Towards an Effective Indonesian Bankruptcy Law, Part 1

The Indonesian Private Business Initiative (IPBI) is a group of over twenty Indonesian business entities who believe that the Indonesian private sector has a valid and important role to play as the Indonesian Government's partner in reforming the Indonesian economy and nurturing it expeditiously back to a healthy growth path after the debilitating financial and political crisis of the last two years. IPBI sees itself as a cooperative interlocutor with Government authorities, not as an adversary.

This article, and three other planned sequels, is derived from a report prepared by Mr. Robin E. Phelan, Esq., subsequent to a comprehensive review of the Indonesian bankruptcy law and a visit to Jakarta in July 1999 at IPBI's invitation to gain a first-hand exposure to the operations of the bankruptcy system in Indonesia. Mr. Phelan is a bankruptcy expert with the law firm of Haynes & Boone in Dallas, Texas, USA, who is a director of the American Bankruptcy Institute and has taught US bankruptcy law at Southern Methodist University in Dallas.

Operating Principles

IPBI believes that the key to a successful resolution of the Indonesian corporate debt problem is the preservation of the Indonesian corporate sector as a going concern, not liquidation. Thus, there should be:

- ***A Fresh Start.*** Viable Indonesian businesses should be given every opportunity to reorganize and to recover from the unprecedented losses arising from the Asian and Indonesian financial crises and the massive depreciation of the rupiah.
- ***Comprehensive Debt Restructuring.*** The resolution of Indonesian corporate debt should be wide-ranging and encompass as large a proportion of Indonesian corporations as possible.
- ***Timeliness.*** Indonesian corporate debt restructuring and corporate reorganization should be completed as soon as possible to preserve jobs, maintain the ability to repay restructured debt and prevent erosion of asset values.

The Indonesian Bankruptcy Law

IPBI is concerned that the present insolvency system of Indonesia, embodied in the Government Regulation in Lieu of Law Number 1 of 1998 issued on April 22, 1998, is not serving the needs of creditors, employees, Indonesian businesses and the Indonesian economy.

The current system has been little used by either debtors or creditors. It does not promote reorganization of distressed business entities, and consequently does not preserve going concern value for the benefit of creditors, employees, taxing authorities and others. It is clearly not contributing to either the reform or the recovery of the Indonesian economy. In comparative terms, it lags far behind those of Thailand and South Korea, two other countries hard hit by the Asian crisis, where there have been substantial debt resolutions through the bankruptcy courts.

A functioning reorganization system must include all parties and be flexible enough to accommodate the financial restructuring of entities ranging from small individual debtors with few creditors and simple problems, to large businesses with thousands of creditors and complex corporate structures. The current Indonesian system does not include all of the parties and does not provide an appropriate degree of flexibility. Consequently, debtors do not voluntarily enter the system and creditors have become so frustrated that they now largely ignore the system.

Although the current law requires significant revision to modernize the statute and to meet the needs of contemporary Indonesia, fortunately, the fundamental framework for a modern bankruptcy and reorganization system is essentially in place. The Indonesian insolvency statute can be amended to encourage reorganization, preserve value for creditors and others and prevent unnecessary loss of employment.

This article highlights a number of areas that need amendment and offers suggestions to accomplish this objective.

Involuntary Standards

As currently written, Article 1 of the Indonesian bankruptcy law requires one petitioning creditor to prove that the debtor has at least two debts and that the debtor is failing to pay at least one debt that has matured and is payable. This standard for an involuntary bankruptcy ignores the collective nature of a bankruptcy proceeding. Bankruptcy is a collective process where the assets of the debtors are sold in a liquidation and the proceeds distributed to creditors, or where the debtor restructures its debt in a reorganization and obtains a fresh start in its business for the benefit of its creditors, employees and shareholders.

The failure of a debtor to pay a single creditor ignores this collective approach and is normally unrelated to a determination of whether or not a debtor needs to be placed in the collective process of bankruptcy. A dispute or collection action between two creditors can be resolved by the District Courts. However, if the debtor is not paying many of its creditors as the debts become due then the debtor probably needs either to reorganize or to liquidate in a bankruptcy proceeding.

Indonesian creditors have become frustrated with recent court decisions which have concluded that certain debtors could not be placed in bankruptcy. In general, the courts rendering these decisions have concluded that the petitioning creditor did not hold a claim that was due and payable, thus preventing the creditor from proving the existence of the unpaid “debt” required by Article 1. Often these cases involve a bona fide dispute between the debtor and the petitioning creditor over the existence of the debt.

The courts have concluded that the time frames for a declaration of bankruptcy by the courts set forth in the current law (see Articles 5 and 6 of the Indonesian bankruptcy law) do not permit them to resolve these disputes, and that the petitioning creditor cannot comply with Article 1 until it obtains a judgment from the District Court, or the dispute is otherwise resolved.

In one case, a contractor sued the owner for a declaration of bankruptcy even though the owner disputed the quality of the workmanship. In another case, a bank sued a borrower for bankruptcy even though the borrower contended that the bank had breached its lending commitment. Little wonder then that creditors, particularly secured creditors, have come to view the bankruptcy system as ineffective and a place to be avoided.

A debtor belongs in bankruptcy or reorganization if its creditors can collectively benefit from the process. This element is missing from Article 1. Likewise, the existence of one unpaid debt, often the subject of a dispute, does not warrant invoking the collective bankruptcy process. The collective process should only be invoked involuntarily if the debtor is generally not paying its debts as they become due. This standard for the declaration of bankruptcy could be defined.

The debtor would be deemed to meet the standard if it is not paying 20% of its due and payable debts as they become due. (There is nothing special about 20%. Perhaps 15% or 25% should be the standard.) In order to determine the extent of payment of debt, the debtor would be required to file with the court an updated list of creditors and the status of payment. If the court determines that the debtor is generally not paying its debts as they become due, then the court would issue the declaration of bankruptcy.

The standard for a declaration of bankruptcy is different from the determination of whether a creditor should be a petitioning creditor. For example, an unsecured bank group may hold large notes of the debtor, which are not yet due. Assume that the debtor is dissipating its assets, is losing money at a rapid rate and is not paying its small creditors whose claims are due and payable. Clearly, the debtor belongs in bankruptcy whether or not the debts to the banks are due and payable since it is not paying its creditors whose claims are currently due.

The smaller creditors may not have the resources or interest to become petitioning creditors. Consequently, the banks, who are owed money by the debtor and are aware of the deteriorating situation, should be eligible to be petitioning creditors even though their claims are not yet due as long as they can prove to the court that the debtor is not paying 20% of its claims that are due and payable. Of course, the debtor can then voluntarily file for suspension of payments if the debtor feels that it can successfully reorganize.

In addition, in order to minimize the possibility that the system will be utilized to settle two-party disputes rather than to liquidate or reorganize in a collective process, it is suggested that more than one creditor be required to file the petition for bankruptcy. This requirement is consistent with the collective nature of a bankruptcy proceeding since a creditor who wants to file a petition against a debtor would be required to convince one or more other creditors that bankruptcy is warranted. Other creditors should be able to join in the petition and cases should not be dismissed because of payment by the debtor of the petitioning creditors without notice to the other creditors.

Also, the periods for determining the declaration of bankruptcy should be revised to accommodate the standard discussed above.

Recommendation: Language that will accomplish these objectives would read as follows:

Article 1

(1) An involuntary case may be commenced against a debtor by three or more creditors each of which is holding a claim against the debtor that is not contingent or the subject of a bona fide dispute. The claims of the petitioning creditors must total at least Rp10 million in excess of the value of any collateral held by such creditors. Any secured creditors, which are petitioning creditors, do not waive their rights to any collateral. The debtor shall be declared bankrupt by the District Court if the debtor is generally not paying its debts as they become due. A debtor shall be generally not paying its debts as they become due if it is not paying 20% of its debts as they become due and payable. The debtor is required to file with the court a list of creditors and the status of payment of such debts. If the debtor does not provide such list within the time specified by the Court, the Court shall declare the debtor a bankrupt.

(5) An involuntary case should not be dismissed except upon notice to all creditors.

Time Limits

Another impediment to reorganization is the inflexible time limits provided by the current law. These inflexible time limits militate against the pro-active use of the bankruptcy law by debtors which should not be liquidated but are in need of reorganization and suspension of payments.

Most importantly, the current suspension of payments provisions in Article 217 require creditor approval of an extension beyond 45 days of a temporary suspension of payments provided by Article 214. In addition, there is no flexibility for the court to extend the permanent suspension of payments beyond 270 days. While 270 days may be a sufficient amount of time to reorganize a sma1l uncomplicated business, it is not unusual for a complicated business to take longer to reorganize. (The Astra International and Bakrie & Brothers reorganizations, which have taken more than 365 days to resolve, underscore the need for more time in large, complicated cases.)

Consequently, if there is no discretion for the court to extend the 270-day period, uncooperative creditors can refuse to enter into negotiations, just wait until the 270-day period expires and then foreclose or otherwise take action against the debtor. Under these circumstances, debtors will not voluntarily file for a suspension of payments and seek to reorganize because of the inherent risk of the bankruptcy proceedings.

The statute should provide that the court can extend both the 45-day period of the temporary suspension of payments and the 270-day period of the permanent suspension of payments for good cause. Large debtors with complicated debt structures may need more time to reorganize and the process is unbalanced if the secured lenders can merely wait 270-days and then foreclose and wipe out unsecured creditors, employees and shareholders.

Consider the following Example1. Assume that a business debtor, PT XYZ, voluntarily files for suspension of payments or bankruptcy under the current law and reaches agreement on a plan of reorganization with unsecured creditors. Assume further that the plan provides for payments over time (perhaps three years) to the unsecured creditors of the full amount of their claims at a market rate of interest. Also assume that PT XYZ's assets are subject to the liens of a secured bank creditor group and that because of the current Indonesian economic situation, the assets do not have a liquidation value much in excess of the secured debt to the banks. Under this scenario, even if the unsecured creditors approve the plan in the amount required by the statute, the secured banks can wait until the end of the 270-day period of the suspension of payments and foreclose upon the assets. In that event, the plan will fail and the unsecured creditors will receive little, if anything.

In addition, the temporary suspension of payments should be effective from the date of filing the petition. The statute now provides for a delay between the filing of the petition and the grant of the temporary suspension of payments by the court. The suggestion to remove the delay is to insure that creditors do not remove assets during the period between the filing of the petition and the decision of the court.

Likewise, both the 45-day period and the 270-day period should be shortened or terminated by the Court upon the request of a creditor if the court determines that cause exists for such action. If the debtor is losing money and has no realistic prospect for reorganization in a reasonable period of time, a creditor should have the opportunity to convince the court that termination of the proceeding is in order.

Recommendation: Provisions to allow this flexibility could read as follows:

> **Article 290**
> Notwithstanding any thing to the contrary contained in this statute, the Court, for sufficient cause, may extend or shorten any period set forth in this statute.
>
> **Article 56A**
> The creditor's execution right as intended in Article 56 paragraph (1) and the right of a third party to claim his assets which are under the control of the bankrupt debtor or the liquidator shall be deferred for a period of not more than 90 (ninety) days from the date of the filing of the petition for bankruptcy.

Further Issues

In the sequels to this article, we will consider the following issues: The need to include all relevant parties and the use of prepackaged reorganizations to bind dissenting creditors; set off and use of cash collateral; post bankruptcy petition financing (new money); discharge of indebtedness; retention rights of creditors; and the Courts themselves.

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Towards an Effective Indonesian Bankruptcy Law, Part 2

In Part 1 of this series, we highlighted two issues with the Indonesian bankruptcy statute which we believe should be rectified as soon as practicable in order to make it more effective as a means of resolving the Indonesian corporate debt problem.

Those issues were: (1) The need to include more parties and redefine the standard in an involuntary bankruptcy petition to make the process collective, as it affects the interests of creditors, shareholders, employees and taxing authorities alike, not just the interests of one creditor who claims not to have been paid; and (2) The need for flexible time limits in the initiation and resolution of suspensions of payments and bankruptcy proceedings. This is to provide an assurance to debtors who voluntarily petition for reorganization that they will not be involuntarily dragged into liquidation by the unwarranted inaction of uncooperative creditors.

In Part 2, we will consider the following issues: First, the advisability of including all relevant parties in the bankruptcy process to recognize the collective nature of bankruptcy and reorganization. The second is the use of prepackaged reorganizations to bind dissenting creditors and to encourage viable businesses to seek reorganization voluntarily as a pro-active means to preservation of value and debt resolution.

This article, and two other planned sequels, is derived from a report prepared by Mr. Robin E. Phelan, Esq., a bankruptcy expert with the law firm of Haynes & Boone in Dallas, Texas, USA, who is a director of the American Bankruptcy Institute and has taught US bankruptcy law at Southern Methodist University in Dallas.

Bankruptcy as a Collective Process

Under the present Indonesian bankruptcy system, a debtor can file for suspension of payments with the ultimate objective to propose a plan of reorganization to its unsecured creditors. However, because secured creditors are not bound by the plan unless they consent, and because the bargaining leverage is not balanced between the debtor and the various creditor groups, the possibility of reorganization is remote, except in the simplest of cases.

Example 1. In Part 1, we gave Example 1 to illustrate this point. In that example, assume that a business debtor, PT XYZ, voluntarily files for suspension of payments or bankruptcy under the current law and reaches agreement on a plan of reorganization with its unsecured creditors. Assume further that the plan provides for payments over time (perhaps three years) to the unsecured creditors of the full amount of their claims at a market rate of interest. Also assume that PT XYZ's assets are subject to the liens of a secured bank creditor group and that because of the current Indonesian economic situation, the assets do not have a liquidation value much in excess of the secured debt to the banks.

Under this scenario, even if the unsecured creditors approve the plan in the amount required by the statute, the secured banks can wait until the end of the 270-day period of the suspension of payments and foreclose upon the assets. In that event, the plan will fail and the unsecured creditors will receive little, if anything.

If, however, the system included secured creditors, the statute could provide for voting by class. Since the secured banks have collateral, they would be placed in a separate class from unsecured creditors, as it is inherently unfair to place a creditor with collateral in the same class as another without collateral. Negotiations would then take place between the creditor classes.

Binding Dissenting Creditors

If the plan is accepted by the unsecured creditor class, but rejected by the secured creditor class, the statute could provide that the plan could still be ratified by the court if the plan provided for full payment of the claim of the secured banks, over a reasonable period of time, at a market rate of interest. As a result, the going concern value of the debtor would be preserved, the unsecured creditors would be paid in full over time, the secured banks would receive payment in full over time with a present value equal to the amount of their claim, and employees would retain their jobs. This ***"required treatment"*** ensures that during the suspension of payments period, all parties retain bargaining leverage to negotiate the length of the payment period and the appropriate interest rate.

The inclusion of secured creditors in the reorganization process is also beneficial for many secured creditors. Assume that the bank group in Example 1 above was comprised of 10 lenders and nine out of the 10 were in favor of the debtor's plan, with one dissenting. Assume further that the participation agreement governing the bank group required unanimous consent to any restructuring. If secured creditors were allowed by the statute to vote as a class, the debtor could file a reorganization case and classify the secured banks as a separate class which would then vote in favor of the debtor's plan and bind the one dissenting member of the secured bank group.

Recommendation: Article 152 of the current law should be amended to provide that the court-approved reorganization plan is binding upon all creditors, not just concurrent creditors. The secured creditors could be obligated to vote for the plan once the suspension of payments case was commenced by contractual agreement or by a non-revocable power of attorney.

If we alter the facts of Example 1, we can see another application of this principle.

Example 2. Assume for the moment that the secured banks are owed Rp25 billion and the unsecured creditors are owed Rp30 billion. Assume further that the value of the assets is Rp15 billion and that the reorganization plan provides for payment to the unsecured creditors of Rp10 billion over five years. Under the present Indonesian insolvency statute, a secured creditor is treated as a secured creditor only to the extent of the value of his collateral and may participate in the case as an unsecured creditor to the extent of his deficiency. In this example, the secured banks would be treated as secured creditors in the amount of Rp15 billion and as unsecured creditors in the amount of their Rp10 billion deficiency. Consequently, the total unsecured claims would become Rp40 billion.

If the class of unsecured creditors approved the plan of reorganization by the required majority in number and two thirds in amount of those voting on the plan, the court could approve the plan. The court could approve this plan, even if the class of secured banks voted against the plan, provided that the plan called for the payment to the secured banks of Rp15 billion over a reasonable period of time (perhaps five years) at a market rate of interest.

The ***"required treatment"*** of the secured banks would give to the secured banks more than they would receive in a liquidation. In Example 2, they would receive a present value of Rp15 billion on their secured claim and Rp2.5 billion as their share of the payments to the unsecured creditors under the plan. The remaining unsecured creditors would receive Rp7.5 billion, much more than they would have received in a liquidation. As in Example 1, jobs would not be lost and the going concern value of the business would be preserved for the future benefit of the taxing authorities and the economy of Indonesia.

The ***"required treatment"*** principle can also be used with respect to unsecured creditors. In Example 1 if the secured banks had accepted the plan of reorganization and the plan had been rejected by the unsecured creditors, the court could still approve the plan since the unsecured creditors are receiving payment in full over time with a market rate of interest. This gives the unsecured creditors more than they would receive in a liquidation. This also allows the shareholders of the debtor to preserve their interests since all creditors are being paid in full. Of course, shareholders can participate even if the class of unsecured creditors is not paid in full if that class agrees to the plan.

Example 2 also provides the framework for balanced negotiations between the parties. Each of the parties knows that if a compromise cannot be reached upon the terms of the plan, the other parties can seek approval of the plan over their objection. As a result, terms of the plan such as the length and final amount of payout and the rate of interest can be negotiated from an equal bargaining position.

Of course, the statute should be flexible enough to accommodate more complicated situations.

Example 3. By altering the facts of Example 2, we can assume that the plan gives the unsecured creditors stock in the reorganized debtor instead of a cash payout (Note: Although it is not completely clear from the current statute, the opinion of knowledgeable Indonesian counsel is that the statute permits issuing stock for debt in a suspension of payments proceeding. Under current law, shareholder approval is required to issue stock for debt.). Again assume that the secured bank creditors vote for the plan but the plan is rejected by the unsecured creditors. In this case, the court could approve the plan since the unsecured creditors are receiving more than they would receive in a liquidation. If the court would find that the stock received by the unsecured creditors is worth Rp40 billion, the shareholders of the debtor could retain an interest in the reorganized business. Of course, other forms of payment may also be utilized. In the reorganization of an airline in another country, one class of creditors (passengers) was given airline tickets as compensation.

This balanced approach to reorganization provides a framework for legitimate negotiations between all of the parties to the proceeding. This is because each party knows that if the variables of the plan are not negotiated and agreed to by the parties, the court could determine one or more of these items in a manner contrary to the position of the dissenting party. In Example 2, if the secured banks do not agree to the plan of reorganization, the court will be required to determine if the rate of interest provided by the debtor in the plan for the secured bank claims is a market rate.

Likewise, if the debtor cannot agree with the secured banks on the rate of interest, the debtor runs the risk that the court will determine that the rate of interest provided for in the plan is below market and must be increased to a level unacceptable to the debtor. The unsecured creditors will normally support the debtor with respect to the rate of interest to be given to the secured banks. All of the parties have an incentive to settle because negotiating leverage is balanced. Consequently, if the secured banks think that the market rate is 35% and the debtor would like a rate of 25%, the parties have an incentive to compromise on 30% to avoid the expense and the risk of a court determination.

The concerns raised with respect to secured creditors also apply to creditors holding entitlements afforded by law. The Indonesian Bank Reconstruction Agency is an example of this type of creditor.

Recommendation: The Indonesian bankruptcy law could incorporate the ***"required treatment"*** concept by adding provisions which read as follows:

Article 134A

(1) A plan may designate classes of creditors and interests and except as provided in subsection (B) of this article, a plan may place a claim or interest in a particular class only if such claim or interest is substantially similar to the other claims or equity interests of such class.

(2) A plan may designate a separate class of claims consisting only of every concurrent claim that is less than or reduced to an amount that the supervisory judge approves as reasonable and necessary for administrative convenience.

(3) A plan may provide for multiple classes of similar claims or equity interests and provide for different treatment of such classes but may not unfairly discriminate regarding such treatment.*

(4) The plan shall provide for the reorganization of the debtor and the treatment of classes of claims and equity interests and may:
   (a) transfer or retain property
   (b) merge or consolidate the debtor with other entities
   (c) provide for the retention or elimination of liens
   (d) provide for the full or partial payment of existing claims in cash or property at ratification or over time
   (e) provide for the issuance of stock or other equity interests for debt

*Note: For example, one class of unsecured concurrent creditors could receive notes and another class of unsecured concurrent creditors could receive stock for their debt as long as the notes and the stock were of roughly equivalent value.

(f) assume or reject existing contracts
(g) amend the debtor's charter
(h) modify the rights of holders of claims
(i) contain other provisions consistent with this statute.

(5) The approval of shareholders shall not be required to accomplish the provisions of the plan.

Article 141

The reorganization proposal shall be accepted if approved in the creditors' meeting by more than 1/2 (one half) of the total of creditors of each class attending the meeting in person or by proxy and whose rights are admitted, or are provisionally admitted, who represent no less than 2/3 (two thirds) of the total claims of each class.

Article 149

(4) The District Court shall approve the plan if it is proposed in good faith, has been accepted by all classes of creditors and provides all creditors and holders of equity interests with property of at least as much value as they would receive in a liquidation.

(5) Even if one or more classes of creditors or equity interest holders rejects the plan, the District Court may still approve the plan if the plan provides fairly for the rights of the non-consenting class.

(6) A plan provides fairly for a class of secured creditors, or a class of creditors holding entitlements afforded by law to any person or entity, if the plan provides that the secured or entitlement creditor retains his lien securing his claim and receives payments or property over a reasonable period of time with a present value equal to the amount of the secured claim (the value of the collateral) or entitlement.

(7) A plan provides fairly for a class of unsecured concurrent creditors if the plan provides that the creditors receive payment or property over a reasonable period of time with a present value equal to the amount of their claims or that no junior class retains property under the plan.

(8) A plan provides fairly for a class of equity interest owners if the plan pays to the class of equity interest owners the amount of any fixed liquidation preference or no junior class retains property under the plan.

Further Issues

In the next two parts of this series, we will consider the following issues: The set off and use of cash collateral; post bankruptcy petition financing (new money); discharge of indebtedness; retention rights of creditors; and the Courts themselves.

Towards an Effective Indonesian Bankruptcy Law, Part 3

In Part 2 of this series, we highlighted two issues with the Indonesian bankruptcy statute which we believe should be rectified as soon as practicable in order to make it more effective as a means of resolving the Indonesian corporate debt problem.

Those issues were: (1) The need to include all relevant parties in the bankruptcy process to recognize the collective nature of bankruptcy and reorganization; and (2) The use of prepackaged reorganizations to bind dissenting creditors and to empower viable businesses to seek reorganization voluntarily as a pro-active means to debt resolution.

In Part 3, we will consider two interrelated issues: Set off and the use of cash collateral and post-bankruptcy petition financing. These affect the capability of a debtor in reorganization to continue operating as a going concern.

This article, and one final sequel, is derived from a report prepared by Mr. Robin E. Phelan, Esq., a bankruptcy expert with the law firm of Haynes & Boone in Dallas, Texas, USA, who is a director of the American Bankruptcy Institute and has taught US bankruptcy law at Southern Methodist University in Dallas.

Set Off and Use of Cash Collateral

In addition to the four impediments previously addressed in this series, another impediment to a successful voluntary reorganization under the present Indonesian bankruptcy statute is the allowance of setoff by parties at the beginning of the suspension of payments proceeding. Although the decision for suspension of payments automatically suspends efforts by creditors to bring suit against the debtor and foreclose upon its property, it does not prohibit a set off of bank accounts by the bank lenders of the debtor.

Consequently, unless the bank lenders agree to the continuation of the debtor's operations and the debtor's use of the cash collateral represented by the debtor's bank accounts for working capital, the debtor cannot operate in the suspension of payments proceeding because it does not have any working capital. The reorganization is, therefore, doomed from the start.

The Indonesian bankruptcy statute should be amended to provide that the debtor can use the cash collateral in its bank accounts at the secured bank lenders if the debtor provides the lenders with reasonable protection. This could be accomplished by giving the lenders a lien on unencumbered assets or by establishing to the satisfaction of the court that the value of the lenders' collateral is sufficiently greater than the amount of the lenders' claims such that the lenders are not placed at unreasonable risk of loss.

Reasonable projections by the debtor should show that the use of the cash collateral to meet the payroll, buy inventory and otherwise continue its operations will generate receivables that can be collected to replace the cash collateral used as working capital during the suspension of payments proceeding.

As a practical matter, the lenders and the debtor will negotiate an agreed order for the use of the cash collateral providing the bank lenders with reasonable protection. Typically, orders in other countries provide for the continuation of the liens of the banks and the right of the banks to approve the debtor's budgets during the suspension of payments proceeding. At any time, the banks may ask the court to terminate the right of the debtor to use the cash collateral and to allow the banks to set off the accounts.

Example 4. To illustrate, assume the debtor owes the secured banks Rp10 billion and the secured banks have liens on property of the debtor with a value of Rp15 billion including cash in bank accounts at the secured banks of Rp1 billion. Assume further that the debtor's reasonable projections show that if allowed to continue to operate its business, the debtor will generate operating profits and positive cash flow during the suspension of payments proceeding. The debtor should be allowed to use the cash in the bank accounts to continue its operations because the secured banks are reasonably protected. Even if the debtor's projections are incorrect and its operations do not produce profits and positive cash flow, the secured banks will have enough collateral remaining to fully satisfy their claims against the debtor. Of course, the secured banks should closely monitor the operations of the debtor and if the debtor is incurring significant losses, the banks should no longer approve the budgets and promptly ask the court to allow them to foreclose upon the collateral.

Recommendation: The Indonesian bankruptcy statute could clarify the ***"reasonable protection"*** concept by amending Article56A to read as follows:

Article 56A

(2) The stay intended in paragraph (1) shall apply to rights of creditors which are secured by cash and the rights of creditors to reconcile debts and any right of set off.

(5) Creditors or third parties whose rights are deferred may file a petition to the liquidator to remove such stay or alter the condition of such stay. The stay must be removed if the debtor has no equity in the collateral (i.e., the collateral is worth less than the amount owed to the secured creditor) and the collateral is not necessary for the reorganization of the debtor and may be removed for good cause. Good cause will include the lack of reasonable protection of the creditor or third party seeking the removal.

Post Petition Financing

Another problem which must be addressed in the context of a reorganization – whether voluntary or not -- is the issue of post petition financing. Although the current law provides for borrowing by debtors during the suspension of payments proceeding, it does not contemplate the situation where the debtor needs to alter the lien of the existing secured creditors.

Example 5. To illustrate, assume that the debtor is a developer who has built an office building that is substantially complete but lacks only a sprinkler system to receive a certificate of occupancy. Assume further that the secured banks holding a lien on the building are owed Rp45 billion. If the sprinkler system is installed, the building will be worth Rp55 billion because a tenant has already committed to lease the building if a certificate of occupancy can be obtained. Also assume that it will cost Rp1 billion to install the sprinkler system but that no lender will lend the Rp1 billion unless it receives a first lien on the building. Assume further that the current lender cannot lend further amounts due to the regulatory restraints of its home country regulators. They will not let the existing secured lender loan money to a bankrupt and such loan would be in violation of the loan limits of the regulatory agency.

Clearly, the statute should provide for the debtor to borrow the Rp1 billion to install the sprinkler system and allow the debtor to grant to the new lender a first lien on the building. The existing lender would then be relegated to a second lien position but the value of its collateral will be enhanced and the existing creditor would be protected because the value of its collateral would be in excess of the amount owed by the debtor to the existing creditor.

Recommendation: Language to accomplish this would read as follows:

> **Article 67**
>
> (4) The receiver or administrator may encumber property of the bankrupt estate with security rights, pledge or collateral rights on unencumbered property, or with a junior lien on property of the estate which is already encumbered. The liquidator may also encumber property at the estate with a lien which is senior to existing liens on property of the estate if the Supervising Judge determines that the receiver or administrator is not otherwise able to obtain such credit and that reasonable protection is provided to the holders of the existing liens because the value of the collateral is in excess of the amount of the debt to the existing creditor.

Further Issues

In the last part of this series, we will consider the following issues: The discharge of indebtedness; retention rights of creditors; and the Courts themselves.

Towards an Effective Indonesian Bankruptcy Law, Part 4

In Part 3 of this series, we highlighted two issues with the Indonesian bankruptcy statute which we believe should be rectified as soon as practicable in order to make it more effective as a means of resolving the Indonesian corporate debt problem.

Those issues were: (1) Set off and use of cash collateral, and (2) post-bankruptcy petition financing. These affect the capability of a debtor in reorganization to continue operating as a going concern.

In Part 4, the last part of a four-article series, we will consider the following issues: Discharge of the debtor from his debts; creditor's retention rights to goods under his possession; and the effectiveness of the Indonesian bankruptcy courts.

This series is derived from a report prepared by Mr. Robin E. Phelan, Esq., a bankruptcy expert with the law firm of Haynes & Boone in Dallas, Texas, USA, who is a director of the American Bankruptcy Institute and has taught US bankruptcy law at Southern Methodist University in Dallas.

Discharge

One issue that should be addressed by the Indonesian bankruptcy statute is the concept of discharge of the debtor.

Originally, bankruptcy was viewed as a creditor remedy. European and other bankruptcy laws did not provide a discharge for the debtor from his debts. As bankruptcy statutes evolved, they were revised to contain provisions that provided that if the debtor surrendered his non-exempt property to a receiver for sale and distribution of the proceeds to his creditors, then he would be discharged from his debts In some countries, corporations that are liquidated in a bankruptcy proceeding do not receive a discharge to prevent trafficking in "shell" corporations. Of course, some types of debts should not be discharged. For example, intentional torts and debts incurred by fraud are often not discharged.

Eventually, the discharge concept was broadened to include reorganizations. If a debtor successfully negotiates a plan of reorganization and the court approves the plan, the debtor receives a discharge. Of course, the debtor is obligated to perform the obligations set forth in the plan and is liable if he does not comply with the terms of the plan. The plan would normally provide that secured creditors would retain their liens or obtain new liens to secure the debts of the debtor to such creditors.

The current Indonesian bankruptcy statute does not contain a discharge provision for individual debtors (human persons, as opposed to a corporation or other form of business entity) in liquidation cases and it is unclear if an individual debtor is discharged in a reorganization. A clear discharge provision should be added to modernize the statute and provide debtors with an incentive to voluntarily reorganize and to cooperate with the receiver in a liquidation.

The discharge would provide the debtor with a "fresh start" and would allow debtors who are otherwise hopelessly mired in debt, in many instances as a result of the recent economic crisis in Indonesia, to resume productive lives.

Recommendation: Discharge provisions could read as follows:

Article 291

(1) Except as otherwise provided in this Article, the Supervising Judge shall grant the debtor a discharge in a liquidation case unless:

(A) The debtor is not an individual.

(B) The debtor has transferred, concealed or destroyed his property or records with intent to defraud his creditors within one year prior to filling the bankruptcy petition or after the bankruptcy.

(C) The debtor defrauds the court or refuses to obey a lawful order of the court.

(D) The debtor has failed to explain a material loss of his assets.

(E) The debtor was granted a discharge within seven years prior to the date of the declaration of bankruptcy.

(2) The discharge shall discharge the debtor from all of his debts that arose before the commencement of the case except:

(A) Debts obtained by fraud.

(B) Debts not listed by the debtor in connection with the bankruptcy proceeding.

(C) Debts for willful injury to the person or property of another.

(3) The Supervising Judge shall determine any of the objections to the discharge of the debtor prior to the closing of the case.

(4) The approval of a plan of reorganization discharges a debtor from all of its debts that arose before approval of the plan and discharges an individual debtor from all such debts except those set forth in Article 291 (2).

In addition to the normal discharge provisions, the Indonesian Parliament should consider adopting special provision to deal with the problems created by the recent economic crisis. Many Indonesian businesses that would otherwise be able to meet their obligations have been devastated by the devaluation of the rupiah and its effect upon the Indonesian economy.

Towards this end, it has been suggested that any revision of the Indonesian bankruptcy statute include a specific provision in connection with a reorganization of an indebted Indonesian business to the effect that the debtor would receive a discharge from that portion of its debts that is solely attributable to the Indonesian economic crisis, ***provided*** the debtor can establish to the satisfaction of the court that it would otherwise have been able to meet its obligations.

Retention Rights

Retention rights of creditors should be preserved in any revision of the Indonesian bankruptcy statute. As it stands, the statute is unclear with respect to the treatment of these retention rights in connection with a liquidation or reorganization proceeding.

Recommendation: In order to clarify creditors' retention rights, it is suggested that the law be amended to read as follows:

Article 59

The creditors who are entitled to retain the goods owned by the bankrupt debtor until their claims on debt are satisfied shall not lose this right to retention in relation to the bankruptcy declaration but the Supervising Judge may require such creditor to turn over such property to the debtor if the debtor provides reasonable protection to such creditor. In such event the creditor will retain his lien on such property.

The Courts

Some parties have raised the issue of whether the court should have discretion to determine the issues discussed in this series of articles. However, if judges have no discretion then a system does not need judges, it merely needs clerks to administer the law. The reorganization of a business entity cannot be reduced to a formula. Different businesses require different periods of time and different solutions to successfully reorganize. Conversely, some debtors believe that they can reorganize but should really be liquidated. Everyone will not always agree upon which entity should be reorganized and which should be liquidated, when the permanent moratorium should be extended and when it should be terminated.

However, in any insolvency regime that has a functioning reorganization system, it is up to the finder of fact to resolve disputes. The debtor can present its financial advisor and other witnesses to testify how it will reorganize and why it should be allowed the continued opportunity to do so. The opposing party (often the secured banks or the unsecured creditors committee) can present their financial advisors and other witnesses to refute the testimony presented by the debtor. The judge can then decide which testimony is credible and accurate, the law then dictates the result. This is no harder a judicial task than that undertaken by judges throughout Indonesia every day who have to hear testimony from witnesses and decide who to believe. Often these witnesses are expert witnesses testifying with regard to scientific, business or other matters.

The judges of Indonesia, as well as the judges of Italy, the United States, Thailand and other countries determine these and similar matters every day. There should be enough judges in this land of over 200 million people to sit on the Commercial Courts of Indonesia who can capably, intelligently and honestly listen to the evidence and render a reasoned decision.

Judges of the Commercial Courts should be compensated commensurately with their responsibility and in such a fashion and amount that they are not tempted or forced to compromise their positions. It is widely believed that the Commercial Court judges are under-compensated, carry out their duties under difficult physical conditions (often without appropriate support staff) and are subject to undue influence.

Fair compensation to Commercial Court judges will be a short term cost which will be repaid many times over by the successful reorganization of one or two large Indonesian business entities. The creditors paid, the taxes collected and the jobs saved by even one or two successful reorganizations will more than compensate for the costs of an appropriately compensated, honest and functioning Commercial Court.

It has been suggested that ad hoc judges be appointed during a transition period while the court system is being revised. These temporary judges would be recruited from the private sector and would handle the additional caseload, which is anticipated after the system is balanced to provide for the respective rights of all parties. The ad hoc judges should be selected for their capabilities and their integrity. Any reformation of the Indonesian bankruptcy statute is a waste of time and effort if the judiciary is subject to improper influence. Capable, ethical people must be recruited to implement the system.

It has also been suggested that the system be self-funded through filing fees and small monthly charges to estates. These charges have been used in other countries to fund bankruptcy systems. These fees and charges should be paid directly to the Indonesian treasury in order to avoid the possibility that judges will be tempted to influence the amount of the collections.

Conclusion

Although the current Indonesian bankruptcy statute requires significant revision to modernize it and to meet the needs of contemporary Indonesia, the fundamental framework for a modern bankruptcy and reorganization system is in place. The Indonesian Private Business Initiative (IPBI) stands ready to assist to the best of its ability with this project.

The IPBI is a group of over twenty Indonesian business entities who believe that the Indonesian private sector has a valid and important role to play as the Indonesian Government's partner in reforming the Indonesian economy and nurturing it expeditiously back to a healthy growth path after the debilitating financial and political crisis of the last two years. IPBI sees itself as a cooperative interlocutor with Government authorities, not as an adversary.

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