INDONESIAN BANKRUPTCY LAW: REVISITED

Wijantini
Prasetiya Mulya Business School, Jakarta
wijantini@pmbs.ac.id

Abstract

One of the key challenges in financial distress resolution is to find the way to renegotiate the debts. Financial troubled firms may apply either court or out-of-court resolution process. Under court supervision, firms have to follow Indonesian bankruptcy law which offers a moratorium on debt repayment through a system of court supervision and liquidation proceedings. Alternatively, firms may apply out-of-court workout. This paper is written to examine process of both resolutions, problem in executing the law and the reasons for least likelihood of filing court solution in Indonesia. In addition, it shows study on bankruptcy filing in East Asia countries.

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During the 1990s, the Indonesian government introduced a number of laws and regulations to protect creditors and investors. The Bankruptcy Law, amended in 1998, and the commercial law are the most relevant laws governing the relationship between debtors and creditors. This bankruptcy law provides two basic means of dealing with bankruptcy problems. First, it provides for liquidation proceedings and second, it provides for a moratorium on debt repayment through a system of court supervision. A moratorium is a legal authorisation to debtors to postpone payment. Even though the new laws may provide better instruments for creditors to resolve corporate distress, in general, the issue of weak judicial systems is still a big problem in executing the law in Indonesia.

The Bankruptcy Law

When firms cannot fulfil their scheduled debt repayments, they may conduct insolvency procedures to resolve the problem. They may apply either formal/in-court (bankruptcy) or an informal/out-of-court resolution process. Under both approaches, the distressed firms may liquidate or recover from the distress. Gilson, John and Lang (1990) provide evidence that firms with high dispersion of debt ownership and a complicated debt structure in the USA are more likely to reorganise under bankruptcy law than to reorganise privately through a private workout with lenders. Claessens, Djankov and Klapper (2003) suggest that bank-owned and group-affiliated firms are more likely to use out of court solutions. They use a sample of 1,472 publicly traded firms in five East Asian countries from 1997-8 and find that stronger creditor rights and a better judicial system increase the likelihood of bankruptcy filing.

The Indonesian bankruptcy law is based on nineteenth century Dutch legislation and was promulgated in 1906. Implicitly, the Indonesian legal system has elements of a civil law system, based on the European civil law tradition. La Porta, Lopez, Shleifer and Vishny (1997) divide legal systems into those with a civil or a common-law origin. They find that common-law countries are characterised by higher efficiency in contract enforcement. These countries are also documented to offer stronger legal protection for outside investors' rights, whether shareholders or creditors. Common-law systems can react faster to new developments and convey much less uncertainty as to the outcome of a given legal dispute than civil law systems. Many developed countries including Japan, the US, the UK, which are Indonesian creditors, adopt a common law system (La Porta, Shleifer and Lopez 1999). The differences in perceptions of the law may create problems for those creditors who are used to the principle of precedent in common-law systems in resolving bankruptcy problems in Indonesia (Tomasic 2001).

In 1998, the government of Indonesia made some important amendments to the bankruptcy law. First, the law introduced new provisions, such as amending a chapter dealing with the creation of a moratorium on debt repayment. Second, it established the new Commercial Court (hereafter, the Court) has exclusive jurisdiction over petitions for declarations of bankruptcy and moratoriums on debt repayment. The following subsections describe the amendments in further detail.

Moratorium on Debt Repayment

The Indonesian Bankruptcy Act in 1998 allows debtors to request a moratorium on their obligation to repay their debts, on the grounds that the debtor intends to prepare and present a composition to include an offer to repay all or part of the debt owed to unsecured creditors (Article 212). The debtor must file the moratorium petition with the Court and the Court must immediately grant a temporary moratorium on debt repayment and appoint a supervising judge and one or more trustees to manage the debtor's assets. The debtor and the creditors have only 45 days before they are required to appear again in Court at a session to consider making a permanent moratorium. If a permanent moratorium is approved at this meeting, the moratorium must not exceed 270 days from the making of the decision on the temporary moratorium on debt repayment (Article 217).

Once a moratorium has been granted, the debtor must not take any part in the management of the debtor's assets or take any action to transfer any of these assets (Article 226). However, the debtor is entitled to dismiss his employees after the commencement of the moratorium and any unpaid salaries then become debited to debtor's assets (Article 237). In addition, once the moratorium has commenced, any execution action against the debtor must be postponed (Article 228). Moreover, the

supervising judge may appoint one or more experts to conduct an investigation and to prepare a report regarding the condition of the debtor's assets. A copy of this report must be made available to the Clerk of the Court and a trustee is required to report every three months on the condition of the assets (Article 225). The granting of a moratorium on repayment of a debt will not apply to secured claims, such as those secured by a pledge or mortgage or to preferred claims in respect of certain goods belonging to the debtor (Article 230).

Under Article 240, the Court may terminate the moratorium in certain situations: First, if the debtor has acted in bad faith on his assets. Second, if the debtor attempts to deceive the creditors. Third, if the debtor fails to perform various acts required of him by the Court or the Trustee.

Fourth, if the debtor takes part in the management of the assets or transfers rights to any assets. Fifth, if the circumstances are such that the continuation of the moratorium becomes unfeasible. Sixth, if the debtor cannot expect to fulfil his obligations to his creditors within the time provided.

The Commercial Court

The 1998 Indonesian Bankruptcy Law established a new Commercial Court to process bankruptcy and moratorium petitions. The Court is responsible for deciding the bankruptcy petition and the suspension of loan payments proposed by the debtor. The bankruptcy proceedings can be applied against a debtor who has two or more creditors to whom the debtor has failed to pay at least one debt which has matured and become payable. A debtor may file bankruptcy petitions on his own or at the request of one or more creditors. In addition, the public prosecutor may also bring in debtors where it is considered to be in the public interest to initiate such proceedings.

In the event that the Court accepts the bankruptcy petition, a receiver will undertake to settle the loan repayment under the supervision of a Supervisory Judge. Within the settlement process, corporate debt can be restructured and reorganised by the receiver in order to maximise the value of the bankrupt assets. Following the settlement of the loan repayment with bankrupt assets, the insolvent corporate debtor can either be liquidated or stay inactive but remains in existence as a legal entity.

The bankruptcy petition must be granted if there are facts or circumstances proving the existence of bankruptcy. The court must decide the petition within 30 days of the registration of the bankruptcy. The lawyers acting for debtor respondents have noted that the time given is usually too short to prepare a full response. The 30-day period set by the Law for making a decision on the bankruptcy petition has also been seen as too short a time for judges to be able to come to a conclusion (Tomasic 2001).

When a declaration of bankruptcy is made, the Court may order the appointment of a supervising judge and a receiver. The debtor forfeits his right to manage or control his assets from the commencement of the bankruptcy. Legal proceedings against the bankrupt estate must be suspended, claims by creditors must be made through the receiver and proceedings initiated by the debtor may be taken over by the receiver. However, the debtor may appeal to the Supreme Court within 8 days after being declared bankrupt. In Indonesia, this article has been widely used and most Indonesian court cases are subject to appeal to the Supreme Court.

In practice, the performance of the Indonesian Commercial Court has not been outstanding. Two main issues challenge the judicial system in Indonesia, namely, charges of incompetence and corruption. The Commercial Court judges have little commercial knowledge and experience. Because many bankruptcy cases recently involved modern and sophisticated transactions, the lack of financial knowledge leads to misinterpretations or narrow understanding of the documents (Asian Development Bank Report 2001). Another issue is the existence of a culture of corruption. The presence of corrupt practices amongst the Indonesian judiciary is extremely difficult to overcome. Inadequate judicial salaries are commonly seen as the fundamental problem underlying the entrenched corruption in Indonesia (Tomasic 2001).

The Informal Procedures

So far, the Indonesian judicial system has not functioned well in dealing with bankruptcy cases; therefore court-supervised restructuring or liquidation is not an attractive option for creditors. **Table 1** presents part of Claessens, Djankov and Ferri's (1999) study on bankruptcy filing in East Asia in 1997 and 1998. It finds evidence of low bankruptcy

Table 1. The Bankruptcy Filing in East Asia in 1997 and 1998

Country	Number of Observations	Number of Distressed Firms	Distressed Firms as a % of Country's Observations	Number of Bankruptcies	Number of Bankruptcies as % of Distressed Firms
Indonesia	133	66	49.62%	2	3.03%
Korea	282	116	41.14%	26	22.41%
Malaysia	627	296	47.21%	21	7.09%
Philippines	68	20	29.41%	1	5.00%
Thailand	362	146	40.33%	33	22.60%
Total	**1,472**	**644**	**43.75%**	**83**	**12.89%**

Source: Claessens et al. (1999)

filing in the East Asian countries. Firms in these countries are closely linked with banks and are commonly part of a business group. The study concludes that bank ownership and group affiliation reduce the likelihood of bankruptcy and court intervention as a means of resolving financial distress. They also find that the combination of better contractibility and judicial efficiency increases the likelihood of bankruptcy filings. Therefore, with the characteristics of poor creditor rights, inefficient judicial systems and prevalent group affiliations, financially distressed firms in Indonesia have the lowest likelihood of filing for court resolution.

Given Indonesia's characteristics, the out-of-court approach seems to be the preferred way of resolving financial distress. However, the main problem with out-of-court resolution is that creditors lack the means to force borrowers to enter the negotiation process. The process may be delayed or even blocked by the debtor or other creditors. As the Asian Development Bank noted in a recent report, the driving force for bringing creditors and debtors together is the sanction that if the negotiation process cannot be started or breaks down, there can be relatively swift and effective resort to the application of an insolvency law (Corporate Restructuring in East Asia. 2001). In other words, Indonesia still needs to build a credible legal infrastructure for an effective informal system of bankruptcy negotiation and settlement. **Table 2** evaluates debt recovery and formal reorganization procedures in Indonesia, Korea and Malaysia. In Indonesia,

Table 2. Evaluation of Debt Recovery and Insolvency Procedures in Asia

1 = Low cost, easy, very efficient, quick 3 = High cost, difficult, inefficient, slow	**Indonesia**	**Korea**	**Malaysia**
1. Time for formal reorganization (months)	12 –18	2 – 4	8 - 12
2. Time for informal workout (months)	4 - 8	2 - 4	2 - 4
3. Process for acquiring security (collateral) over land	2.75	1.25	1.25
4. Process for acquiring security over other property	2.75	1.25	1.25
5. Process for enforcement of security over land	3	1.25	1.25
6. Process for enforcement security over other property	2.5	1.25	1.25
7. Process for debt collection	2.5	1.25	1.25
8. Process for reorganization / restructuring	2.5	1.75	2
Predictability of positive outcome for creditors: 1 = very high 5 = very low			
9. Process for security enforcement; land	5	2	2
10. Process for security enforcement; other than land	5	4	2
11. Judicial handling of security enforcement	2	3	2
12. Judicial handling of debt collection	5	3	2
13. Judicial handling of bankruptcy / liquidation	5	4	2
14. Judicial handling of rehabilitation	5	4	3

Source: Insolvency Asia (1999), Country Report

the process is costly, difficult inefficient and slow, for instance, the time needed for formal reorganization is three times longer than those for informal workout. In addition, judicial handling for debt collection, bankruptcy/liquidation and rehabilitation is very low. Those condition may cause in-court settlement is less favourable than out-of-court approach.

During Asian crisis in 1997-98, Indonesia encounters a more difficult out of court resolution compared with those in non-crisis countries. First, the collapse of the Rupiah against USD has affected the ability of the debtors to pay the loan even when they are willing to do so. Second, the failures of the banking sector cause the renegotiation of debt more complicated. Many banks in

Table 3. Creditors' Rights in Indonesia's Bankruptcy Law (1998)

Restrictions on re-organisation	Yes
No automatic stay on assets	Yes
Secured creditors first paid	No
Management does not stay on in re-organisations	Yes

"Yes" indicates strong creditor rights.
"No" indicates weak creditor rights

Asian Development Bank, 2002. Corporate Restructuring in East Asia. Page 118

Indonesia have been liquidated, merged or taken over. The new bank management has different interests in managing the distressed debtors. The old bank/debtor relationship built up over many years is no longer relevant; all this makes the agency problem more severe. Under the restructuring programmes, distressed firms frequently have to deal with new management in the same banks who have different objectives from the old management. If the old bank is merged or liquidated, the firms have to carry out additional administrative work to negotiate their debts. In other words, under the banking crisis, a higher bank loan fraction may not reduce the cost of financial distress.

The Liquidation Process

Finance theory suggests that liquidations can occur as a result of financial distress or to maximise shareholder wealth. If the value of assets sold piecemeal exceeds the market value of stock, it may be in the shareholders' best interest to liquidate the firm. In normal situations management would not undertake voluntary liquidations unless they expected them to increase shareholders' wealth. Troubled firms may liquidate either under creditor administration or under court control. In Indonesia liquidations can be voluntarily under creditor supervision or under court supervision. But the process of liquidation under court supervision in Indonesia is generally difficult, inefficient and slow (Tomasic 2001).

Under the new bankruptcy law the receiver may replace management in a financially distressed firm before the first bankruptcy verdict if the appealed creditors request it and the court approves it. In this case, the main responsibilities of the receiver are simply to manage the debtor business and to control all payments to the creditors. In priority claims, the secured creditors will get priority after the costs of proceedings, any tax liabilities and claims on wages. Registering under court supervision liquidation does not prohibit most cash or other assets of distressed firms which leave the company. In other words, there is no automatic stay under Indonesia's new bankruptcy law. In summary, following features (**Table 3**) are related to creditors' rights under this law.

Conclusion

Indonesia has reformed its bankruptcy law in 1998. Resolution under court supervision is one of the ways to resolve the financial distress. So far, the Indonesia regulatory framework is quite satisfactory but lacks legal law enforcement. The literature reviews of current Indonesian judicial practice reveal that low legal enforcement is the crucial issue affecting regulations in the country. Thus, the government of Indonesia should support any reform program for better legal and regulatory systems in Indonesia. ■

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