ratio. These ceilings or rates must be effectively enforced in order to preserve monetary stability.

Bank takeovers are not new in Manila. During 1980 and 1981, when one of every six pesos it lent were not repaid, the state-owned Development Bank of the Philippines (DBP) bought out more than 60 companies. Worse, in 1982, 45 percent of its loans due were not paid.[30] For example, $500 million in government debts were owned by Marinduque Mining and Industrial Corporation.

Another government financial institution that had participated actively in the rehabilitaion of distressed firms is the National Development Company headed by the then Minister of Trade and Industry Roberto Ongpin. Considered as the largest government conglomerate, it had heavy investments in a series of industrial projects, some costing $1 billion.[31] Examples of these projects are the aluminum smelter plant, integrated pulp and paper plant, and petro-chemical complex.

LEGAL AND ECONOMIC IMPLICATIONS OF GOVERNMENT BAIL-OUT

The General Banking Act has imposed ceilings on total equity investment of banks in performing regular banking functions to not more than 25 percent of their net worth in allied undertakings and not more than 15 percent of their net worth in any single enterprise.[32]

The CDCP rescue and other bail-outs were ventures which the government could not afford.

The Unibank Law has increased the ceiling for banks licensed to perform expanded commercial banking transactions to 50 percent and 35 percent of their net worth, respectively.[33] These afore- mentioned legal provisions were violated when the loans-to-equity conversion was made in the case of the Construction Development Corporation of the Philippines (CDCP) take-over. Then President Marcos issued Letters of Instructions Nos. 1295, 1296 and 1297 which ordered the conversion of loans extended by six government financial institutions as of December 31, 1982 into shares of common stock of CDCP.

Likewise, the heavy impact on the finances of government financial institutions could not be discounted. If PNB converted its loans to equity, PNB would be giving up its interest income of ₱ 180 million pesos, which is substantial considering that PNB's 1982 net profit was ₱ 159 million pesos.[34] Furthermore, Central Bank would still have to charge interest on the ₱ 300 million loan it gave PNB in 1981 for relending to CDCP. Thus, PNB would stand to lose heavily since, until CDCP makes a turnabout, the bank's ₱ 1.8 billion pesos will be earning nothing even as PNB bears the entire burden of the interest charges.[35]

The CDCP rescue and other bail-outs were ventures which the government could not afford. Its loans to CDCP alone totalled 1/3 of the 1982 budget deficit and it had pledged to the International Monetary Fund to cut its budget deficit by 35 percent in 1983. The grant of emergency loans from IMF and World Bank worth $843 million dollars were predicated upon the following strict conditions:[36]

(1) scrap corporate bail-out program;

(2) defer funding of 11 industrial projects;

(3) cut back government cash expenditures to ₱59.9 billion thus reducing the availability of bailout funds; and

(4) cut government's capital expenditures by 23 percent and reduce equity contributions and cash transfer to public corporations by 50 percent and 43 percent, respectively.

CONCLUSIONS

From the foregoing discussion of alternative coping mechanisms for corporate financial distress and insolvency ranging from intra-corporate strategies and state intervention, one can meaningfully appreciate the awesome responsibility that faces corporate managers on the one hand and the government on the other hand. Having proved themselves as effective vehicles for economic growth and national development, the corporations which experience instability and downslaught become not solely the concern of directors and officers therein but much more so become an object of national concern. Given this growing interdependence, the corporate managers and the government technocrats must incessantly propose new measures and open avenues for cooperation and joint task force in order to plug any existing loopholes in the legal system as well as in the corporate practice with the end result of providing preventive and curative remedies for corporate insolvency.

At the present, however, there are legal barriers on the permissible actions that can be taken by government. There is now, as a constitutional policy, minimum government participation and intervention in the economy. The Constitution expressly provides that before government can own or control a corporation, it may do so only in the interest of the common good and subject to the test of economic viability.

ENDNOTES

1 Grange, Corporation Law for Officers and Directors 601 (1935)

2 Ibid

3 Oleck, Creditors' Rights and Remedies 91 (1949)

4 Hanna, Cases and Materials on Creditors' Rights and Corporate Reorganization 1 (1957)

5 Endriga, Problem Areas in Corporate Financing, VI The SEC Bulletin 2 (1972)

6 Relova, Accounting Problems on Mergers and Consolidations, Quasi-Reorganizations and Joint Ventures, IX The SEC Bulletin 50 (1975)

7 For the first alternative, the corporation must have sufficient retained earnings and since the capital stock basically remains unchanged, it would be an internal affair without need for SEC notification and approval. For the second alternative, a certificate of decrease of capital stock must be filed with the SEC and its approval will depend on the absence of prejudice to the creditors due to such reduction.

8 Endriga, supra at 5

9 Dodd, Cases and Materials on Corporate Reorganization VII (1950)

10 Relova, supra at 50

11 Endriga, supra at 8

12 Oleck, supra at 57

13 Herwitz, Corporation Course Game Plan 29 (1975) as cited in Campos, The Corporation Code: Comments, Notes and Selected Cases 673 (1981)

14 De Castro, Security Interests in Bankruptcy and Reorganization Proceedings 116 (1982)

15 These articles refer to the classification, concurrence and preference of credits.

16 3 Philippine Annotated Laws (P.A.L.) Title 9, 368 (1956)

17 Act No. 1956, Sec. 14 (1909)

18 P.A.L., supra at 408

19 Act No. 1956, Sec. 63 (1909)

20 De Castro, supra at 162-163

21 PHILFINANCE, INC. was one of the biggest players in the speculative commercial paper market.

22 Selverstone, Bankruptcy and Reorganization V (1940)

23 Pres. Decree No. 902-A, Sec. 6 as amended further by Pres. Decree No. 1799 (1981)

24 Rep. Act No. 265, Sec. 2 (1948) as amended by Pres. Decree Nos. 72, 1007 and 1282, Batas Pambansa Blg. 67 and Pres. Decree Nos. 1771 and 1827

25 Id at Sec. 28-A

26 Ibid

27 Id at Sec. 29

28 Ibid

29 Ibid

30 The State Bail-out that's Rocking Manila. Business Week 45 (1983)

31 Friends in High Places. The Economist 89 (March 1983)

32 Rep. Act No. 337, Sec. 21-A (1948) as amended by Pres. Decree No. 71

33 Id at Sec. 21-B

34 CDCP Rehabilitation Hits Snags. Business Day 9 (1983)

35 Ibid

36 Strict Loans Help Manila Avoid Default. The Asian Wall Street Journal 4 (1983)

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4. Republic Act No. 265 as amended by P. D. Nos. 722, 1007 and 1282, B.P. Blg. 677 and P.D. Nos. 1771 and 1827.
5. Republic Act No. 337 as amended by Rep. Act Nos. 4879 and 4910, Pres. Decree Nos. 71, 515, 865-BB and 1317, B.P. Blg. 61 and Pres. Decree Nos. 1795 and 1828.

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