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Reform of Indonesian Bankruptcy Law

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In 2004 foreign investors were once again alarmed by the use of Indonesian bankruptcy law to force a solvent Indonesian subsidiary of a multinational financial institution into insolvency proceedings (The *Pru* case – see below). This led the Indonesian Government to introduce legislation in late 2004 to limit the possibility of such events occurring in the future.

Background to the Indonesia Bankruptcy Law

Insolvency proceedings can be started in Indonesia by court proceedings or through informal mechanisms. The Commercial Court, which was established on 21 August 1998, deals with bankruptcy petitions (before then insolvency cases were handled by the ordinary civil courts). During the 1998 banking crash, the government set up a number of informal mechanisms to facilitate negotiations between a debtor and its creditors:

- The Jakarta Initiative Task Force (JITF) whose aim is to provide corporate debt restructuring and 'workout' plans for creditors and debtors.
- Indonesian Debt Restructuring Agency (INDRA) which assists companies in resolving their debt problems by giving them fixed exchange rates to strengthen the value of IDR.
- The Indonesian Bank Restructuring Agency (IBRA) which facilitates bank and loan restructuring. The IBRA acquires the banks' non-performing loans and injects new funds to recapitalize the companies concerned.

In order to understand how the *Pru* case arose it is necessary to consider the genesis of the 1998 amendment to the bankruptcy law. It was amended at the behest of the International Monetary Fund ('IMF') as a result of the IMF's insistence that there should be suitable creditor protection as one of the conditions of its USD 4.8 billion bailout package (following the banking crash earlier that year). The result was that the bankruptcy law did not focus on a company's solvency but only on whether it had paid its debts. Indeed, pursuant to Article 1 of the Bankruptcy Law, a debtor who has two or more creditors and fails to pay at least one matured debt may be declared bankrupt by the court.

The *Pru* case

A former consultant, Lee Boon Siong, of the local arm of Prudential PLC (one of the UK's largest insurers) sought USD 40 million in damages after PT Prudential Life Assurance (Indonesia's leading investment-linked insurance company) terminated an agent recruiting and training contract with him in late 2003. The Indonesian court decided that Lee was owed USD 400 000 and in late April 2004 the Central Jakarta Commercial Court declared PT Prudential Life Assurance bankrupt. Under the applicable Indonesian law, any company with more than one unpaid debt could be declared bankrupt by a commercial judge. The effect of the judgment was, according to the Prudential's spokesperson, that it had to halt its Indonesian operations temporarily and to seek Court approval before continuing.

The Prudential appealed the bankruptcy ruling and in early June 2004 the Indonesian Supreme Court overturned the lower court's decision. One of the three Supreme Court judges who made the new ruling, Abdul Rahman Saleh, said the affair was a contractual dispute and should never have become a bankruptcy case. The judge was quoted on Reuters as saying 'This should have gone through an ordinary court, not a bankruptcy hearing'. The Supreme Court's decision was a victory for common sense given that the company was solvent (its local assets exceeded USD 400 000 many times over) and able to meet its debts as they fell due.

The *Pru* case was not a one-off. In 2002 the Indonesian arm of Canada's Manulife Financial Corp was declared bankrupt despite being solvent. The decision was subsequently overturned by the Supreme Court after protests by the Canadian Government and foreign business groups. If Indonesia had a concept of legal precedent the Prudential bankruptcy case should have been rejected at first instance. However, it follows a civil law approach and the judiciary is able to apply the law as they see fit without being bound by the previous decision of a higher court.

Such decisions of the lower courts to declare solvent companies bankrupt matter not only because of the potential loss of shareholder control of the company and the local business interruption, but also because of the potential wider implications such a decision could have upon a multinational group (e.g. a global holding company could find that the insolvency of its Indonesian subsidiary triggers events of default in its borrowing agreement leading to issues with a far greater reach than just Indonesia). More widely, as the Republic of Indonesia's UK embassy website recorded shortly after the *Pru* case, continued unpredictability of the Indonesian legal system would have an adverse effect on foreign direct investment.

At the end of 2004 the *Economist* noted that approved foreign direct investment in Indonesia fell 31.3% year-on-year in the first 11 months of 2004. Whilst, of course, other issues had an effect on such investment (such as oil prices, terrorism and 2005 budget subsidies), the need for a stable judicial system with a fair and workable insolvency regime is clearly very important to foreign investors.

New legislation

Following these cases, in September 2004 the Indonesian Parliament passed a new bankruptcy law aimed at closing this loophole and ensuring that such cases do not arise in the future.

The new law, which was first proposed in 2001, prevents creditors filing bankruptcy petitions against solvent insurance and reinsurance companies and should afford international investors better protection from the risk that their Indonesian subsidiaries and affiliates will be declared bankrupt notwithstanding their solvency. In future only the finance minister is permitted to file a bankruptcy petition in the commercial court against an insurance company or a reinsurance company or certain state owned utility companies. Similarly, the Capital Markets Supervisory Agency will take responsibility for the oversight of any petitions against securities companies. These amendments to the bankruptcy law bring the insurance and capital markets sectors in line with the regime that applies in respect of the banking industry, where only the Attorney General or the Central Bank are allowed to file a petition against a bank.

Yusril Mahendra, the justice minister, has said that the amended bankruptcy law was designed to 'give certainty for all, not just foreign investors' and 'would be effective' in preventing future cases such as those against Manulife and Prudential 'if it is well implemented'.

The amendment (known as Law 37 of 2004 on Bankruptcy and Delay of Debt Obligation) was enacted on 18 October 2004 and signed by President Megawati Soekarnoputri, and is therefore now in force.

One of the other issues which the new legislation clears up is the effect an arbitration clause has upon bankruptcy proceedings (previously it was uncertain whether, by electing to arbitrate, the parties had excluded the right to commence insolvency proceedings). It is now clear that any such arbitration agreement does not give the debtor company a defence to a properly brought bankruptcy application.

Bankruptcy mechanisms

By way of overview it is worth remembering that bankruptcy proceedings can result in:

– a moratorium or suspension of payments (as near as Indonesia has to the US's Chapter 11 or England's administration); or

– liquidation of the bankrupt debtor's estate.

A bankruptcy declaration does not mean that the debtor is insolvent (this is in contrast to the use of the term in other jurisdictions, where a state of insolvency may lead to a declaration of bankruptcy; in Indonesia, the bankruptcy declaration occurs first).

Once declared bankrupt, the debtor may propose a compromise or composition plan and, if accepted by the creditors, insolvency does not occur. That said, if no compromise or composition plan is put forward by the debtor, if the proposal is rejected, or if the supervisory judge declines to ratify the proposal then, at that time, the estate of the debtor is deemed insolvent.

Powers of the parties involved in bankruptcy

The bankruptcy law gives a number of persons certain rights and powers, including the following:

Supervisory Judge:

– supervises the management and settlement of the bankrupt estate (the Commercial Court is obliged to hear and consider the advice of the Supervisory Judge before it decides any matters related to the management and settlement of the bankrupt estate);

– has power to hear witnesses or order experts to carry out investigations in order to obtain relevant information relating to the bankrupt entity.

The Receiver:

– manages and settles the bankrupt estate;

– is empowered to obtain third party loans in order to increase the value of the bankrupt estate;

– may continue the business of a bankrupt debtor provided he has the approval of the Creditors' Committee (if any) or supervising judge and notwithstanding that an appeal to the Supreme Court

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may have been made or a judicial review filed in respect of such bankruptcy declaration.

Creditors' Committee:

- may request that the receiver allow them to inspect the books and records of the bankrupt's estate at any time.

The receiver is required to ask the Creditors' Committee for its advice before commencing proceedings or pursuing or defending a pending lawsuit unless it concerns the validity of debts of the bankrupt's estate.

Assets caught by the bankruptcy order

The bankrupt estate includes all of the assets of the debtor at the time bankruptcy is declared. This includes those assets acquired during the bankruptcy proceeding and those assets of the debtor located outside of Indonesia.

All assets (except those which are the subject of security) owned and possessed by the debtor are included as part of the bankrupt estate and are available to the receiver to satisfy the claims of unsecured creditors.

Overturning antecedent transaction

Past transactions can only be overturned if it can be proved that at the time of the transaction both the debtor and the counterparty to the transaction were aware or should have been aware that such a transaction would cause losses to the creditors. The receiver bears the burden of proving such knowledge. (Compulsory transactions, which arise from contractual obligations, or by law cannot be set aside under this provision.)

If a transaction causing loss to the creditors took place within a year of the bankruptcy declaration both the debtor and the counterparty are deemed to have known or been aware that the transaction would cause loss to the creditors, provided such transactions:

- were transactions at an undervalue;
- constitute a preference of the counterparty; or
- were between the debtor and certain specified relatives and/or affiliates.

The debtor and the counterparty can rebut this assumption but the onus of proof is upon them to do so.

Examination of the debtor

Under Article 101(1) of the Bankruptcy Law the bankrupt, once asked (e.g. summonsed), is required to appear before (a) the Supervisory Judge, (b) the Receiver, or (c) the Creditors' Committee in order to provide all and any relevant information. In the case of a corporation becoming bankrupt, a member of the Board of Directors and Commissioners will be served with the summons and will be required to provide relevant information relating to the insolvent company.

Types of creditor

The recent amendment to the law makes clear that creditors under the Bankruptcy Law fall into three categories:

- *secured creditors*
  e.g. creditors holding pledges and security rights. Secured property is not included in the bankrupt estate. Therefore, secured creditors may:
  - exercise their security within two months from the date the bankrupt estate is deemed to be insolvent, and
  - seek to claim as unsecured creditors to the extent that their debts are not fully covered by the security.
- *preferred creditors*
  under the Civil Code certain creditors are given preference over specific assets or the entire property of a debtor (e.g. certain employee wage claims and certain tax liabilities).
- *unsecured creditors*
  the proceeds of the bankruptcy, after deductions for payments for court costs, auction expenses, costs of the receiver and privileged creditors, are divided among all other creditors pari pasu (i.e. on a pro-rata basis, according to the respective amounts owing to each).

Liability of the former directors

Under the Company Law each member of the Board of Directors:

- should act in good faith and with full responsibility for the performance of his duties in the interests and for the benefit of the company (Article 85 paragraph 1);
- is personally liable if such a member either commits a breach of law or is neglectful in performing his duties (Article 85 Paragraph 2);
- is jointly and severally liable for any losses of the bankrupt company if the bankruptcy was caused by the members' wrongful act or negligence in performing their duties; therefore, the former management of the company would be liable for the bankruptcy of a company if there is evidence of such a wrongful or negligent act(s) (Article 90 Paragraph 2).

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Possible further reform required

Whilst last year's revision to the law means that the position of insurance companies, reinsurance companies and pension funds has been improved, it is still the position that other corporate vehicles remain at risk of being declared insolvent notwithstanding the fact that they are nothing of the sort.

A further revision which could be made whilst still ensuring that there is sufficient creditor protection would be to provide a mechanism whereby (a) a company is entitled to be involved in the bankruptcy decision-making process (including providing evidence of its solvency and, if appropriate, evidence disputing the debt) before the declaration/order is made and (b) the Court takes account of the company's solvency before deciding whether to make a bankruptcy order.

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