

ASIAN DEVELOPMENT BANK

**REGIONAL TECHNICAL ASSISTANCE
TA NO: 5795-REG
INSOLVENCY LAW REFORM
SUPPLEMENTARY REPORT ON
INDONESIA**

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A. Insolvency Processes

1. Please supply number and details of cases of:

- (a) **corporations whose financial affairs have been or are being handled under the relevant process, framework or agreement governing informal corporate debt restructuring the numbers should be from the date that the process, framework or agreement established to facilitate informal restructuring; details of the corporations should relate to size, industry type, debt level;**

A number of corporate debt restructurings have been arranged internally, but details of these are not available to the public. The sizes of the corporations and their debt levels vary. These corporations include banking, property, trading, manufacturing and insurance companies, among others.

- One of the main elements in the success of these settlements has been the role of the Jakarta Initiative Task Force (the "JITF"). We have obtained information from the JITF that up to September 1999 there had been approximately 350 cases involving 250 medium to large-scale companies. However, since this sort of information is not available to the public, we have no information with regard to the extent of the JITF's involvement in these restructurings and how many have actually been settled.
- The JITF supported by the International Monetary Fund and the World Bank, should help accelerate the Indonesian economic recovery by increasing employment opportunities, promoting the recovery of the banking and financial sectors and generating tax revenues for the state. JITF aims to promote the availability of interim financing to companies being restructured, as well as to assist these companies in preparing their restructuring proposals to be effectively evaluated by their creditors.
- An out-of-court commercial negotiation between a company and its creditors, on an expedited basis, is the best method to accomplish corporate and debt restructuring. The Government of Indonesia (the "GOI") should play a limited but crucial role in facilitating and encouraging this process such as by providing a fixed exchange rate determined by the Indonesian Debt Restructuring Agency ("INDRA").
- Another agency set up with regard to company reorganization, especially for commercial banks, is called the Indonesian Bank Restructuring Agency (Badan Peyehatan Perbankan Nasional, or "IBRA"). IBRA is an institution directly under the control of and responsible to the Minister of Finance of the Republic of Indonesia. IBRA was first established by Presidential Decree No. 27 of 1998 dated January 26, 1998. By the issuance of Government Regulation No. 17 of 1999 regarding IBRA dated February 27, 1999, IBRA was appointed as the special institution in charge of handling the Indonesian banking restructuring program as referred to in Law No. 10 of 1998 on the amendment to the Banking Law (Law No. 7 of 1992).

IBRA has the following tasks in executing the Indonesian banking restructuring program:

- (a) restructuring banks stipulated and turned over by Bank Indonesia ("BI");
- (b) settling the assets of banks, both physical assets and the liabilities of debtors, through an Assets Management Unit ("AMU"); and

- (c) striving to obtain the repayment of state money already channeled out to banks through the settlement of Assets in Restructuring or Assets Management Investment ("AMI").
- (b) corporations placed in formal liquidation under the relevant insolvency law [numbers and details should be from January 1999];**

Before answering this question, we feel it would be useful to first have an understanding of bankruptcy proceedings through the Indonesian Commercial Court. A debtor having two or more creditors and failing to pay at least one matured debt can be declared bankrupt by a court decision instituted by either the debtor or a creditor.

Under the Bankruptcy Law, the bankruptcy declaration does not mean the debtor is insolvent. (This may be in contrast to the use of those terms in other jurisdictions, where a state of insolvency may lead to a declaration of bankruptcy. In Indonesia, the bankruptcy declaration occurs first.)

Once the debtor is declared bankrupt, the debtor may propose a reconciliation plan. If the creditors accept the plan, then the insolvency does not occur. However, if at the creditors' meeting on the verification of claims no reconciliation plan is offered, or if the offered reconciliation plan is rejected, or if the ratification of the reconciliation plan is rejected by the supervisory judge, then the bankrupt estate of the debtor is deemed insolvent by law.

In the event the Court accepts the bankruptcy petition, the loan repayment will be undertaken by a receiver under the supervision of a Supervisory Judge.

Within the settlement process, it is possible that the corporate debtor is restructured and reorganized by the receiver in order to maximize and increase, if possible, the value of bankrupt assets. Following the settlement of the loan repayment with bankrupt assets, the insolvent corporate debtor can be liquidated or stay dormant but remain in existence as a legal entity.

A cassation appeal may be filed with the Supreme Court as a challenge to the decision on a bankruptcy petition made at the Commercial Court level. This cassation appeal shall be filed within 8 days from the date of the decision of which the appeal is filed, and shall be heard and decided within 30 days from the date of registration of appeal at the Court.

A review petition may be filed with the Supreme Court in respect of decisions of the Commercial Court that have already become final. This is a final legal action that can be taken in respect of the decision on a bankruptcy petition. A review petition may only be filed if (i) there is important new written evidence which, if it had been known at the previous session of the Commercial Court, would have resulted in a different decision; or if (ii) the Commercial Court committed a serious error in the application of the law in rendering the judgement.

As of the end of September 1999, 62 bankruptcy cases had been filed with the Indonesian Commercial Court in Jakarta as of January 1999. To date, 57 decisions and rulings have been rendered. There have been 13 bankruptcy decisions and 26 rejected petitions, 6 decisions to suspend debt payments (PKPU) and 12 bankruptcy petitions withdrawn by the Petitioners, while 5 petitions are still pending a decision of the Commercial Court. Out of the 57 decisions and rulings, 26 cases have been filed with the Supreme Court for cassation appeals and 20 for review petitions.

Again, the sizes of the corporations involved and their debt levels vary. There is no specific minimum amount of debt for which a corporation can be subject to a petition for

bankruptcy. However, the levels of debt vary from Rp.90 million (around USD 14,000) to hundreds of millions of USD.

Pursuant to the above data, there should have been 13 corporate debtors placed into formal liquidation under Law No. 4 of 1998 regarding the Government Regulation In Lieu of Law No. 1 of 1998 on The Amendment of the Law concerning Bankruptcy dated September 9, 1998, (the "Bankruptcy Law"). However, based on information obtained from the receivers' association, none of these companies have been liquidated as the settlement of debt payments has not been completed.

None of the companies declared bankrupt since the enforcement of the Bankruptcy Law has completed its liquidation process, due to the limited time-span for completion of the verification of debts and the settlement of bankruptcy assets. Due to the complexity of the settlement of assets and liabilities of the bankrupt company, in practice, a liquidation process could take a number of years. Once the debts of creditors of such bankrupt companies have been verified and the settlement of assets and liabilities is in process, the appointed receiver will prepare quarterly reports on the completion of the liquidation process of the bankrupt company. These reports will be held by the Clerk of the Commercial Court and such information should be available to the public.

(c) corporations whose financial affairs have been or are being handled under the relevant insolvency law governing reorganization [numbers and details as in (b)].

As noted above, out of the 57 bankruptcy decisions from January to September 1999, there have been 6 decisions to suspend debt payments and 12 bankruptcy petitions withdrawn by the Petitioners. Suspensions of debt payments are conducted under the supervision of a judge of the Commercial Court and an independent administrator, while withdrawals of bankruptcy petitions are usually followed by a debt restructuring in an out-of-court settlement. Unfortunately, as noted above, the details of these debts restructuring arrangements are not available to the public. However, once the debt restructuring has been settled, the appointed administrator of the corporate debtor will submit quarterly reports to the Supervisory Judge on the settlement process with the creditors. As with the receivers' reports, the administrators' reports will be held by the Clerk of the Commercial Court and such information should also be available to the public.

2. Provide details and copies of any published comments, articles, opinions or statements describing how the above processes are working and the level of success or otherwise.

Please see Exhibit I.

B. Insolvency Reforms

1. Provide details of any reforms that have occurred in relation to insolvency law and practice and related areas (such as corporate governance, secured transactions and so forth) since January 1999.

Since January 1999, a large number of regulations have been issued by the GOI. Some of the regulations issued, which relate to insolvency law reform, corporate governance and secured transaction follow:

1. Government Regulation No. 64 of 1999 regarding the Amendment of Government Regulation No. 24 of 1998 on Annual Corporate Financial

Reports dated July 9, 1999, containing elements of legal certainty, transparency and access to financial information. This regulation requires most types of companies to submit their annual financial reports to the Department of Industry and Trade. Please see our answer to C.1 below for a more detailed explanation.

2. The new central bank law, Law No. 23 of 1999 on BI was issued on May 17, 1999 ("Law No. 23"). It replaces and revokes Law No. 13 of 1968 regarding the Central Bank. This law provides that BI is the Government's treasurer and an independent state institution free from government intervention whose key functions are (i) to determine and implement monetary policy, (ii) to regulate and maintain an efficient payment system and (iii) to regulate and supervise banks.

Law No. 23 is intended to guarantee the independence of BI, bearing in mind that the weaknesses of BI were partly due to its subordination to the GOI and its vaguely stated purposes. Law No. 23 is expected to become the legal basis for the central bank to effectively undertake its responsibilities by focusing on a single objective and operating without any interference from the Indonesian government or other parties.

3. Government Regulation No. 17 of 1999 regarding IBRA dated February 27, 1999. IBRA was appointed as the special institution in charge of handling the Indonesian banking restructuring program as referred to in Law No. 10 of 1998 on the amendment to the Banking Law (Law No. 7 of 1992).
4. The new Fiduciary Transfer Law, regarding Fiduciary Transfers and Their Registration, Law No. 42 of 1999 (September 30, 1999) (the "Fiduciary Law"). This is the first time that fiducia has been enacted into law as previously fiducia was not codified in any Indonesian Statutory Law. It has, however, come into use as a "Common Law" security device due to the commercial necessity for a financing device which requires the physical transfer of the secured assets.
5. Under the Fiduciary Law the fiduciary rights must be registered at the Fiduciary Registration Office. The fiduciary rights holder has priority over the assets being secured under the fiducia.

Another form of legal reform that has occurred in relation to insolvency law and practice and related areas is the appointment of a number of ad hoc judges by the Supreme Court to assist the Commercial Court judges in ruling on bankruptcy cases. However, to date, there has been no precedence where ad hoc judges were involved in the proceedings and trial of bankruptcy cases.

2. Provide details of any proposed reforms as above.

In May 1998 the Department of Justice formed a Law Reform Team whose duty is to advise the Minister of Justice on legal policy, covering three elements: legal structure, legal substance and legal culture.

Legal structure reform is the restructuring of legal institutions which are no longer relevant and the establishment of new legal institutions such as the Commercial Court, IBRA and the Investigation Committee on Business Competition and Anti-Monopoly Law.

Legal substance reform is the restructuring of legal materials which are no longer relevant to legal developments in society, for example, proposed revisions to the Indonesian Civil Code (the "ICC") and the Indonesian Criminal Code.

Legal culture reform is legal education through several programs to disseminate information to the public, for example, training of Commercial Court Judges by international organizations and registration of Fiduciary Transfer Rights at the Department of Justice.

C. Corporations

1. **Identify and detail the areas in which it is considered that relevant accounting practice or regulation is weak and could be strengthened for example, accounting and financial information; projections of income/expenditure; valuation of assets; debtor and creditor control.**

Under the Indonesian Company Law, Law No. 1 of 1995 regarding Limited Liability Companies (the "Company Law") the Board of Directors of a limited liability company has to prepare an annual report to be approved by the General Meeting of Shareholders of the company. The annual report should be prepared pursuant to the prevailing Financial Accounting Standards and signed by the Board of Directors as well as the Board of Commissioners; if otherwise, the Board of Directors must provide the reasons therefor. The annual report contains, among others, the annual calculation of the prior and current years' balance sheets, profits and losses during the said financial year, consolidated balance sheets of the companies in the same group, and a report on the results achieved by the company.

The Company Law does not stipulate whether the annual report should include projected income.

The Company Law also requires companies to register with the Department of Industry and Trade pursuant to Law No. 3 of 1982 regarding Compulsory Company Registration, dated February 1, 1982 ("Law No. 3 of 1982"). Failure to register a company not only results in several or joint personal liability for the members of the Board of Directors for any legal action the company takes, but also may lead to imprisonment or a penalty of Rp.3 million for any of such members.

The Government has also enacted Government Regulation No. 64 of 1999 regarding the Amendment of Government Regulation No. 24 of 1998 regarding Annual Corporate Financial Reports ("GR No. 24 of 1998"), dated July 9, 1999 ("GR No. 64 of 1999"). GR No. 64 of 1999 amends Article 3 of GR No. 24 of 1998, which stipulates that the annual report shall contain a balance sheet, profit and loss report, a report on equity and any changes thereto, a cash flow report and a financial report, including any debts and share participation in other companies.

GR No. 64 of 1999 requires only the following types of company to provide annual reports audited by a public accountant: (i) a publicly listed company; (ii) a company which mobilizes private funds; (iii) a company issuing debentures; (iv) a company having total assets or property of at least Rp.50 billion; (v) a company that is a debtor of a bank which has requested an audited financial report of said company; (vi) a foreign company domiciled and operating its business in Indonesia under the prevailing laws, including any of its branch offices, supporting offices, subsidiaries, or representatives that have the capacity to enter into an agreement; (vii) certain state-owned companies and regional state-owned companies.

Basically, GR No. 24 of 1998 and GR No. 64 of 1999 require companies to submit an annual report if such companies meet the following qualifications: (i) if they constitute a business form; (ii) if they conduct periodic or continuous activities; (iii) if they obtain profits; and (iv) if they are operated by an individual or a business entity, whether or not a legal entity, established and domiciled under Indonesian law.

Failure to provide an annual report will lead to the criminal sanctions stipulated in Law No. 3 of 1982. Law No. 3 of 1982 provides that any party failing to perform its obligation to register a company pursuant to Law No. 3 of 1982 and/or its implementing regulations will be subject to criminal sanctions. It imposes a maximum imprisonment of two months or a penalty of up to Rp.1.5 million on any company failing to provide information required to be reported.¹

We are aware that in practice not all companies have complied with these requirements. It was recently reported that only six percent of companies have so far submitted their annual reports to the Department of Industry and Trade.²

The registration of a financial record of a company may create healthy business behavior since, to a certain degree, this provides corporate disclosure and an opportunity for the public and business community to access financial information on existing companies. By the same token however, GR No. 24 of 1998 also creates potential problems by exempting those companies that do not qualify under GR No. 24 of 1998, as revised by GR No. 64 of 1999, from the obligation to submit their annual reports. The Company Law requires all established companies to register under Law No. 3 of 1982. Such registration does not, however, include an obligation to submit the annual report. Thus, referring only to such registration may create misleading information for the public, which is far from the main purpose of the registration, particularly for a creditor seeking financial information of the company.

So far only public companies are legally required to disclose not only financial information to the public but also any meeting of shareholders and any other material information, resulting in transparency, making the Board members accountable and making the shareholders responsible to the public at large.

More importantly, we do not have an integrated information system on company registrations. As all company registrations are performed manually, this naturally leads to inaccuracy in the company data.

2. Identify and detail areas of weakness in corporate governance by reference to such factors as director's duties and their performance; financial management and responsibility; the interests of shareholders and creditors. If possible, provide specific examples of cases in which examples of such weakness have been found to exist.

The Company Law provides several articles stipulating the duties and responsibilities of the Board of Directors. Pursuant to Article 82 of the Company Law, the primary duty of the Board of Directors is the management of the company. In performing their management duties, Directors are jointly and severally empowered to represent the company in its external relations, including before the court, unless specifically restricted by the company's articles of association or in the event of a conflict of interest.

¹ Article 34 of Law No. 3 of 1982.

² Bisnis Indonesia, June 21, 1999.

Furthermore, the Company Law provides that a third party has a statutory right of action (i) if the third party is a creditor of the company, against a Director whose negligence or mistake caused the bankruptcy of the company, where the company's assets are inadequate to provide relief to such creditor, and (ii) against Directors for any company commitments made during the interim period between the Minister of Justice's approval of the company's articles of association and the date the company's deed of establishment containing such articles is announced in the Indonesian State Gazette.

Although the Company Law and other related laws provide several articles on the duties and responsibilities of the Board of Directors, it does not stipulate any legal sanctions or legal penalties for misconduct by members of the Board of Directors. Nor does the Company Law provide any provisions on the standard due care of members of the Board of Directors other than as stipulated in Article 85 paragraph 1.

The existence of an independent supervisory board to control corporate practice in Indonesia should help to develop the application of corporate governance. Although some economists remain skeptical, the independent supervisory board should at least provide a standard of care for the performance of the duties and responsibilities of the shareholders and the Board of Directors of a company, including their business practices. The independent supervisory board may act as an alternative means of law enforcement on business practices, thus filling the gaps between written laws and business practice.

Please also see our discussions in Section G.1 (f and g) below.

3. Identify and detail areas of concern regarding political, government or commercial links with corporations, by reference to such factors as "cronyism", "patronage" and corruption.

By its enactment of Law No. 28 of 1999 regarding the Implementation of Clean Governance Free of Corruption, Collusion, and Nepotism dated May 19, 1999 ("Law No. 28 of 1999"), the GOI assumes a commercial link between business entities and incumbent high-ranking government officials. Law No. 28 of 1999 applies not only to government officials, but also to their relationships with other parties.

In addition to Law No. 28 of 1999, the GOI has also passed Law No. 31 of 1999 regarding the Eradication of Corrupt Practices, dated August 16, 1999 ("Law No. 31 of 1999"), which amended Law No. 3 of 1971 regarding the Suppression of Criminally Corrupt Acts dated March 29, 1971. Law No. 31 of 1999 not only implements several Articles of the Indonesian Criminal Code, but also clarifies further on the applicability of criminal sanctions to corrupt practices by government officials and other involved parties, and stipulates more severe penalties and criminal sanctions than those found under Law No. 3 of 1971.

Law No. 31 of 1999 also invites community participation in the prevention, identification and eradication of corrupt practices amongst governments officials by granting several rights, among others, legal protection for those who provide information on corrupt practices.

Theoretically, Law No. 28 of 1999 and Law No. 31 of 1999 should be applicable to any misconduct in business practices, including banking practices. On examining the current case involving Bank Bali, we note the involvement of a number of high-ranking government officials. However, no clear explanation has so far been given to the public.

Corrupt practices in Indonesia can be identified in almost all areas where the Government is involved. Specific examples of cases in which weaknesses exist concern government projects. There is an indication of corrupt practices involving the state owned

electricity company (PLN). The current PLN chairman has collected evidence on corrupt practices to secure power purchase contracts from PLN. Although he has claimed that he will complete the investigation on corrupt practices in PLN, he has not given any time frame for this.

We note that rather than completing the investigations and bringing the KKN cases to court, many high ranking officials prefer to rely on rhetoric in their 'battle' against KKN practices.

In practice, the investigation of KKN faces several hurdles, such as the difficulty in collecting sufficient evidence to bring a case to court. Most incumbent government officials have not made proper investigations since they themselves often have political links with the case being investigated. Until an independent organization handles these cases, we believe that cases of KKN will not be easily resolved.

4. Identify and detail areas of concern regarding the size and power of corporations, corporate groups or conglomerates.

Law No. 5 of 1999 regarding the Prohibition of Monopoly Practices and Unfair Business Competition was enacted on March 5, 1999 ("Law No. 5 of 1999"). This new law classifies certain kinds of business arrangements as monopoly practices or unfair business competition. Law No. 5 of 1999 is intended to encourage equal opportunities for all business community members to participate in the production process and in the marketing of goods and services. Besides implementing the GOI's commitments to the international community, the enactment of Law No. 5 of 1999 is meant to encourage the development of fair, effective and efficient markets without centralization of economic power in one (or two) business actor(s).

Alleged violations of Law No. 5 of 1999 are first investigated by the Business Competition Supervisory Commission (the "BCSC") and then decided upon by the BCSC in its capacity as an administrative tribunal. BCSC decisions may be appealed to the District and Supreme Courts.

In order to prevent monopoly practices and unfair competition, Law No. 5 of 1999 generally regulates three key areas:

- (a) Prohibited agreements. These are agreements entered into between business actors which take the form of oligopoly, price fixing, price discrimination and discounts, stipulation of a distribution area, boycott, cartel, trust, oligopsony, vertical integration, a closed agreement, or an agreement with foreign parties causing monopolistic practices and/or unfair business activities.
- (b) Prohibited activities. These activities include activities of business actors constituting monopoly, monopsony, controlling the market, dumping, cost manipulation, and/or conspiracies with other parties.
- (c) Abuse of dominant position when one business actor controls 50% or more of the market share of a certain good or service. If a party controls 50% or more of the relevant market, such party will be deemed to hold a dominant position in the relevant market.

Law No. 5 of 1999 describes four ways of abusing a dominant position, which may occur through (i) general trade; (ii) common management personnel; (iii) share ownership; and (iv) mergers, acquisitions and consolidations. However, holding such a dominant position is not objectionable so long as the business does not take advantage of its dominant position by hampering other potential business actors from entering the relevant market.

Rather than stipulate on conglomerates in Indonesia, the GOI has enacted Law No. 9 of 1995 regarding Small Scale Business Enterprises dated December 25, 1995 ("Law No. 9 of 1995"). The main purpose of the enactment of Law No. 9 of 1995 is to implement national development so as to create more even-handed and healthy business practices by maintaining the existence of small scale business enterprises in the business community. Law No. 9 of 1995 provides that a small scale business enterprise is any company (i) having maximum net assets of not more than Rp.200 million, excluding land and buildings; (ii) having annual revenue of not more than Rp.1 billion; (iii) owned by Indonesian nationals; (iv) being an independent entity which is not a subsidiary, branch, or affiliate, either directly or indirectly, of a medium or large scale business enterprise; and (v) in the form of an individual business entity, a legal entity, cooperative or others.

The GOI also provides certain financing schemes for these small scale enterprises through loans from banks and non-banking finance institutions, venture capital, reserved funds of state owned companies, grants and so on. The GOI has also issued Presidential Decree No. 99 regarding Lines/Types Of Business Reserved For Small-Scale Businesses And Lines/Types of Business Open To Medium-Scale Or Large-Scale Businesses Under Partnership Requirements, dated July 14, 1998 ("PD 99"). PD 99 essentially implements Law No. 9 of 1995 by requiring medium and large scale business enterprises in certain sectors to enter into partnerships with small scale business enterprises.

Ideally, the enactment of Law No. 9 of 1995 and PD 99 should together create a balanced market share between small scale and medium or large-scale business enterprises. In practice, however, the GOI has no means to control the law enforcement of either regulation. As a result, this effort to protect small-scale enterprises may not be very effective in practice.

5. Is it practical and might it be of benefit to introduce legal guidelines on director duties and responsibilities and provide sanctions or penalties for breach or non-observance of such duties? If so, outline the areas to be covered and the nature of any sanctions.

Yes, legal guidelines on the duties and responsibilities of company directors would be very helpful for the enforcement of the Company Law. Legal guidelines are actually also needed for company shareholders and commissioners.

The guidelines on the duties and responsibilities of the company's organs should not only contain provisions on the performance of the directors, shareholders, and commissioners of a company, but also provide legal sanctions for any breach thereof.

Enforcement would be more effective with an independent supervisory board responsible for examining and evaluating company documents relating to any apparent breach. This supervisory board would need to be under the auspices of the Department of Justice and should be authorized to issue recommendations to courts of justice for any breach of duty or responsibility causing substantial damage to third parties.

Perhaps these guidelines for the company organs should take the form of regulations that implement the Company Law in order to have legal power to enforce compliance. More importantly, the judiciary systems should prioritize the enforcement of compliance.

6. Would directors of corporations benefit from education and training on such areas such as financial management and responsibility, negotiations of a financial restructuring, informal work out techniques? If so, detail the areas and the type of program.

Yes. An education program would certainly be beneficial, since it would help company officers to carry out their duties and responsibilities. To date, the Company Law provides no standard of performance for the officers of a company. Banking regulations provide the criteria for membership of the Board of Directors and Board of Commissioners of a bank, whereby such persons must pass the "fit and proper test" conducted by the Central Bank. We would expect the issuance of guidelines for standard performance of these duties to greatly reduce cases of misconduct within the organs of a company.

D. Banks/ Finance Providers

1. Identify and detail the areas in which it is considered that the lending practices of domestic banks are weak and might be improved or strengthened.

Under the Decision Letter of the Board of Directors of BI No. 27/162/KEP/DIR on the Obligation of Commercial Banks to Formulate and Implement Bank Credit Policies, dated March 31, 1995 ("Decision 27/162") jo. Decision Letter of the Board of Directors of BI No. 31/147/KEP/DIR on the Quality of Productive Assets, dated November 12, 1998, commercial banks are obligated to determine their credit policies in writing. These credit policies should regulate at least the following fundamental matters: (i) the principle of prudence in credit affairs; (ii) the organization and management of credit affairs; (iii) credit approval policies; (iv) the documentation and administration of credits; and (v) the settlement of credit problems.

However, in practice, only a few banks have complied with Decision 27/162. Such lack of compliance has caused the large percentage of non-performing loans in commercial banks, as indicated in the table below.

Non Performing Loans – Indonesian Banks³			
As of December 1998			
Type of Bank	Credit Amount (Rp Trillion)	Non Performing Loans	
		(Rp Trillion)	(%)
National	545	316.1	58
State-Owned	280	145.6	52
Foreign Exchange Private Bank	180	129.6	72
Non Foreign Exchange, Private	7	2.59	37

Source: Bank Indonesia; reprocessed by the Research Bureau

A bank will be categorized as a bank with non-performing loans when the size of the non-performing loans is more than 7.5% of its total loans.

In this case, Decision 27/162 can be used as the basis for indicating the weaknesses in the lending practices of domestic banks, as follows:

³ InfoBank, Indonesian monthly magazine on banking, March No. 235/1999.

- **Principle of Prudence in Credit Affairs**

There are Basic Provisions on Credit Extension which regulate not only the legal lending limit as stipulated by the banking regulations but also credit requirements (interest, credit forms, installments and collateral, which are stipulated further in the loan agreements).

In lending practice, the provisions on the legal lending limit have been violated, as have the credit requirements. In some cases, loans have been granted at a very low rate of interest and have even been extended without any collateral (see our answer to D.2 below). Such activities obviously damage the banking business.

In the case of private banks, these are usually used by their owners to obtain public funds to finance their business. In the case of state-owned banks, most loans have been channeled to certain groups of businesses.

It is common knowledge that the lending practice of domestic banks in Indonesia, particularly of state-owned banks, incorporates a recommendation letter issued by a high-ranking government official to force the banks to channel their funds to specified debtors. This form of abuse of power puts the debtors in a stronger position than the banks. The debtor only provides the bank with minimum security, such as a personal guaranty or a corporate guarantee, which would be impossible to enforce considering the position of the debtor. Furthermore, feasibility studies for project finance transactions have not been seriously assessed and, consequently, when debtors cannot repay their loans, these projects cannot be sold.

We note that pursuant to Article 8 of Law No. 10 of 1998 Regarding The Amendment of Law No. 7 of 1992 On Banking, dated November 10, 1998 (the "Banking Law"), banks are not obliged to ask for procedure collateral i.e. collateral in the form of goods not directly connected with the object which are finance. However, before channeling the credit, banks must conduct a thorough evaluation of the character, capacity, collateral and business prospects of the debtors. Since collateral is one element of credit channeling, in the event debtors are believed capable of repaying their liabilities, the collateral may only take the form of goods, projects and rights for receivables financed by the relevant credits.

In conclusion, the principle of prudence is not being implemented in lending practice. This is a crucial problem that will prevent any banking system from working properly.

- **The Organization and Management of Credit Affairs**

The bank credit policy should also include the organization and management of credit, the bank's authorities and responsibility in the credit activity, consisting of the Committee on Credit Policies, the Credit Committee, the Board of Commissioners, the Board of Directors, and the Credit Task Force. The function of these committees is in brief to assure the implementation of bank credit policies and the principle of prudence.

In practice, these committees or management bodies do not carry out their duties properly, since they can approve loans which are not in compliance with bank credit policies and the banking regulations. For example, in its December, 1998 announcement, the Indonesian Economic and Finance Resilience Council (DPKEK) noted a number of violations in the banking sector, among others, the extension of credit for prohibited activities such as the purchase of shares⁴ or the purchase of land for property projects⁵ or becoming commercial paper issue underwriters⁶, all of which are prohibited by BI.

⁴ Pursuant to Article 2(1) of the Decision Letter of the Board of Directors of BI Number No. 23/70/KEP/DIR regarding Restrictions on Credit Extension to Purchase Shares and Share Ownership by Banks, dated

- **Credit Approval Policies**

In the bank credit policy, every credit approval should be based on a strong and accurate credit analysis in accordance with the relevant business activities. However, the marking-up of the value of assets or projects' is rampant in the banking business. This is one factor which causes the collapse of banks, when they are not able to recover losses from the debtor's assets. Currently, credit analyses are not being carried out properly and accurately. Many business groups have used this method to obtain huge funds from their banks.

In addition, there is none of the specialization among banking officers, needed to deal with the particular businesses of prospective customers. A company engaging in oil and gas mining is of course different from a distribution company. Without an understanding of the particular business, it is impossible to appraise a credit proposal or the assets secured. There will therefore be an opportunity for the prospective debtor to mark up its assets without the bank officer being aware. As a result, bank officers are unable to provide accurate credit approval recommendations.

- **The Documentation and Administration of Credits**

Banks should determine classifications of credit documentation, the procedure to examine the validity of documents, and the credit administration procedure to be used for reporting to the Central Bank. A crucial problem concerning credit documentation is that bankers/owners of banks who obtain funds from their own banks for their own use do not usually use complete or valid credit documentation.

- **Monitoring and Supervision of Credit**

The monitoring and supervision of credit should also include internal audits on all aspect of credit by an audit working unit. This is regulated in the Decision of the Board of Directors of BI No. 27/163/KEP/DIR Regarding the Obligation of Commercial Banks to Apply Standards for Implementing their Bank Internal Audit (Function), dated March 31, 1995 ("Decision 27/163"). Decision 27/163 requires commercial banks to implement their internal audits according to the standards for internal bank audits found in the supplement to Decision 27/163. Under the bank internal audit standards, commercial banks must formulate internal audit charters, set up audit councils, form internal audit working units, and draw up internal audit manuals.

Many banks have failed to conduct internal audits as required by Decision 27/163. In the framework of the bank recapitalization program, BI required all commercial banks to be audited by an independent foreign auditor. The result of this audit of 208 banks as of December 1998 indicated that the CAR (Capital Adequacy Ratio) of approximately 100 banks was below 4% of which approximately 40 banks has CAR below -25%. While, according to the Bank for International Settlement (BIS), the minimum CAR for a bank to be able to operate effectively is 8%. Clearly banks were used to issuing inaccurate financial reports and had never carried out proper internal audits.

February 28, 1991, banks are prohibited to extend credit to purchase shares or to provide working capital in the framework of the sale and purchase of shares.

⁵ Pursuant to Article 2 of the Decision Letter of the Board of Directors of BI No. 30/46/KEP/DIR regarding Restrictions on Credit Extension by Commercial Banks to Finance Procurement and/or Cultivation of Land, dated July 7, 1997, banks are prohibited to extend credit to developers, directly or indirectly, or to purchase/secure Commercial Paper from developers to finance the procurement and/or cultivation of lands.

⁶ Pursuant to Article 10(2) of the Decision Letter of Board of Directors of BI No. 28/52/KEP/DIR on Requirements for the Issuance and Trading of Commercial Paper Through Commercial Banks in Indonesia, dated August 11, 1995, banks are prohibited to become commercial paper issue underwriters.

- **Settlement of Credit Problem**

Banks should have a rational procedure for settling the credit problems by first categorizing the collectible loan⁷. However, in order to deliver pleasing financial reports, many banks do not disclose problems with non-performing loans. Such banks prefer to use plafondering methods to settle their problems, with the bank extending another loan to the debtor for the payment of his previous debts. Under the Decision Letter of the Board of Directors of BI No. 31/150/KEP/DIR Regarding Credit Restructuring dated November 12, 1998 ("Decision 31/150"), banks are prohibited to restructure credit for the purpose of avoiding (i) downgrading in the classification of the quality of credits; (ii) having to allow greater provision for productive assets depreciation or; (iii) terminating recognition of accrual interest earning.

Decision 31/150 provides a number of methods for restructuring credit. These include lowering the interest rate, reducing arrears of credit interest rate or arrears of principal, extending the period of credit, supplementing credit facilities, taking over the debtor's assets in accordance with the prevailing regulations and converting credits into provisional capital participation in debtors' companies.

The problems with the lending practices of domestic banks are essentially as follows:

- a. the "Moral Hazard" of bankers and debtors, as well as high-ranking government officials who abuse their power;
- b. there is no law enforcement for any violation of banking regulations;
- c. lack of supervision by the central bank, BI; and
- d. the technical ability of bank officers to understand their customers' business is still weak.

The above matters should be addressed and resolved first prior to addressing technical matters. To overcome the moral hazard of bankers, BI conducts a "fit and proper test", which should entail an evaluation of the competence and integrity of the controlling shareholders, as well as the competence, integrity, and independence of the Board of Directors and the Board of Commissioners in controlling the operational activities of commercial banks⁸. While BI has provided guidance and provisions on lending practice, further efforts are needed to implement these matters seriously and properly. The role of BI in enforcing the banking regulations is crucial to educate Indonesian bankers to become more professional.

There have been no court trials for violations of the banking provisions, indicative of the lack of any law enforcement in the banking sector.

2. Identify and detail areas of concern regarding the involvement of banks with corporations (for example, through equity holding, long term relationship, government association).

With the introduction of a package of banking regulations issued in 1988, many banks were established as a consequence of the minimal requirements for a bank to be established, including paid-up capital of only Rp.10 billion (these regulations were later revoked). A lot of banks were owned by holding companies of conglomerates and used to

⁷ Decision Letter of the Board of Directors of BI No. 31/147/KEP/DIR on the Quality of Productive Assets, dated November 12, 1998.

⁸ The Fit and Proper Test is regulated under Article 5 of the Joint Decree of the Minister of Finance and the Governor of BI No. 53/KMK.07/1999 and No. 31/12/KEP/GBI regarding the Realization of the Recapitalization Program for Commercial Banks, dated February 8, 1999. This test was originally intended for banks in Category B (-25% to 4% CAR), for inclusion in the Recapitalization Program, but is also needed for other banks.

support other companies within the group. They became tools in a business strategy to obtain funds from public. Consequently, almost all of such banks violated the legal lending limits. At that time, the legal lending limit for affiliate parties to the shareholders, directors, commissioners, and their families was ten percent, while the legal lending limit for companies within one group was twenty percent (the ratio between a bank's own equity and its loans to related parties). Under Law No. 10 of 1998, the legal lending limit was increased to 30% of a bank's capital.

We note that not all violations of the legal lending limit are deliberate. Some violations have been due to US Dollar exposure and the hefty exchange rate fluctuations. Aside from this foreign exchange exposure, it is clear that almost all banks that have group credit are in category C (CAR of -25% or below). Although the capital of these banks is negative, their owners have still obtained loans from them. So they must have violated the rules.

Biggest Debtors to Their Own Banks⁹ Which Have Now Been Closed Down (in Rp. Trillion)			
No.	Bank	Biggest Debtor	Size of Loan (Rp. Trillion)
1.	Modern	Danamon Group	0.6
2.	BUN	Kaharudin Ongko	3.3
3.	BDNI	Gajah Tunggal Group	16.0
4.	Hokindo	Hokindo Group	0.2
5.	Deka	Deka Group	0.2
6.	Surya	Golden Truly	1.6
7.	Centris	Centris Group	0.6
8.	Subenta	Asdina Kara Group	0.05
9.	Pelita	Pelita Group	1.2
10.	Istimarat	Istimarat Group	0.1

Source: KONTAN research

In these cases, the owners of the banks were in a position to assign their people to the management or force the management to channel funds into companies within the group. Even though the banking provisions regulate the legal lending limit and include penalties for violations, the central bank is weak at upholding the law and imposing appropriate penalties.

Some examples of violations of the legal lending limit taken from the table include Bank Surya, which has violated the legal lending limit by channeling 94% or Rp.1.6 trillion to its own group, and BDNI, which has channeled 95% to its own group. The loans extended to the Hokindo Group and the Centris Group were 8.5 and 10 times the respective equities of Bank Hokindo and Bank Centris¹⁰.

Other transactions which have harmed the banks are foreign exchange and derivative transactions. The owner of a bank usually arranges matters so that if its companies benefit from such transactions, the profit will be treated as company revenue. However, if they lose from a transaction, this loss becomes the bank's loss.

⁹ KONTAN, Indonesian weekly bulletin, No. 17, Year III, January 18, 1999.

¹⁰ KONTAN No. 17, Year III, January 18, 1999.

The most recent related case concerns Bank Bali and is popularly known as “Baligate”. The scandal arose with the transfer of Rp.546 billion from Bank Bali to PT Era Giat Prima (“PT EGP”) as a “commission” fee for its assistance in claiming Bank Bali receivables to the closed-down Bank Dagang Nasional Indonesia, which claims were taken over by IBRA. Such commission fee constituted 60% of Bank Bali’s total claims to BDNI of Rp.904 billion. PT EGP is owned by a politically well-connected businessman and the deputy treasurer of the ruling Golkar party. This scandal indicates that political aspects and relationships with prominent political figures have a great influence over the banking business.

State-owned commercial banks have the same problem as private banks since they rarely refuse any request to channel their funds to projects owned by cronies of high-ranking Indonesian officials. The state-owned banks have not been run on prudent and proper banking principles. Instead, their business has been based on political considerations.

In most cases, there has not been sufficient analysis of the feasibility of the proposed projects. Consequently, all state-owned commercial banks do not show good performance. Their CARs are all under -25%. As an example, around 46% of the bad debts in PT Bank Bumi Daya (Persero), amounting to Rp.10.3 trillion, have come from loans extended to only 20 debtors. Again, this is in violation of the legal lending limit.

NON-PERFORMING LOANS AT STATE-OWNED BANKS BY CATEGORY AND PROJECTION (In Rp Trillions)											
No.	Collectability	March 1999					December 1999				
		BNI	BRI	BTN	Bank Mandiri	Total	BNI	BRI	BTN	Bank Mandiri	Total
1	Special Attention	5.9	2.1	0.9	12.8	21.7	10.3	2.0	0.6	6.8	19.7
2	Substandard	7.2	1.9	0.8	15.2	25.1	3.2	5.8	0.4	8.9	18.3
3	Doubtful	16.4	8.6	0.3	21.3	46.6	2.1	2.7	0.1	5.5	10.4
4	Loss	0.9	2.2	0.4	2.0	5.5	0.3	2.2	0.0	3.0	5.5
	Sub Total	30.4	14.8	2.4	51.3	98.9	15.9	12.7	1.1	24.2	53.9
5	Liquid	13.8	18.6	5.9	0.4	38.7	20.9	21.1	7.1	27.4	76.5
	Total Non Performing Loans	44.2	33.4	8.3	51.7	137.6	36.8	33.8	8.2	51.6	130.4

Source: The Office of the State Ministry for the Empowerment of State Owned Enterprises

The list of the 200 largest debtors recently announced by IBRA is full of companies owned by politically well-connected businessman who have enjoyed low interest on their loans. A state owned bank might charge such debtors interest at between 1% and 30.5%, while the market interest rate at that time was 32% and above.

3. Would officers/employees of banks/finance institutions benefit from education and training on such areas as lending practices, formal insolvency practices, informal work out techniques and practices? If so, detail the areas and the type of program.

Yes. Education and training in such areas is essential for the bank officers, particularly with regard to informal work-out techniques. It is imperative to hold such training since many debtors are now facing difficulties in their cash flow, while most bank officers

have no experience of using informal work-out techniques and practices to obtain win-win solutions. Since there has been no specialization among bank officers dealing with particular debtor businesses, they do not understand how to recover credit from the insolvent debtors.

In fact, training for bank officers is required under the Decision Letter of the Board of Directors of BI No. 23/80/KEP/DIR on the Obligation to Provide Funds For Human Resource Development, dated February 28, 1991 (“Decision 23/80”). Banks are obligated to provide funds for the education of their employees amounting to at least 5% of the annual budget for human resources expenditure. These funds should be used to improve the skills and knowledge of bank employees in the operational and banking management field. Large banks such as Bank Central Asia, Bank Niaga, and Bank Danamon have established their own training centers.

Many banks already offer special training (of up to a year) for new employees who will be posted in first level management positions. Such training usually covers banking management as well as the business sector in which the bank has been developing. However, more specialized education and training methods are required, such as work shops and apprenticeship programs. These should become a focus for domestic banks as they try to improve their human resources.

E. Property Law

1. **To what extent might the law relating to ownership, mortgages and the creation of other security interests in land and other property be improved/reformed to enable secured transactions to be transacted more efficiently?**

Indonesian Law distinguishes between tangible property and intangible property. Tangible property is further differentiated into immovables and movables.

As to in immovables, the proper type of security is a mortgage or “Hak Tanggungan”. For tangible movables the security can be a pledge or a fiduciary transfer.

Therefore, securities under the Indonesian Securities Law consist of (i) mortgages on land, pursuant to Law No. 4 of 1996 regarding the Law on Land Security and Any Goods Related Thereto dated April 9, 1996 (“Law No. 4 of 1996”); (ii) fiduciary transfers of movable assets, including fiduciary assignments of account receivables; and (iii) pledges of movable property, as stipulated under the ICC;

- a. **Mortgages on Land (“Hak Tanggungan”): Under Law No. 4 of 1996 security interests over land are used for certain types of land, including or excluding any goods attached to such land, in order to guarantee settlement of a certain type of debt. Hak Tanggungan grants its holder a privilege right for settlement of a debt prior to other creditors. Hak Tanggungan does not, however, grant its holder ownership of the secured land, other than the right to sell the land, either informally or by public auction, to settle unpaid debts. Multiple titles of this type of security interest can be held over a single plot of land by several creditors.**
- b.
 - (i) **Fiduciary Transfer Agreements (“FTA”): A FTA is an agreement by which title is transferred to a secured party, while the debtor is allowed**

- to remain in possession of the collateral. This title will automatically be reconveyed to the debtor once the indebtedness has been discharged.
- (ii) Under the Fiduciary Law (Law No. 42 of 1999 (September 30, 1999)), a Fiducia is a security interest on movable assets, whether tangible or intangible, that are not subject to (i) Hak Tanggungan under Law No. 4 of 1996, (ii) hypothecs on ships with gross tonnage of 20 M3 or more, (iii) hypothecs on aircraft or (iv) pledges. As with the holder of Hak Tanggungan, the holder of a Fiducia has a priority right over the secured assets.
 - (iii) **Fiduciary Assignments of Account Receivables (“Cessie”)**: This security interest is perfected only when notice is given to the account debtor upon an event of default (Article 613 of the ICC). Upon the notification of such an assignment, the account debtor is required to pay the account receivables directly to the creditor.

c. Pledges: Under Indonesian Law, a pledge is a security device pursuant to which the pledgor grants the pledgee a security interest over movable and intangible property.

Under the Indonesian Company Law, a pledge of shares in an Indonesian company is established by way of an agreement between the pledgor and the pledgee and notification to the company whose shares are being pledged. This is in line with Article 1153 of the ICC, which provides that a pledge of intangible property is made by giving notification of the pledge to the party against whom the right is to be exercised. With regard to pledges of shares, a company’s articles of association will typically provide for internal corporate approval requirements before a pledge of shares can be given and will set forth the formalities with regard to such a pledge.

Pledges of movable assets do not involve any governmental registration process.

There are several issues relating to security interests:

- Overlap between security interests under the security right and under the fiduciary right

Under Law No. 16 of 1985 regarding Apartments dated December 31, 1985 (“Law No. 16 of 1985”), an apartment unit built on a certain type of land derived from the State, namely “Right to Use” or “Hak Pakai”, can be secured under a fiduciary transfer arrangement, while an apartment built on “Right of Ownership” or “Hak Milik” land can be secured by a mortgage.

However, by the enactment of Law No. 4 of 1996, Hak Pakai land is now an object of Hak Tanggungan, and is no longer subject to fiducia under the security rights on apartments, as contained in Law No. 16 of 1985. The Fiducia is therefore no longer applicable to any security on land under Law No. 16 of 1985 since it only applies to movable assets.

- There are also issues of conflict between the holder of the Fiducia and the holder of Hak Tanggungan. Typically, the terms of Hak Tanggungan will provide that any equipment or plant permanently attached to the land will become subject to Hak Tanggungan. This may create a situation where competing and conflicting rights exist between the secured party under Hak Tanggungan and under the Fiducia. It is not clear under Indonesian law which of the two secured parties would prevail in the

event of a dispute. The holder of the Fiducia would be well advised to obtain a waiver from the holder of Hak Tanggungan with respect to such property.

- **Central Registration**

There is no central registration system. Local land offices do not have integrated information for land title searches. In addition, the registration of secured land is still not computerized.

- **Executorial Title**

Both the Mortgage Law and the Fiduciary Law provide an immediately executable title to the secured assets.

Both types of holder may request the district court to issue a court order to enforce their rights ("Fiat executive"). In practice, however, such a court order could take months to be issued.

2. Are there particular commercial or other practices (as distinct from formal laws) associated with the laws relating to property and secured transactions impeding or restricting the latter?

One principle of the Basic Agrarian Law and Law No. 4 of 1996 is horizontal separation. This means that an object attached to land may be owned separately from the land itself, in line with customary (Adat) law. Consequently, different owners of the land and the object can secure their property to different creditors. However, horizontal separation tends, in practice, to lead to disputes between the owner of land and the owner of the attached goods.

In anticipation of any disputes that may arise, Law No. 4 of 1996 requires the parties to Hak Tanggungan to expressly state the object of the security rights in the Deed of Hak Tanggungan.

On the other hand, we note that the practice of the sale and purchase of land tends to ignore the principle of horizontal separation. This is due to a circular letter issued by the Department of Agriculture and Agrarian Affairs No. Unda 9/1/14 dated February 8, 1964. This circular letter prohibits land deed officials from drawing deeds on transfers of land without also transferring any attached buildings. To date this circular letter has not been revoked and has caused problems in separating titles.

F. Secured Transactions

1. What are the major restrictions to the enforcement of security rights over property?

The major restrictions are, among others, (i) the registration system; (ii) the administration of the courts; and (iii) the definition of the objective market price of the collateral.

- (i) The GOI has no registration system for security interests other than Hak Tanggungan and the Fiducia. As discussed in Section E.1, there is no system for recording a security interest (other than Fiducia) in movable assets in Indonesia. Thus, it is not possible for a lender to ensure that an Indonesian debtor has not previously granted security over the same collateral.

- (ii) The enforcement of Hak Tanggungan and Fiducia should be affirmed by a district court which will issue a court order to execute the collateral of the security right. However, it is a well-known fact that the Indonesian court system does not satisfy the needs of the business community. The management of courts is inefficient and lacks transparency. Thus, it is possible for the execution of Hak Tanggungan to be temporarily delayed due to management inefficiencies.
- (iii) Law No. 4 of 1999 permits the holder and the grantor of Hak Tanggungan to agree to foreclose Hak Tanggungan collateral by private sale. However, there are no specific guidelines on this procedure or on the requirements for a private sale as the execution of collateral.

2. How might these impediments be best overcome?

- (i) Through improvements in the registration system for the security interests. A registration system is needed for Hak Tanggungan, FTAs, Pledges, and Fiduciary Assignments on Account Receivables in order to protect parties acting in good faith from fraudulent debtors. To date, the GOI has only implemented a registration system for Hak Tanggungan, while the Fiducia is so new that its implementation is as yet unknown.

A specific registration system for movable assets is needed. If machinery is secured by an FTA, for example, the secured party should be able to require the debtor to place a permanent label or plate on the machinery indicating that it is subject to an FTA in favor of the secured party. The secured party could then give all other potential lenders notice that such equipment is subject to an FTA and thus prevent any conflict with a second secured party.

In line with the proposed registration of the Fiducia, it is desirable to have a centralized, computerized and integrated registration system for the other security interests in order to facilitate the public's need for legal certainty on immovable and movable assets.

- (ii) With reference to our discussion in Section H.4, improvements to the courts are needed. The improvements should cover the human resources and the court institution, as well as the judicial system itself. To increase the accountability of the court system, the involvement of government executives should be diminished. Increased independence and transparency in the courts is also needed. Courts of justice should be able to try cases more effectively according to the prevailing laws.
- (iii) The use of independent appraisals would be very helpful, particularly to determine the fair market value of collateral.

3. Is there a fair balance between the enforcement of secured property rights and the restraint on those rights under relevant insolvency law? If not, in which areas is there an imbalance and outline what improvements might be made.

Pursuant to the ICC, all movable and immovable properties shall be available to satisfy a debtor's personal obligations. Upon a bankruptcy declaration, all of the property of the bankrupt debtor becomes bankrupt assets.

Although the Bankruptcy Law stipulates that any secured creditor may exercise its right as if there were no bankruptcy proceeding, the secured creditor is still prevented from executing its right for ninety days as of the bankruptcy declaration.

By the same token, during the bankruptcy proceeding a debtor may request the Commercial Court to suspend debt payments. If this request is granted, the debtor may be granted a maximum of 270 days by the Court to negotiate with its creditors permanent settlement agreement to restructure the debts. If during such period the unsecured creditors refuse to accept the settlement agreement, the Commercial Court will declare the debtor bankrupt.

On the other hand, if the settlement agreement is accepted by the unsecured creditors, the bankruptcy petition will then be cancelled. If the secured property is not sufficient to cover the debt, the secured creditors may join the unsecured creditors to settle their remaining debts together on a pro-rata basis.

Thus, in this case, notwithstanding that the Bankruptcy Law provides legal protection to secured creditors, they would not be able to exercise their rights until the bankruptcy declaration is granted or the permanent suspension of payment is ratified by the Commercial Court.

G. Insolvency Law

- 1. What are the major substantive weaknesses in the corporate insolvency law viewed from the respective positions of:**
 - (a) banks/financial providers**
 - (b) secured creditors**
 - (c) unsecured creditors**
 - (d) employees**
 - (e) corporations**
 - (f) directors**
 - (g) shareholders?**

(a) The Bankruptcy Law does not specifically provide any provisions that weaken the position of banks or financial providers. Instead, the Bankruptcy Law has certain substantive improvements, such as a speedy time frame of thirty days from the date of the filing of the petition at the Commercial Court in the bankruptcy proceeding for rendering the decision, and other changes as mentioned in our answer to H.1(d) below.

(b) Under Law No. 4 of 1996 on Hak Tanggungan, a plot of land can be given as security together with all objects erected on the land, including buildings, plants, plantations, and machinery. Both the Bankruptcy Law and Law No. 4 of 1996 are silent as to whether a security right over land will automatically cover all objects erected on the land in the event the security right deed does not specifically cover such additional objects. A problem might arise when the object is machinery which has been granted to another creditor by way of fiduciary transfer. If the debtor, as the grantor of both securities, goes bankrupt, a conflict may arise between the holder of the security right and the holder of the fiducia. Either party may have difficulty in executing and foreclosing its encumbrance.

The Bankruptcy Law and Law No. 4 of 1996 are also ambiguous on the procedure and requirements to execute or foreclose an encumbrance through a private sale besides the public auction. Their implementing regulations should provide more detail and comprehensive procedures to execute any security right, mortgage, fiduciary or pledge held by a secured creditor.

- (c) We note that not all claims are treated equally under the ICC. Certain privileges under Indonesian law are created pursuant to Articles 1139 and 1149 of the ICC. While a privilege under these Articles does not create a security interest in a particular asset of the debtor, the holder of a privilege will be entitled to a preferential distribution of certain of the debtor's assets over unsecured creditors that do not hold a privilege should the proceeds of the sale not cover all creditors' claims.

Law No. 9 of 1994 on the Amendment to Law 6 of 1983 on General Tax Provisions and Procedures (November 9, 1994) provides that the State has a preferential right and priority over all other rights, except for court costs incurred in the auction of assets, expenses incurred to safeguard goods, and court costs incurred with regard to inheritance. Accordingly, the proceeds from the sale of both secured and unsecured assets must be used for the payment of the debtor's taxes prior to any other claims except those noted for court costs and auction expenses.

In summary, the assets of the bankrupt estate will be applied to the creditors' claims in the following order of priority:

- I. court and auction costs;
- II. taxes;
- III. claims of secured creditors;
- IV. privileged creditors;
- V. unsecured creditors.

As provided in most insolvency laws, unsecured creditors will only gain, on a pro-rata basis, the balance after all sums for preferred debts have been paid, namely government taxes, employee severance pay, and payments to secured creditors. In some cases, there may be nothing left for the unsecured creditors. There is no guarantee that unsecured creditors will obtain payment of any monies due to them.

For more details, please see our discussion in Section L1 of our previous report.

- (d) Employees of the bankrupt debtor may resign or the receiver may dismiss them subject to employment periods stipulated in employment contracts and subject to their rights under manpower laws. Six weeks' termination notice must be given. As from the effective date of the bankruptcy declaration, remuneration to employees is a debt of the bankrupt estate.

There is no protection for the employees of a bankrupt corporate where the proceeds from the sale of the assets of the corporate are insufficient to pay employees severance or other benefits. The shareholders should be liable to pay the minimum employee severance provided by the prevailing laws.

Article 110 of Law No. 25 of 1997 regarding the Labor Code (which is to become effective in October 2000) provides that in the event an employer is declared bankrupt or is liquidated, the employees' wages are given a priority based on the "prevailing regulations". This ambiguity has not yet been clarified by a government regulation.

- (e) Despite current practice, under the provisions of the Bankruptcy Law, corporations can easily be petitioned for bankruptcy. This is because the Bankruptcy Law only requires simple evidence to prove that the company has at least two creditors one of whose debt is due. In order to protect the interests of both debtor and creditor, as well as to improve judicial proceedings, the provisions on evidence should be amended.

- (f) The Bankruptcy Law does not provide sufficient provisions on the rights and duties and responsibilities of the directors and commissioners of a bankrupt company. However, as provided in our discussion in Section F on Civil and Penal Sanctions in our previous Report, the Indonesian Company Law provides certain provisions on these matters.

Article 90(2) of the Company Law provides that where the bankruptcy occurs due to the mistake or negligence of the Board of Directors and the company's assets are inadequate to cover the losses caused by such bankruptcy, each member of the Board of Directors is jointly responsible for such losses. However, if a member of the Board of Directors can prove that the bankruptcy was not due to his mistake or negligence, he is not jointly responsible for the losses. Article 85(2) of the Company Law provides that each member of the Board of Directors of a company will be held personally liable if he has committed a wrongful act or is negligent in conducting his duties with good faith and with full responsibility for the interests and business of the company.

Furthermore, pursuant to Article 79(3) and Article 96 of the Company Law, members of the Board of Directors or the Board of Commissioners who are responsible for the bankruptcy of another company are not eligible to be appointed as members of the Board of Directors or Board of Commissioners of any company for a minimum period of five years.

Article 100 paragraph 3 of the Company Law imposes the same standard of care on Commissioners as Directors, and Commissioners can be held liable as Directors if they assume a management role.

The above provisions of the Company Law are not easy to apply because there is no clear guidance on the procedure and requirements as to when and how a director or commissioner can be held personally liable for actions causing the company to go bankrupt. Therefore, there should be clear and comprehensive implementing regulations for this matter.

- (g) Article 3(1) of the Company Law provides that shareholders of a limited liability company are not personally liable for agreements made on behalf of the Company and are not responsible for company losses exceeding the nominal value of the shares subscribed.

In certain cases, it is possible for the shareholders to lose their limited liability. We note that in addition to the situations enumerated therein, the founding shareholders of a company may be personally liable for the company's debts if the company has not been established under the Company Law.

Article 3 of the Company Law provides, inter alia, that the shareholders of a limited liability company may be personally liable for company losses in the following situations:

- I. the relevant shareholder either directly or indirectly in bad faith uses the company solely for personal purposes;
- II. the relevant shareholder is involved in unlawful acts committed by the company; or

- III. the relevant shareholder, either directly or indirectly, unlawfully uses the company's assets, causing such company's assets to be inadequate to settle the company's debts.

As provided in our answer to 1(f) above, there is an ambiguity on when and how a shareholder can be charged personally liable for actions causing the company to go bankrupt. Therefore, there should be clear and comprehensive implementing regulations for this matter.

- 2. What are the major practical weaknesses in the application of the insolvency law viewed from the respective positions of:**
- (a) corporations**
 - (b) creditors?**

As noted in the answer to No. G.1(e) above, the Bankruptcy Law only requires simple evidence to prove that the company has two or more creditors, one of whose debt is due. The major weaknesses in the application of the insolvency law for both debtor and creditor are (a) the incomplete rules for judicial proceedings, and (b) the presiding judges being incapable of handling the complicated loan arrangements amongst creditors and debtors.

Please see our more detailed discussion in Section H.4 below.

H. Judicial System

- 1. Has there been any discernable improvement or change in the operation of the judicial system in relation to the conduct of:**
- (a) debt collection/recovery processes;**
 - (b) enforcement processes in respect of secured property rights;**
 - (c) recovery or enforcement processes in respect of leased property;**
 - (d) formal corporate insolvency processes?**

If possible, provide some detail of cases in which any such change or improvement has been made apparent.

- (a) No, there has not been any discernable improvement in the operation of the judicial system in relation to the conduct of debt recovery processes through the formal corporate insolvency process. (Samples of cases can be found in a separate report.)
- (b) No. Nevertheless, Law No. 4 of 1996 has helped in the clarification of secured property rights.
- (c) No. However, since 1988 the Supreme Court has opined that a lease agreement cannot be cancelled unilaterally, except where the lessee is unwilling to fulfill its obligations under the lease agreement (Decision of Supreme Court No. 1724.K/Pdt/1988, August 31, 1988).
- (d) Yes. The improvements are as follows:
 - (i) Under the amended Bankruptcy Law, there are two types of insolvency proceeding: (i) bankruptcy and (ii) the suspension of debt payments. The insolvency of a corporate can now be determined by a more simple method: the corporate must have at least two creditors, one of whose debt is due.
 - (ii) The bankruptcy proceeding now has a speedier time frame of thirty days from the date of the filing of the petition at the Commercial Court and from the date of the filing of the appeal petition at the Supreme Court.

- (iii) Any objection to the Commercial Court's decision can now be appealed directly to the Supreme Court and will be decided within 30 days as of the date of the filing.
- (iv) The Bankruptcy Law offers a simple authentication procedure requiring only written evidence of the (due and payable) debts.
- (v) Also, the hearing process and the announcement of the bankruptcy decision are now open to the public, and copies of the decisions are also publicly available.

Notwithstanding the above, the enactment of the amended Bankruptcy Law has not brought much satisfaction to creditors. But with the passage of time and the benefit of additional resources, the judiciary is likely to become more consistent in its decision-making and earn the confidence of creditors and investors. A recent Supreme Court case involving PT Dharmala Agrifood is an early but important step in this direction. Most of the problems in the judiciary arise at the first stage of a trial in the Commercial Court. We provide details of this particular case separately.

3. What reforms, if any, have been made to improve the operation of the judicial system in relation to the above 4 areas?

The only improvement of the judicial system is in relation to the formal corporate insolvency process. Details follow:

- (i) Following the enactment of the Bankruptcy Law there was only one Commercial Court, established within the domain of the Central Jakarta District Court, which tentatively operated for the whole territory of the Republic of Indonesia until August 18, 1999 when 4 additional commercial courts were established by the issuance of Presidential Decree No. 97 of 1999. The Commercial Court is the court in charge of hearing and deciding on petitions for bankruptcy adjudication.

In addition to hearing and deciding petitions for both adjudication of bankruptcy and suspension of debt payments, the Commercial Court should also have jurisdiction to hear and decide other cases in commercial fields. This jurisdiction should be stipulated by a government regulation.

- (ii) Law No. 30 of 1999 on Arbitration and Dispute Settlement Alternatives was enacted on August 12, 1999 ("Law No. 30"). In the development of national as well as international business and commercial traffic as well as the development of law in general, the regulations that were used as arbitration guidelines and contained in the old civil procedure law (*Reglement op de Rechtsverding or RV*) are no longer applicable. The RV does not stipulate on international contracts and their implementation. This no longer conforms to the reality of the Indonesian business world, especially since the signing of the GATT treaty and Indonesia involvement in APEC.

Arbitration as regulated in Law No. 30 is a means of settlement outside the general judicial court system based on the written agreement of the disputing parties. However, not all disputes may be settled through arbitration, only disputes regarding rights which according to the law are held by the disputing parties on the basis of their agreement.

Law No. 30 has now set forth the procedures for case submissions before the arbitration committee, and creates the possibility of arbitrators issuing provisional decisions, stipulation impounds, ordering the safekeeping of goods or the sale of damaged goods, as well as hearing witnesses and expert witnesses.

In general terms, the arbitration body holds certain advantages over the judicial body. The former:

- a. guarantees the confidentiality of the parties;
- b. may avoid delays due to procedural and administrative matters;
- c. allows the parties to select those arbitrators they deem as honest and fair and having sufficient knowledge, experience and background regarding the matter being disputed;
- d. allows the parties to select which law to use to settle the matter as well as the process and place of arbitration;
- e. makes the decision of the arbitrator binding on the parties through simple procedures or direct implementation.

Therefore, as mentioned above, the option for any party to resolve its dispute through arbitration may improve the operation of the judicial system.

- (iii) Establishment of the Steering Committee under the management of the Indonesian Supreme Court. This Steering Committee has made improvements such as appointing ad hoc judges and determining the court fee for bankruptcy proceedings. However, the functions, authorities, and administration of ad hoc judges are still unclear.

3. Are there any identifiable proposals for reforms in these areas?

Yes, there are some proposals for such reforms as follows:

1. The Bankruptcy Law is to be revised, among other things to accommodate a proposed broader definition of "debt" currently exists.
2. Review of Law No. 14 of 1970 on the principles of Judicial Authority.

Both of these proposed laws will be submitted to the new House of Representatives for approval.

4. What are the main problems or difficulties regarding the operation and application of the corporate insolvency law through the court system?

The main problems are as follows:

- (i) Lack of fairness in the trials, due to the questionable credibility of the presiding judges. It is common knowledge that corruption is rampant in the courts. Judges, prosecutors, and lawyers are all involved in such dirty games.
- (ii) Many of the bankruptcy petitions submitted involve modern and sophisticated transactions of derivatives, swaps, commercial paper, etc. In many cases, the Panel of Judges presiding over the hearing does not quite understand the transactions. This leads to misinterpretations or narrow interpretations of the documents provided by the parties.

Some problems have arisen in practice due to the unclear provisions in the Bankruptcy Law, particularly on procedural matters. In practice, the procedural law used in bankruptcy trials still refers to the Indonesian Civil Procedural Law. The definition of debt in the Bankruptcy Law has been interpreted in two different ways. One side argues that the legal term "debts" in the Bankruptcy Law refers to the law of obligations in the ICC. Under Article 1233 of the ICC, obligations or debts can arise either out of contract or out of law. There are obligations to provide something, and obligations to do or not to do something (Article 1234 of the ICC). A creditor is entitled to expect the performance of the obligation by the debtor, which obligation the debtor is obliged to perform. In contrast, the Supreme Court has a totally different opinion about the meaning of the legal term "debts". The Supreme Court effectively narrowed the meaning of this term in its judgement in the Modernland

Realty-case (Decision No. 03/K/N/1998). In this case, the Supreme Court decided that debt consists of the principal debt plus interest. Consequently, only loans would then qualify as debts under the Bankruptcy Law.

5. What practical improvements might be made to overcome these problems?

The following are some practical solutions to those problems:

- (i) Improving the salaries of judges and other government law enforcement officials might help.
- (ii) Providing the judges who are in charge of the Commercial Court with more training concerning modern business transactions.

Such improvements would be more effective if the Supreme Court decides that the judges are bound to jurisprudence with respect to commercial cases, including bankruptcy cases.

I. Informal Work Out Techniques

1. Provide detailed examples of some cases of successful informal work-outs and also cases of genuine attempts at informal work-outs not successful.

The following are examples of some successful informal work-out cases:

PT Astra International Tbk. (AI): AI, whose core business is the automotive industry, has successfully rescheduled payment of its debts with more than 200 creditors. Its debts, nearly Rp.1 Trillion, have been rescheduled for three to seven and a half years.

PT Danareksa (mutual fund): Danareksa has combined a buy-back scheme with the rescheduling. This means that Danareksa buys back its debts, but gets a discount. Creditors who did not want to be restructured walked out by selling their debts back to Danareksa. Danareksa has benefited, because it gained a hair cut of the buy-back. At the outset, Danareksa owed USD370 million to 53 creditors in 14 countries. Danareksa then bought back debts to the amount of USD182 million, around a 49 percent discount of the promissory notes it issued.

Some cases have not been very successful or are being delayed, such as the debt restructurings of PT Chandra Asri Petrochemical Center, PT Timor Putra Nasional, and PT Semen Cibinong Tbk. (in the cement production and distribution industry).

Most of the above information is available to the public because these cases involve the reorganization or debt restructuring of public companies. The Capital Market Law, Law No. 8 of 1995 and the rules of the Capital Market Supervisory Agency (BAPEPAM) specifically require public companies to make such information public.

2. In practice, are such technique/s operating efficiently and successfully?

Not very successfully, considering that progress has been quite slow due to the complexity of each settlement, so only a few deals have been made. As we mentioned earlier, the Jakarta Initiative noted that only 24 companies out of 2,200 companies had completed restructurings.

Settlement methods being used include reverse Dutch auctions, debt-equity swaps, interest/maturity tradeoffs, partial restructurings/ liquidations and the use of third party advisors. In general, both debtors and creditors still consider out-of-court settlement to be the best way to settle their debts.

3. What are the major problems in the application of these techniques?

The major problem is not actually always related to the techniques, but due to the size of the debts, which far exceed the debtors' assets. Most debtors propose a discounted settlement of their debts, while most creditors try to avoid such settlements bearing in mind that the debtors might have other valuable assets. Besides, the major problem also lies in the complexity of the debts, particularly corporate foreign debts, which could involve hundreds of creditors for a single company. A lack of coordination among economic and banking authorities has made the debt restructuring process move very slowly, causing great concern over the amount of foreign debt in the very near future.

Is it considered that training and education in the operation of these techniques would be valuable and, if so, in what areas and to whom should the training be directed?

Yes, training and education in the operation of these informal work-out techniques would be valuable, especially in the banking and finance sectors. This training and education should be directed at employees of banks and financial companies, employees of other companies, accountants, financial advisors, lawyers and other professionals.

J. Insolvency Administration System

1. Comment on the extent of development, expertise and efficiency regarding both public and private sector administration of formal cases of:

- (a) corporate liquidation; and
- (b) corporate reorganization

- (a) Unlike the previous law on bankruptcy which only recognized the state receiver to manage and settle the bankruptcy assets and liabilities of a bankrupt debtor, the Bankruptcy Law recognizes two alternative methods for appointing receivers in the insolvency administration of formal cases. First, there is the so-called Orphans Chamber (BHP), which is a special agency of the Department of Justice. Second, there are private receivers. Private receivers must be individuals or civil partnerships domiciled in Indonesia possessing specific expertise required in respect of the management and/or the settlement of bankrupt estates and must be registered with the Department of Justice. The receivers appointed must be independent and have no conflict of interest with either the debtor or the creditor. This provision enables creditors and/or debtors to choose a receiver they deem better skilled and more accountable for the insolvency administration.

Any creditor may, before the adjudication of a bankruptcy proceeding, request the Commercial Court to appoint a temporary receiver to supervise the management of the debtor's business and to supervise payments to creditors, also to transfer or encumber the debtor's assets. These actions require the receiver's approval in respect of the bankruptcy. Additionally, the Court may establish a temporary Creditors Committee consisting of one to three members appointed from the creditors to provide advice to the receiver if it is deemed necessary or desirable for the interest of the bankrupt estate.

The Bankruptcy Law is more comprehensive and also provides details of the powers given to the Supervisory Judges who control the management and settlement of the bankrupt estate. Among these are the rights to hear witnesses and to order investigations by experts in order to obtain full information with regard to the bankruptcy proceedings.

With the approval of the Creditors Committee, the receiver may take over the running of the business of a bankrupt debtor, notwithstanding any appeal to the Supreme Court or request for judicial review filed in respect of such bankruptcy declaration.

Other developments in the administration of formal cases include greater transparency and access to information regarding bankruptcy decisions as well as the provision of quarterly reports prepared by the receiver during the insolvency process. (Please see our discussion in Section A.1(b and c) above for more detail.)

(Please also see our detailed discussions on the power and duties of receivers, Supervisory Judges and the Creditors Committee in Sections C5 and E4 of our previous Report.)

With regard to skill in the administration of corporate liquidations, since the Bankruptcy Law permits the appointment of independent receivers, there has been a quite discernable improvement in the administration of corporate liquidations. At present, most of the formal corporate liquidations are being conducted by independent receivers. These independent receivers are usually lawyers, accountants, or other professionals with legal and/or business backgrounds. Their skills and experiences have certainly helped the receivers to perform their duties.

Since the Bankruptcy Law does not provide a time frame for a corporate liquidation to be completed and due to the complexity of each case, there is no assurance as to when the liquidation process shall be completed. Therefore, the time frame for the completion of the administration of formal cases depends on the willingness of the bankrupt debtor, with the assistance of the receiver and Supervisory Judge, as well as on the cooperation of the creditors.

- (b) Please see our answer to J.1(a) paragraphs 1, 3, 5, 7 and 8 above with regard to the administration of formal cases of corporate reorganization.

2. Is it considered that education and training in these areas would be valuable and, if so, in what areas?

Yes. Training and education should particularly cover the restructuring and recapitalization of the banking, insurance, corporate finance and capital market sectors and other relevant issues. Considering their huge powers and duties under the Law, independent receivers, officials of the state receiver and Supervisory Judges (including all Commercial Court judges), should be given more training and education to improve their skills and knowledge on current business and legal practices so that they can make the corporate liquidation and reorganization processes more efficient and effective.

3. Is it considered desirable to introduce more formal structures of both public and private sector administration of insolvency cases?

No, because we believe the Bankruptcy Law has sufficiently addressed most of the formal structures required in the insolvency proceedings. Instead of setting up new formal structures for the insolvency proceedings, as mentioned above, there should be encouragement to improve transparency within the judicial system, to improve generally poorly-trained and accountable judges and receivers and to employ judges from professional fields with a solid background in business. We would also recommend optimizing the function of ad hoc (expert) judges appointed for insolvency proceedings.

K. Information & Statistics

- 1. Is it desirable to establish systems to gather information concerning:**
 - **Incidence and results of formal insolvency cases under the insolvency law**
 - **Incidence and results of informal work out cases**
 - **Statistics of value of assets and liabilities**
 - **Causes of financial failure, main area/s of business?**

Yes, the establishment of a system to allow the public to obtain information on all the above matters is highly desirable. Currently, information on formal insolvency cases and informal work-outs has only been available from newspapers, magazines or in the court. It would be helpful to introduce an on-line system to provide easy access to all bankruptcy decisions. In addition, there is currently no public access to information on the value of assets and liabilities and the causes of financial failure, or the main areas of business of the companies concerned.

- 2. If so, how best might such system/s be established?**

Such information systems should be available to the public in a computerized and centralized form. We note that under the new Fiduciary Law, the registration of fiduciary securities is to be computerized and integrated under the supervision of the Department of Justice. This proposed registration should be followed by the establishment of the registration of other security documentation, court decisions, and other relevant business and corporate documentation.

L. General Insolvency Information and Developments

- 1. Provide details of any other relevant information or developments since January 1999 in regard to such issues as the effect of insolvency law policies on areas such as employment, fiscal/revenue debts, detection and recovery of corporate fraud, domestic and foreign investment and etc.**

Apart from the Draft Amendment to the Bankruptcy Law, the Government has already prepared a Draft Law on Debt and Limited Liability Company Restructuring ("Draft Restructuring Law"), as an extensive amendment to the provisions on suspension of debt payment provided in the Bankruptcy Law.

This Draft Restructuring Law was prepared considering that a bankruptcy decision issued by the Commercial Court may have a wide-ranging impact on the termination of employees, suppliers, distributors distributing products and services produced by the bankrupt company, as well as on the consumers of the products and services produced by the bankrupt company. Accordingly, insofar as a corporate debtor and its debt can feasibly undergo reorganization and restructuring, respectively, efforts undertaken in such context should benefit debtors and creditors, unsecured creditors in particular. Therefore, in order to guarantee the protection of creditors and debtors, shareholders and related parties, the Draft Restructuring Law should be immediately enacted to protect employees and to support the recovery and collection of debts, as well as for foreign and domestic investments.

2. **Is there any evidence of a change in attitudes (such as social/commercial stigma, aversion to strict legal processes, fear of loss of control) toward the use of:**
- (a) **formal insolvency processes; and**
 - (b) **informal insolvency processes**

in respect of corporations in financial difficulty or insolvent corporations? If possible, provide details of any specific cases reflecting evidence of change.

- (a) Despite the slowness of improvements in the implementation of the Bankruptcy Law, there has been some change in attitudes toward the use of formal insolvency processes. The Bankruptcy Law has at least acted as a tool to encourage corporate debtors to negotiate the settlement of their debts. The shareholders of corporate debtors prefer to settle their debts outside formal bankruptcy proceedings to avoid the risk of losing control of the Company.
- (b) Many creditors seem as yet unwilling to accept that there is little likelihood of any meaningful recovery of their debts. While most appear willing to accept some loss, they have not accepted the likelihood of substantial write-downs. Nevertheless, with mutual cooperation and good faith, certain methods of debt restructuring and rescheduling may lead to a more significant and valuable recovery.