

## **ROLE OF INDONESIAN INSOLVENCY SYSTEM: CASE FOR OPTIMISM AND CASE FOR CAUTION**

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As will undoubtedly be discussed elsewhere, the Indonesian insolvency system has been subject to well-publicized problems in its operation. Questions of judicial professionalism have been raised and will undoubtedly persist until enough cases of significant size of handled by the Commercial Courts in a transparent and professional manner. While these issues will be discussed at great length elsewhere, it is perhaps important to highlight the impact of the evolving Indonesian insolvency system on out-of-court corporate debt restructuring which, in Indonesia as in most countries, accounts for the lion's share of restructured debt. As will be discussed below, this linkage is important, as the efficiency and effectiveness of a given insolvency system will directly impact the speed and quality of corporate debt restructuring.

That problems with the implementation of the Indonesian insolvency system have slowed the pace of corporate debt restructuring should be obvious two years into the financial crisis. However, recent developments in the handling of Indonesian insolvency matters – including the increasing use of “pre-negotiated” composition plans and the related use of allegedly fraudulent or fictitious creditors for their implementation -- have already had a pronounced impact on corporate restructuring. It is the purpose of this brief paper to highlight these developments and to discuss their ramifications for Indonesian corporate debt restructuring.

### Linkage Between Insolvency System and Corporate Debt Restructuring

Before turning to the specific developments in Indonesian insolvency practice, it is important to reiterate the linkage between the quality of a given insolvency system and the pace of corporate debt restructuring. It is, or should be, the purpose of most insolvency systems to facilitate the recovery and reorganization of viable businesses in a manner that does not ignore the contractual rights of the parties. Where reorganization is not possible, the assets of the business should be allocated in a speedy and efficient manner consistent with those contractual rights.

No matter how efficient the insolvency system is in practice, experienced parties will normally prefer to avoid judicial intervention in favor of consensual resolution of a distressed debt situation. Doing so avoids the cost, uncertainty and delay of a legal proceeding. In order for such out-of-court “workouts” to succeed, however, it is critical that there be reasonable certainty regarding the results that would be achieved in a legal proceeding. Unless there is a minimal level of predictability regarding the legal rights of the parties, there will be no way for the parties to determine their respective leverage points, and a negotiated result will be difficult or impossible to achieve.

In Indonesia, the slow pace of legal reform has resulted in a situation where there is little confidence that the insolvency law will be enforced appropriately. As expected, this has slowed the pace of consensual corporate restructuring, as neither debtors nor creditors can be sure of their ultimate legal rights. Nevertheless, there are signs that this situation may be changing.

Established in 1998, the Jakarta Initiative Task Force (“JITF”) is the Government of Indonesia’s mediation body charged with facilitating corporate debt restructuring in Indonesia. With a current docket of cases in excess of US\$ 17 billion in aggregate debt, the JITF is in a good position to observe the effects of the Indonesian insolvency system (and recent developments in its operation) on the progress of corporate debt restructuring. Set forth below are the observations of the Jakarta Initiative Task Force regarding these developments.

### Jakarta Initiative Task Force Observations

#### A. Pace of Corporate Restructuring is Quickening In Spite of the Insolvency System

Despite the excruciatingly slow pace of corporate restructuring during 1998 and 1999, it is clear that more out-of-court deals are now being done. In the second-half of 2000, over US\$9.4 billion in aggregate debt was restructured under the Jakarta Initiative alone, which amount represents a **five**-fold increase in the amount of debt restructured over all deals completed in 1998, 1999 and the first-half of 2000. Could it be that the increased pace of corporate restructuring is a result of renewed confidence in the Indonesian insolvency system? The answer is “probably not”.

As discussed above, out-of-court restructurings tend to take place when both parties can adequately define their legal rights so as to determine their negotiating leverage. The Indonesian insolvency law, which, on paper, provides creditors with the ability to liquidate companies in default of their obligations, has been interpreted in case after case in a manner which prevents such liquidation from taking place. As a result, Indonesian debt restructuring negotiations have often been directionless, as the parties struggle to determine whether a negotiated solution is, indeed, preferable to a legally-imposed solution.

Over the past year, however, many creditors have taken a more pragmatic view of their legal rights and have assumed that, regardless of what the insolvency law states, it is highly unlikely that it will be enforced in their favor in the short-term. Such creditors suffering “credit fatigue” have, over time, begun to soften their negotiating positions rather than to wait for judicial reform.

Similarly, many companies have begun to realize that, regardless of whether they are successful in securing the dismissal of bankruptcy petitions brought against them, their creditors will not go away without a negotiated solution. These companies, particularly those which desire to return to the capital markets or gain a competitive advantage over their peers, are similarly softening their negotiating positions in the interest of reaching settlement. As such, the parties have assumed stalemate in the courts, and have begun to reach deals in cases where both parties prefer a negotiated solution to continued stalemate. In other words, restructuring transactions are closing in spite of the insolvency system, rather than because of it.

#### B. Increased Use of Pre-negotiated Bankruptcy Plans

Although the Indonesian insolvency system has not played a tremendous role in helping parties to define their negotiating leverage, there are promising signs that the Commercial Courts may nevertheless play a constructive role with the implementation of agreed deals. In several notable cases, most recently **PT Anwar Sierad, Tbk. and PT Bakrie & Brothers, Tbk.**, the Commercial Courts have demonstrated a willingness and ability to approve so-called “pre-negotiated” composition plans.

The need for such plans is clear. In most sizable cases, it will be impossible to secure the agreement of 100% of creditors to a restructuring plan. However, unless such agreement can be secured or implied by law, dissenting creditors will retain their rights to bring legal action against the debtor, rendering an effective restructuring impossible. In many countries, the mechanism exists for a minimum percentage of creditors and the company to agree on the terms of a restructuring plan outside of court, and then proceed to have the court approve and enforce the plan on an expedited basis.

Although the Indonesian insolvency law does provide that, in a suspension of payments proceeding, two-thirds of unsecured creditors can approve a composition plan which will be binding on dissenting unsecured creditors, there has been, until now, little indication as to how the Commercial Courts would handle such pre-negotiated restructuring schemes. Over the past six months however, several large and complex restructuring plans have been negotiated out of court and approved by the Commercial Court in relatively short order.

The importance of this development cannot be underestimated. With a workable mechanism to implement these so-called “pre-negotiated” restructuring plans, parties will move more quickly to finalize their deals, and potential holdout creditors will become more pragmatic in their approach to the workout process. This will result in an increased pace of out-of-court restructuring negotiations. Although it is beyond the scope of this paper, it should be mentioned that the effectiveness of pre-negotiated composition plans can be further enhanced by amendments to the existing insolvency law that permit a composition plan to bind secured creditors as well as unsecured creditors, provided that the secured creditors are treated fairly and retain the benefit their contractual rights vis-à-vis their collateral. Providing this modification will insure that composition plans of universal application (*i.e.*, plans applicable to both secured and unsecured creditors) can be utilized to speed the restructuring process.

C. Alleged Use of Fraudulent Claims: Danger Signs on the Horizon

The newfound feasibility of pre-negotiated bankruptcy plans does not come without costs, however. In at least two recent cases, it appears that a dangerous practice has arisen of using allegedly “fictitious creditors” as a tool to engineer the confirmation of composition plans that would otherwise be rejected by legitimate creditors. In these cases, the debtor’s attorney has filed affidavits from “would-be creditors” voting in favor of a composition plan put forward by the debtor. These allegedly “newly found creditors” (who are invariably absent from court) possess sufficient claims in amount and number to out vote existing creditors, insuring that the debtor’s composition plan is confirmed.

If allowed to continue, this alleged practice will undermine the fragile progress being made in out-of-court debt restructuring. Keeping in mind that such progress now rests on mutual frustration with the existing stalemate in the courts, an ad hoc approach to confirmation of suspect composition plans will cause many debtors to walk away from the negotiating table and return the parties to a state of uncertainty. With this uncertainty, the out-of-court restructuring process will once again suffer from stagnation and lack of progress, as the parties are unable to assess their negotiating leverage.

C. Solution is in the Implementation

As will undoubtedly be discussed elsewhere, the solution to this threat is in better implementation of the existing insolvency laws. While the use of pre-negotiated composition plans is, in itself, helpful, the Commercial Courts must be on guard to prevent abuse of the process that will undermine both faith in the judicial system and the viability of the out-of-court workout process.

This solution is, of course, deceptively difficult to implement. Nevertheless, professionalism and transparency in the implementation of the law should be the watchwords of all concerned, particularly as it relates to the confirmation of composition plans. If this step is taken, it will become clear that Indonesia already possesses most of the ingredients to complete the restructuring of its corporate sector for the good of all parties.