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Informal Workouts in Indonesia:
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INFORMAL WORKOUTS IN INDONESIA

I. Background

Among the countries negatively affected by the Asian financial crisis, Indonesia arguably suffers from one of the weakest legal systems, particularly when it comes to the enforcement of creditors' rights. Cases such as PT Asuransi Jiwa Manulife Indonesia have cast doubt over the operation of the Indonesian legal system as a whole, and cases such as PT Panca Overseas Finance[1] have served to underscore the lack of faith which creditors possess when negotiating debt restructuring transactions with Indonesian borrowers.

At first blush, one would be forgiven for assuming that the lack of a credible legal remedy against defaulting debtors would lead to a greater volume of informal out-of-court restructuring transactions in Indonesia. After all, out-of-court restructurings are the primary, if not the only, alternative to court-administered reorganization. However, the reverse has proven to be true. Absent legally enforceable rights in Indonesia, creditors have been forced to face borrowers from a position of extreme weakness, and, as a result, many borrowers have found themselves under no real pressure either to pay their debt or to restructure. Moreover, such nonpayment and associated inaction have, within many industries, become strategic in nature, since any given company's competitors are frequently avoiding payment and by servicing debt, such company would place it at a competitive disadvantage.

During the course of the crisis, the argument has been raised on numerous occasions that future funding pressures should, and will, ultimately force borrowers to restructure their debt in good faith. After all, the argument goes, borrowers which restructure early and constructively will be favored when it comes to obtaining future financing, and will grow their businesses at the expense of their recalcitrant brethren. This, however, has not been the case in practice. Though there have been many complaints regarding a lack of working capital, most companies have been able to continue operating during the crisis by diverting internal cash flow (which would otherwise have been used to service debt) to working capital purposes. It is also the case in Indonesia that many corporate owners have diverted large amounts of cash offshore, and these funds can be called upon to keep corporate operations afloat. Finally, it has been observed that, even for those companies who restructure their obligations, new financing has been extremely difficult to obtain in Indonesia, such that cooperation with creditors poses little, if any, short-term benefit for many Indonesian corporates.

As a result, without the "stick" of credible enforcement of creditors' rights, and absent the "carrot" of future financing to motivate companies, informal workouts in Indonesia are predisposed to proceed at an extremely slow pace. Frustration with this slow pace has been high. However, as set forth below, mechanisms to solve this impasse have been developed

[1] In the PT Manulife case, the lower court ruled that the Indonesian subsidiary of the Canadian insurer could be bankrupted over a failure to pay a dividend to an ousted former partner. The case was later reversed on appeal. In Panca, the debtor was able to obtain confirmation of a composition plan based upon the affirmative votes of a large number of newly-created creditors, despite objections by the IFC that such claims had been fraudulently created.

and most parties remain engaged within existing restructuring mechanisms, since there are few alternatives available.

II. INFORMAL WORKOUT MECHANISMS

It was recognized early on that Indonesia would be in need of a mechanism to facilitate corporate restructuring and, as early as 1998, several steps were taken to ensure that corporate restructuring proceeded. First, while not directly related to informal workouts, substantial revisions to the Indonesian Bankruptcy Law were put in place with the knowledge that a smoothly-functioning formal insolvency mechanism would provide the necessary certainty to make informal workouts possible. In addition to the revisions to the bankruptcy law, the Jakarta Initiative Task Force ("JITF") was created to provide a forum for the mediation of debt restructuring negotiations based upon the "London Approach" to corporate debt restructuring. [2] Finally, the Indonesian Bank Restructuring Agency ("IBRA") was created to, among other things, administer the distressed-debt portfolios of nationalized Indonesian banks. Taken together, it was thought that these institutions, along with the structural changes to the bankruptcy law, would provide the necessary framework within which informal restructurings could take place.

However, as set forth above, the Indonesian bankruptcy law revisions were never implemented effectively by the Commercial Courts and, as a result, effective pressure has never been brought to bear against defaulting Indonesian corporates. Despite the massive-scale of the Indonesian corporate debt crisis, it is telling to note that only a handful of distressed companies have ever undergone involuntary liquidation in the Commercial Courts. The resulting lack of creditor leverage has had follow-on effects for both the JITF and IBRA in that the former was originally designed as a strictly voluntary body while the latter has been, in actual operation, highly dependent on the Indonesian courts for the enforcement of its rights.

When this state of affairs became apparent, steps were taken by the Government of Indonesia to, as best as possible, correct the situation. IBRA has increased its engagement in the informal workout process as time has gone by, and the JITF program was amended in early-2000 to comprise a structured, time-bound process with implicit incentives and sanctions to motivate borrowers to cooperate.[3] These revisions have had a positive effect on the performance of the JITF, and as of the date of this paper, memoranda of understanding had been obtained with respect to over US$ 18 billion in debt under the JITF program. However, it bears mention that the fundamental inoperability of the Indonesian bankruptcy system, coupled with the relatively modest extent of proffered JITF incentives, has limited the extent to which the JITF has been able to operate as a catalyst for informal workouts. A significant number of cases have remained impossible to solve, and frustration remains at the slow pace of corporate restructuring.

[2] The "London Approach" is a set of informal workout "best-practices" articulated by and informally enforced by the Bank of England.

[3] These incentives and sanctions will be addressed separately in the remarks of Bacelius Ruru, Chairman of the Jakarta Initiative Task Force.

III. INFORMAL WORKOUT TECHNIQUES

The fundamental problem facing most Indonesian corporates is the mismatch between ongoing debt and cash flow. Of course, this mismatch is, in many cases, a product of inefficient operations or faulty business models, but from the perspective of the owners of the corporation, it is the cash/debt mismatch that is of primary concern.

Typically, this mismatch is rectified through a debt-for-equity conversion, with the result that existing ownership is diluted and the company emerges from the restructuring exercise with a rationalized balance sheet. However, for many Indonesian companies, the scale of the overleveraging is so great that any market-based debt-to-equity conversion would result in forfeiture of control over corporate operations, a result that has not been palatable to most equity owners in Indonesia. Because, as discussed at length above, there is no credible mechanism to force equity owners to surrender control, stalemate has resulted, as creditors have refused to write-off debt while owners have refused to surrender control absent a mechanism to force them to do so.

Against this backdrop, two mechanisms have successfully been employed in Indonesia to permit restructurings to take place without the necessity of directly addressing the thorny control issue. Each is discussed separately below.

A. SECONDARY MARKET DEBT REPURCHASES

The secondary debt market has, of course, been around for some time; however, within the past two years, it has emerged as the primary restructuring catalyst in Indonesia, permitting deals to be completed which, in earlier years, were thought to be impossible. Some four years into the crisis, creditor fatigue has set in, and given the current lack of a meaningful enforcement mechanism, secondary debt prices for many Indonesian corporates are extremely low. At the same time, the equity owners of these same corporations possess, in many cases, significant offshore resources (allegedly pilfered from the corporation in some cases) which can be used to repurchase outstanding debt at a discount. This has proven to be a key technique by which informal workouts are completed in Indonesia.

There are undoubtedly advantages to this approach. By repurchasing loans at a discount, unsustainable debt is reduced and, from the perspective of the equity holder, the situation is improved, since less of a debt-to-equity dilution will be required upon restructuring. From the perspective of creditors, this situation is an improvement so long as outside funds are used to effectuate the purchase. If corporate funds are employed, then the benefit of such purchase will, of course, depend on the discounts obtained. In any event, following a period of suspicion evidenced by creditors against the practice, there now seems to be wide-spread acquiescence among most creditors to related-party debt repurchases (at proper discounts),

since creditors are permitted the opportunity to exit without "surrendering" the control debate while those who stay are, in most cases, enabled to achieve a higher rate of recovery.[4]

B. SHARE LOCK-UP MECHANISMS

Aside from secondary-market debt repurchases, certain restructurings have been completed through the use of so-called share "lockup" mechanisms. Under such arrangements, a controlling interest in the debtor corporation is placed in escrow, or under similar control, and its subsequent disposition is then made dependent on the borrower's performance under the restructuring agreement. Under such arrangements, compliance with the restructuring terms will result in the existing owners retaining control over the corporation while default will result in a surrender of control to creditors.

The advantage of such share incentive plans is that they provide existing equity holders with the hope that control can be regained while, at the same time, providing creditors with some assurance that the company will perform under the terms of its restructuring documentation. Given the fact that most companies are over-indebted to the extent that equity is of dubious value at the time of restructuring, agreement to such lock-up mechanisms may be less of a concession by creditors than it first appears, since it gives a new assurance that the contractual terms between the parties will be honored.

IV. BENEFITS AND DANGERS OF INFORMAL WORKOUTS

To date, the primary benefit of informal workouts in Indonesia has been the deleveraging that has occurred. At the onset of the crisis, it was clear that Indonesian companies were carrying far too much debt, and if anything approaching economic recovery were to be achieved, substantial deleveraging would need to take place. As a result of the large amount of secondary-market debt that has been repurchased, as well as the direct restructuring efforts of private actors, IBRA and the JITF, many Indonesian debtors have significantly lessened their debt burdens and are in a position to share in any economic recovery.

However, this emphasis on deleveraging has not been without its costs. To begin, deleveraging has, in most cases, come at the expense of credible operational restructuring, and the same individuals and practices responsible for past failures have, in many cases, been left in place. This, of course, creates significant moral hazard, and has denied Indonesia the usual rejuvenating effects of economic crisis, namely, the injection of new management and entrepreneurial talent to maximize efficiency and economic output. Additionally, the deleveraging that has occurred has been accomplished with no small amount of bitterness among those in the business of providing cross-border capital (and, indeed, it is precisely such bitterness that has driven debt prices down to levels sufficient to have permitted these restructurings to take place). Although it is too early to tell for certain, it is likely that this

[4] Unlike commercial creditors, however, IBRA has stated a policy of refusing to sell loan positions back to original equity owners. However, it is suspected by many that creative equity holders are finding routes around this restriction.

experience will result in at least a short-term reluctance of outsiders to commit further funding to Indonesia, at a time when the country needs such investment to lift itself out of economic crisis.

V. CONCLUSION

As indicated above, the Indonesian debt restructuring experience has very much been a product of the failure of the country's legal system to deal adequately with issues of default and creditors' rights. In light of the complete absence of pressure available to force companies to deal with their debt obligations, it is perhaps surprising that progress has been made at all, and the restructurings that have occurred are testament to the ingenuity and dedication to those involved. That being said, the past and ongoing challenges should serve as a cautionary tale to those contemplating informal workout systems in countries with weak legal systems. The experience in Indonesia has made it amply clear that the success of informal workout efforts will be directly dependent on the speed, predictability and efficiency of existing in-court insolvency procedures, and absent credible creditors' rights, the restructuring techniques ultimately employed in such jurisdictions will be targeted toward deleveraging at the expense of longer-term operational restructuring.