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Working Paper

Special Purpose Vehicles and Insolvency Reforms in the Philippines

PIDS Discussion Paper Series, No. 2005-06

Provided in Cooperation with:

Philippine Institute for Development Studies (PIDS), Philippines

Suggested Citation: Pasadilla, Gloria O. (2005) : Special Purpose Vehicles and Insolvency Reforms in the Philippines, PIDS Discussion Paper Series, No. 2005-06, Philippine Institute for Development Studies (PIDS), Makati City

This Version is available at:

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Surian sa mga Pag-aaral Pangkaunlaran ng Pilipinas

Special Purpose Vehicles and Insolvency Reforms in the Philippines

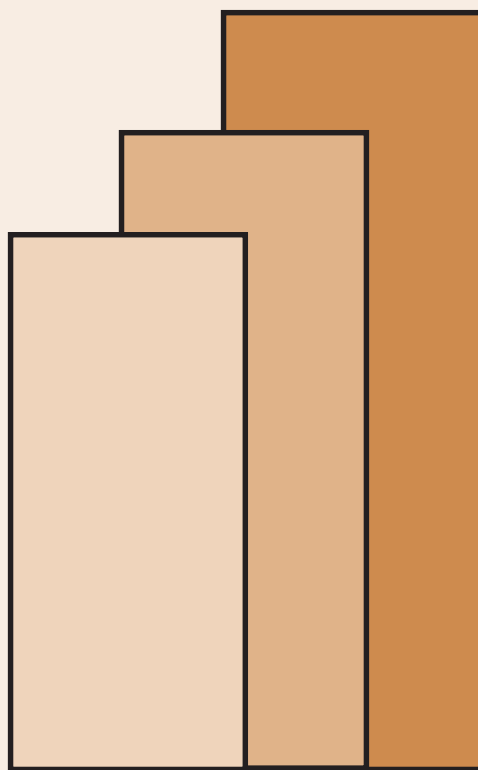
Gloria O. Pasadilla

DISCUSSION PAPER SERIES NO. 2005-06

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March 2005

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Special Purpose Vehicles and Insolvency Reforms in the Philippines

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This Draft: March 20, 2005

Abstract

This paper focuses on the legal environment, particularly the insolvency system, that would influence the success of Philippine Special Purpose Vehicles (SPVs), also known as asset management companies (AMCs) in other countries. Since SPVs will have to operate under a given insolvency regime after they acquire the bad assets, existing bankruptcy procedures have an impact on SPV behavior, *ex-ante*. In particular, it influences the price that SPVs offer for the NPAs that, in turn, affects the banks' willingness to sell, and thus the achievement of the government goal of banks' bad loans clean-up.

The paper discusses the features of the SPV Act, the pace of bad asset transfers to SPVs, the current rehabilitation procedures, and the proposed legal bankruptcy reforms that would affect the effectiveness of SPVs.

Keywords: bankruptcy, insolvency, bank reforms, nonperforming loans, asset management companies.

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Introduction

Unlike other Asian countries, the Philippines had not really had major reforms in its insolvency procedures since the Asian crisis. About the only major changes in the Philippine legal landscape that relate to nonperforming loans (NPLs) and corporate bankruptcies are: 1) the transfer of jurisdiction over corporate rehabilitation cases from the Securities and Exchange Commission (SEC), a quasi-judicial government body, to the Regional Trial Courts (RTCs) in 2000; and 2) the signing of the Special Purpose Vehicle (SPV) Act, which provides fiscal incentives for banks to solve their NPL problems, in January 2003. Thus while the other severely affected countries like Indonesia and Thailand had taken advantage of the crisis to modernize their insolvency laws, the Philippines still awaits the dawn for major legal bankruptcy reforms.

Meanwhile, the NPL problem of the financial system has gone from bad to worse. From a mere 4 per cent NPL ratio in 1997, the Philippines, now has the highest NPL ratio in Asia. The amount of foreclosed but undisposed assets have continued its increase and is now about half of the total nonperforming assets (NPAs). The government's response to this problem of the banking system is to provide a legal framework through which banks can transfer these NPAs to a separate entity called Special Purpose Vehicles (SPV), which are private-owned asset management companies (AMC). In this, the Philippines differs from other Asian countries which sought to restructure its banks through centralized AMCs like Danaharta in Malaysia, Indonesia Bank Restructuring Agency (IBRA), KAMCO in Korea, and Thailand Asset Management Company (TAMC).

In many other countries that have experienced financial crisis, the transfer of banks' bad assets to a private or public AMC has become the norm. Yet, if the metric used is recovery maximization or efficiency of the disposition process, studies have shown that not all AMCs have been successful. Klingebiel (2000), Ingves, et.al. (2004) have pointed out important common factors that contribute to AMCs' success, such as leadership, commercial orientation, independence, adequate incentives, and very importantly, legal environment.

This paper focuses on the legal environment, particularly, the insolvency system that can help the Philippine SPVs succeed in putting back vitality in the bank and corporate sector.¹ Insolvency reforms can be considered as a long-run solution to the banking problems. It can help prevent the accumulation of large NPLs in the future, improve credit supply, and promote a better credit culture. Meanwhile, in the short-run, the SPVs are designed to help solve the mounting bad debt problems. But to the extent that SPVs will have to operate under a given insolvency regime once they acquire the bad assets, existing bankruptcy procedures have an impact on SPV behavior, *ex-ante*. That is, it affects the price that SPVs offer for the NPAs that, in turn, affects the banks' willingness to sell, and thus the achievement of the government goal of bank clean-up.

The paper argues that the SPV's effectiveness hinges on institutional factors, not the least of which is an improved insolvency rules and procedures. Indeed, the SPV without good legal and institutional reform in the insolvency process would be hampered in much the same way as the banks. Poor insolvency process in the Philippines explains, in part, the huge discounts for the banks' bad assets and the consequent reluctance of banks to part with them through SPV sale.

The paper is organized as follows: the next section discusses the nonperforming assets problem in the Philippines and the trend in growth of Real and Other Properties Owned or Acquired (ROPOA). Section 3 evaluates the Special Purpose Vehicles (SPV) Law and the pace of asset transfers. Section 4 focuses on the parallel reforms in the legal/institutional front – the rehabilitation and insolvency law. Section 5 analyzes the existing and proposed insolvency reforms' effect on SPVs and other creditors, and section 6 concludes.

¹ Ingves, et. al. (2004) include legal protection for the AMC staff, clean transfers of titles to AMCs, and special powers accorded to AMCs when they talk of the legal environment of AMCs. This paper, however, focuses only on the insolvency system.

2. NPL problem after the Asian Crisis

At the onset of the Asian financial crisis, in contrast to other Asian countries, the Philippines boasted of a strong financial sector. In 1997, its bank capitalization was way higher than the 8% international minimum standard and its nonperforming loans was a mere 4% of total loans. Yet, a few years later, it emerged as a laggard in Asia because as NPL ratios of its neighboring countries went down, the Philippines' continued on its climb until 2001 (see Figure I).

<insert figure I here>

A major reason for these two different trends in NPL ratios is government intervention in the resolution of the banking problems. Aggressive recapitalization of the banks by the government as well as transfers of bad loans and assets to centralized Asset Management Companies (AMCs) helped bring down the banking system's bad loans burden in Korea, Malaysia, Thailand and Indonesia. In contrast, faced with a mild banking problem, the Philippines did no comparable major government initiative to bail out the banking sector. The result is a sustained increase in NPLs which reached its peak at 17% of total loans in 2001. The ratio dipped thereafter but the Philippines now has the highest NPL ratio in Asia, closely followed by Thailand. Indonesia, Korea, and Malaysia now have single digit NPL ratios - a staggering feat, considering their high double digit figures during the financial crisis.

Nonperforming assets (NPAs), defined as NPLs combined with foreclosed assets or Real and Other Properties Owned or Acquired (ROPOA), is now about P540 billion², with roughly 50-50 share of NPL and ROPOA, and constitute about 14% of total banking assets. In 1997, NPA share to total banking assets only stood at 4 per cent. Of the total NPAs, close to 90 per cent are

² As of September 2004.

in the books of commercial banks, while the rest are shared between thrift banks and rural banks (Figure II).

<insert figure II here>

One trend that is worth noting, though, is that even as NPLs have gone down starting in 2002, the amount of ROPOA in the banking system continued to go up. In 1997, ROPOA constituted only a quarter of total NPAs; now, it is close to 50 per cent (see Figure III). One reason for this trend is that banks have converted unpaid loans into foreclosed assets, kept them in their books, without necessarily bringing down the level of the entire nonperforming assets. Considering that more than 60 per cent of bank lending is secured lending, of which, nearly 50 per cent is collateralized by real estate properties, banks' ROPOA would indeed increase as borrowers are unable to pay up their loans.

<insert Figure III here>

Why have banks accumulated bad assets but not disposed of them quickly enough? The answer lies, partly, in the lackluster state of the real estate market since the Asian crisis until recently, and partly, on the relatively lower cost of maintaining ROPOA in banks' books compared to NPLs. Following the Asian crisis, the property market has been characterized as a buyers' market, although, of late, some indications of a real estate recovery have been noted. If the recovery is sustained, this can encourage banks to unload its accumulated ROPOA and, thereby lessen total NPAs in the system. As for the cost of loss provisions, despite its maintenance cost, ROPOAs are less costly to keep in the books compared to keeping NPLs. For ROPOA, the Bangko Sentral ng Pilipinas (BSP) requires provisions of 10 per cent every year starting at the end of the sixth year after acquisition up to the 10th year, for a total of 50 per cent

of the difference between the excess of book value over the appraised value of real estate property. For NPLs, however, the provisioning requirement starts immediately, the moment the loan becomes specially mentioned. Provisioning cost is also higher, ranging between 5 per cent to 100 per cent of the total value of the unpaid portion of the loan depending on the quality of the loan (see Table 1). With an unbalanced loss provisioning cost, therefore, banks sought to reduce NPLs by shifting to ROPOA, continue to hold on to them, until the real estate market improves.

<insert Table 1 here>

3. The Short-term Solution: Special Purpose Vehicle (SPV)

To provide relief from the huge burden of nonperforming assets, the government passed the Special Purpose Vehicle (SPV) Law in December 2002 and signed in January 2003. The Law provides fiscal incentives for the transfer of NPAs from banks to SPVs which, as envisioned, would then dispose of them with greater flexibility and speed than banks. SPVs are private-sector owned asset management companies, much like the AMCs that were set up by the four other crisis-affected economies (ie. KAMCO, Danaharta, IBRA, and TAMC) that purchased the bad assets in these countries' banking system and eventually disposed of them. Lack of government funds and the seemingly non-systemic nature of the banking problems in the Philippines have led to the private-sector led initiative that is encouraged by the SPV Law, instead of the establishment of government-funded centralized AMC. India and Taipei, China are the two other Asian countries that went by way of the private-sector owned AMCs.

3.1 Asset Management Companies

In general, asset management companies are effective means to expeditiously solve NPL problems. This explains why countries that experienced banking crisis, whether developed countries like the US or Sweden or developing countries like the Asian countries, have utilized

AMCs. The usual procedure is that banks unload nonperforming assets to an AMC, clean up their books, and continue on with its primary role of financial intermediation. The AMCs, either government- or private-owned, then take care of disposing the acquired assets through a variety of means: public auction, resale of assets to original borrowers, joint ventures, securitization, or even running the acquired business themselves.

Typically, the special character of AMCs makes them more flexible than banks to carry out certain activities that help maximize asset values. For example, banks cannot easily grant loan discounts to one bad debtor, else, even the good borrowers clamor for the same special discounts. AMCs, in contrast, can pursue bad debtors more aggressively and, likewise, entice them with favorable loan repayment schemes, discounts, or debt buybacks, with less moral hazard risk. AMCs, it is presumed, have, in addition, better expertise in collection and asset management than do banks. This, perhaps, explains why the length of a banking or financial crisis appears to have been made shorter in countries that made use of AMCs (Hagiwara and Pasadilla, 2004).

3.2 The SPV Law

Main Features

Following a similar strategy of alleviating the financial system's bad loans problem, the government passed the Special Purpose Vehicle Act (SPV Act) in 2003. The SPV Act eliminates existing barriers in the acquisition of NPAs by SPVs (or individuals)³ and provides fiscal incentives for banks to transfer these assets, as well as for its eventual disposition by the

³ The SPV Act includes transfer of assets to individual buyers but this is limited to a single family residential unit ROPOA or NPL secured by a real estate mortgage on a residential unit. It is further limited to one property per individual. The SPV Act also allows settlement by the borrowers through *dacion en pago* (debt-for-asset) arrangement. Subsequent discussion focuses on SPV transactions.

acquiring party. It is time-bound: registration of SPVs is only up to September 2004, transfer of assets from banks, up to April 8, 2005, and transfers of acquired assets to third parties have to be within five years following the date of acquisition. Otherwise, the transaction would no longer qualify for tax and other fiscal benefits available under the SPV Law.

The fiscal benefits include exemption from payments of documentary stamp tax, capital gains tax, creditable withholding tax and value added tax or gross receipts tax. Transactions qualified under the SPV Law are also entitled to various fee reductions such as mortgage and land registration, filing fees, transfer fees. On top of these, banks are allowed to deduct a portion of their losses from the SPV transactions from their taxable gross income for up to 10 years.

Since the SPV Act stated that only loans/assets which are nonperforming as of June 30, 2002 are qualified, the Bangko Sentral ng Pilipinas (BSP) required all banks to report each loan that was nonperforming or under litigation as of June 30, 2002. The BSP combined them together into a masterlist of all qualified NPAs in the financial system. Subsequently, all related transactions by banks or SPVs that are covered by the Act would have to be reconciled with the BSP's masterlist for the issuance of the Certificate of Eligibility (COEs).⁴ The COEs are then used by the seller or buyer of assets to avail of the tax exemption and fees reduction when approaching concerned government agencies e.g. the Bureau of Internal Revenue (see Figure IV).⁵

⁴ The COEs are issued by the Appropriate Regulatory Authority (ARA). But since the BSP is the ARA for banks, the paper only mentions the BSP. Transactions by non-bank government institutions like the National Home Mortgage Finance Corp., for instance, need not go through the BSP but through the Department of Finance.

⁵ For COE application, the bank has to submit details of proposed transactions, the identity of counterparties, and should disclose the terms and conditions and all material commitments related to the transaction to the BSP.

< insert Figure IV>

There are stringent conditions for the type of transactions that will qualify for the fiscal incentives. First, the bank-SPV transaction has to be ‘true sale’, i.e. the asset has been completely removed from the bank’s or debtor’s control, and the bank has no equity share exceeding 5 per cent in the buying SPV and no direct or indirect management.⁶ The originating bank cannot even extend credit facility, guaranty or any similar financial transaction, whether directly or indirectly, to the transferee SPV. Furthermore, banks are required to notify the borrowers about the impending transfer of their loans and to give them a 90-day period for renegotiation and restructuring, if they are interested.

The SPV is organized as a stock corporation under Philippine Laws with the primary purpose of investing in or acquiring NPAs of financial institutions, and disposing of them through various strategies. If the SPV will acquire land, foreign investors face a maximum of 40 per cent share of its capital stock, with the rest being owned by Philippine nationals. The SPVs can issue equity or participation certificates or other forms of Investment Unit Instruments (IUIs) for the purpose of acquiring, managing, improving, and disposing of the NPAs. Banks are not allowed to purchase the IUIs issued by the SPV that acquired its NPAs.⁷

⁶ Under a ‘true sale’ requirement, the risk assessment of the banks would be improved because the market could evaluate the risk of sold NPLs separately from the other kind of risks that the bank assumes. Without it, and assuming asymmetry of information, both bank creditors and depositors would remain cautious about the general solvency of the bank, despite the NPLs removal from its books. I thank Prof. Kozuka, my discussant in the RIETI Workshop, for this insight.

⁷ However, originating banks may buy other type of debt instruments which the SPV may issue. This is one way by which banks can participate in the upside of their bad assets. These other debt instruments should have been disclosed in the SPV plan and would normally be subordinated to the IUIs.

Philippines and India compared

The Philippines, India and Taiwan are the only economies in Asia that pursued private-sector-led asset management companies, instead of government or centralized AMCs. To better appreciate the features of the Philippine SPV Act, this section presents some salient comparisons, particularly with India's SERFAESI Law which was passed at around the same time as the SPV Act (see Table 2). For instance, Asset Recovery Companies (ARCs) in India are partially owned by banks. While no one bank has controlling interest in an ARC, banks participate in the future uptake in the sale of bad assets, but the government does not grant them any fiscal incentives for transferring their assets to ARC. The downside is that the financial system is not necessarily cleaned out of its NPA problem because of the seemingly cosmetic solution. In the Philippines, the 'true sale' requirement attempts to give banks a clean break from the bad assets that saddle them, encouraging them to take losses in exchange for the fiscal incentives granted by the government.

Another major difference is the sweeping power granted to ARCs to seize assets and take over the management of companies. In contrast, Philippine SPVs have no other special privilege than what banks and other creditors have, making them hostage to a possibly lengthy judicial process. Other differences rest on the notification requirement, the equity limits for foreign investors, and qualified NPAs under the law. The Philippines has all three, while India does not. India has no time bound for the transfer of the NPAs and thus ARCs are projected to last as a permanent business institution.

<insert Table 2 here>

SPV's incentive to rehabilitate

How would the SPV's preference of disposition strategies be affected by the time-boundedness of the fiscal incentives? The fact that the SPV Law mandates the disposal of assets within five years after acquisition, the SPVs are, likely, going to be more inclined towards short-

term strategies, i.e. strategies that would allow quick returns. Examples of these disposition schemes include resale of debt to original borrowers or auctioning of assets after minimal improvements. Long-term rehabilitation of companies would likely be put in the back burner, while liquidation would be preferred.

To address this concern and to encourage infusion of capital by the SPV, the SPV Law grants additional tax holidays on net interest income arising from new loans that are extended for corporate rehabilitation, and exempts these loans from documentary stamp taxes. However, considering that all tax holidays would end within five years of acquisition, long-term rehabilitation by SPVs is going to be unlikely.

3.3 Current Performance under SPV Law

BSP- Approved transactions

Records of the BSP show that there are P520 billion of NPAs as of June 30, 2002, representing 14.9% of the banking system's gross assets of P3.5 trillion. Of this, about P80 billion are expected to be sold before the expiration of the current SPV Law in April 2005, roughly P30 billion of which have already been completed, while the rest are awaiting the completion of required documents and the issuance of COEs. A total of 8 COEs have been issued to banks for SPV transactions worth more than P20 billion, 52 COEs for *dacion en pago* with loan equivalent of P9 billion, and 82 COEs for sale to individuals worth P345 million. Table 3 shows the different approved transactions by the BSP by type of banks.

<insert Table 3 here>

The amount of announced NPA transactions by commercial banks, however, is bigger than the BSP reported transactions. Table 4 shows that there are more P120 billion worth of planned asset disposition in 2005, if we include those transfers that are not going to be coursed via the SPV Law. For example, National Home Mortgage Finance Corp. (NHMFC) is tying up with a foreign partner in a joint venture; by the SPV law, such transactions coursed through

partially-owned joint ventures would not qualify for tax reprieve and other fiscal incentives.

Other banks are also pursuing retail sales, instead of bulk sales to SPVs.

<insert Table 4>

Registered SPVs

On the SPV registration, records from the Securities and Exchange Commission (SEC) show that 36 Special Purpose Vehicles have registered before the deadline last September 18, 2004 (see Table 5). Seventeen of the 36 SPVs, however, are owned by domestic banks, themselves. Absent any final negotiations with NPA buyers, banks have put up their own SPVs for the mere purpose of beating the deadline for SPV registration in the SPV Law. However, if they want their NPA transfers to qualify for tax exemption, banks would have to divest, not only of their bad assets but also of their majority ownership in the SPVs. Since the SPV Law allows a maximum of only 5 per cent equity share by banks, the projected strategy is to proceed in a two-step process: the buyer of NPA buys the bank-owned SPV (assuming they do not have their own) then buys the NPAs from the banks.

<insert Table 5>

NPL vs. ROPOA Transactions

Of the close to P30 billion transferred under the SPV Law, 70 per cent was sold to SPVs. These assets, as well as those that remain under negotiation, however, are comprised of nonperforming loans and not ROPOA. The only ROPOA that have been transferred under the SPV Law were mostly single residential housing units sold to individuals, not to SPVs.

Several reasons explain why ROPOAs are not sold while NPLs were easy to dispose. For one thing, industry reports have it that potential buyers gave very low offer prices for the ROPOA that did not meet the banks' reservation prices. For NPLs, the story was different. Banks have already fully provisioned for the sold NPLs so that no matter how low the offer price might have been, banks could not lose from the sales. Any difference in the loan's face value and actual

purchase value from the SPV transactions, therefore, would not adversely affect their balance sheets. In fact, banks have earned profits from the transactions because the book values of disposed NPLs were already zero, not to mention the additional liquidity benefits from the cash payments received in exchange for the NPLs.⁸

As regards ROPOAs, banks prefer to dispose of them on a piece-meal basis, rather than through bulk sale to SPVs. Or, they go into joint venture management of these assets to be able to participate in future profits from the asset sale. The former could still qualify for tax benefits under the SPV Law, specially if they are single-housing units sold to individuals; the joint venture schemes, however, are not going to give banks any tax exemption benefits under the SPV Act. Another downside from the joint venture scheme is that banks run the risk of prolonged warehousing of those assets instead of more quickly making a new start from the NPA problems.

3.4 Evaluation

Judging from the less than P100 billion projected SPV transactions out of the more than P500 billion bad assets that are supposed to benefit from it, the SPV Law has not been all that successful. If the idea of the law is to get rid of the bad assets in the banking system, it will have achieved only roughly 20% of its avowed target by the time the Law expires in April.

Nothing yet can be said about the SPV's role on corporate restructuring nor on their disposition strategies since only very few NPAs have been transferred, and the few that were, have taken place barely a few months ago. What the section attempts to do is to explain the various factors that affected the low amount of NPA transfers from banks.

⁸ It is, however, expected that, as banks unload NPLs with less than 100% loss provisions, negotiated prices between banks and SPVs would go up.

Government Factors

Several factors contributed to this result. One is the delays in drafting all the necessary rules and guidelines necessary for the implementation of the SPV Law. In particular, the Law was signed on January 10, 2003, the implementing rules and regulations was approved on March 19, 2003 and took effect April 9, 2003, but the BIR Revenue Regulation came out much later, leaving banks with little time to prepare all the necessary documentation and paper chase to meet the deadlines mandated by the SPV Law. In addition, the implementation of the Securitization Act which is, supposedly, a companion law to the SPV Act has been delayed for lack of implementing rules. This affects the use of asset-backed securities by SPVs in the future.

Another factor is the bureaucratic requirements for obtaining the Certificates of Eligibility from the appropriate regulatory agency, which for banks meant the BSP. On one hand, a BSP official considers the COE application a “cleansing process” for banks whose data documentation support or information systems for their bad assets have been relatively weak. Meeting the BSP requirements for the COE issuance, therefore, forces banks to have all their loan and asset records and documents in order. On the other hand, banks consider the process of reconciling any given pool of bad assets with what the BSP have in their masterlist, for purposes of verifying eligibility under the SPV Law, onerous. In addition, government agencies were also poorly coordinated in implementing the fiscal benefits to the extent that some government employees, when presented with the COEs for the availment of tax or registration fee reductions, were reportedly unaware of the fiscal perks from the SPV Law.

Banks' Considerations

On the part of banks, there are also important reasons for spurning low price offers, specially for their ROPOAs. First, the loss provisioning for ROPOA is capped at 50 per cent of the difference between book and appraised value of the real estate property and does not start until years 6 to 10 following the acquisition of the asset, while that for NPLs starts immediately

and ranges from 5 to 100 per cent. Even with the maintenance cost of the ROPOAs, keeping them in banks' books is cheaper, on the basis of loss provisioning, than keeping NPLs.

Second, banks have also no reason to hurry on the disposition of bad assets because of concern over the effect of fire sale prices on real estate markets which, only now, appears to have a nascent recovery. Add to this the fact that the SPV Law has a stringent 5 per cent maximum bank equity share in SPVs, banks loathe the idea of not being able to fully participate in the eventual uptrend in the real estate market. This seems to explain why many banks are entertaining the idea of establishing joint venture companies instead.

Third, the terms of payments that were reportedly offered, particularly the portion paid in debt securities or notes, are riddled with uncertainties. Much of its value depends on the efficiency of the SPV partner and other contingent costs. If it turns out that the value of the notes is worthless, the bank merely pushed back the book recognition of its loss. Thus, depending on the risk appetite of banks, they can accept full payment with majority paid in notes, or accept some losses upfront but with greater cash component. For a relatively conservative bank, more cash payment upfront is definitely preferred.

As to recognition of losses, even though the BSP allowed loss carry over from the NPA sale for a 10 year period, the benefit of the regulation to the bank is neutralized by the International Accounting Standards (IAS) which does not allow deferred loss recognition. Thus, if banks were to follow the IAS, losses from the NPA sale would have to be immediately reflected in their balance sheets.

Considerations by SPVs

As a general rule, bulk sale mechanism, such as envisioned under the SPV Law, compared to other disposition mechanisms like retail sales, contract management, or joint ventures, usually tend to yield the maximum discount or the lowest value for assets. These discounts usually reflect the potential earnings by the SPVs which are, in turn, affected by the

overall economic and legal environment. In particular, unsatisfactory insolvency regimes have an *ex-ante* impact on the transfers of assets and the strengthening of banks' financial positions. Put differently, the rock-bottom price offer by SPVs merely reflects many uncertainties that they would have to assume in the asset purchase, not the least important of which is the legal uncertainty which are tied up with the bankruptcy and foreclosure regimes in the country. Given the problems, expenses and delays of collection through the legal system, the SPVs are, understandably, unwilling to offer a high price.

Typically, buyers price the pools of assets by assuming the worst of bankruptcy and foreclosure delays and litigation costs. After assuming the maximum delay, the projected value of loan collateral is conservatively estimated and the projected proceeds of sale in the far future is discounted back at a high rate to the purchase date. Once the buyers purchase the asset pool, it approaches the borrower with a heavy carrot and stick, but with greater flexibility than banks. They are normally willing to negotiate a settlement somewhere between the present collateral value and the steeply discounted purchase price from the banks. Negotiating a low acquisition value from the banks is, therefore, crucial to the SPV's profitability and its ability for quick disposal.

3.5 Are Prices Really Too Low?

A nagging question from the "price conflict" between SPVs and banks is whether the SPV offer prices are, indeed, too low? Without more available data, it is hard to make an assessment of this, but information from other countries can serve as a benchmark for comparisons. For example, Thorburn (2000), using data from Swedish firms which have undergone liquidation procedures, found that, for all debt classes, average recovery is about 35% of face value of the claims, while it is 27% for piecemeal liquidations, and 39% for going concern sales and successful reorganizations (see Appendix Table 1). This means that discounts on distressed asset average about 60-70%. Auction prepack, which is a going concern sale that is

negotiated prior to bankruptcy filing, has a debt recovery rate of 32%, while the equivalent figure for Chapter 11 cases in the US, i.e. those reorganizations that were negotiated out-of-court, is 73%.

In Korea, KAMCO acquired assets depending on asset quality, whether secured or unsecured, with the unsecured getting a recovery rate of anywhere between 10 -30% of face value. Going concern assets were bought at higher prices than those from the Korea Deposit Insurance Corporation (most of the workout loans). Secured loans pitched the highest price, with recovery rates of about 70%. The average recovery rate for the loans sold to KAMCO is 36%, or an average discount rate of 64% (see Appendix Table 2).

In the Philippines, if unofficial news that banks are offered 10-20 percent of the claim value from NPA buyers is correct, then the price appears low, indeed, compared to figures presented in Thorburn (2000) or culled from KAMCO. But to the extent that recovery rates are a function of legal systems, and to the extent that more developed economies have stronger judicial institutions and more developed bankruptcy regimes, then the offer price from SPVs to banks would, necessarily, be lower than the 30 per cent and above, recovery rates found for developed economies. When the difficulty of maximizing asset values, in an environment in which legal processes could be uncertain and strongly biased towards continuation even of inefficient firms, is considered, the high NPL discounts become understandable.

3.6 SPV Law Amendments

To attain the intended benefits from the SPV Law, Congress is considering extending the deadlines for both the SPV registration and the asset transfers to SPVs. Originally, the SPV registration was only up to September 18, 2004, and bank transfers up to April 8, 2005. The proposed bill is moving the deadlines two years hence, while giving the SPVs up to 5 years to dispose of their assets as previously. The qualified NPAs are also going to expand to include those that became nonperforming after June 30, 2002 up to December 2004.

In addition, the BSP is studying changing some regulations to push banks to unload their ROPOAs. These include frontloading their loss provisions from years 6-10 to years 1-5. That is, banks have to immediately provision for bad assets they acquire and mark-to-market these assets every two years. The idea is to make holding on to soured loans more costly and pressure them to unload those loans earlier on.

As in the deliberations of the SPV Law, the present amendments in the bill falls short of what many in the banking industry would wish to see, like eliminating stays or temporary restraining orders (TROs) on foreclosures by SPVs – a special power granted to AMC's in other Asian countries during the Asian crisis - as well as removal of the required 90 day notification to borrowers of the impending asset or asset transfer. They would also like to see an expanded definition of ROPOA for purposes of the SPV Law to include assets that resulted, not from loan foreclosures but from, say, mergers and acquisitions, but are superfluous just the same and, thus, are nonperforming assets, as far as the bank is concerned. The present SPV Law also limits sale to individuals to only assets that are single residential housing units; banks want to include sale of empty lots to individuals, not only those with finished or unfinished housing structures.

Rather than dealing with SPVs, banks would actually prefer to sell their assets to the government in exchange for government securities, as was done in Indonesia or in the Philippines during the debt crisis, and let the government take care of asset disposition through agencies similar to the Asset Privatization Trust, a government AMC in the 1980s. This arrangement, however, has moral hazard implications that it is unlikely to be considered, not to mention the obvious fact that the government has no money for such bank bailout. The NPL problem of the banking sector is likewise not considered so dire that it should necessitate massive government bailout at this point, unlike the situation in Indonesia during the Asian crisis, or the Philippines in the 1980s.

4. Long-run Solution: Insolvency Reforms

As discussed above, poor insolvency regime has affected the *ex-ante* behavior of SPVs in terms of influencing low offer prices for banks' NPAs. In turn, banks are reluctant to sell bad assets wholesale to SPV, thereby rendering the SPV Act ineffective in attaining its goal of lowering nonperforming assets in the financial system. Conversely, an improved bankruptcy regime is expected to benefit, not only the SPVs, but bank restructuring as a whole. In the first place, a properly functioning insolvency system will prevent the high accumulation of nonperforming loans because the shadow of effective foreclosures can lead to an enhanced credit culture. Should banks still accumulate some NPLs, good insolvency procedures would allow it to mitigate its losses through non-prolonged asset seizures, thus preventing NPLs in the entire banking system from rising into systemic proportions.

However, effective insolvency system is not only pro-creditor but also pro-debtor. Indeed, it contains a balance between the rights of both creditors and debtors and is a legal system where both bank and corporate restructuring meet. Highly pro-debtor system can result to a very slow exit procedures for truly insolvent and inefficient firms, thus to a delay in resource realignment in the economy. It can also create adverse incentives for corporations to over-borrow and renege on their credit commitments lightly. However, highly pro-creditor procedures may also be too biased towards quick liquidation, without providing a breathing space for firms that are in temporary difficulties. This, too, can be wasteful of resources because, among others, the intellectual and non-physical assets of enterprises take years to build, not to mention the lost employment that accompanies liquidation. Besides, preservation of some firms as going-concern tends to maximize recovery value which, in the end, is to the creditors' advantage.

This section will trace the evolution of Philippine insolvency regimes, discuss some open questions from existing rehabilitation rules, and analyze the currently proposed changes in insolvency laws in the Philippine Congress. Section 5 discusses the implications for SPVs and other creditors.

4.1 Brief Background

Like other Asian countries, the Philippine insolvency laws are antiquated, dating back to the turn of the 20th century. The principal law governing the remedies of insolvency and suspension of payments is the Insolvency Law (Republic Act 1956), enacted in 1909. Both remedies for ailing corporation were administered by the regular courts.

Republic Act 1956 did not provide for the rehabilitation of distressed corporations. This is a remedy provided in Presidential Decree (PD) 902-A, enacted in 1976, which lodged jurisdiction on the Securities and Exchange Commission (SEC) over three different remedies, namely: 1) suspension of payments; 2) rehabilitation; and 3) dissolution. The SEC did not have clear rules and procedures for applying PD 902-A and had taken each petition for suspension of payments on an ad hoc basis. Pressured by the increase in petitions during the Asian crisis, the SEC belatedly issued, in December 1999, the Rules and Procedures on Corporate Recovery that set out a framework for processing and quickly resolving rehabilitation cases. The procedures are considered to be largely SEC-controlled or regulator-driven whereby the grant of the remedies depends exclusively in its sound discretion, albeit prudently exercised after notice and hearing (Concepcion, 2000). The SEC framework has a strong discretionary aspect in which the SEC wields the power to overrule creditors' oppositions.

While remedies for distressed corporations were available, very few distressed corporations have actually availed of these remedies until the Asian crisis in 1997. Faced with ballooning debt payment obligations resulting from the huge peso devaluation and high interest rates, many firms defaulted on their debt obligations and sought debt relief through the SEC. From 1997 to 1999, SEC received a total of 76 filings for suspension of payments and rehabilitation, almost half of which were either eventually withdrawn by the petitioner or dismissed by the SEC (Lamberte, 2002). The SEC took much longer time to decide on the cases in 1997 than in later years.

With the passage of the Securities Regulation Code (SRC) in July 19, 2000, the jurisdiction over cases falling under RA 1956 and PD 902-A was transferred to the Regional Trial Courts (RTCs), except for cases that have already been filed with SEC before June 30, 2000. The Supreme Court, thereby, issued the Interim Rules on Corporate Rehabilitation (“Interim Rules”) in December 2000 to provide a framework for resolving rehabilitation cases in the RTCs.

4.2 Interim Rules on Corporate Rehabilitation

Following the enactment of the Securities Regulation Code, the Supreme Court designated 64 specific branches of Regional Trial Courts all over the country as commercial courts which would hear bankruptcy and rehabilitation cases, intellectual property rights (IPR) cases, or intra-corporate disputes. The commercial courts, however, continue to hear other civil and criminal cases and are not exclusively devoted to commercial cases.

The Interim Rules allow a distressed debtor or a creditor or a group of creditors, holding at least twenty five percent of total liabilities of the debtor, to file a petition for rehabilitation. If the court decides that the petition has merit, it issues a stay order against all claims against the debtor during the duration of the rehabilitation proceedings. Under the Interim Rules, the current management retains the right to run the firm.

The rehabilitation court appoints a receiver from among the nominees of the petitioner. The receiver’s primary tasks are to monitor the operations of the debtor under rehabilitation, evaluate the feasibility of rehabilitating the debtor, propose a final rehabilitation plan, and implement the rehabilitation plan upon court approval.

Like the SEC Rules and Procedures on Corporate Recovery, the Interim Rules have a strong discretionary element on the part of the RTC. Creditors’ concerns are considered but the final decision rests on the RTC judge. The Interim Rules, however, specifies criteria on when the judge can consider creditors’ opposition as manifestly unreasonable. In section 23 of Rule 4, the court shall consider the following in ruling whether the creditors’ opposition is unreasonable:

- “a. That the plan would likely provide the objecting class of creditors with compensation greater than that which they would have received if the assets of the debtor were sold by a liquidator within a three-month period;
- b. That the shareholders or owners of the debtor lose at least their controlling interest as a result of the plans; and
- c. The rehabilitation receiver has recommended approval of the plan.”

Most importantly, the Interim Rules have strict time-bound procedures whereby the petition is dismissed if no rehabilitation plan is approved within 18 months after the filing of the petition (Rule 4, section 11) (see Figure V). If a rehabilitation plan is approved by the court, the plan is immediately executory and is protected from restraining orders unless an Appeals Court orders a temporary restraining order (TRO). If no rehabilitation plan is approved, what happens to the firm afterwards, whether it goes straight away to liquidation, is unclear from the Interim Rules. Previously, the SEC also supervised the dissolution of the firm if rehabilitation is no longer feasible. In the current regime, however, there is no seamless transition from rehabilitation to dissolution. To address this, the Supreme Court is, reportedly, preparing another Interim Rules for Insolvency and Liquidation to address issues related to RA 1956.

<insert Figure V here>

4.3 Comparison of RA 1956, PD 902-A, Interim Rules

Table 6 summarizes the main features of the three different insolvency regimes in the Philippines. The procedure under RA 1956 did not effectively provide for breathing space for corporations that are undergoing temporary difficulties; PD 902-A provided this avenue through rehabilitation. The rehabilitation remedy might have been unthinkable in 1909 but is very much part of common business life today. Furthermore, RA 1956 is deemed strongly pro-creditor in that creditors had an effective veto over any suspension of payments applications. Concepcion (2000) argues that creditors, in most instances, would have incentives to vote against suspension

of payments because delays cause possible dissipation of assets and lessens the potential amount which they could collect. PD 902-A and the Interim Rules counterbalance this so-called “pawnshop mentality” of creditors through a more court or regulator-controlled procedure.

<insert Table 6 here>

The downside of PD 902-A was the lack of clear framework and procedures in its application by SEC. For example, even though, in principle, insolvent companies cannot apply to SEC for remedies, in practice, both insolvent and solvent corporations avail of suspension of payments remedy because creditors do not have power to question the claim of solvency by the debtors. Typically, too, government agencies have no incentive to question the solvency claim but are rather inclined to give petitioners the benefit of the doubt. Hence, the bias swung towards debtors, in particular, towards continuance of the operations of companies, whether deserving or not, and whether economically efficient or not. The procedures in SEC did not also follow strict timelines that creditors, prior to the Asian crisis, would cajole debtors not to file for suspension of payments with SEC and, instead, more quickly settled their problems outside its auspices. The result was that few companies availed of the remedies available with the SEC, until the Asian crisis forced many companies to run under its shelter.

The Interim Rules is a marked improvement over SEC procedures because of its strict deadlines, forcing a rehabilitation decision within 18 months from the filing of the petition. However, an efficient bankruptcy procedure is marked not only by speed but also by accuracy. Bankruptcy lawyers claim that the advantage of the procedures with SEC is that the SEC officials were more familiar with commercial cases than judges. Thus, while, so far, the five RTC rehabilitation decisions on record since 2000 have met the 18 months deadline, there have been questions on the quality of the decisions (as seen in the case studies below). Of the five rehabilitation plans that were approved by the RTCs since 2000, three went to the Court of Appeals (CoA), of which, two are pending, while one CoA decision sustained the RTC decision.

Despite the strict timeline in the RTC, the procedures for Appeal potentially carries the same problem of delays, because the procedure now follows other Civil Procedures with less stringent timelines than the Interim Rules. Fortunately, or unfortunately for some, the rehabilitation plan approved by the RTC remains enforced, even as the appeals process continues.

For debtors, the indirect costs, in terms of managerial time and negative reputational effects in product and capital markets, decreased with the new time-bound procedures. However, for banks, the immediate executoriness of the RTC decisions is not necessarily a cause for celebration, because most of the decisions have actually been highly pro-debtors. For example, the mandatory nature of ‘dacion en pago’ arrangements in RTC rehabilitation calls for a re-think about the proper authority of commercial courts over private business contracts.

4.4 Evaluation of Court Cases since 2000

Without a new bankruptcy law, the relevant procedural legal rules which govern bank- and SPV- related foreclosures would be the Supreme Court–issued Interim Rules on Corporate Rehabilitation. Do the current Interim Rules provide some benefits for SPVs? To assess the prevailing legal environment, this section analyzes four of the five RTC- approved rehabilitation plans since the courts took the jurisdiction over corporate rehabilitation cases, and draws some implications from how the court conducted the rehabilitation cases.

Actually, as of November 2004, there have been 77 petitions for rehabilitation and suspension of payment cases with different regional trial courts, but only five approved rehabilitation have been reported as of end-2004. Of these, 37 are in the RTCs within Metro Manila, while the remaining 40 are in different regions of the Philippines. Fifteen, out of the 40, are in General Santos City RTC in Mindanao (see Table 7). Not all petitions, however, make it to the rehabilitation process. For example, in Quezon City RTC, almost 50% of petitions were dismissed without the benefit of any ‘stay’ order. Without more detailed information, it is

unclear why these petitions were dismissed, whether it was for lack of “form” or “substance”, or the petitioner was deemed unworthy of rehabilitation.

<insert Table 7>

The five approved rehabilitation cases are: Ramcar Corporation, Bayantel, Sarabia Hotel, First Dominion Prime Holdings, Inc., and Manuela, Corp.⁹ Many other rehabilitation cases are ongoing with different RTCs, like Maynilad Water Services, while others are being wound up with SEC like the CAP Educational Plans Company. These are all very interesting case studies but in the interest of space, the paper will focus on the four plans that have passed the RTC level. The idea is to highlight the quality of decisions and many other potential gray areas in the law that have been spawned by the commercial courts’ decision.

Ramcar

Ramcar is an automotive battery manufacturing firm, the largest dry-charged and plate battery in the Philippines, and one of the largest in Southeast Asia. It produces 480,000 battery units monthly, 40% of which are sold abroad. Its financial trouble began after the Asian crisis, because of interest rates increase, peso devaluation, and sluggish domestic demand for manufactured batteries. It had also significantly invested in non-operating assets like real estates. In December 18, 2001, it filed a debt moratorium (suspension of payment) with the RTC of Quezon City (Branch 90) which issued a stay order on January 2, 2002. The rehabilitation plan was amended in December 2002 and again in February 2003. The court approved the final rehabilitation plan in August 2003.

Bayantel

Bayantel, a telecommunications company, owes \$200 M to bondholders and \$277 M to banks, 47.4% and 52.6% of total debt, respectively. The former are unsecured loans (senior notes due in 2006), the latter are secured by company assets. Bayantel had sought a restructuring of

⁹ The author was, unfortunately, unable to find any information on the rehabilitation proceedings of Manuela Corp., a shopping mall operator in Metro Manila.

these loans since 2001, but while the negotiations were underway, Bank of New York, upon instructions from unsecured debtholders petitioned the Pasig RTC (Branch 158) for corporate recovery in July 2003. The court approved a rehabilitation plan on June 28, 2004, after about a year from filing of petition and well within the 18 months maximum allowed under the Interim Rules. However, the RTC decision on Bayantel has been appealed by all the parties: petitioner, debtor, secured creditors. The issues on appeal include the treatment of secured debts during rehabilitation.

Sarabia Hotel

Sarabia Manor Hotel and Convention Center (SMHC) is a top hotel in Iloilo, a province located south of the Philippines. It filed for rehabilitation in July 2002 with the RTC in Iloilo. Its total debt was P225 million, more than P190 million of which is with Bank of the Philippine Islands (BPI). BPI sought to foreclose Sarabia's assets after repeated easing of loan terms. The RTC approved a rehabilitation plan in August 2003. The rehabilitation is on-going, BPI is collecting loan payments, even as the case went to the CoA. BPI is questioning the right of the court to cancel private contracts between debtor and creditor.

First Dominion

First Dominion Prime Holdings, Inc (FDPHI), which started in 1994, owns and operates a number of affiliates and subsidiaries involved in the manufacture, marketing and distribution of canned tuna foods for both the domestic and international markets. It is the country's largest canned tuna exporter and exports its products to the US (its main market), Canada, Germany, United Kingdom, Japan and other countries in Europe, the Middle East and even in South America and Africa. It employs approximately 1,600 employees, down from its peak of 6,000. It sought to restructure its P2.7 billion loans with its creditors in 2000. The company problem with its loan was due to the massive depreciation of the peso and the soaring interest rates which caused its debt payments to balloon. It filed for rehabilitation on February 15, 2001 with the RTC in Pasig City (Branch 158). The Pasig City RTC approved a 10-year rehabilitation program in

February 2002. Two creditor banks appealed, arguing for liquidation instead of rehabilitation, but the Appeals Court sustained the RTC decision.

General Observations on Rehabilitations

Based on the above RTC rehabilitation decisions, recent rehabilitation cases have mostly abided with the timelines prescribed by the Interim Rules, except for Ramcar which exceeded it by about two months (see Table 8). However, three of the cases have gone or are going through the Court of Appeals which does not have clear timelines. For example, in the case of FDPHI, the Appeals Court took more than two years to review and decide on the case, even though the RTC rehabilitation decision took only one year.

<insert Table 8 here>

Moreover, even though by law, the court can overrule creditors' opposition to the rehabilitation plan, in practice, RTC judges tend to wait until a majority of creditors have withdrawn their opposition. The role of the court receiver has also been key to the approval of the rehabilitation as almost 90% of his proposed plan tend to be adopted in the court's final ruling.

The common issues in these rehabilitations touch on: 1) valuation problems of assets that are going to be used for *dacion en pago* or debt-for-asset arrangements; 2) the amount of 'haircuts' by the creditors as well as the power of the court to encroach over private contracts; 3) whether there should be consolidated filing or not; 4) the choice of the receiver; and 5) whether the company ought to be liquidated rather than rehabilitated.

On valuation, the disagreement had focused on the appraised value of the assets that would be transferred to creditors in a 'dacion en pago' arrangement. The creditors, of course, usually bat for low values, while the debtors argue for a high one. In the case of Ramcar, the RTC facilitated the discussion between the parties until they agreed on the average price of

accredited appraisers. Another contentious issue related to valuation was the use of audited statements in court. Creditors want only audited financial statements.

On ‘haircuts’, creditors often balk at debt-asset swaps, arguing that banks are already saddled with bad assets which they have not yet successfully disposed. They also complain about the quality of assets that are being given in exchange for the debt. For the titling and other accompanying expenses for the transfer of assets, creditors argue that these should be borne by debtors, while debtors naturally disagree. In the case of Sarabia Hotel, the court imposed punitive interest rate ‘haircuts’, slashing it down from more than 12% to a fixed rate of 6.75% over the entire 17-year rehabilitation period. The creditor bank, in its Appeal, alleged that the interest rate reprieve even went below the bank’s own cost of funds of 10%. Moreover, the RTC canceled the surety agreement¹⁰ between Sarabia and its creditor which BPI appealed as an encroachment on the right of private contracts.

On consolidation, the RTCs do not have a consistent stand. In FDPHI, consolidated filing was accepted to avoid multiplicity of suits, particularly when they involve the “resolution of common questions of law or facts.” In this case, non-consolidated filing was deemed to lead to further protracted litigations and further delays in the resolution of the case. Similarly, in Ramcar’s case, the court upheld the receiver’s suggestion of including the company affiliates, even if, independently, one of them is not insolvent and, in fact, engages in food rather than battery manufacturing. However, in the case of Bayantel, the court rejected the receiver’s suggestion that the case should include the firms’ two other subsidiaries, Nagatel and RCPI, because it would, allegedly, delay the determination of the case. Interestingly, these two different treatment on consolidation (FDPHI and Bayantel) were tried in the same commercial court and by the same judge.

¹⁰ Surety agreements are promise of individuals to pay if corporate fund is not enough to pay off the debt. The advantage of surety agreements is that banks can opt to go after the individual’s assets if corporate assets were not sufficient.

On the choice of court receiver, the Interim Rule allows the petitioner to nominate three possible receivers who satisfy the conditions laid down by the Supreme Court. It is unclear whether the court is limited to the names which the petitioner has nominated. In some cases, the choice of the receiver proceeded smoothly; in others, either the creditors opposed it or complained about the receiver's style e.g., merely adopting the debtor's proposal without incorporating the creditors' comments. In general, the receivers who are either lawyers, business consultants, or both, have been perceived as capable. Nevertheless, there is concern about a possibly pro-rehabilitation bias by the receiver resulting from an incentive problem derived from the law. The receiver, after all, stands to benefit from a rehabilitation plan being approved as he/she remains as the overseer of the process throughout the rehabilitation period.

On the question of liquidation or rehabilitation, only the case of FDPHI was appealed on this basis. In the other cases, there was general consensus among creditors about the need for rehabilitation; the question was on how to go about with it. In the case of FDPHI, a minority creditor batted for the application of RA 1956 i.e. insolvency proceedings, instead of PD 902-A, i.e. rehabilitation. However, in the Sarabia Hotel case, the creditor bank wanted asset foreclosure but was denied, and instead, was forced to accept deep long-term interest rate cut.

Open Questions from Rehabilitation Decisions

Some RTC rehabilitation decisions have spawned a number of important questions in Philippine commercial law. One is whether and how far could courts interfere in contractual arrangements between debtors and creditors. For instance, could the court simply dissolve a surety agreement between creditor and debtor, as in the case of Sarabia Hotel? Bank lawyers allege that this is an absolute disregard for the constitutional right of contract of private parties.

Another is the power of the courts to mandate *dacion en pago* arrangements. Banks think that while debt-asset swaps, as well as other 'haircut' arrangements can be done, this should be left to the creditors and debtors to negotiate, rather than dictated by the court. The flip-side,

however, is that, if the court could not impose some reductions in commercial claims, bankruptcy procedures might lose its usefulness.

Another open question is whether or how to implement the absolute priority system (APS) during rehabilitation. For instance, in the case of Bayantel, the court decided that secured creditors have priority, only if the company is liquidated, but that during rehabilitation, all creditors should be treated equally in the periodic payment of the debtor. This reasoning has been appealed in the CoA

4.5 Proposed Corporate Recovery and Insolvency Law

After a few years of RTC jurisdiction over insolvency cases, some of the laws' limitations have surfaced. First is the lack of seamless conversion from rehabilitation to liquidation. It is unclear, under the Interim Rules, whether there is need for a separate filing for liquidation and what procedures to follow. Second, while RTC process is guided by an 18 months deadline, the Appeals decision has no such timeline. Third, a strongly pro-debtor bias, similar to how it had been under the SEC, remains in the law. For instance, creditors' approval is not explicitly required by law for the court to approve the plan (even though, in practice, the courts wait until majority of the creditors has approved it or has withdrawn its opposition). Fourth, the Interim Rules do not explicitly require the use of only audited financial statements in court. Nevertheless, the existing regime had already been a marked improvement from previous ones, judging from a relatively high number of filings. Still, the fact remains that the existing legal basis are somewhat antiquated and is badly in need of modernization.

Corporate Recovery and Liquidation Act

There are two house bills filed in Congress addressing the issue of insolvency. One is House Bill 2204, or the Corporate Recovery and Liquidation Act (CRLA); the other is House Bill 2073, or the Corporate Recovery Act (CRA).

The CRLA addresses the issue of seamless conversion from rehabilitation to liquidation through a court order of conversion, in the event that the rehabilitation plan fails, or no viable plan is approved within the prescribed 18 months duration of the proceedings. Of course, there is also a direct voluntary or involuntary filing for liquidation. In the case of the latter, however, the court can convert from liquidation to rehabilitation if the debtor files a motion within 15 days from commencement date of liquidation proceedings.

The proposed insolvency act had greatly boosted the power of creditors over the entire process. The creditors' vote is required for the approval of a receiver, for the extension of rehabilitation plan submission, and for the final approval of the plan. In particular, for a plan to be approved, it has to have the support of 80% of creditors or majority of creditors in each sub-class of creditors. Receivers are also required to meet with the creditors, unlike in the Interim Rules where this is left to the Receiver's discretion. The bill also contains similar timelines as the Interim Rules, with a maximum of 18 months for the entire court proceedings from filing to approval of the rehabilitation plan. In this regard, the proposal is a marked departure from PD 902-A, as applied by SEC.

The CRLA has also clearly established the Absolute Priority System (APS) in case of liquidation, where property tax is ranked high in priority, next only to administrative expenses related to court proceedings, and ahead of secured creditors. The proposed bill also contains provisions for the treatment of rapidly deteriorating assets, maintains the taxability of forgiven debts, and provides conditions for consolidated filing of affiliates. It continues, however, to grant debtor-in-possession (DIP) privilege, except in situations where a management committee may be called for. It is, however, silent on the use of audited financial statements.

Though the CRLA contains a chapter on Pre-Negotiated Rehabilitation, it is unclear on what the benefits under this procedure would be for the debtors and creditors that would take this route. Finally, the provision allows for debt-equity swap within the statutory equity ownership

limits allowed for banks. However, the law prescribes a mandatory disposal of such acquired equity within five years.

Corporate Recovery Act

A major difference between the Corporate Recovery Act and the Corporate Recovery and Liquidation Act is that the CRA contains provisions for fast track rehabilitation. The fast track rehabilitation is patterned after pre-packaged bankruptcy concept in other countries. It involves the creation of a new, debt-free company from the assets of the old one, auction of the shares of the new company to pay off the debts of the previous one, and the continuation of business under the new company. The fast-track process facilitates the sale of the company as a going-concern without the need for the court to decide on rehabilitation or liquidation.

In theory, fast track appears an efficient process, but given the novelty of the remedy, it is doubtful whether the Philippines is the right country to introduce such a major innovation in the insolvency system; the procedure crafted in insolvency law seems to be a first in the entire world. In the first place, the judges are just now gearing up to understand commercial cases better; introduction of even more novel ones would, likely, merely create confusion. Secondly, the fast-track process requires a deep capital market to get an adequate price for the new company's shares, a requirement which is not yet present in the Philippines.

Other points of difference between the two include: 1) timelines of the rehabilitation procedures; 2) voting by creditors; 3) debtor-in-possession provisions; 4) application for court-supervised rehabilitation; 5) use of audited statements. The CRA does not have an absolute maximum deadline for the court to approve the rehabilitation plan, even though there are timelines for the submission of plans by the petitioner, failure of which can result to conversion of the case to liquidation. The CRLA, in contrast, stipulates 18 months maximum. Second, approval of the plan is based on majority approval by each class of creditors as well as shareholders; the CRLA does not include approval by shareholders but only by majority of each class of creditors or the approval of 80 per cent of creditors regardless of class. Third, the CRA

has confusing provisions on DIP. On one hand, it vests full control on the conservator/receiver; on the other hand, it mandates delegation to debtor management, unless circumstances justify otherwise. The CRLA, in contrast, states clearly that the receiver only has power to review and to access all records available to its management and Board of Directors, thus, is unambiguous about DIP. Fourth, while both creditors and debtors are allowed to file for fast track rehabilitation, only debtors are qualified to apply for court-supervised rehabilitation, in the CRA. Fifth, the CRA has the advantage of stating explicitly that audited financial statements be part of the requirements for filing for rehabilitation.

As a whole, both CRA and CRLA grant improved powers on creditors, provide seamless conversion from rehabilitation to liquidation, contain provisions for APS, and address informal workouts. Both, therefore, introduce some improvements in the current insolvency law.

5. Implications for SPVs

Without a number of publicly available transactions by the SPVs at the moment, this section will merely advance some *ex-ante* or likely effects of the insolvency reforms on the SPVs. A more definitive, evidence-based appraisal of the reforms would have to come later after SPVs' operations in the Philippines have come in full swing. At present, many SPVs are still winding up negotiations with banks and presumably finalizing their disposition strategies for those acquired assets.

Upon asset acquisition, the rights of the creditor banks are completely transferred to the SPV. Therefore, to the extent that insolvency laws have moved a little towards more creditor-friendly regimes, SPVs are benefited. For instance, the introduction of clear timelines and maximum periods in the Interim Rules allows SPVs to expect, barring any delays from any court appeals, a more predictable timeframe in which to base their restructuring or disposition plans. In addition, the continuing education of judges in commercial courts is another booster for the entire credit system.

Similarly, to the extent that both the CRLA and CRA address the concerns of creditors over an overly pro-debtor insolvency procedure, the proposed bills would also be beneficial for SPVs. The easy conversion from rehabilitation to liquidation, for instance, would remove another layer of confusion or difficulty for creditors. The granting of voting powers for creditors over the choice of the rehabilitation receiver and the approval of the plan would be, again, another plus for SPVs.

One remaining problem with existing and proposed laws is the debtor-in-possession privilege which is retained in both versions of the insolvency reform laws. The problem is that SPVs, unlike banks which have its main expertise in financial intermediation, might, actually, have the turn-around experts among its personnel that could greatly improve the firm's performance, or have excellent asset managers that would maximize, not only the values of particular assets, but of the entire business as a whole. Yet, because of DIP, it is unlikely that the debtor management would voluntarily relegate their role.

A possible improvement that can still be introduced in the proposed bills is the granting of DIP privilege only in the case of voluntary insolvency procedures. In the case of involuntary filing for rehabilitation, the DIP should not apply. In this way, the DIP privilege also becomes the incentive for early rehabilitation filing before the company situation becomes worse.

Another problem, specially with regard CRLA, is the mandated disposal of equity, which banks had swapped for debt, within five years. Banks should be allowed to dispose of these equity shares when they deem it beneficial for them, for instance, when the equity values of the company had sufficiently appreciated. Given unpredictabilities in the equity market, it is hard to tell whether such could be achieved within five years.

6. Summary, Conclusions, and Recommendations

What had become transparent from the study of insolvency procedures and NPLs is that banks are the institutions that are caught in the middle. On one hand, courts are usually pro-

debtor: they give breathing space to borrowers to regain profitability, impose ‘haircuts’ on banks, mandate *dacion en pago* arrangements, etc. On the other hand, the BSP exerts pressures on banks to reduce its ROPOA holdings which, in many cases, have been thrown at banks through court-mandated debt-for-assets swap. Meanwhile, banks have to provision for losses for these transferred assets as well as spend for their maintenance costs.

Courts, too, seem to operate on a different time frame from banks. While courts can approve 10 or 20-year rehabilitation plans, banks have a more pressing and shorter time frame. They want repayment of loans sooner; they want sooner conversion of those loans to performing status, or else, liquidate them altogether. Banks are also required to grant secured loans equivalent up to only 60% of the value of the collateral; yet courts accuse them of being overcollateralized, at times even interfering in the valuation of asset securities for loans.

The present situation, therefore, clamors for a reform of the insolvency regime at this present juncture. The two proposed bills on insolvency reforms appear on track, by improving the role of creditors and putting time-bounds in the entire process. To the extent that Special Purpose Vehicles take over the rights of the creditor banks, a more pro-creditor improvement in the insolvency regime would also be good for SPVs.

What remains to be addressed is the use of debtor-in-possession, the timelines for the Appeals process, as well as improvements in the informal workout process. The paper argues that DIP should only be a privilege for voluntary rehabilitation and should be made an incentive for early filing by firms. Maximum periods for review should also be put for cases on Appeal. Finally, the insolvency law should make clear the incentives and the benefits for debtors and creditors to engage in informal work-outs.

Last but not least, on the administrative side, the continuing education of commercial court judges through the Philippine Judicial Academy (Philja) should be given priority. After all, at the end of the day, the effectiveness of the insolvency process

lies not so much on how avant-garde the rules and procedures are, but on the competent, fair and open-minded decisions by the court. Better to stick to time-tested bankruptcy procedures that had worked well in many other countries than create a new and innovative one that is yet untested anywhere else.

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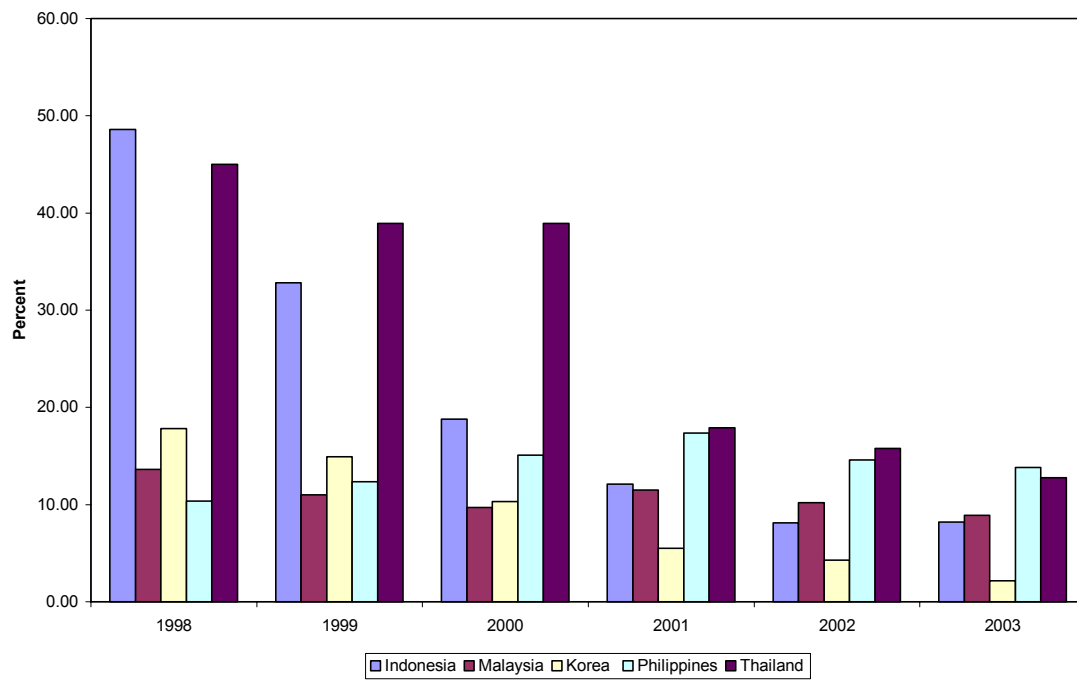
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Figure I. NPL Ratios in Crisis-Affected Countries



**Figure II. Non-Performing Assets Share
(By Type of Bank)**

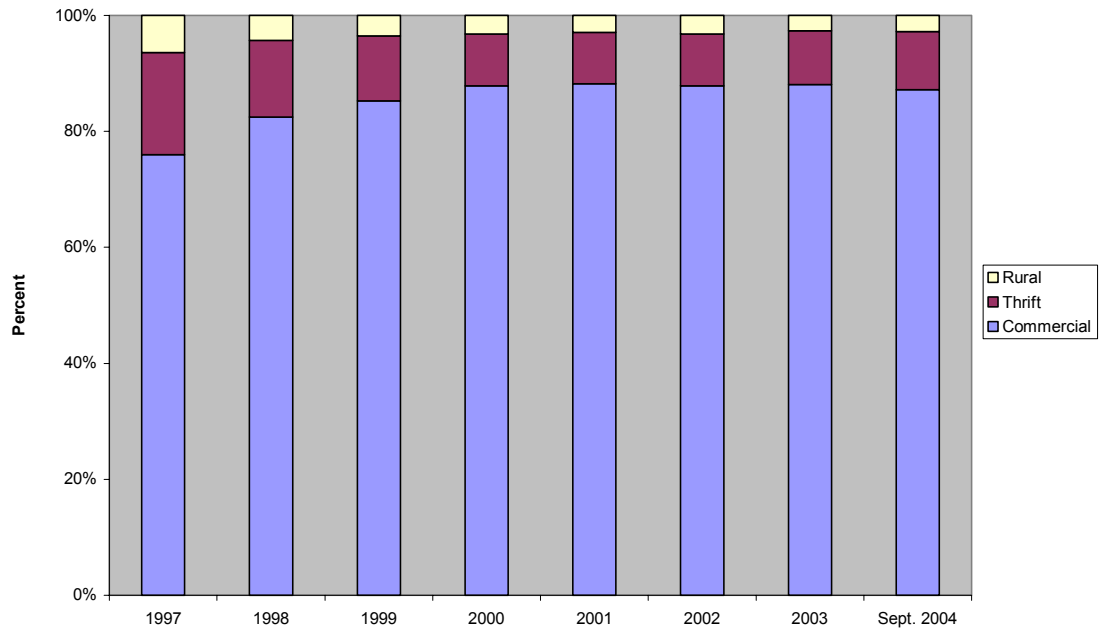


Figure III. Increasing Share of ROPOA
(entire banking system)

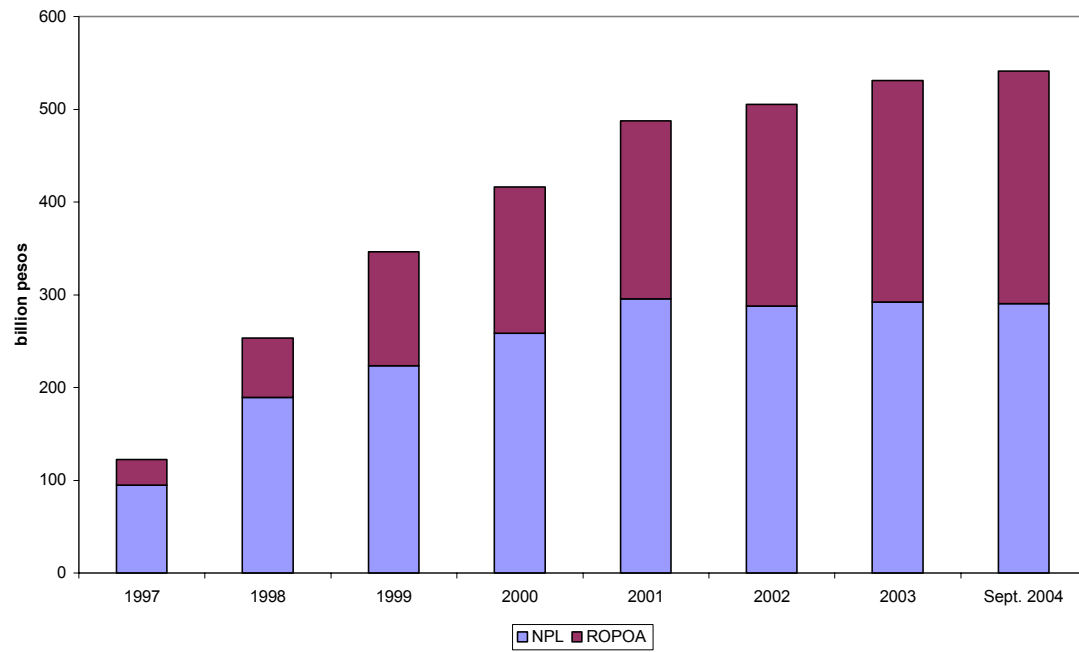


Figure IV. Simplified NPA transfer process under the SPV Act

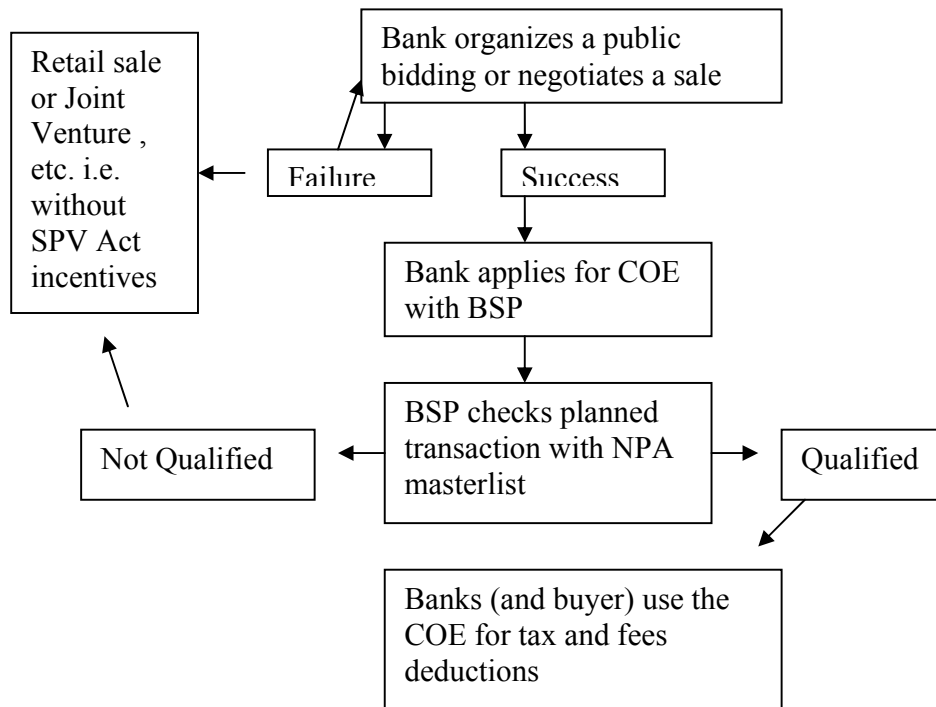


Figure V. Rehabilitation Proceedings in RTCs

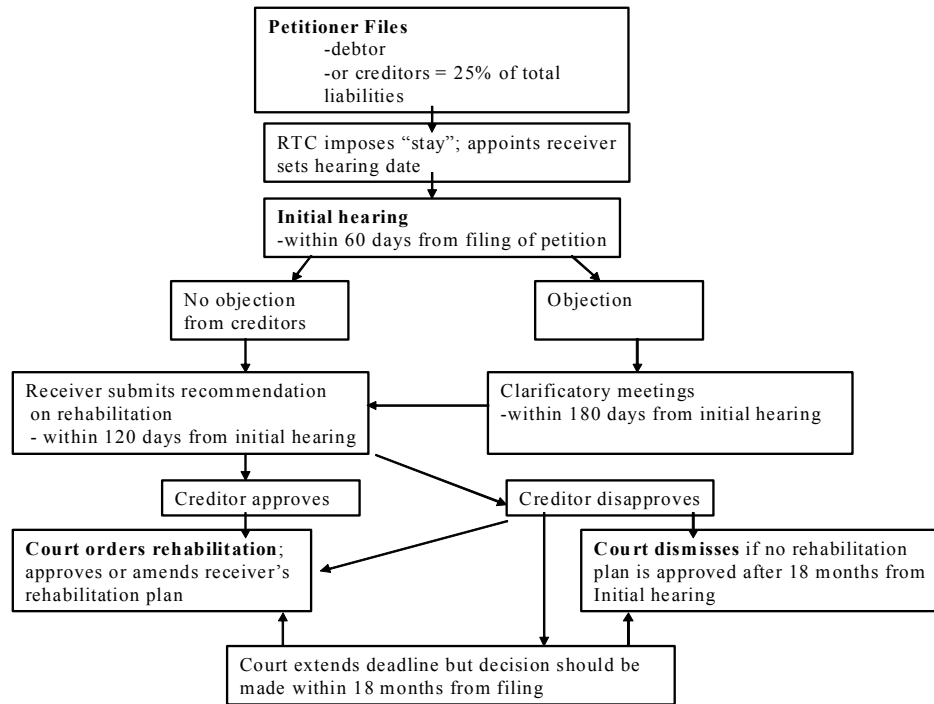


Figure VI. The Proposed Corporate Recovery and Liquidation Act

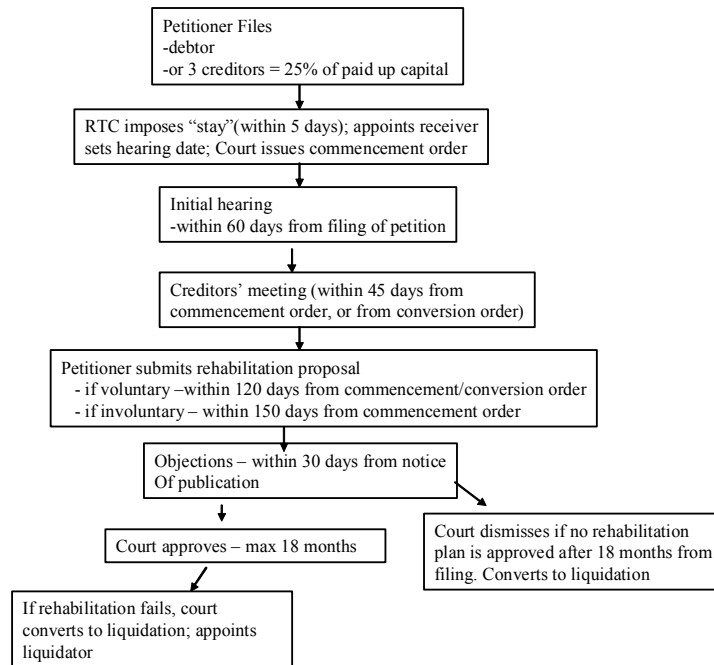


Table 1. Unbalanced Loss Provisioning and the Rise of ROPOA

Classification	Allowances
<i>For NPLs</i>	
Unclassified	0%
Loans specially mentioned	5%
Substandard	
Secured	6% to 25%
Unsecured	25%
Doubtful	50%
Loss	100%
 General loan loss provision	
Unclassified restructured loan	5%
Unclassified loans (not restructured)	1%
 <i>For ROPOA</i>	max of 50% (10% /year from 6th to 10th year)

Source: Bangko Sentral ng Pilipinas (BSP)

Table 2. Comparison of India's Asset Restructuring Corp. (ARC) with RP's SPV

	SPV	ARC
Enabling Law	Special Purpose Vehicle Law – December 2002	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act – December 2002
Limitations on equity	5% max equity share of originating bank; 40% max for foreign investors	No one has controlling interest; Still partly owned by banks
Foreign participation in ARC or SPV	40% equity share max	None; but structural barriers to foreign investment in financial services applies
Qualification of NPAs	Non-performing as of June 30, 2002 Notification of borrowers required	Any type of NPA. Assets where 75% of creditors (by value) have agreed to sell to ARC; No prior notification of borrowers necessary Foreign banks are not qualified to sell their NPLs under the Act
Loss carryover	10 years	?
Terms of sale of NPLs	'true sale' requirement (relinquish effective control over assets and legally isolated from transferor and its creditors); Do not participate in the profit of SPV; loss may or may not be reflected upon transfer from banks. No possibility of window dressing	Banks can participate in the profit of the NPL sale but cannot underwrite; 'without recourse' – bank cannot assume liability if ARC makes a loss; Loss or profit are recorded on bank books once realized i.e. once ARC had sold the NPLs (although part may be reflected if 'fair' value at which NPLs were transferred to ARCs differs from book value); Possibility of window dressing exists
Special powers (statutory)	Nothing special for SPV; Same as banks	ARC has unprecedented power to take over management of the business of the borrower or seize assets
Fiscal Incentives	Tax and fees deduction	None; Law just allowed the establishment of ARCs
Time – bound	Yes	No
Main financial instrument	IUIs – Investment Utility Instruments – participation certificates	Third party investors can subscribe for security receipts

Table 3. BSP- Approved Transactions under the SPV Act
(December 2004, in million pesos)

Bank Classification	ROPOA SALE TO INDIVIDUALS		DACION EN PAGO		SALE TO SPV	
	Book Value	Number of COEs issued	Book Value	Number of COEs issued	Book Value	Number of COEs issued
private domestic universal banks	71.729	37	7,613	30	8,510	3
domestic commercial banks	41.068	6	301.195	7	33.21	1
thrift banks	218.37	38	878.867	12	450.442	1
branches of foreign banks	13.781	1	409.51	1		
subsidiaries of foreign banks			4,679	1		
government banks			250	1		
NBQB					1,531	1
consortium of banks/non-banks ¹					11,050	2
TOTAL	344.946	82	9,458.00	52	20,046	8

¹ National Steel Corp.

Source: Bangko Sentral ng Pilipinas

Table 4. Announced Bank Transactions
(as of February 15, 2005)

<i>Name of Bank</i>	<i>Assets under Negotiation or Planned Transfer (billion pesos)</i>	<i>SPV Partner</i>	<i>Remarks</i>
Allied Bank	12.55	ABC Resources Holdings, Inc.	
Asiatrust Development Bank	0.204	n.a.	
Bank of the Philippine Islands	8.6	Philippine Asset Investment (affiliate of Morgan Stanley Emerging Markets, Inc)	additional 3 billion planned
Bank of Commerce	1.6	n.a.	
Equitable- PCIB	10.5	Philippine Investment One, Inc (partly owned by Lehman Brothers	
Export Bank	5	n.a.	
Landbank	13.5	Deutsche Bank - Cargill Financial Services Intl, Inc. and JP Morgan	two different pools of NPLs
			4.3 ROPOA unsold; plan another 20 billion sale, of which 10 billion are ROPOA
Metrobank	0.23	n.a.	
PNB	20	n.a.	Of which 10 billion is ROPOA
Philippine Bank of Communication	12.156	Unimark Investment Corp.	10 billion sale was a condition for PDIC extending credit worth 8 billion
RCBC	7	Philippine Investment One, Inc (partly owned by Lehman Brothers	additional 3.9 billion is planned
UCPB	13.6	First Sovereign Funds Corp. (owned by South Koreas Shinhan Mergers and Acquisition)	2.2 billion additional through retail disposition
<i>Not through SPV:</i>			
China Bank	0.5 - 0.6	n.a.	through negotiated sale or public auction
NHMFC	13.4	Deutsche Bank Real Estate Global Opportunities	Joint venture; NHMFC equity share is 49%

Source: Various Businessworld News Articles

Table 5. Registered Special Purpose Vehicles - AMC with SEC

Name	Majority Owner
1 Asset Conversion and Enhancement Strategies (SPV-AMC) Inc.	C-E Construction Corp.
2 Colony Investors (SPV-AMC) Inc.	No controlling share by individual investor; 70% Filipino-owned, 30% Chinese
3 RIS-(SPV-AMC) Inc.	RIS Development Corporation
4 First Sovereign Funds (SPV-AMC) Corp.	Eastbrook Capital Holdings -60%; Pennsylvania Capital Holdings, Inc - 40%
5 EB Capital "SPV-AMC (Asset Management Company)" Inc.	Manuel Singson
6 Cameron Granville Asset Management (SPV-AMC) Inc.	Equitable PCI Bank
7 ABC Resources & Holdings (SPV-AMC) Inc.	Allied Banking Corporation
8 Prime Assets Management (SPV-AMC) Inc.	No controlling share by individual investor
9 One Stonehenge Asset Resolution (SPV-AMC) Inc.	One Stonehenge Capital Holdings, Inc.
10 Philippine Investment One (SPV-AMC) Inc.	Lehman Brothers Southeast Asia Pte Ltd
11 NP Plus (SPV-AMC) Corp.	ING Institutional and Government Advisory Services
12 Bancommerce Corporation SPV-AMC	Bank of Commerce
13 Philippine Opportunities for Growth and Income (SPV-AMC) Inc.	Landbank
14 Advanced Solutions for Asset Recovery (SPV-AMC) Corp.	Landbank
15 Asset Recovery Innovations (SPV-AMC) Inc.	Landbank
16 Opal Portfolio Investments (SPV-AMC) Inc.	Philippine National Bank
17 Tau Portfolio Investments (SPV-AMC) Inc.	Philippine National Bank
18 Tanzanite Investments (SPV-AMC) Inc.	Philippine National Bank
19 EIB SPV-AMC (Asset Management Company) Inc.	Export and Industry Bank
20 Omicron Asset Portfolio (SPV-AMC) Inc.	Philippine National Bank
21 Schuylkill Asset Strategist (SPV-AMC) Inc.	No controlling share by individual investor
22 New Pacific Resources Management (SPV-AMC) Inc.	Rizal Commercial Banking Corp. (RCBC)
23 LNC (SPV-AMC) Corp.	Philippine Bank of Communications
24 Global Asset Management and Recovery Corp. SPV-AMC	Prudential Bank
25 Asian Pacific Recoveries (SPV-AMC) Corporation	RCBC
26 Unimark Investments (SPV-AMC) Corp.	No controlling share by individual investor
27 Golden Desert Philippines (SPV-AMC) Inc.	J.P. Morgan International Finance Ltd
28 Tranche 1 (SPV-AMC) Inc.	Marathon Master Fund
29 EB Management Capital (SPV-AMC) Inc.	Export and Industry Bank
30 Odyssey Capital Ventures (SPV-AMC) Inc.	Security Bank - 35%
31 Tiger Asia Fund SPV-AMC Inc.	Asia Equity Partners Co., Ltd (Korean)
32 Blue Box (SPV-AMC) Inc.	Kidson PTE Limited (Singapore)
33 Philippine Investment Two (SPV-AMC) Inc.	Lehman Brothers Southeast Asia Pte Ltd
34 First Sovereign Asser Management (SPV-AMC) Inc.	China Banking Corporation
35 Landlink Property Investments (SPV-AMC) Inc.	Security Bank
Global Ispat Holdings (SPV-AMC) Inc. (formerly Global Ispat Holdings, Inc.)	Global Steelworks International, Inc - 59%

Source: Securities and Exchange Commission (SEC)

Table 6. Snapshots of Three Insolvency Regimes

	RA 1956	PD 902-A	Interim Rules
Date of enactment	1909	1976	2000
Remedies Available	Suspension of payments; Liquidation	Suspension of payments; Rehabilitation; Dissolution	Suspension of payments; Rehabilitation
Jurisdiction	RTCs	SEC	RTCs
Who can apply for suspension of payments	only solvent corporations	Only solvent corporations but because there is no need for creditor approval, effectively both solvent and insolvent corporations apply	No requirement of solvency
Liquidation filing	Separate filing by either debtor or creditors (or group of creditors)	Conversion from rehabilitation to dissolution is automatic; seamless procedure	Nothing is said; presumption is that it would be a separate filing.
“Stays” on creditors	Excludes secured creditors	Does not exclude secured debts	Does not exclude secured debts
Role of creditors	Creditor approval needed to approve suspension of payments petition; Needs at least 2/3 affirmative vote from creditors representing at least 3/5 of total liabilities	No creditor approval is needed; SEC-controlled process; overrule of creditors is possible	No creditor approval needed but oppositions are heard
Management of suspension / or rehabilitation	Stay on corporation excludes dispositions which are necessary in the ordinary course of business	Needs SEC approval for whatever corporate dispositions	Receiver oversees rehabilitation and approves or disapproves disposition
Time caps	None	None	Within 18 months from filing, rehabilitation should be approved; decision is immediately executory

Table 7. Petition for Rehabilitation with Prayer for Suspension of Payments Filed with Various RTCS (as of November 17, 2004)

Regional Trial Court	Number of Cases Filed
<i>A. Metro Manila</i>	37
Quezon City (Br 23, 93, 90)	9
Pasig City (Br 158)	6
Makati City (Br 142, 138, 61)	8
Muntinlupa/Paranaque (Br 256, 258)	2
Manila (Br 24, 46)	2
Las Pinas (Br 253)	5
Pasay City (Br 231, 117)	5
<i>B. Outside Metro Manila</i>	40
<i>C. Total</i>	77

Source: Office of the General Counsel, Supreme Court

**Table 8. Summary of available rehabilitation decisions
(June 2000 – January 2005)**

Name of Company	Petitioner	Duration of the proceedings	Inclusive Dates	Regional Trial Court	Status / Other info
Ramcar, Inc. (car battery manufacturing)	debtor	19-20 months	December 2001 – August 2003	Branch 90, Quezon City, Metro Manila	Rehabilitation is ongoing
Bayantel (Telecom)	Unsecured creditor – led by Bank of New York	11 months	July 2003 – June 2004	Branch 158, Pasig City, Metro Manila	All parties are appealing the decision
Sarabia Hotel	debtor	13 months	July 2002 – August 2003	Iloilo	On appeal
First Dominion Prime Holdings, Inc (Canned tuna exports)	debtor	12 months	February 2001 – February 2002	Branch 158, Pasig City	Appealed (April 2002 – September 2004); Court of Appeal sustained RTC decision; petition for reconsideration in January 2005 denied

Appendix Table 1

Debt recovery rates for Swedish and U.S. firms filing for bankruptcy, 1985-1993

	Swedish firms			Publicly traded U.S. firms		
	<i>Market values</i>			<i>Face values</i>		<i>Market values</i>
	Mean	Median	Standard deviation	Mean	Median	Median
<i>Panel A: In-bankruptcy auctions</i>						
Sample size	210					
All debt classes	0.35	0.34	0.21	----	----	----
Secured debt	0.69	0.83	0.33	----	----	----
Priority claims	0.27	0.19	0.28	----	----	----
Junior debt	0.02	0.00	0.11	----	----	----
Time in bankruptcy (months)	2.4	1.50	3.4	23	19	
<i>Panel B: Piecemeal liquidations</i>						
Sample size	63					
All debt classes	0.27	0.25	0.24	----	----	----
Secured debt	0.50	0.45	0.36	----	----	----
Priority claims	0.21	0.14	0.26	----	----	----
Junior debt	0.02	0.00	0.12	----	----	----
<i>Panel C: Going concern sales and successful reorganizations</i>						
Sample size	142				38	12
All debt classes	0.39	0.38	0.19	----	0.51	0.41
Secured debt	0.77	0.87	0.28	----	0.80	----
Priority claims	0.30	0.20	0.29	----	----	----
Senior debt	----	----	----	----	0.47	----
Junior debt	0.02	0.00	0.11	----	0.29	----
<i>Panel D: Prepacks</i>						
Sample size	53				49	
All debt classes	0.32	0.31	0.22	0.73	----	----
Secured debt	0.74	0.89	0.32	0.99	----	----
Priority claims	0.26	0.19	0.28	----	----	----
Senior debt	----	----	----	1.00	----	----
Junior debt	0.01	0.00	0.07	0.64	----	----
Time in Bankruptcy (months)	-2.2	-0.2	4.1	2.9	1.9	

Source: Thorburn (2000).

Debt recovery rates for 263 Swedish firms filing for auction bankruptcy in 1988-1991, and for publicly traded US firms filing for Chapter 11 in 1985-1993. Debt recovery is defined as payment to a class of debtholders measured as a fraction of the face value of claims held by that debt class. Auction prepack is a going concern sale that is negotiated prior to bankruptcy filing, for Sweden. For US, prepack is reorganization plan negotiated out-of-court.

Appendix Table 2. KAMCO NPL Purchase
(November 1997 - November 2002, in trillion Won)

	Face Value	Amount Paid	Discount Rate
Ordinary Loan - secured	10.6	7.1	0.33
Ordinary Loan - unsecured	20.1	2.3	0.89
Special Loans - secured	27	12.8	0.53
Special Loans - unsecured	14.5	4.2	0.71
Daewoon Loans	35.4	12.7	0.64
Workout Loans	2.6	0.6	0.77
Total	110.1	39.8	0.64

Source: KAMCO