THE DYNAMIC BETWEEN THE ROLE OF THE COURT AND INFORMAL WORKOUTS

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In light of the limited time available today, I would like to make the following brief points which will touch on a number of areas in the hope of stimulating discussion.

There is an inherent relationship between the courts and informal workouts which take place out of court. However, the relationship operates differently in different countries. The way in which the courts recognise various debtor-creditor rights and enforce insolvency and other laws directly affects the way in which out of court workouts operate. Indeed, the way in which the courts treat insolvency cases affects the entire dynamics of informal workout negotiations.

At its extreme, an efficient court which applies, in a predictable fashion, an effective insolvency law may do so with the consequence of eliminating the need for informal workouts. This will only occur in economies which have a highly developed understanding of insolvency and rehabilitation laws and where, as a result, the stigma associated with entering a formal process has been extinguished by a history of beneficial results for creditors and debtors through the formal process.

Some examples of the interaction are worth considering. In Australia, the way in which the courts have applied the laws in relation to unfair preferences has meant that informal workouts are rare and, at times, non-existent. Creditors realise that if one creditor does not get paid there is an efficient court process under which the company could be placed in liquidation or some other insolvency process. Secured creditors' rights are respected by the court and the ability to appoint a receiver can be exercised quickly and through a simple process entirely out of court with the secured creditor commonly needing to

do little more than sign a demand followed by a deed of appointment to appoint a receiver to take control of the debtor's assets. The ease with which a secured creditor can enforce its security and the ability of any creditor to place the company into liquidation combined with the ease with which a company can appoint a voluntary administrator to initiate a voluntary formal rehabilitation mean that creditors are reluctant to enter into informal workout agreements, especially when not all creditors are covered by the out of court workout. Creditors know that payments that they would receive under the workout plan are quite likely to be recovered as preferences if the company enters a formal insolvency process. Add to this the growth, with the court's approval, of insurance schemes to fund actions by liquidators to recover preferences and the result is that out of court workouts have become rare.

Since the Asian economic crisis began in 1997, a number of Asian countries have introduced frameworks for informal workouts. Some of these frameworks have developed, in Thailand for example, into binding agreements which set out the procedures for out of court workouts. In cooperative workouts conducted in accordance with these out of court frameworks, the court rehabilitation process has been used to put prepackaged plans into effect and bind all creditors to the workout plan.

Some Asian countries have been faced with the reality of inefficient and at times unpredictable courts. Thailand's new Central Bankruptcy Court has made a significant difference in the way out of court debt restructuring is progressing. The court has been fairly predictable in interpretation its of Thailand's rehabilitation law. This has armed creditors with the ability to threaten debtors with rehabilitation if debtors do not co-operate in the debt restructuring negotiations. This is material because historically in Thailand debtors have not been overly concerned that a creditor will commence ordinary debt recovery civil actions against then due to the inefficiencies involved in those actions. The Central Bankruptcy Court's application of the rehabilitation law has created a real "stick" for creditors at the restructuring negotiating table.

Debtors have carefully watched the way in which the courts have treated applications by creditors to place recalcitrant debtors involuntarily into formal insolvency or rehabilitation proceedings and have adjusted their positions in debt restructuring negotiations accordingly. Where the creditor's threat of placing the debtor into a formal process is not a threat which the debtor takes seriously as a result of the way the courts deal with aggressive rehabilitation

petitions brought by creditors, creditors have little to negotiate with in countries where other debt recovery legal processes are not effective.

Similarly, debtors who wish to frustrate formal proceedings watch carefully the way courts deal with applications by debtors, or creditors who are in reality merely stooges for the debtor, which are aimed at challenging the rehabilitation process sponsored by the creditors.

In countries where independent parties (called trustees, receivers, administrators, planners etc.) can be appointed to take control of a company's assets and formulate rehabilitation plans, the degree of protection extended to these independent parties by the courts is crucial in determining whether creditors can use the threat of formal proceedings to make a debtor act reasonably in out of court workout negotiations. If debtors know that the courts will not come to the aid of these independent parties, debtors can stand bold in workout negotiations as they know that they could frustrate an aggressive involuntary rehabilitation commenced by the creditors by civil and criminal attacks at the independent party. The degree of protection extended by the courts to these independent parties, for example, by dismissing spurious claims brought against them by the debtor or stooge creditors which are in reality attempts by the debtor to frustrate the rehabilitation process, affects the willingness of talented restructuring experts to make themselves available to take on these important roles. If the talent pool is significantly reduced as a result of poor protection from the courts, the quality of restructuring is almost certain to decline and economic recoveries will be delayed.

On the other hand, in countries which allow the debtor or its related parties to be the planner or rehabilitation administrator, the court's role in ensuring that creditor interests are protected becomes crucial. In Thailand some debtors have viewed the formal rehabilitation process, under which the courts have allowed the debtor to act as its own planner on occasion, as a useful tool for delay. By putting themselves forward as planner and then submitting unworkable and unacceptable plans, they achieve numerous months of delay, force the creditors through an expensive proof of debt process and whittle down the endurance of the creditors. If the plan is not approved, the law allows the company to be returned to its original status as the court can only order bankruptcy if a bankruptcy petition was pending at the time the rehabilitation petition was filed.

One of the greatest risks facing Asia at present is that many restructuring plans are not feasible. They are fictions with unrealistic debt repayment plans

which few, if any, involved in the restructuring expect that the debtor will be able to comply with. Many restructurings in Thailand are nothing more that reschedulings of debts. The restructuring plans do not truly focus on the viability of the business; rather, they are simply a rescheduling of debts with no real expectation that the debtor will be able to comply with the rescheduled debt reduction program-in particular, the significant balloon payment which is a common feature of many restructurings. In the desire to restructure non-performing loans quickly, if is fair to say that some countries have only recently begun to focus on the quality of the restructuring. When these pre-packaged workout plans are taken to the court to be formalised by a court process which will bind all creditors and/or enable aspects of the plan to be implemented which would otherwise not be possible (for example, debt to equity swaps in Thailand), the degree to which the courts scrutinise a deal approved by a majority of creditors is crucial if the courts are not to be tools used to perpetuate fictional restructurings.

As discussed above, plans are being submitted to courts for approval which involve repayment plans over many years with a significant and often unrealistic balloon payment in the final year. As many countries have maximum time periods prescribed by law for formal rehabilitations, many plans provide for the company to be subject to the formal process during the first 5 or 7 years of the plan and then outside the formal process for the balance of the term of the workout plan. It is important that the court, in approving the plan and approving the company's exit from the formal process, considers whether it is allowing an insolvent company to reenter the world of business. Surely, any rehabilitation process under court supervision must prevent this circumstance. The aim must be to rehabilitate the company under the formal process and only allow companies which have reattained solvency to reemerge from the formal process. The reality is that many rehabilitations do not result in the debtor's business being rehabilitated and it continuing in existence with a fresh start, solvent and free of unsustainable debt.

Many insolvency laws require that any rehabilitation plan approved by the court must satisfy some criteria. Commonly there are very few criteria but most insolvency regimes require that the plan provide for creditors to receive more than they would in liquidation. This nebulous concept which requires a degree of guesswork by the court really imposes on the court a duty to ensure that if a workout plan is brought to court as a prepackaged plan to be put through a formal rehabilitation process the result must be beneficial to all

creditors.

Another danger facing restructuring in Asia is the fact that the informal workouts can take place without creditors having the opportunity to make fully informed decisions about the feasibility of the restructuring plans. Increasingly it seems creditors are not being allowed full access and disclosure of information about the company's position and prospects. In some cases cost constraints or reluctant debtors prevent the creditors having an independent investigative accountant investigate the companies' affairs and advise on the plans proposed by the debtor. In these cases the danger arises if the plans are then submitted to the court as prepackaged plans which the court approves without too much review. Parties could abuse court process by having plans which conceal fraud or unfairly discriminatory transactions sanctioned by the court through the formal insolvency process. Whilst the majority of creditors might approve the plan, the court is really the bastion of protection for each and every creditor, particularly those who are unfairly discriminated against or from whom important information is concealed.

Out of court workouts are by their nature flexible; they are limited only by the creativity of the parties and their advisers and the limits of the law as identified by the participating advisers. When these workout plans are then submitted to the court to obtain the benefits of the court process (for example, a cramdown or tax waivers) the court's identification of unworkable or illegal aspects of the plan is a crucial quality control aspect of allowing debtors and creditors to utilise the court process to implement pre-agreed workouts.

Bankruptcy or liquidation is the backbone of an insolvency law. To the extent that a court or its agencies are responsible for the administration of bankruptcies, the degree to which creditors are able to obtain a prompt and efficient liquidation of the debtor's assets and payment of distributions through the bankruptcy process affects the entire dynamic of out of courts workouts. If the court or its agencies are responsible for administrating bankruptcy cases allow bankruptcy to be an inefficient or unworkable process, debtors will not fear the threat of bankruptcy, as they will realise that creditors do not consider it a realistic option. If at a practical level creditors are likely to have to wait years to receive any distribution in a bankruptcy, creditors will always prefer any deal in an out of court workout (or formal rehabilitation if the process exists in the country) which involves real money to bankruptcy. This can mean that insolvent companies with businesses that are not viable will be allowed to continue in existence.

CORPORATE VOLUNTARY ADMINISTRATION IN AUSTRALIA

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BACKGROUND TO THE VOLUNTARY ADMINISTRATION SCHEME

In 1983 the then Attorney-General requested the Australian Law Reform Commission ('the Commission') to inquire into the law relating to insolvency.

The Commission was directed to have regard to international developments in bankruptcy and company law and practice including, in particular the recommendations of the United Kingdom Insolvency Law Review Committee (known as the Cork Report). Those recommendations had led to the introduction of a corporate administration procedure in the United Kingdom.

At the time the Commission was requested to conduct the review, the schemes available for rescue/rehabilitation of insolvent companies in Australia were:

- schemes of arrangement; and
- official management.

Schemes of arrangement were time consuming and costly. Official management was cumbersome and not often used. The only other formal schemes for dealing with insolvent companies were receivership and liquidation.

After an exhaustive consultation procedure, the Commission completed its report in 1988. The report's official title is *General Insolvency Inquiry*, but is more commonly referred to as 'the Harmer Report' (after the Commissioner-in-charge of the Insolvency Reference, Mr. R.W Harmer).

In the Harmer Report, the Commission expressed the view that the schemes then available in Australia for dealing with the affairs of a company in financial difficulty were too conservative. They placed insufficient emphasis upon encouraging a constructive approach to corporate insolvency by, for example, focusing on the possibility of saving the business (rather than saving the com-

pany) and preserving employment prospects. The Commission stated that:

> "A constructive approach to corporate insolvency requires the preservation, if practical and possible, of the property and business of the company in the brief period before creditors are in a position to make an informed decision. This assists in an orderly and beneficial administration whether creditors decide to wind the company up or accept a compromise. An ordered form of administration of the affairs of an insolvent person is at the centre of insolvency law — whether, in the case of an insolvent company, that law offers the prospect of a winding-up or continuation of the corporate business. This approach is similar to that taken by insolvency law inquiry bodies in many overseas countries, such as the United States of America, Canada, the United Kingdom and some of the European nations.
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> The Commission does not suggest that its approach will result in the salvation of failed companies or even companies which show signs of failing. Nonetheless, the aim is to encourage early positive action to deal with insolvency. It will be worthwhile and a considerable advantage over present procedures if it saves or provides better opportunities to salvage even a small percentage of the companies which, under the present procedures, have no alternative but to be wound up."[1]

The Australian Government ('the Government') was inclined to implement the recommendations in the Harmer Report, especially since they then enjoyed a substantial degree of support within the professional community. In 1991, the Government commenced the corporate insolvency law reform process by issuing discussion papers to peak professional and business bodies. Those papers focused on aspects of the Harmer Report and preceded the exposure of draft legislation.

The voluntary administration ('VA') reforms became part of a package of insolvency reforms that were incorporated in the Corporate Law Reform Bill 1992. The Bill was released for three months public exposure in Febru-

[1] Australian Law Reform Commission, *General Insolvency Inquiry* (Report No. 45, 1988), paras 53 and 54.

ary 1992. Over 2,000 pages of submissions were received. Also, hearings and forums on the Bill were conducted in every major Australian city by the Attorney-General's Department and a parliamentary committee. After a rigorous assessment of the submissions, further consultation took place, culminating in meetings with committees of expert insolvency practitioners. As a result of these consultations, some changes were made to the Bill.

The Bill was to become the *Corporate Law Reform Act 1992*. The Act abolished the official management regime, and replaced it with the regime known as the voluntary administration scheme which is now Part 5.3A of the Australian Corporations Law ('the Law'). The scheme commenced operation on 23 June 1993.

The objective of Part 5.3A, as stated in section 435A of the Law, is to allow the

> "business, property and affairs of an insolvent company to be administered in such a way that:
> (a) maximises the chances of the company, or as much as pos sible of its business, continuing in existence; or
> (b) if it is not possible for the company or its business to continue in existence — results in a better return for the company's creditors and members than would result from an immediate winding up of the company."

The voluntary administration scheme seeks to overcome the shortcomings of the schemes available previously by providing a flexible and relatively inexpensive procedure pursuant to which a company may obtain some breathing space, so that it can attempt a compromise or arrangement with its creditors. The voluntary administration scheme is intended to be an alternative to situations in which a company limps along, continuing to trade after it has lost the capacity to repay, playing innocent third party creditors off against one another. The breathing space should enable directors in smaller companies to take a rest from "bush fire fighting", and contribute some technical expertise back to the business.

THE LEGISLATIVE FRAMEWORK

Part 5.3A of the Corporations Law contains the main provisions dealing with voluntary administration scheme. The primary purpose Part 5.3A is to provide a flexible and relatively inexpensive procedure pursuant to which a company may obtain a breathing space, so that it can attempt a compromise or arrangement with its creditors aimed at saving the company or the business and maximising the return to creditors. If successful, the arrangement will be set out in a deed of company arrangement, which binds the company and the creditors. However, if the attempt fails, the legislation provides for an automatic transition to liquidation.

The Administration

The appointment of an administrator has some immediate and important consequences. On appointment, control of the company and its property, business and affairs is vested in the administrator. The administrator acts as the company's agent, and the powers of all other officers of the company may not be exercised except with the administrator's written approval. Under the Law, the company's directors must give such assistance to the administrator as reasonably required by the administrator, including details of company assets and liabilities, and handing over books and company records.

Having taken control of the company's affairs, the primary task for the administrator is to investigate the financial position of the company, with a view to making a recommendation to a meeting of creditors about what should be done with the company and its business.

Who may appoint an administrator?

An administrator may be appointed by the following persons to take over the affairs of a company:

- firstly, (and most commonly), by a majority of the company's directors — where those directors think, either that the company is insolvent, or that it is likely to become insolvent at some time in the future, they may pass a resolution to appoint such administrator; or
- secondly, a liquidator or provisional liquidator of the company; or
- thirdly, a chargee entitled to enforce a charge over the whole or substantially the whole of the company's property.

The administrator must be a qualified liquidator registered by the Austra-

lian corporate regulator, the Australian Securities and Investments Commission ('ASIC'). Those persons are usually private sector insolvency specialists. Their fees for conducting the administration are paid for out of the assets of the company.

Points to note

Appointment by the company

The voluntary administration procedure may be initiated by the company alone. There is no requirement for any application to be made to the Court.

The administration procedure is open to companies that are not insolvent at the time the resolution is passed. The directors merely have to be satisfied that it is likely that the company will become insolvent at some future time. The directors will therefore be able to initiate the procedure when insolvency is impending, but before the duty arises to prevent insolvent trading.

Appointment by the liquidator or provisional liquidator

Where the appointment is made by a liquidator (or provisional liquidator), that person may also act as the administrator provided that the Court's leave is obtained.

Circumstances in which a liquidator may wish to utilise the administration procedure could include where the company is in members' voluntary winding up and the view has been formed that the company is insolvent or is likely to become insolvent. There may also be circumstances where the moratorium provided for by Part 5.3A would assist a liquidator or provisional liquidator in implementing a plan to dispose of the business of the company as a going concern.

Appointment by the holder of a charge on the whole, or substantially the whole, of a company's property

The holder of a charge on "the whole, or substantially the whole, of a company's property" may also appoint an administrator, if the charge has become and remains enforceable.

Consent of the administrator

The written consent of the person to be appointed administrator must be obtained before the appointment is made.

The moratorium

One of the most important effects of the appointment of an administrator is the triggering of a moratorium on actions against the company.

The reasons for placing a freeze on all actions against the company during the period of administration is to give the administrator and the creditors a chance to assess the situation and work out the best course of action. If one or more creditors were allowed to pursue their individual claims, the administrator would have to become involved in defending the proceedings. That would detract from the other important work the administrator has to do in a short amount of time and would incur considerable expense, which would operate to the detriment of the other creditors, the members and the company. If the administration is followed by a winding up or a deed, the creditor can always prove for the claim in the winding up or the deed.

Amongst other things, the moratorium:

- prevents the company being wound up;
- prevents charges being enforced (subject to some exceptions-see below);
- prevents an owner or lessor recovering property which is being used by the company (also subject to exceptions);
- prevents proceedings being commenced or continued against the company and any enforcement action in relation to proceedings already; and
- prevents a guarantee by the company's directors or relatives being triggered.

Exceptions to the moratorium

There are a number of exceptions to the moratorium.

The most important exception to the moratorium is that which allows a chargee of the whole or substantially the whole of the company's property to appoint its own receiver. The chargee must act, however, within 14 days of the appointment of the administrator.

The phrase "the whole, or substantially the whole, of the property of a company" is not defined in the Law. However, the rationale for the exception is that the holder of such a charge will be in a position to achieve an orderly realisation of the company's assets. In deciding whether a charge is "on the whole, or substantially the whole, of the company's property", the issues include whether the charge covers sufficient of the assets of the company to enable the chargee, or a receiver appointed by the chargee, to control and

carry on the business of the company with a view to achieving such an orderly realisation. A standard full fixed and floating charge over all the company's property will amount to such a charge.

The enforcement by the secured creditor of a charge or charges over the whole, or substantially the whole, of the company's property does not bring the administration to an end. However, as the whole, or substantially the whole, of the company's property will be under the control of the chargee, or a receiver appointed by the chargee, the administrator will effectively have no assets to administer, and no indemnity out of the assets of the company subject to the charge once written notice of enforcement is given to the administrator. In practice, therefore, potential administrators would be likely to ascertain the attitude of such a chargee to an administration before accepting an appointment as an administrator.

Other exceptions are that:

- a creditor who takes steps to enforce a charge prior to the appointment of an administrator, may continue to enforce that security;
- a creditor may enforce a charge in relation to perishable property, notwithstanding the appointment of an administrator; and
- where an owner or lessor of property used by the company takes steps, before the beginning of the administration, to recover that property, that recovery process will be allowed to continue.

<u>Point to note</u>

If one of the exceptions to the moratorium applies, that isn't the end of the matter. The administrator can still apply to the court for an order restricting any of the owners or chargees of the property from exercising their rights. But the court will only make such an order if it is satisfied that what the administrator proposes to do during the administration will 'adequately protect' that person's interests.

First meeting of creditors

In order to ensure that creditors are kept fully informed during the course of an administration, the administrator is required to call a first meeting of creditors within five business days of his or her appointment.

At that meeting, the creditors will consider whether:

- to remove the administrator, and appoint someone else in his or her place;

- a committee of creditors should be appointed.

The function of any committee of creditors will be to liaise with the administrator during the administration. The creditors' committee cannot give directions to the administrator, other than to require the administrator to report to the committee about matters relating to the administration.

Meeting to determine the company's future

Assuming the administrator hasn't been replaced at the first meeting, he or she will have been busily going about investigating the companies affairs. Having formed an opinion about what should be done in relation to the company, the administrator is required to call a meeting of creditors to determine the company's future. Generally the meeting will have to be held within 28 days (in the usual case) or 35 days (where Christmas or Easter intervenes) of the administrator's appointment.

A number of reports and statements must accompany the notice of the meeting to determine the company's future, including the details of any arrangement with the creditors, proposed by the administrator. The administrator must send the creditors a statement containing an opinion as to each of the following three options:

- whether it would be in the interests of the company's creditors to execute a deed of company arrangement;
- whether it would be in the interests of the company's creditors for the administration to end; and
- whether it would be in the interests of the company's creditors for the company to be wound up.

Under the Law, there are no other options that the administrator can recommend.

The administrator must also send to creditors an opinion regarding whether there are any transactions which might be voidable and which might enable a liquidator to recover money, property or other benefits.

The creditors may resolve at the meeting to:

- execute a deed of company arrangement;
- terminate the administration;
- have the company wound up; or

- adjourn the meeting for a further period of up to 60 days. No further extension beyond 60 days is possible.

Voting at the meeting

Most of the rules in relation to how voting is to be conducted are found in Part 5.6 of the Corporations Regulations.

A vote on a resolution is determined on the voices, unless a poll is demanded. If no poll is demanded, the Chair of the meeting (who, under the Corporations Regulations, is usually the administrator) must decide whether it is carried, carried unanimously, lost or so on. The Chair's declaration is conclusive evidence of the result unless a poll is demanded.

A poll can be demanded by the Chair, any two creditors or anyone present or voting by proxy with at least 10% of the voting rights. If a poll is taken, the resolution is determined by simple majority by number <u>and</u> value of debts owed.

If there is a deadlock, which can happen either if the voting is 50/50 or, more commonly, where the majority by number vote one way but the majority by value vote another way, then the Chair gets a casting vote.

The exercise of a casting vote by the Chair can be reviewed by the Court on the application of a dissatisfied creditor.

In many cases, some of the creditors are related somehow to the company or its directors. The legislation recognises that votes could be unduly influenced by related parties, particularly in smaller companies where there could be director finance. Accordingly, the Law permits the Court to set aside a resolution or order that a meeting be reconvened if it finds that:

- the vote would have gone another way if the votes of related parties are disregarded; and
- the result of the vote is contrary to the interests of creditors as a whole, or likely to prejudice the interests of creditors who voted the other way.

The Deed of Company Arrangement

Assuming the resolution is not set aside, the company will enter into a deed of company arrangement. The deed of company arrangement is really what the voluntary administration scheme is all about—the rest of it is all about how to get to this point, and ensuring that it is reached quickly.

Most deeds will be in one of two forms, or a combination of both. In a moratorium type of deed, the creditors agree to accept payment at a later time, usually in instalments (like a drip-feed arrangement). In a compromise

deed, the creditors agree to accept less that 100 cents in the dollar in full satisfaction of their claims. In many cases compromise deeds will provide that some third party will make a contribution to the assets of the company.

What does the deed contain?

Where a company's creditors resolve that the company execute a deed of company arrangement, the legislation sets out broadly what the deed of company arrangement must contain. It must identify:

- the property that is to be available to pay creditors' claims;
- the nature and duration of any moratorium period for which the deed provides;
- the extent to which the company is to be released from its debts;
- the conditions (if any) for the deed to come into operation;
- the conditions (if any) for the deed to continue in operation;
- the circumstances in which the deed terminates;
- the order in which the proceeds of realising the property available to satisfy creditors' claims is to be distributed; and
- the day (not later than the day when the administration began) on or before which claims must have arisen if they are to be admissible under the deed.

The deed will also be taken to include the provisions set out in the Corporations Regulations unless the deed provides otherwise. The prescribed provisions are only a general guide—in many cases they won't be especially suitable for the specific type of arrangement contemplated.

Effect of the deed

The company has 21 days after the end of the meeting of creditors to determine the company's future (subject to any extension granted by the Court), to then execute the deed. Once the deed is executed, the administration of the company ends and the moratorium on actions against the company is replaced by more limited restrictions on actions against the company.

These restrictions are that, while the deed is in place, all persons bound by the deed are prevented from:

- applying for the company to be wound up;
- bringing or continuing a proceeding against the company or its property; or
- attempting to levy execution or other enforcement process, except with

the leave of the Court.

Who is bound?

All unsecured creditors will be bound by the deed, but only those secured creditors that agree to be bound will be bound.

Where a particular secured creditor has not agreed to be bound by the deed and that creditor's dissent threatens the viability of the entire deed, the court is permitted to order that the creditor refrain from exercising its security.

The deed administrator

The administrator of the company will become the administrator of the deed of company arrangement unless the creditors resolve otherwise. The deed administrator's role will be set out in the deed. A long list of powers and functions are set out in the Corporations Regulations, but it is not necessary to include those in every deed.

In the bigger administrations it will usually be appropriate for the administrator to play a role in the management of the company's affairs. But, for smaller companies, the deed administrator's role may be limited to things like making sure the deed is complied with. The day-to-day management of the company may essentially be handed back to the directors while the deed administrator takes a less active role.

Variation of a deed

Once the deed is in place, the deed may be varied by resolution of the creditors. The administrator of the deed may convene a meeting for this purpose at any time, and is required to do so if requested in writing by creditors holding claims against the company in excess of 10 per cent of the value of all creditors' claims.

The Court has the power to cancel a variation of a deed either wholly or in part on the application of any creditor and make such other orders as it thinks appropriate.

Termination of a deed

A deed of company arrangement terminates if:

- the Court so orders on application by: the company; a creditor; or any interested person (the grounds on which the Court may terminate the deed

include where the resolution that led to the company executing the deed was based on materially false or misleading information, where there has been a material contravention of the deed, or where the deed is oppressive or unfairly prejudicial to one or more creditors or is contrary to the interests of the creditors as a whole);
- the creditors of the company so resolve at a meeting; or
- the conditions specified in the deed for termination are met.

Transition to Winding up

It may be, of course, that the creditors decide at the meeting called to decide the company's future that the company should be wound up. In that case, the company will be deemed to have entered into a creditors' voluntary winding up and the administrator will be deemed to have been appointed as the liquidator of the company.

A similar transition from administration into a deemed creditors' voluntary winding up will also occur:
- where the company fails within 21 days to execute a deed of company arrangement agreed upon by the creditors; or
- where the creditors terminate a deed of company arrangement and resolve that the company should be wound up.

However, the Court may stay or terminate the winding up process, for example in circumstances where the company can establish that it is in fact solvent (for the directors may place the company in administration where they believe that the company *will become* insolvent at some future time, so it is possible that the company may still technically be solvent).

THE ROLE OF THE COURT

It was a core aim when introducing the VA system to maximise speed and efficiency by eliminating unnecessary Court involvement. In many cases, VAs proceed from beginning to end without any consideration by the Court whatsoever. However, the potential for Court involvement, particularly to supervise its operation where a party considers the scheme is being abused, is a critical feature of the VA scheme.

The Court is given numerous powers to make orders of a supervisory nature on the application of creditors, administrators and other interested persons (including ASIC). For example, the Court is given powers to:

- make any order about how Part 5.3A of the Law (the VA provisions) should operate in relation to a particular company;
- make any order it thinks necessary to protect the interests of a company's creditors while the company is under administration (ASIC or a creditor of the company may apply);
- make an order declaring that the appointment of an administrator of a company or a deed, is valid;
- grant leave to a person who, although qualified to be appointed as administrator, is precluded from doing so by virtue of a professional or commercial relationship stipulated in the Law;
- review the administrator's remuneration if fixed by creditors;
- remove an administrator;
- excuse an administrator from personal liability;
- extend the time periods for meetings (up to certain statutory limits) and in certain cases, cure failures to comply with mandatory time periods; and
- grant leave to an administrator to dispose of property the subject of a charge or that is owned or leased by a third party to the company under administration, where the Court is satisfied that adequate arrangements have been made to protect the secured creditor, owner or lessor.

Court involvement at some stage of the process is a common occurrence, particularly in larger administrations. However, usually this has not led to significant delays and often the Court's intervention by way of making a supervisory order has facilitated timely progress of administrations.

<u>Point to note</u>

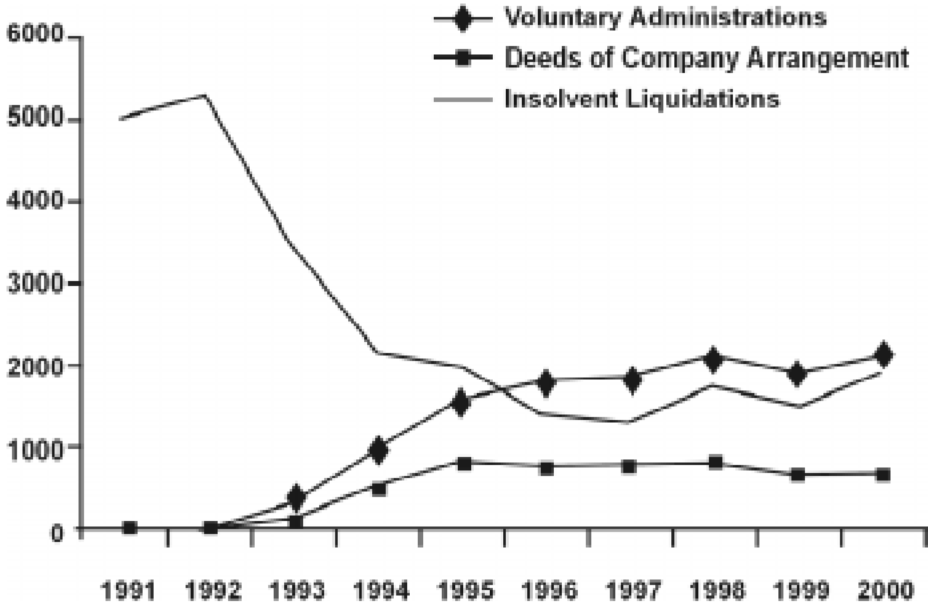
The administrator of a company or a deed may also apply to the Court for directions about a matter arising in connection with the performance or exercise of any of the administrator's powers or functions, and anything arising in connection with the operation, or giving effect to the deed.

AUSTRALIA'S EXPERIENCE WITH VA

If numbers alone are a guide, VA has been and continues to be hugely successful in Australia. The chart below shows the number of VAs and deeds of company arrangement entered into on an annual basis since its commencement. Also shown, by way of comparison, are the numbers of insolvent liquidations (either court-ordered or voluntary). VA is now the single most popular

formal procedure for dealing with companies in financial difficulty.

ANNUAL RATES OF VOLUNTARY ADMINISTRATION, DEEDS OF COMPANY ARRANGEMENT AND INSOLVENT LIQUIDATIONS IN AUSTRALIA



(Source: Australian Securities and Investments Commission monthly statistics)

The chart indicates that, generally, somewhere between 25 and 50 percent of voluntary administrations are successfully converted into deeds of company arrangement. The vast bulk of the remainder would proceed into liquidation, as very rarely is a company that enters VA found to be in a sound financial condition and able to be returned immediately to the hands of the directors to continue business as usual.

Perceived difficulties

Despite its popularity, there have been some concerns expressed from time to time about the VA system. Most commonly, complaints are from creditors who consider that the system is being abused by directors by, for example, appointing a 'friendly' administrator who acts in the interests of the directors when advising on the best course of action rather than the interests of the

creditors. These complaints often centre on the failure to advise creditors effectively about returns from potential actions against directors or related parties if the company were to be placed into immediate liquidation rather than enter into a deed of company arrangement.

More recently, the number of complaints about possible abuse has diminished. It may be that, as creditors become more familiar with how the scheme operates, and their own roles, rights and responsibilities, they are becoming more active in ensuring that their interests are protected. Some support for this view may be found in the statistical data that indicates the proportion of companies now entering deeds of company arrangement is somewhat less than the number doing so at the commencement of the scheme.

Other concerns raised are of a more technical nature, such as the length of the statutory time frames and the details of the voting procedures. These matters have been examined by the Legal Committee of the Companies and Securities Advisory Committee, which has produced a detailed report on the VA scheme. That Committee has made a number of recommendations about 'fine tuning' of the VA system, which are expected to be considered by the Government as part of an upcoming wide-ranging review of the corporate insolvency provisions generally. However, it is not expected that any major structural changes to the scheme will need to be made as part of that review.

CONTEXT OF THE VA SCHEME

As with all insolvency systems, it is very important in gaining an understanding of its operation to consider not only the scheme itself, but also important contextual factors.

Avoidance of personal liability by directors

Directors of an insolvent company may be personally liable to pay group tax debts (federal tax on the salaries of employees) if they do not act quickly to put the company into VA or liquidation when the Australian Taxation Office issues a certain notice. That notice sets out that the company has failed to remit certain group tax or other deductions, and that the directors are to be personally liable for the debts unless they act within a certain period Commonly directors will, on receipt of such a notice, place the company in VA.

Also, under the Law, directors have a specific duty to prevent the company from engaging in insolvent trading. Breach of this duty exposes directors to liability to personally *compensate* the company (or its creditors) for *any loss*

suffered *as a result of* the company *trading* while insolvent. Placing a company in VA at an early date is a means of avoiding this potential liability if the directors think the company is either insolvent or likely to be so in the future.

The above factors are likely to explain, to a some degree, the popularity of the VA scheme.

Insolvency profession

One of the critical factors in the success of the VA scheme in Australia is the availability of skilled, honest and independent administrators. As mentioned above, these are drawn from registered insolvency professionals, specifically licensed to do this kind of work.

Also, as mentioned above, most complaints about the scheme relate to alleged abuses by administrators who are perceived to be 'too close' to management. The means of ensuring that administrators are independent is one of the key issues that are likely to be considered in the review of the VA framework.

Debtors and creditors

Australian debtors and creditors are now quite familiar with the concept of the VA scheme and, by and large, consider it as a useful tool. During the earlier years of its operation there were some 'teething difficulties', but through accumulation of court decisions and experience creditors (particularly professional creditors such as financial institutions) accept the VA scheme as a legitimate means of dealing efficiently with a debtor company in financial difficulties. They see the potential for getting a larger return than would occur with immediate liquidation and are getting more skilled at identifying rehabilitation proposals that are likely to be successful, and rejecting proposals that are not viable.

CONCLUSION

Rather than place hurdles before debtor companies seeking relief from creditors through rehabilitation procedures, Australian insolvency laws actively encourage corporate debtors in financial difficulties to enter administration_voluntarily at an early stage. Entering the procedure early prevents problems escalating, further debts being incurred and further creditors being adversely affected. A key to the success of this approach is that the procedure is very short in time frame, relatively inexpensive, and therefore interference

with the rights of creditors, particularly secured creditors, is kept to a minimum. It is usually the need to prevent undue interference in the rights of creditors that drives other systems to have elaborate legal requirements concerning use the rehabilitation procedure.

Despite its 'creditor-friendly' nature, in terms of the proportion of companies entering the scheme that are successfully rehabilitated, VA compares quite favourably with other schemes that are widely considered more 'debtor-oriented'.

The Court has quite a limited role in VA compared to a number of other rehabilitation frameworks. It is not required to make decisions on commercial matters such as the prospects for success of a plan—those decisions are left solely to the creditors on the advice of the administrator. However, the existence of an efficient and competent body to take on the role of general supervision of the process and making binding rulings where disputes arise is critical to the operation of the scheme.

Also playing a large role in the success and popularity of the VA scheme are Australia's private sector insolvency practitioners and the attitudes of debtors and creditors themselves to the procedure. Encouraging companies to enter the scheme by use of incentives for management is also important.

It is helpful to consider that between the two extremes of an informal 'out of court' compromise and a formal rehabilitation mechanism which has a high level of court involvement, there are 'in between' semi-formal systems. The Australian VA scheme is one such system. However, when considering possible models it is just as important to examine the surrounding context in which a scheme operates as the details of the scheme itself.

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RELATIONSHIP BETWEEN INFORMAL WORKOUTS AND THE COURTS IN MALAYSIA

BY
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Malaysia has a traditionally strong judiciary system and an established insolvency legislation derived from the British and Australian models. This legal infrastructure has served Malaysia well in dealing with insolvency proceedings for distressed companies, especially those that resulted from the recessions of the 1970s and 1980s.

However, over the last 5 years, the approach in Malaysia has shifted away from formal insolvency proceedings towards a restructuring-based approach. This is due to the perception that the existing legal infrastructure is not as responsive and is inadequate to deal with present day's problems although the mechanisms are in place to provide a solution. The impetus for this change came in the 1997 financial crisis when Malaysian companies, same as its counterparts in the region, required help in over-coming financial problems arising from both a currency depreciation and the overnight collapse of the economy. The magnitude of the problem is just beyond the capacity of the legal infrastructure, thereby prompting the advent of informal workout proceedings best reflected in the creation of the Corporate Debt Restructuring Committee ("CDRC").

Whereas insolvency proceedings are commonly associated with liquidation of assets for the benefit of creditors (and therefore are viewed to be destructive in nature), the restructuring-based approach advocates creation of value for all stakeholders. Insolvency proceedings also suffer from the rigidity of complying with a set of lengthy legal procedures. The result of which is a lack of flexibility to meet specific demands of stakeholders in a restructuring case. Nonetheless, insolvency proceedings remain an important arsenal in dealing with problem companies. This is because not all companies can be restructured.

The task given to CDRC is to assist in the restructuring of large "viable" corporate borrowers. It was important for these engines of growth of the economy

to be restructured so as to avoid unnecessary collapses of viable companies as well as to avoid large scale job losses. Insolvency proceeding for so many large and strategic companies was never an option due to the systemic risks they posed to the financial system. Furthermore, many of these companies were financially sound just before the crisis. This fact has been confirmed by independent studies including that of the World Bank that concluded Malaysian companies were suffering from a liquidity crisis and not financial insolvency.

The CDRC's framework has been structured to avoid moral hazard issues. Firstly, CDRC will only mediate between debtor companies and their creditors if it is acceptable to both parties. Secondly, the legal rights of creditors are never compromised throughout the informal workout process. Thirdly, the solution proposed under the CDRC workout require the unanimous consent of creditors before a restructuring scheme can be implemented. These conditions ensure that CDRC's restructurings are done with maximum transparency for all stakeholders. This fomula has helped CDRC to complete the restructuring of 33 Groups of companies involving debts of RM25.5 billion (US$6.7 billion) as at end-January 2001.

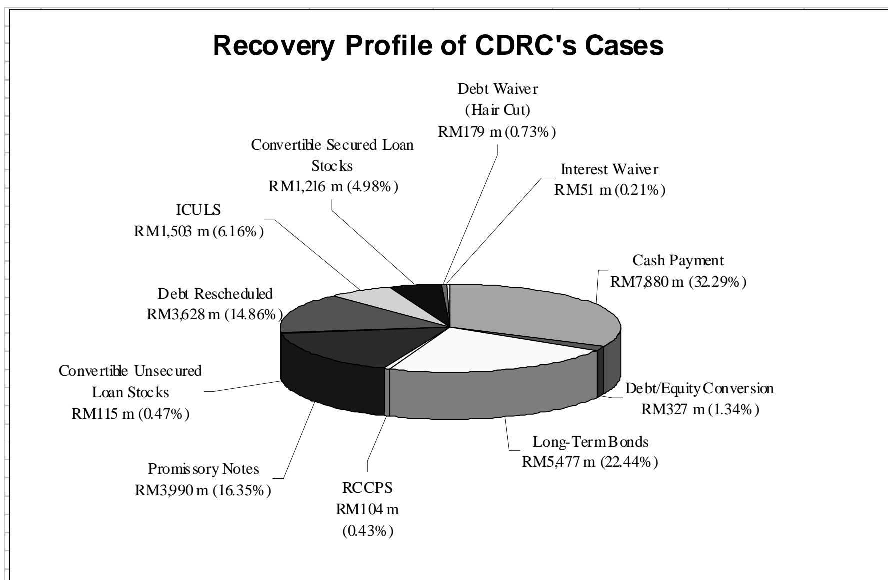
Table: Number of Applications Made to CDRC

	Number		Amount	
	Units	%	RM million	%
Applications Received	75	100.00	47,209.75	100.00
Less: Withdrawn/Rejected Cases	21	28.00	7,825.89	16.58
Less: Transferred to Danaharta	9	12.00	1,813.54	3.84
Cases under CDRC	45	60.00	37,570.32	79.58

Table: Statistics on Status of CDRC's Cases

	Number		Amount	
	Units	%	RM million	%
Cases under CDRC	45	100.00	37,570.32	100.00
Less: Restructured Cases	33	73.33	25,476.92	67.81
Outstanding Cases	12	26.67	12,093.40	32.19

CDRC's restructuring schemes have relied on the full spectrum of capital market instruments to give excellent recoveries (> 99%) for creditors. Only 0.9% of the debt amount has to be written-off, comprising 0.7% of principal hair-cut and 0.2% in interest waiver. This 99% recovery in NPLs comprise 32.3% in the form of cash repayment; 50.8% in debt/quasi-debt instruments; 1.3% in debt-equity conversion and 14.9% in rescheduled term loans (see pie chart below). Upon the listing of Time dotCom Berhad in March, the cash portion will improve to 48.6% with the scheduled redemption of RM3,990 million (US$1,050 million) promissory notes.



CDRC's experience shows that informal workouts can co-exist with formal insolvency proceedings. For informal workouts to be effective, there must be mechanisms in place within the existing legal infrastructure to translate the informal agreements into legally effective solutions. This is a process often taken by the CDRC to conclude difficult restructurings.

In any restructuring, the support of all stakeholders is essential to reach a common goal, that is, to achieve a solution that is supported by creditors, shareholders and management. In Malaysia, such proposal must also comply with companies and securities laws and would be subject to the approval of the Securities Commission and also shareholders of the distressed company. It

is therefore an ardous task which is best taken one step at a time.

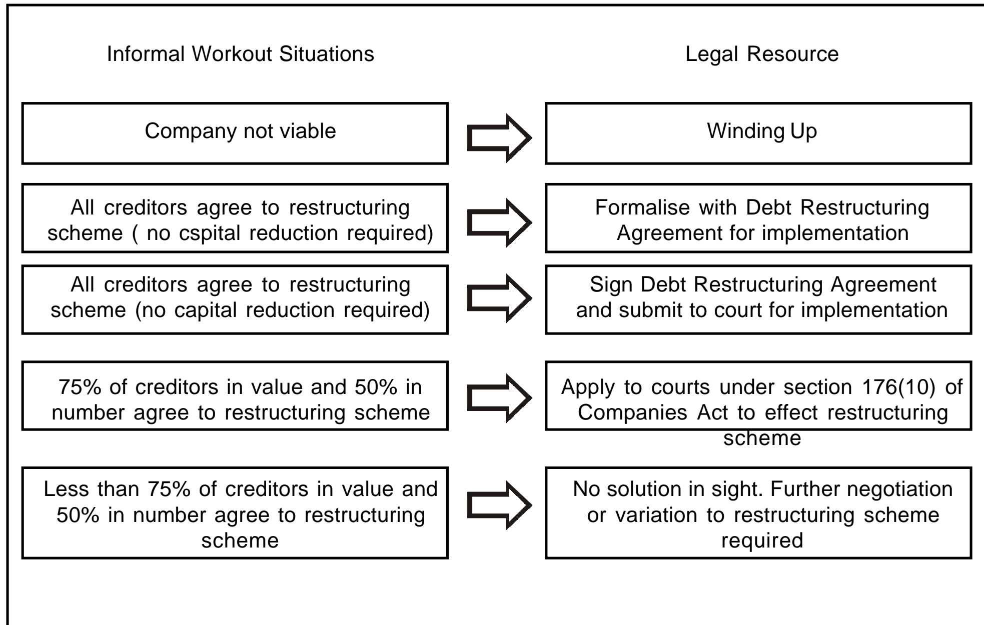
First and foremost, the idea of a workout is to package a solution to a problem. Unlike a formal process which does not have the flexibility of material variation once a restructuring scheme is proposed, an informal process based on negotiation allow a scheme to obtain support of creditors before it is formally proposed. This friendly approach can be conducted on a discrete basis, thereby shielding the company from unwanted publicity. At all times, we ensure that the restructuring schemes offered to creditors have taken into account their different security rankings prior to restructuring and must be consistent for different creditors within the same security ranking.

It is not necessary for informal workouts to seek the assistance of the courts should there be unanimous approval from creditors. Under this scenario, the restructuring could be effected through the signing of a Debt Restructuring Agreement between the debtor company and its creditors. However, due to the diverse demands of different classes of creditors, it may not always be possible to obtain unanimous approval of all creditors. In this situation, it would be necessary to pre-package a solution that is acceptable to the majority to move the restructuring forward. Section 176 of the Malaysian Companies Act 1965 allow for such a legal remedy. The law requires creditors to vote in their respective classes. As long as more than 75% in value and 50% in number of creditors in each class support the restructuring scheme, then the proposed scheme will be made binding on all creditors by the courts. Thus, the role of courts would be very important in most debt restructuring as it is difficult to ensure 100% of creditors sign a Debt Restructuring Agreement to restructure debts.

The role of the courts is also indispensable in cases where companies have to undertake a capital reduction. This is because the court is the sole authority under the Companies Act for this purpose.

Thank you.

The chart below summarised the common link between informal workout proceedings and legal recourse to speed up the restructuring of distressed companies in Malaysia:



SOME CHALLENGES FOR INSOLVENCY SYSTEM REFORM IN INDONESIA

BY
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> "Before the onset of the Asian financial crisis insolvency laws of many Asian economies were generally speaking, out of date and irrelevant to modern commercial needs. In many cases the insolvency laws had been imported from overseas jurisdictions at the turn of the last century, and had never been reviewed. Available statistics indicate that in many of the economies there had been no cases of corporate bankruptcy at all. In some of the economies there were no experienced judges, administrators or professionals to administer the insolvency laws. Related laws and practices, such as those relating to debt recovery and security enforcement, were similarly defective. The area of secured transactions was quite undeveloped in many of the economies."
>
> **Ronald Harmer** (Asian Development Bank)[1]

> "There are technical problems with Indonesian bankruptcy law, but the over-riding issue is whether Indonesian society believes that functioning bankruptcy law serves Indonesia's interests rather than solely those of foreign creditors.... The immediate connection to the current insolvency reform debate is the way in which Indonesian debtors commonly resist foreign creditor actions by claiming their personal interest as 'national interest'."
>
> **David K Linnan** (University of South Carolina)[2]

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[1] Asian Development Bank, "Insolvency Law Reforms in the Asian and Pacific Region: Report of the Office of the General-Counsel on TA 5795-REG: Insolvency Law Reforms", (prepared by RW Harmer), at (pp 10-99) in *Law and Policy Reform at the Asian Development Bank*, April 2000 Edition, Vol. 1, p 11 (referred to hereinafter as 'ADB, "Insolvency Law Reforms in the Asian and Pacific Region: Report of the Office of the General-Counsel on TA 5795-REG: Insolvency Law Reforms"').

[2] D Linnan, "Bankruptcy Policy and reform: Reconciling Efficiency and Economic Nationalism", (pp 94-112) in T Lindsey (Ed), *Indonesia: Bankruptcy, Law Reform & the Commercial Court*, Sydney, Desert Pea Press, 2000 at p 94 and p 109 (cited hereinafter as Linnan, 2000).

> Thus far, the performance of the judiciary [in Indonesia] has been disappointing vis-à-vis important aspects of international trade such as enforcement of loan agreements..., and certainly in the enforcement of arbitration awards. Unless there is an appeal by the people themselves for improvement by the judiciary, it will be difficult for Indonesia to have significant leverage in the free markets of APEC and ASEM."
>
> **Charles Himawan** (University of Indonesia)[3]

INTRODUCTION

This session is entitled "Informal Peer Review – Indonesia". It follows extensive discussions of judicial structures for dealing with insolvency matters. In contrast, this session is intended to review recent insolvency law reforms in Indonesia in the light of the amendments which have been made to the Indonesian Bankruptcy Law in 1998 and the establishment of the Commercial Court to deal with bankruptcy cases.

It has frequently been noted that the judicial system in Indonesia has not functioned well in dealing with bankruptcy cases.[4] This has meant that there has not been great confidence in Indonesia in the court system as a means of dealing with bankruptcy cases.[5] Can we have more confidence in out of court mechanisms? Yes, but the two kinds of mechanisms go hand in hand. As in more advanced insolvency law systems, non-judicial mechanisms have provided more effective means of dealing with problems of debt recovery in Indonesia. Indonesia has a long tradition of using negotiation and other informal methods of dispute handling and there is no reason why this tradition should not be drawn upon in fashioning an insolvency system more closely attuned to Indonesian circumstances.[6]

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[3] C Himawan, "Indonesia", (pp 196-262) in Poh-Ling Tan (ed), *Asian Legal Systems*, Sydney, Butterworths, 1997 at pp 255-256 (referred to hereinafter as Himawan).

[4] It has been noted by David Linnan that in the five year prior to the bankruptcy law amendments of 1998 (Perpu No 1 of 1998), there were only 120 bankruptcy cases in a country of over 200 million: in Linnan, 2000 at p 95.

[5] See generally, P Little, "Indonesia", (pp 201-228) in R Tomasic and P Little (Eds) in *Insolvency Law & Practice in Asia*, Hong Kong, FT Law & Tax 1997 (cited hereinafter as Tomasic and Little). Also see generally: T Lindsey (Ed), *Indonesia: Bankruptcy, Law Reform & the Commercial Court*, Sydney, Desert Pea Press, 2000; and P Little and Bahrin Kamarul, "Company Law in Indonesia" (pp 475-506) in R Tomasic (Ed), *Company Law in East Asia*, Aldershot, Ashgate/Dartmouth, 1999 at pp 494ff).

[6] See for example, T Lindsey, *Indonesia: Law & Society*, Sydney, Federation Press, 1999.

However, it could well be argued that the increasing focus upon the development of the rule of law and the court system in Indonesia is part of a wider process of political reordering which is aimed at curbing patrimonial practices that work against the interests of increasingly important business and middle classes in Indonesia. It is also aimed at the effective management of an inefficient bureaucracy. But the impact of such legalisation has also been constrained by strong centralisation pressures, which have limited the operation of the separation of powers doctrine and hence limited the independence of judges[7]. The importance of patriarchal influences in East Asian law making processes cannot be ignored, as scholars have argued in regard to others areas of Asian law reform, such as labour law and human rights law[8]. Legalism has clearly been used in Indonesia as an instrument of state strategy, leading to an increase rather than a diminution in state power.[9]

THE PLACE OF INFORMAL MECHANISMS IN THE INSOLVENCY SYSTEM

The continued reliance upon informal mechanisms will be essential in Indonesia, as no legal system is able to deal with insolvency or bankruptcy problems solely through the judicial system.[10] The court should be seen as but one of the elements of an integrated insolvency system, albeit but a small part of such a larger system which is mainly comprised of insolvency practitioners and credit providing institutions. Unfortunately, it is far easier to set up a new court with a small number of specialist judges than it is to create a well trained insolvency practitioner community and the values or culture which support

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[7] See generally, D Bourchier, "Magic Memos, Collusion and Judges with Attitude" (pp 233-252) in K Jayasuriya (Ed), *Law, capitalism and power in Asia*, London, Routledge, 1999 at p 248. Also see: B Quinn, "Indonesia: Patrimonial or Legal State?" (pp 258-268) in T Lindsey, *Indonesia: Law & Society*, Sydney, Federation Press, 1999.

[8] A Woodiwiss, *Globalisation, Human Rights and Labour Law in Pacific Asia*, Cambridge, Cambridge University Press, 1998.

[9] See further, K Jayasuriya, "The Rule of Law and Governance in the East Asian State", (1999) 1(2) *The Australian Journal of Asian Law* 107 at 112-113.

[10] See generally, M Galanter, "Justice in many rooms: Courts, private ordering and indigenous law", (1981) 19 *Journal of Legal Pluralism and Unofficial Law* 1-47; M Galanter, "Reading the Landscape of Legal Disputes: What we know and don't know (and think we know) about our allegedly contentious and litigious society", (1983) 31(4) *UCLA Law Review* 4-71 and FEA Sander, "Varieties of Dispute Processing" (25-43) in R Tomasic and MM Feeley, *Neighborhood Justice: Assessment of an Emerging Idea*, New York, Longman Inc, 1982.

the work of both the courts and this practitioner community.[11]

It should also be reiterated that bargaining is most effective when it occurs in the "shadow of the law". In other words, informal mechanisms work best where there is easy resort to the court should there be a breakdown in negotiations. This has been seen to be relevant in regard to informal insolvency negotiations. As the ADB noted in a recent report, the main impetus 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".[12]

However, a credible legal infrastructure is still an essential background for an effective informal system of bankruptcy negotiation and settlement. To this end, a new draft Indonesian Bankruptcy Law has been prepared but has yet to be enacted. However, this new law seems to have been caught up somewhere within the Department of Justice.[13] In the meantime, a number of domestic and foreign inspired informal arrangements have played a vital role in responding to the debt crisis that has gripped Indonesia in recent years. One of these informal initiatives has been the so-called Jakarta Initiative that commenced operation in 2000 and has sought to provide a mechanism for debtors and creditors to negotiate "workout" plans. Whilst the Jakarta Initiative is somewhat like to "London approach" and has the main purpose of seeking to facilitate negotiations and to refer public interest cases to the courts. It also seeks to provide a point of reference for obtaining government approval for restructuring plans.

This said, a recent ADB report noted that 350 cases had come under the Jakarta Initiative debt restructuring program (including about 250 medium to

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[11] For an analysis of the importance of culture to the effectiveness of any insolvency system see further R Tomasic and P Little (Eds) in *Insolvency Law & Practice in Asia*, Hong Kong, FT Law & Tax 1997. The continuing importance of religious and cultural values in Indonesia is well known and needs to be seen in the context of the overriding political philosophy of facilitating national unity as expressed in the motto Bhineka Tunggal Ika: see further, C Himawan, "Indonesia", (pp 196-262) in Poh-Ling Tan (ed), *Asian Legal Systems*, Sydney, Butterworths, 1997 at pp 203-205.

[12] ADB, "Insolvency Law Reforms in the Asian and Pacific Region: Report of the Office of the General-Counsel on TA 5795-REG: Insolvency Law Reforms", supra p 54.

[13] An English translation of a version of this proposed new Indonesian Bankruptcy Law is to be found in Appendix IV (pp 253-305) of T Lindsey (Ed), *Indonesia: Bankruptcy, Law Reform & the Commercial Court*, Sydney, Desert Pea Press, 2000. See however, Mrs SH Elijana, (Chair of the Bankruptcy Bill drafting team), "The Principles of Modification in the Bankruptcy Law", Mimeo, Jakarta, September 2000; and OECD, "Synthesis Note: Informal Experts Meeting on Insolvency Law Design", Mimeo, Jakarta, 14 September 2000.

large scale companies), but concluded that "[t]he experience of the Jakarta Initiative is somewhat difficult to discover. The local expert for Indonesia suggested that progress under this initiative has been a lot slower than anticipated and only a few restructurings have been put in place."[14] Very few of these 350 cases led to the adoption of a rescue or reorganisation plan.

The Indonesian Debt Restructuring Agency (INDRA) has also been established to facilitate the settlement of debts and restructuring of non-bank institutions in Indonesia[15]. One means of resolving debt problems is to in effect provide a government bail out through shrinking the value of foreign debt merely by arbitrarily strengthening the exchange value of the rupiah.[16] Because the Bankruptcy Law does not provide a broad mechanism for dealing with bank debts[17], in 1998 the Indonesian Bank Restructuring Agency (IBRA) was established to deal with bank restructuring by taking over many non-performing loans and to inject new funds to recapitalise banks. Although IBRA has very wide powers; it does not require court approval to take over bank assets, and its claims take priority over those of other debtors, it seems that IBRA has been reluctant to use its powers unless a matter is very clear.[18] One journalist has noted that "the central bank and the Indonesian Bank Restructuring Agency (IBRA) have displayed an unpredictable pattern in combating the unholy alliance between well connected borrowers and their lenders. Sometimes the authorities have taken bold action to put a stop to such collusive practices; at other times, they have appeared almost paralysed."[19] Through IBRA, the government of Indonesia has effectively become a creditor in most

[14] ADB, "Insolvency Law Reforms in the Asian and Pacific Region: Report of the Office of the General-Counsel on TA 5795-REG: Insolvency Law Reforms", supra pp 58 and 72.

[15] Linnan 2000, supra, notes (at p 95) that two years after the 1998 financial crisis, there have been "relatively few reorganisations in an advanced negotiation stage" brought under such mechanisms: Linnan 2000, at p 95.

[16] As suggested by Linnan, supra at 107.

[17] Article 1(3) of the consolidated Indonesian Bankruptcy Law only permits Bank Indonesia to file a bankruptcy petition in regard to a debtor that is a bank.

[18] H Sender, "Smoke and Mirrors", (1999) *Far Eastern Economic Review* 30 September 34 at p 36.

[19] Ibid at p 36. In June 2000, the Indonesian government withdrew action against Texmaco, a textile company involved in a $1.8 billion scandal. Exposure of IBRA and other state banks amounts to about $2 billion. An *Asiaweek* report on the dropping of this matter quoted the official explanation for this decision, that the matter had been dropped as "Texmaco has not been proven to have damaged state finances." : JM Tesoro, "Open but Not Shut" , *Asiaweek*, 2 June 2000, p 36 at 37.

major potential reorganisations. The main issue here is the extent to which Indonesia's banking crisis can be separated from its insolvency crisis[20]. The effectiveness of these extra-judicial mechanisms is in need of serious assessment. Concluding its review of recent Indonesian experience a recent ADB report noted that:

> "The reasons why the operation of the Indonesian informal process initiative does not appear as successful as those of Thailand, Korea or Malaysia appear to be that, firstly, the bank restructuring authority, IBRA, does not appear to exert the same leverage on corporate debtors as its Malaysian counterpart, Danaharta. Secondly, recourse by a creditor to the formal insolvency processes (in particular, liquidation) in respect of a reluctant or hostile debtor does not pose any great threat in Indonesia. Thus there is less motivation for a corporate debtor to engage in a voluntary informal workout."[21]

USING LAW REFORM AS AN INSTRUMENT FOR ECONOMIC REFORM

When the IMF agreed to provide assistance to Indonesia after the 1997 Asian financial crisis, it required Indonesia to agree to revise its bankruptcy laws and this led to the Government Decree which amended Indonesia's Bankruptcy Laws in 1998.[22] The role of multilateral agencies, such as the IMF, in pushing for bankruptcy reform is not without some problems as multilateral agency expectations and timeframes may not always be in accord with local realities and expectations.[23] However, bodies like the IMF have found that they had far less leverage in being able to move opinion or change behaviour than they had thought.[24]

A key issue in regard to bankruptcy law reform in Indonesia has been the perception that such reforms may serve the interests of foreign creditors more

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[20] Linnan, 2000, supra at p 108.

[21] ADB, "Insolvency Law Reforms in the Asian and Pacific Region: Report of the Office of the General-Counsel on TA 5795-REG: Insolvency Law Reforms", supra p 58.

[22] M Reksodiputro, "Bankruptcy Reform: Lessons from the First Nine Months", (pp 48-51) in Lindsey (Ed), *Indonesia: Bankruptcy, Law Reform & the Commercial Court*, supra at p 48.

[23] See further, WE Holder, "Indonesian Bankruptcy Reform: The IMF Approach", (pp 44-47) in T Lindsey (Ed), *Indonesia: Bankruptcy, Law Reform & the Commercial Court*, supra.

[24] H Sender, "IMF in Indonesia: Insufficient Leverage", (1999) *Far Eastern Economic Review* 30 September pp 38-39.

than they serve Indonesia's interests[25]. The quote from David Linnan at the head of this paper also illustrates this nationalist sensitivity. That such a conclusion should be drawn is not surprising as insolvency law reformers, multilateral agencies and forums such as this all too readily seek to justify the development of new bankruptcy and secured transaction laws in terms of enhancing investor confidence. Whilst this is a factor, it should not be seen as the overriding or even the principal reason for the development of a modern insolvency regime in Asian countries such as Indonesia.

A fundamental issue in the adoption of new laws and legal institutions into Asian countries has been the concern over the imposition of law[26]. It has long been understood that simply seeking to impose a foreign derived law onto an alien social setting may mean that the law may not take root in the new land or social setting. This is because law is not an abstract instrument but a product of particular social and economic conditions. The attempt to uncritically impose a foreign derived law on a new society may lead to implementation games being played in the new environment by those seeking to avoid or undermine this Law.[27] This is especially likely where the social conditions in the new society differ significantly from those from which the law was derived.

Unless laws become embedded within a social and legal system they are unlikely to be accepted by local political and economic forces. One of the most important ways of seeking to embed a law into the social fabric is to undertake extensive programs of education and training for the professional, business and other communities subject to it.[28] Indeed, it can be said that the passage of a new law by itself is not very important. This is so even where the law is only seen as an instrument of changing social practices (such as in the way that debt problems are handled); this is because law is a poor instrument

[25] Linnan, 2000, supra at p 94.

[26] This has of course been a basic theme of law and society scholarship over many year : see generally, SB Burman and BE Harrell-Bond (Eds), *The Imposition of Law*, New York, Academic Press, 1979; and A Allott, *The Limits of Law*, London, Butterworths, 1980. This has also been an issue canvassed by Tim Lindsey and Veronica Taylor in "Rethinking Indonesian Insolvency Reform: Contexts and Frameworks", (pp 2-14) in T Lindsey (Ed), *Indonesia: Bankruptcy, Law Reform & the Commercial Court*, supra, at 12ff.

[27] See generally, E Bardach, *The Implementation Game: What happens After a Bill Becomes a Law*, Cambridge, Mass, MIT Press, 1977; Tomasic, R (Ed), *Legislation and Society in Australia*, Sydney, Allen & Unwin, 1980.

[28] M Hiscock, "Remodelling Asian Laws" (pp 28-42) in T Lindsey (Ed), *Indonesia: Bankruptcy, Law Reform & the Commercial Court*, supra, at p 37.

of social change.[29]

The acceptance of commercial law reforms by local elites is also of critical importance. Indeed, the development of any effective insolvency system in Indonesia must be accompanied by the development of an overarching corporate governance framework which provides an appropriate set of values and culture for accountability in business management. A recent ADB insolvency report has echoed this theme when it stated that there is "a significant need to encourage the development of and compliance with proper standards of corporate governance and corporate management. Serious deficiencies in these areas undermine the effect of even the most advanced forms of corporate insolvency law regimes."[30]

CHARACTERISTICS OF THE INDONESIAN INSOLVENCY SYSTEM

The first thing for an Australian lawyer to note about the Indonesian legal system is that it has elements of a civil law system, based on the European civil law tradition. This may sometimes lead to differences between civilian and common law lawyers as to the proper shape of law reforms. It also creates problems for those foreigners who may be used to the system of precedent used in common law systems. This has caused concern with insolvency cases decided by Indonesian courts that have come to what have been seen as "seemingly irreconcilable conclusions".[31] This uncertainty presents obvious problems for achievement of greater consistency in judicial decision making (although it has to be said that this doctrine of precedent should not be pushed too hard as it is a standard that is not always met even in common law systems)[32]. Having said this, it is reasonable to expect a degree of legal certainty in any rule of law system; this is so at least in regard to core areas of law, if not at the boundaries of the system.

Fortunately, in commercial law area there are signs of an increasing convergence and this has had an effect upon the insolvency laws of some coun-

[29] J Griffiths, "Is Law Important?", (1979) 54 *New York University Law Review* 339-74.

[30] ADB, "Insolvency Law Reforms in the Asian and Pacific Region: Report of the Office of the General-Counsel on TA 5795-REG: Insolvency Law Reforms", supra at p 12.

[31] Ibid at 77.

[32] The writings of Professor Julius Stone, which refer to the doctrine of precedent as categories of illusory reference, suggest that we need to adopt a realistic view of notions of precedent. Having said this, it is not unreasonable to expect to find a greater degree of coherence in Indonesian judicial decision making: J Stone, *Legal System and Lawyers' Reasonings*, Sydney, Maitland Publications Pty Ltd, 1968, Ch 7.

tries, such as through the work that has occurred on the UNCITRAL Model Law on Cross-Border Insolvency.[33] The use of arbitration in dealing with commercial disputes has also led to some convergence in commercial practice. Both the World Bank and the IMF have also sought to develop principles of good practice relating to insolvency,[34] and the Asian Development Bank has now published a number of comparative reports on good insolvency practice.[35] The use of broad-based principles of good practice in regard to insolvency is a systematic and useful means of evaluating any one insolvency system, provided that some flexibility is adopted.[36] The Asian Development Bank on "Insolvency Law Reforms in the Asian and Pacific Region" makes some useful contributions in this regard.[37]

Finally, the growth of international accounting and auditing firms applying international accounting standards and the importance of international lending have introduced some further degree of commonality.[38] Such international service firms have responded to the corporate culture and practices that has been internationalised. International business education, such as the standard MBA courses which have become so popular around the world, has also facilitated this process of convergence of business practices and values. The growth of multinational corporations and international trade has facilitated the process of greater harmonising of commercial laws.

Having said this, it should be added that it may be dangerous to draw too

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[33] *UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment*, New York, United Nations 1999. Also see generally, JS Ziegel (Ed), *Current Developments in International and Comparative Insolvency Law*, Oxford, Clarendon Press, 1994. In Indonesia its bankruptcy law takes a territorial and foreign insolvency decrees or orders will not be recognised: see further, ADB, "Insolvency Law Reforms in the Asian and Pacific Region: Report of the Office of the General-Counsel on TA 5795-REG: Insolvency Law Reforms", supra, pp 51-53.

[34] IMF Report, "Orderly and Effective insolvency Procedures: Key Issues, International Monetary Fund, Kay 1999; World Bank, "Building Effective Insolvency Systems: Towards Principles and Guidelines, World Bank, February 2000.

[35] ADB, "Insolvency Law Reforms in the Asian and Pacific Region: Report of the Office of the General-Counsel on TA 5795-REG: Insolvency Law Reforms", at (pp 10-99) in *Law and Policy Reform at the Asian Development Bank*, April 2000 Edition, Vol. 1.

[36] Such an approach has been adopted in other countries, such as China, see further, R Tomasic, "Insolvency law Principles and the Draft Bankruptcy Law of the People's Republic of China", (1998) 9 *Australian Journal of Corporate Law* 211 and Tomasic and Little (Eds), *Insolvency Law & Practice in Asia*, supra.

[37] ADB, "Insolvency Law Reforms in the Asian and Pacific Region: Report of the Office of the General-Counsel on TA 5795-REG: Insolvency Law Reforms", supra.

[38] J Flood, "The cultures of globalization: professional restructuring for the international market", (pp 139-169) in Y Dezalay and D Sugarman (Eds), *Professional Competition and Professional Power*, London, Routledge, 1995.

sharp a distinction between different legal families as each legal system should be understood within the context of its own cultural experience, as has been argued in the case of Japan[39] and would also be applicable to Indonesia as well where local cultural factors extremely important, especially in relation to insolvency matters.[40] Indeed, enthusiastic talk about the globalisation of laws (such as insolvency law) should be tempered, as law is one of the least readily globalised features of any society.[41]

It should also be noted that legal systems, regardless of their family resemblances, do develop what has been described as a kind of "path-dependency", which leads them along set paths of development and makes it difficult to easily change directions.[42] In the case of Indonesia, for example, the overriding importance of national unity as a goal may overshadow the achievement of democratic goals which may conflict with this overriding goal. As Professor Himawan from the University of Indonesia notes, "[n]o legislation will be tolerated [in Indonesia] if it encourages diversity at the expense of unity, the basic legal strategy of Indonesia's founding fathers and of today's development practitioners."[43]

However, the existing Indonesian Bankruptcy Law is based on nineteenth century Dutch legislation[44] and upon amendments made in 1998. In 1998 Government Regulations made amendments which introduced new provisions such as by amending a Chapter dealing with the creation of a moratorium on debt repayment,[45] as well as by introducing a new Chapter III which established the new Commercial Court which now has exclusive jurisdiction to deal with petitions for declarations of bankruptcy and moratoriums on debt repayment. Various other changes were made by the 1998 Government Regulations to the earlier Bankruptcy Law so as to correct, supplement and delete "provisions that are deemed irrelevant to the requirement and development of

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[39] A Marfording, "The Fallacy of the Classification of Legal Systems: Japan Examined", (pp 65-89) in V Taylor (Ed), *Asian Laws Through Australian Eyes*, Sydney, LBC, 1997.

[40] P Little, "Indonesia", (pp 201-228) in Tomasic and Little supra at 204-05.

[41] See generally, M Waters, *Globalisation*, London, Routledge, 1995.

[42] M Roe…

[43] C Himawan, "Indonesia", (pp 196-262) in Poh-Ling Tan (Ed), *Asian Legal Systems*, Sydney, Butterworths, 1997 at p 203.

[44] Faillissements-Verordering Staatsblad (StateGazette) *Year 1905 Number 217 jo*. Staatsblad (StateGazette) *Year 1906 Number 348*.

[45] Articles 212-217E, 22-226, 228, 230, 231A, 234, 237, 240-241, 246-247, 250, 252-254, 258, 261, 264-269, 273-275 and 279.

law in the society and leaving the other provisions to remain applicable"[46]. Other changes were made to references to other courts so as to align the amended Law with the new provisions establishing the Commercial Court.[47]

The 1998 Bankruptcy Law provides two basic means of dealing with bankruptcy problems; firstly, it provides for liquidation proceedings[48] and secondly it provides for a moratorium on debt repayment through a system of court-supervised compromise, based on a proposal prepared by the debtor and filed with the Court.[49] The Law provides for a degree of conversion from reorganisation to liquidation, satisfying Harmer's suggested general principle of "one law, two systems" aimed at providing greater flexibility to insolvency law procedures.[50] The 1998 revisions to the compromise procedures have however created a procedure that has been seen to be "relatively weak".[51]

It has been argued that the 1998 reforms do not cater for the types of debt so prevalent in Indonesia; thus it is said that the 1998 Reforms are suitable for dealing with the kinds of problems that would arise from slow paying debtors; they are simply inadequate when one needs to deal with what have been described as the "deeply-underwater debtor". The latter type of debtor requires a system that facilitates reorganising companies in terms of shedding businesses and recasting debt as equity. Instead, the focus of discussion has been on more modest issues, such as the settlement of foreign currency debts.[52] As Linnan notes, "[t]he underlying problem with Indonesia's deeply-underwater debtors may be that their manager-controlling equity-holders simply lack sufficient incentives to resolve the status of financially distressed enterprises under their control. Once the real value of their equity stake is gone they become *de facto* option-holders." He adds that in this situation:

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[46] Mrs SH Elijana, (Chair of the Bankruptcy Bill drafting team), "The Principles of Modification in the Bankruptcy Law", Mimeo, Jakarta, September 2000, at p 2.

[47] The English language text of the consolidated amended Indonesian Bankruptcy Law is to be found in Appendix III of T Lindsey (Ed), *Indonesia: Bankruptcy, Law Reform & the Commercial Court*, Sydney, supra at p 193. Also see the translation in J Hoff and GJ Churchill, *Indonesian Bankruptcy Law*, Indonesian Law and Practice Series: 2, Jakarta, PT Tatanusa, 1999.

[48] See Chapter I of the consolidated Indonesian Bankruptcy Law 1998, (Government Regulation in Lieu of Law, and No 1 of 1998.

[49] Articles 212 to 279 of the Indonesian Bankruptcy Law 1998.

[50] ADB, "Insolvency Law Reforms in the Asian and Pacific Region: Report of the Office of the General-Counsel on TA 5795-REG: Insolvency Law Reforms", supra at pp 29-31.

[51] Linnan, 2000, supra p 95.

[52] Ibid at pp 98-99.

> **Once his equity interest loses substantially all its value, the manager/controlling equity-holder has all the wrong incentives from a creditor perspective as long as he is protected by the insolvent corporation's limited liability shield…There is no immediate economic loss to the extent that, pending reorganisation, there is no residual value to be captured by his equity interest. The incentives, while he remains in control of the financially distressed enterprise, are all wealth diminishing at the social level. At best he behaves as an option holder, adopting too-risky strategies, or less favourably as a potential corporate looter stripping assets for his personal benefits."[53]**

Unfortunately, the Bankruptcy Act procedures apply to both natural persons and to corporate entities.[54] A failure to make a clear differentiation between corporate and individual debt handling procedures is undesirable, as different policy considerations would arise in regard to each. For example, in regard corporate debtors it is more likely that broader commercial and economic considerations will be relevant than in the case of a personal bankruptcy. Policies in regard to individual debt may be more protective than those in regard to corporate debt. Harmer has, for example, noted that this problem has caused problems in the application of insolvency laws in Thailand where the criteria regarding the commencement of insolvency proceedings have been narrowly interpreted.[55]

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[53] Ibid at pp 106 and 107.

[54] It should also be noted that Chapter IX of the 1995 *Companies Act* provides three procedures for the winding up a company; in each case the dissolution of a company is followed by the administrative process of liquidation. The three methods of dissolution available under the Company Law are firstly, the dissolution of the company as a result of a resolution passed at a general meeting of shareholders; Secondly, the company will be dissolved at the expiration of the period of time for which the company was established; Thirdly, the District Court may dissolve a company following receipt of a request from the public prosecutor, or as a result of a request from one or more members representing at least 10% of the voting shares, or as a result of a request from a creditor after it is declared bankrupt, or at the request of a party claiming a defect in the company's deed of establishment: see further, Tomasic and Little, supra at p 208.

[55] See ADB, "Insolvency Law Reforms in the Asian and Pacific Region: Report of the Office of the General-Counsel on TA 5795-REG: Insolvency Law Reforms", supra at p 28.

LIQUIDATION PROCEEDINGS UNDER THE PERPU NO 1 OF 1998

Liquidation proceedings may be brought against a debtor who has two or more creditors where the debtor has failed to pay at least one debt that has matured and become payable. A debtor may file bankruptcy petitions on his own petition or at the request of one or more creditors; they may also be brought by the public prosecutor where it is considered to be in the public interest to initiate such proceedings. However, the term "debt" is not defined, nor is the phrase "due and payable". Any discussion of the meaning of the term debt should also have regard to Articles 1233 and 1234 of the Indonesian Civil Code.[56] An ADB report has noted in this regard that "Indonesia has a particularly good, low threshold, criteria for its reorganization process. It states that a debtor who is unable or expects to be unable to continue to pay matured debts may apply for reorganization."[57] In the case of a debtor that is a bank, only the Bank of Indonesia may petition for a declaration of bankruptcy, whilst in regard to a debtor that is a securities company, only the Capital Market Supervisory Agency (Bapepam) may petition for a bankruptcy declaration.[58] Where the debtor has not initiated bankruptcy proceedings, the Court is required to summon the debtor.

The bankruptcy petition must be granted if there are facts or circumstances which prove the existence of the bankruptcy and a bankruptcy decision must be made within 30 days of the registration of the bankruptcy petition. Under Article 6, the Clerk of the Court must summon the debtor no later than seven days prior to the hearing of the Petition. Lawyers acting for debtor respondents have noted that this is usually too short a time for them to prepare a full response and the 30 day period set by the Law for making a decision on the bankruptcy petition has also been seen as being too short a time for the judges to be able to make their decisions.[59] Where a declaration of bankruptcy is made, the court may order the appointment of a supervising judge and a receiver; the receiver must be independent and not have a conflict of interest

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[56] See further, K Muljadi, "A Critical Assessment of Recent Bankruptcy Law reforms", (pp52-56) in T Lindsey (Ed), *Indonesia: Bankruptcy, Law Reform & the Commercial Court*, Sydney, at p 54.

[57] ADB, supra at 32.

[58] Article 1 of the Indonesian Bankruptcy Law 1998. In regard to BAPEPAM, see generally, B Ruru, "Development of Equity and Bond Markets: History and Regulatory Framework Indonesia", (1995) 5 *Australian Journal of Corporate Law* 326.

[59] K Muljadi SH, supra at p 52-53

with either the debtor or the creditor.[60] The debtor forfeits his rights to manage or control his assets from the commencement of the bankrupt[61]. Legal proceedings against the bankrupt estate must be suspended and claims by creditors must be made through the receiver and proceedings initiated by the debtor may be taken over by the receiver or otherwise adjourned.[62]

However, a debtor may seek to appeal to the Supreme Court against a declaration of bankruptcy. Most Indonesian court cases are the subject of an appeal and there are at least 6000 appeals to the Supreme Court each year. Indeed, one Indonesian commentator has noted that "losing parties now often use it simply as a tactic to extend the period for settlement of the case."[63] One recent report noted that of 59 insolvency cases in which decisions were handed down by the new Commercial Court, 25 went on appeal to the Supreme Court and 14 of these subsequently underwent a further review before a differently constituted panel of the Supreme Court.[64] To deal with possible problems of delay in this area, the Supreme Court is required by Article 10 to hold a hearing within 20 days from the date of the registration of the bankruptcy appeal and a determination must be made by the Supreme Court within 30 days from this date. The tight time lines which have been provided in the Bankruptcy Law may well avoid problems of delay and prevent cases from disappearing from the judicial system, but many of them fail to recognise the considerable time that it may take creditors, especially foreign creditors, to identify a debtor's assets, liabilities and other creditors.

Where the debtor has disposed of property to creditors prior to the declaration of bankruptcy, at a time that it was known that such an "act of bankruptcy" would cause damage to other creditors, such a transaction may be annulled. Such loss to creditors will be deemed to have occurred where the transactions took place up to one year prior to the declaration of bankruptcy, unless it can be proved to the contrary.[65] Thus Article 42 applies this deeming provision to preferences involving family members, and in the case of a debtor that is a corporate entity, it is applied to preferences involving directors or management of the debtor company, or of a related company. Gifts made by

[60] Article 13.

[61] Article 22.

[62] Articles 25 and 26

[63] E Rajagukguk, "Judicial Reform: A Proposal for the Future of the Commercial Court" (pp 57-60) in Lindsey (Ed), *Indonesia: Bankruptcy, Law Reform & the Commercial Court*, supra at p 58.

[64] ADB, "Insolvency Law Reforms in the Asian and Pacific Region: Report of the Office of the General-Counsel on TA 5795-REG: Insolvency Law Reforms", supra p 77.

[65] Articles 41-42.

the debtor may also be annulled if it is proved that, at the time that the gift was made, the debtor was aware that the making of the gift would cause loss to a creditor.[66] However, Article 50, para 3, provides that "[r]ights acquired by third parties acting in good faith shall be respected."

Missing from the consolidated Indonesian Bankruptcy Law of 1998 are adequate sanctions for insolvent trading by directors of the kind found in other national laws. Such laws would impose a personal civil liability on directors where they allowed their company knowingly to incur debts, which the company would be unable to pay.[67]

The rights of secured creditors are protected (by Article 56), subject to the requirement that any enforcement of such rights must be deferred for up to 90 days from the date of the bankruptcy declaration being made; creditors may apply to the receiver to remove such deferment or to alter any conditions applying to it: Art 56A(1) and (5). A secured creditor must however exercise any rights that they have within two months of the commencement of the insolvency.[68] The Bankruptcy Law also provides a procedure for the verification of claims by creditors and for the challenging of such claims by the debtor: Arts 104-133.

Provision is made for forming a committee of creditors and for creditors' meetings: Articles 72 and 77. However, decisions at such meetings are to be made only on the basis of votes case by unsecured creditors (see Articles 72(2) and 141), and no provision is made for meetings of different classes of creditors or casting votes by a class of creditor. This is not satisfactory, as a recent ADB study has also suggested.[69] It may be noted that the recent ADB Report has reiterated the good practice standard that "[a]n insolvency law regime should, as far as possible, preserve the principle of equal treatment for all creditors…" The aim of this is to limit priority of claims as much as possible after the payment of secured creditors and the costs of the insolvency administration.[70]

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[66] Article 43.

[67] See generally, ADB, "Insolvency Law Reforms in the Asian and Pacific Region: Report of the Office of the General-Counsel on TA 5795-REG: Insolvency Law Reforms", supra pp 50-51.

[68] Article 57. There has been some debate as to whether secured creditors were entitled to file a bankruptcy petition against a debtor, but this has now been settled by the Supreme Court in the *Dharmala Agrifood* Case in favour of the rights of secured creditors to bring such action: see further, K Muljadi, supra at p 53.

[69] ADB, "Insolvency Law Reforms in the Asian and Pacific Region: Report of the Office of the General-Counsel on TA 5795-REG: Insolvency Law Reforms", supra at pp 42-44.

[70] Ibid at pp 48-9.

Under Article 134 the debtor is entitled to offer a composition to all of his creditors. However, where no composition is offered, the bankrupt estate will be regarded as being insolvent: Art 168. Where a composition is offered by the debtor, the receiver and the committee of creditors are required to provide written opinions in regard to this composition offer: Art 136. If the creditors agree to the proposed compromise, the Court will need to ratify the composition before it will have effect; however the court may decline to ratify the composition in a number of circumstances, such as where the performance of the composition is insufficiently assured: Art 149. The debtor may appeal where the court refuses to ratify the composition that has been agreed upon. However, once the ratification of the composition becomes final, the bankruptcy will terminate: Art 157. Following the termination of the bankruptcy, the bankrupt debtor may seek rehabilitation (under Article 205) from the Court that declared the bankruptcy.

MORATORIUM ON DEBT REPAYMENT UNDER THE PERPU NO 1 OF 1998

Chapter II of the consolidated Indonesian Bankruptcy Act 1998 provides a procedure for debtors to request that a moratorium be placed on their obligation to repay their debts on the grounds that the debtor intends to prepare and present a composition which is to include an offer to repay all or part of the debt owed to unsecured creditors: Art 212. The moratorium petition must be filed by the debtor 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 will have no more than 45 days before they will be 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: s 217(4).

Once a moratorium has been granted, the debtor must not take any part in the management of the debtor's assets or take any actions to transfer any of these assets: Art 226. However, subject to this, the debtor is entitled to dismiss his employees after the commencement of the moratorium and any unpaid salaries will become the debts of the debtor's estate: Art 237. Also, once the moratorium has commenced, any execution action against the debtor must be postponed: Art 228. Where a moratorium on debt repayment has been granted

by the Court, Article 224 provides that one or more experts may be appointed by the supervising judge to conduct an investigation and to prepare a report regarding the condition of the assets of the debtor; a copy of this report must be made available to the Clerk of the Court; also, the trustee is required to report every three months on the condition of the assets (per Art 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: Art 230.

The moratorium may be terminated by the Court under Article 240 if : (i) the debtor has acted in bad faith in the management of his assets, (ii) if the debtor attempts to prejudice the creditors, (iii) if the debtor fails to perform various acts that are required of him by the Court or the trustee; (iv) if the debtor takes part in the management of the assets or transfers rights to any assets (as provided under Article 226); (v) if the circumstances are such that the continuation of the moratorium becomes unfeasible; or (vi) if the debtor cannot expect to fulfil his obligations to his creditors within the time provided for.

Once a composition proposal has been filed with the Court, it must be available for inspection by interested persons: Art 250. The Clerk of the Court must announce the latest day on which claims by persons affected by the moratorium may be submitted to the trustee: Art 252. The trustee under Article 256 will then prepare a list of claims. A meeting of creditors will then be able to vote on the composition proposal and this proposal may be accepted once it is approved by more than half of the unsecured creditors whose rights have been admitted or provisionally admitted and are present at the meeting, as provided for in Articles 252, 264 and 265.

If the composition is accepted, the supervising judge must submit a written report to the Court for the purposes of gaining the Court's ratification of the composition. A Court hearing will be held to ratify the composition and this hearing must be held no more than 14 days after the creditors approve the composition proposal. The moratorium will end upon the Court's ratification of the composition: Art 273. However, the Court may yet decide not to ratify the composition if, for example, it concludes that the composition was reached as a result of fraud or collusion with one or more creditors or if it concludes that the implementation of the composition is not sufficiently assured. A refusal to ratify the composition must lead the Court to declare the debtor bankrupt: Art 269. Once the Court has ratified the composition, it will bind all

creditors to whom the moratorium of debt was applicable: Art 270.

THE COMMERCIAL COURT

Chapter III of the 1998 consolidated Indonesian Bankruptcy Law established a new Commercial Court to process bankruptcy petitions and moratorium on debt repayment petitions. The Court is being established progressively in different parts of Indonesia and in the first instance it will hear and decide cases by resort to a panel of judges (usually with three judges): Art 282. In its first nine moths of operation, one practitioner has noted that "[t]he court had heard only 58 cases as at mid 1999 and some of its decisions had raised questions about the competence of the judges in understanding the goals of the Bankruptcy Court."[71] Similarly, another commentator has noted of the judges of the Commercial Court that "[t]heir performance, most who have been involved agree, has not been stellar. Charges of incompetence and corruption began to circulate within a month or so of their inauguration."[72] A recent ADB funded report noted that Commercial Court judges have little commercial knowledge or experience and quoted an Indonesian expert who said that "many of the [cases] involve modern and sophisticated [commercial transactions]" but that the Commercial Court judge "presiding over the hearing does not understand the transactions [and this] leads to misinterpretations or narrow interpretations of the document."[73]

The criteria for appointment of judges to the new Commercial Court require some expertise in areas of jurisdiction dealt with by the Commercial Court, but probably the most important criterion for appointment, at this point in time, is that which requires that appointees are "...honest, being just and being free of any misconduct..." (Article 283). However, once this basic requirement is satisfied, some expertise on the part of the judges in handling insolvency cases will become very important.

As most cases go on appeal (cassation) to the Supreme Court, it may also be necessary to improve the training of Supreme Court judges in the area of insolvency law and practice. As this may be asking too much, ways should be

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[71] M Reksodiputro, supra at p 51.

[72] DS Lev, "Comments on the Course of Law Reform in Modern Indonesia", (pp 74-93) in T Lindsey (Ed), *Indonesia: Bankruptcy, Law Reform & the Commercial Court*, Sydney, supra at p 89.

[73] ADB, "Insolvency Law Reforms in the Asian and Pacific Region: Report of the Office of the General-Counsel on TA 5795-REG: Insolvency Law Reforms", supra p 77.

found to further limit appeal to the Supreme Court or at the very least to avoid the tendency of the Supreme Court appeal becoming a rehearing rather than the review of questions of law, as is required in Indonesia. As Rajagukguk argues, "the Supreme Court should emphasise its role as an institution conducting judicial review, not as a forum for retrials." [74]

Court supervision of the reorganisation or rescue process is desirable for a variety of reasons, such as to ensure the efficient conduct of the process, to resolve disputes or uncertainties, to ensure proper procedures are followed and to determine whether the plan that is ultimately approved is fair to the creditors as a whole. As yet, the Commercial Court does not full play such a general supervisory role in reorganisation matters.[75]

The new Commercial Court has not gone without some criticism, as David Linnan has noted in a book published in the year 2000.[76] Linnan is critical of the decision to staff the court with judges without significant business experience, but who were to be given special training in areas relevant to the jurisdiction of this new court. The presence of corrupt practices amongst the Indonesian judiciary has meant that the mere retraining of existing judges might not be enough to deal with problems of corruption.

One Indonesian practitioner has noted that the "lack of confidence in the judicial system is a major constraint to recreating Indonesia as a country which upholds the rule of law - it is useless to have modern and just laws if the courts cannot enforce them."[77] As is well known in other legal institutions (such as police forces), the existence of an entrenched culture of corruption is extremely difficult to overcome within such a group. The need to improve the judicial culture of Indonesian judges has also been recognised in Indonesia.[78]

However, as judges do not work alone, but are part of a larger court room work group, which extends into the professional communities working in the courts, it is vital that private insolvency practitioners are in a position to influence to decision-making processes of the Commercial Court. However, there are limits to the extent to which private practitioners might be drawn upon to

[74] E Rajagukguk, supra at p 59.

[75] ADB, "Insolvency Law Reforms in the Asian and Pacific Region: Report of the Office of the General-Counsel on TA 5795-REG: Insolvency Law Reforms", supra at p 47.

[76] Linnan, 2000, supra, at pp 97-98.

[77] M Reksodiputro, supra at p 50.

[78] E Rajagukguk, supra at p 57.

fill positions as judges on the Commercial Court due to the financial sacrifices that such persons would need to make because of poor judicial salaries.[79] One senior Jakarta lawyer has noted in this regard that before Indonesian courts have real authority, the remainder of the legal profession should also be reformed as "[o]nly through a strong legal profession can misuse and abuse by the courts be held in check."[80] However, as Linnan also notes, because bankruptcy petitions are "rarely" admitted by judges many of these court-related problems have been avoided.[81]

RECENT INDONESIAN INSOLVENCY REFORM DEVELOPMENTS

It is beyond the scope of this paper to provide a detailed assessment of the current draft of the Indonesian Insolvency Law.[82] However, some brief comments on this draft are appropriate. Based on the information currently available to me, the structure of the Draft Law is as follows:

> Chapter I contains general provisions (Article 1) which provide definitions of key terms such as "debts", "creditor" and "debtor".

This definition provision is a welcome addition to the Law and is aimed at eliminating the kinds of differences in interpretation, which have occurred in the past.[83] Chapter II largely follows the provisions currently found in Chapter I of the present Indonesian Bankruptcy Law provisions. Newer provisions stemming from the 1998 amendments have remained largely unchanged, whilst the older provisions have not been significantly changed.

> The eleven Parts of Chapter II in the proposed Draft Law are as follows:

Part One: The Bankruptcy Judgement (Arts 2-18)
Part Two: The consequences of bankruptcy (Arts 19-60)
Part Three: Management of the Insolvent Assets (Arts 61-88)

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[79] DS Lev, supra at p 90.
[80] M Reksodiputro, supra at p 50. Daniel Lev has also noted that private lawyers are in a position to make a much greater contribution to changing the culture and practices of the court: DS Lev, supra at pp 90-91.
[81] Ibid at 98.
[82] An English version of the Proposed Draft is to be found in Appendix IV of T Lindsey (Ed), *Indonesia: Bankruptcy, Law Reform & the Commercial Court*, supra at p 253.
[83] SH Elijana, (Chair of the Bankruptcy Bill drafting team), "The Principles of Modification in the Bankruptcy Law", Mimeo, Jakarta, September 2000, at p 8.

Part Four:	Remedies following the declaration of bankruptcy and the duties of the receiver (Arts 89-108)
Part Five:	Verification of Claims (Arts 109-139)
Part Six:	Composition (Arts 140-173)
Part Seven:	Settlement of Insolvent Assets (Arts 174-199)
Part Eight:	Legal Status of the Bankrupt Debtor after Settlement (Arts 200-202)
Part Nine:	Bankruptcy of the Estate of a Deceased Person (Article 203-207)
Part Ten:	Provisions of International Law (Arts 208-209)
Part Eleven:	Rehabilitation (Arts 211-217)

Chapter III deals with the Moratorium on Debt Repayment and is in two parts, as follows:

Part One:	Granting of Moratorium and its Consequences (Arts 218-259)
Part Two:	Composition (Arts 260-289)

The moratorium provisions in the new Art 218 are identical to those in the present Art 212. Indeed, virtually all of Part One is identical to the provisions in the present Bankruptcy Law (as amended in 1998) dealing with the granting of a moratorium in regard to debt repayment. It is understandable that these earlier provisions have been preserved as many were only recently introduced. Similarly, the composition procedures currently found in Articles 249 to 279 are virtually identical to the proposed new Composition procedures. It is unfortunate that the new Draft Law does not provide for additional forms of dealing with corporate insolvency, such as for voluntary administration procedures. Chapter III of the present Bankrutpcy Law, dealing with the Commercial Court, is not covered by the new draft as it is assumed that such a provision should more properly be contained in a separate law governing the Commercial Court or in the Law concerning Principles of Judicial Power.[84] This is an appropriate position to adopt especially as the jurisdiction of the Commercial Court is likely to be somewhat broader than merely entertaining bankruptcy cases.

However, if experience in other jurisdictions is any guide, the new draft of the Bankruptcy Law should be seen as a transitional Law which might make

[84] Ibid at p 9.

way for a more modern piece of legislation which seeks to reflect the greater range of models that are available in some other insolvency jurisdictions. For example, the Judicial Management provisions found in the Singaporean insolvency provisions might have served as a useful model for more rescue oriented provisions.

CONCLUSIONS: BANKRUPTCY REFORM, BANK BALI AND BEYOND

Indonesia still has a long way to go until it has developed a well-rounded and effective insolvency system that is comparable to the systems found in other developing countries in the region. International best practice provides many useful solutions to what are common problems of debt. The use of informal methods and the creation of a credible rescue culture will depend upon having in place a qualified insolvency practitioner community and a real commitment to finding efficient solutions to corporate debt problems. However, progress in reform has been frustratingly slow. This is not unusual as insolvency reform is rarely amongst the issues that are seen by governments as most urgent, at least until there is a crisis.

If one reviews the press reports of the last few years that have chronicled Indonesia's progress in responding to the recent Asian financial crisis, there is not much comfort to be had for the more optimistic or impatient amongst us. In September 1999, the *Far Eastern Economic Review* noted that "[d]elay, not determination, seems to mark Asia just two years after the region's financial crisis started".[85] This report went on to refer to an episode which still echoes almost 18 months later, when it noted:

> "Illusions about the extent to which the Indonesians were fixing their banks were shattered by the revelation that Bank Bali made a $70 million payment to an official of the ruling Golkar Party – a payment that was only discovered because a foreign bank went over the books. Soon after, Indonesian authorities, citing ethical concerns, stripped the Widjaya family of control over Bank Internasional Indonesia."[86]

Prior to this scandal breaking, Bank Bali had been regarded as Indonesia's

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[85] H Sender, "Smoke and Mirrors", (1999) *Far Eastern Economic Review* 30 September 34 at p 34.
[86] Ibid at 34.

soundest private bank. Interestingly, the former CEO of Bank Bali was said to be seeking to regain control of the Bank and undisclosed sources seemed to have acquired almost 40% of the shares in the company. This seemed to be aimed at blocking a takeover of the bank by Standard Chartered.[87] One Jakarta-based World Bank official was reported to have said in September 1999 that the Bali Bank affair was "a real test for foreign confidence" as it was an indicator of systemic problems in Indonesia.[88] This proposition is hard to refute if the affair is seen as an illustration of the oversight ability of the central Bank of Indonesia, which had responsibility for monitoring banks like Bank Bali.[89]

In a further interesting comment on the Bank Bali affair, a team of *Far Eastern Economic Review* journalists noted in 1999 that "the siphoning-off of funds from Bank Bali is a prime example of how corruption undermines economic reforms – and why both agencies [the IMF and the World Bank] have warned that any attempt at a coverup is unacceptable."[90] Later in 1999 it was reported that a consequence of the Bank Bali affair was that the program of recapitalising banks had been stalled.[91] However, the IMF seems to have negotiated further agreements (the 12th by January 2000) with the Indonesian government that are apparently aimed at achieving greater transparency and control in the banking system and within the Bank of Indonesia in particular.[92] The Bank Bali affair was first dismissed as but a one off matter, but it has come to signal serious problems at the central Bank of Indonesia.[93]

In relation to the Bank Bali affair, by late December 2000 little progress had been made in dealing satisfactorily with this financial scandal.[94] Meanwhile, corporate restructuring activity in Indonesia seems to have stalled with four large and heavily indebted business groups (Barito Pacific; Texmaco Group;

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[87] M Shari, "The Haunting of Bank Bali", *Business Week*, 13 September 1999, 20-21.

[88] Quoted by H Sender, "IMF in Indonesia: Insufficient Leverage", *Far Eastern Economic Review* 30 September 1999, 38 at p 39.

[89] D Murphy, "New Dogs, Old Tricks", *Far Eastern Economic Review* 19 August 1999, p 12.

[90] J McBeth et al, "Indonesia: Double Whammy", Far *Eastern Economic Review* 23 September 1999, 8 at p 8.

[91] M Shari and P Engardio, "A Nation Holding its Breath", *Business Week*, 11 October 1999, 24 at p 25.

[92] M Shari, "Will Candor Pay Off, *Business* Week, 31 January 2000, pp 18-19.

[93] See generally, M Shari, "Where Did the Billions Go: Investigations tangled offshore dealings", *Business Week*, 28 February 2000, pp 26-27.

[94] W Caragata, "A Comedy of Errors", *AsiaWeek*, 22 December 2000, pp 22-23.

Gajah Tunggal Group and Salim Group) together holding 107 trillion rupiah or $ 12.2 billion in outstanding corporate debt. This figure is a large part of the 257 trillion rupiah that is owed to IBRA. The owners of these four companies have nevertheless remained in control of them.[95] It seems that IBRA has managed to dispose of less than 20% of the assets under its control and in regard to the remaining entities, the original owners seem to have remained in control and few new investors have been sought out.[96]

By allowing former owners to remain in control of management the performance of that company can be controlled so as to ensure that it is not attractive to potential buyers; Also, the original owners have little interest in reviewing past management practices, with the consequence that new corporate governance ideas are unlikely to be adopted. The *Far Eastern Economic Review* even suggested recently that the momentum for structural reform in the Indonesian economy is now passing with a new focus on growth. The latter was seen as being more readily achieved by reviving the old conglomerates than waiting for new business players to grow."[97] None of this augurs well for the development of an effective corporate insolvency system or for an effective insolvency law in Indonesia.

[95] M Vatikiotis, "Going Backwards: Indonesia's corporate landscape isn't changing – because politicians in need of funds have started protecting their cronies again", *Far Eastern Economic Review*, 19 October 2000, pp 76-79.

[96] Ibid at p 76.

[97] Ibid at p 79.

ROLE OF INDONESIAN INSOLVENCY SYSTEM: CASE FOR OPTIMISM AND CASE FOR CAUTION

BY
BACELIUS RURU
CHAIRMAN, JAKARTA INITIATIVE TASK FORCE

As will undoubtedly be discussed elsewhere, the Indonesian insolvency system has been subject to well-publicized problems in its operation. Questions of judicial professionalism have been raised and will undoubtedly persist until enough cases of significant size of handled by the Commercial Courts in a transparent and professional manner. While these issues will be discussed at great length elsewhere, it is perhaps important to highlight the impact of the evolving Indonesian insolvency system on out-of-court corporate debt restructuring which, in Indonesia as in most countries, accounts for the lion's share of restructured debt. As will be discussed below, this linkage is important, as the efficiency and effectiveness of a given insolvency system will directly impact the speed and quality of corporate debt restructuring.

That problems with the implementation of the Indonesian insolvency system have slowed the pace of corporate debt restructuring should be obvious two years into the financial crisis. However, recent developments in the handling of Indonesian insolvency matters – including the increasing use of "pre-negotiated" composition plans and the related use of allegedly fraudulent or fictitious creditors for their implementation – have already had a pronounced impact on corporate restructuring. It is the purpose of this brief paper to highlight these developments and to discuss their ramifications for Indonesian corporate debt restructuring.

LINKAGE BETWEEN INSOLVENCY SYSTEM AND CORPORATE DEBT RESTRUCTURING

Before turning to the specific developments in Indonesian insolvency practice, it is important to reiterate the linkage between the quality of a given insolvency system and the pace of corporate debt restructuring. It is, or should be, the purpose of most insolvency systems to facilitate the recovery and reorganization of viable businesses in a manner that does not ignore the contrac-

tual rights of the parties. Where reorganization is not possible, the assets of the business should be allocated in a speedy and efficient manner consistent with those contractual rights.

No matter how efficient the insolvency system is in practice, experienced parties will normally prefer to avoid judicial intervention in favor of consensual resolution of a distressed debt situation. Doing so avoids the cost, uncertainty and delay of a legal proceeding. In order for such out-of-court "workouts" to succeed, however, it is critical that there be reasonable certainty regarding the results that would be achieved in a legal proceeding. Unless there is a minimal level of predictability regarding the legal rights of the parties, there will be no way for the parties to determine their respective leverage points, and a negotiated result will be difficult or impossible to achieve.

In Indonesia, the slow pace of legal reform has resulted in a situation where there is little confidence that the insolvency law will be enforced appropriately. As expected, this has slowed the pace of consensual corporate restructuring, as neither debtors nor creditors can be sure of their ultimate legal rights. Nevertheless, there are signs that this situation may be changing.

Established in 1998, the Jakarta Initiative Task Force ("JITF") is the Government of Indonesia's mediation body charged with facilitating corporate debt restructuring in Indonesia. With a current docket of cases in excess of US$ 17 billion in aggregate debt, the JITF is in a good position to observe the effects of the Indonesian insolvency system (and recent developments in its operation) on the progress of corporate debt restructuring. Set forth below are the observations of the Jakarta Initiative Task Force regarding these developments.

JAKARTA INITIATIVE TASK FORCE OBSERVATIONS

Pace of Corporate Restructuring is Quickening In Spite of the Insolvency System

Despite the excruciatingly slow pace of corporate restructuring during 1998 and 1999, it is clear that more out-of-court deals are now being done. In the second-half of 2000, over US$9.4 billion in aggregate debt was restructured under the Jakarta Initiative alone, which amount represents a five-fold increase in the amount of debt restructured over all deals completed in 1998, 1999 and the first-half of 2000. Could it be that the increased pace of corporate restructuring is a result of renewed confidence in the Indonesian insolvency system? The answer is "probably not".

As discussed above, out-of-court restructurings tend to take place when

both parties can adequately define their legal rights so as to determine their negotiating leverage. The Indonesian insolvency law, which, on paper, provides creditors with the ability to liquidate companies in default of their obligations, has been interpreted in case after case in a manner which prevents such liquidation from taking place. As a result, Indonesian debt restructuring negotiations have often been directionless, as the parties struggle to determine whether a negotiated solution is, indeed, preferable to a legally-imposed solution.

Over the past year, however, many creditors have taken a more pragmatic view of their legal rights and have assumed that, regardless of what the insolvency law states, it is highly unlikely that it will be enforced in their favor in the short-term. Such creditors suffering "credit fatigue" have, over time, begun to soften their negotiating positions rather than to wait for judicial reform.

Similarly, many companies have begun to realize that, regardless of whether they are successful in securing the dismissal of bankruptcy petitions brought against them, their creditors will not go away without a negotiated solution. These companies, particularly those which desire to return to the capital markets or gain a competitive advantage over their peers, are similarly softening their negotiating positions in the interest of reaching settlement. As such, the parties have assumed stalemate in the courts, and have begun to reach deals in cases where both parties prefer a negotiated solution to continued stalemate. In other words, restructuring transactions are closing in spite of the insolvency system, rather than because of it.

Increased Use of Pre-negotiated Bankruptcy Plans

Although the Indonesian insolvency system has not played a tremendous role in helping parties to define their negotiating leverage, there are promising signs that the Commercial Courts may nevertheless play a constructive role with the implementation of agreed deals. In several notable cases, most recently *PT Anwar Sierad, Tbk. and PT Bakrie & Brothers, Tbk.*, the Commercial Courts have demonstrated a willingness and ability to approve so-called "pre-negotiated" composition plans.

The need for such plans is clear. In most sizable cases, it will be impossible to secure the agreement of 100% of creditors to a restructuring plan. However, unless such agreement can be secured or implied by law, dissenting creditors will retain their rights to bring legal action against the debtor, rendering

an effective restructuring impossible. In many countries, the mechanism exists for a minimum percentage of creditors and the company to agree on the terms of a restructuring plan outside of court, and then proceed to have the court approve and enforce the plan on an expedited basis.

Although the Indonesian insolvency law does provide that, in a suspension of payments proceeding, two-thirds of unsecured creditors can approve a composition plan which will be binding on dissenting unsecured creditors, there has been, until now, little indication as to how the Commercial Courts would handle such pre-negotiated restructuring schemes. Over the past six months however, several large and complex restructuring plans have been negotiated out of court and approved by the Commercial Court in relatively short order.

The importance of this development cannot be underestimated. With a workable mechanism to implement these so-called "pre-negotiated" restructuring plans, parties will move more quickly to finalize their deals, and potential holdout creditors will become more pragmatic in their approach to the workout process. This will result in an increased pace of out-of-court restructuring negotiations. Although it is beyond the scope of this paper, it should be mentioned that the effectiveness of pre-negotiated composition plans can be further enhanced by amendments to the existing insolvency law that permit a composition plan to bind secured creditors as well as unsecured creditors, provided that the secured creditors are treated fairly and retain the benefit their contractual rights vis-à-vis their collateral. Providing this modification will insure that composition plans of universal application (i.e., plans applicable to both secured and unsecured creditors) can be utilized to speed the restructuring process.

Alleged Use of Fraudulent Claims: Danger Signs on the Horizon

The newfound feasibility of pre-negotiated bankruptcy plans does not come without costs, however. In at least two recent cases, it appears that a dangerous practice has arisen of using allegedly "fictitious creditors" as a tool to engineer the confirmation of composition plans that would otherwise be rejected by legitimate creditors. In these cases, the debtor's attorney has filed affidavits from "would-be creditors" voting in favor of a composition plan put forward by the debtor. These allegedly "newly found creditors" (who are invariably absent from court) possess sufficient claims in amount and number to out vote existing creditors, insuring that the debtor's composition plan is confirmed.

If allowed to continue, this alleged practice will undermine the fragile progress being made in out-of-court debt restructuring. Keeping in mind that such progress now rests on mutual frustration with the existing stalemate in the courts, an ad hoc approach to confirmation of suspect composition plans will cause many debtors to walk away from the negotiating table and return the parties to a state of uncertainty. With this uncertainty, the out-of-court restructuring process will once again suffer from stagnation and lack of progress, as the parties are unable to assess their negotiating leverage.

Solution is in the Implementation

As will undoubtedly be discussed elsewhere, the solution to this threat is in better implementation of the existing insolvency laws. While the use of pre-negotiated composition plans is, in itself, helpful, the Commercial Courts must be on guard to prevent abuse of the process that will undermine both faith in the judicial system and the viability of the out-of-court workout process.

This solution is, of course, deceptively difficult to implement. Nevertheless, professionalism and transparency in the implementation of the law should be the watchwords of all concerned, particularly as it relates to the confirmation of composition plans. If this step is taken, it will become clear that Indonesia already possesses most of the ingredients to complete the restructuring of its corporate sector for the good of all parties.

THE INDONESIAN BILL ON RESTRUCTURING DEBTS AND REHABILITATION OF COMPANIES

BY
PROF. DR. SUNARYATI HARTONO*)

Moderator, Ladies and Gentlemen,

I feel very fortunate that I was scheduled to speak after Mr. Bacelius Ruru, who pointed out the problems of an "out of court" composition in Indonesia. Because the team working on the Bill on Debt Restructuring and /or Rehabilitation of Companies, of which I have been entrusted by the Ministry of Justice and Human Rights to chair, has exactly set our focus on :

a. Overcoming the gaps and problems mentioned and experienced by Mr. Ruru and many creditors;
b. Forming the bridge between the "out of court composition " and the bankruptcy procedures as regulated by our bankruptcy law;
c. Thereby remedying the legal uncertainty experienced by creditors (local and foreign) and government agencies, as well as the banks, in particular Bank Indonesia and the BPPN;
d. all this in the hope that our economic and investment climate will improve, both for the benefit for our people and foreign investors alike;
e. by improving our legal environment, without sacrificing and violating the general legal principles, in a law abiding country.

APPROACH

The team drafting the Restructuring Debts and Rehabilitation of Companies (RDRC for short) takes a different philosophy compared to the bankruptcy law which takes a private law stand.

Our Philosophy and approach is broader than this legalistic private law approach, on the basis of the following assumptions and prepositions:

a. that bankruptcy of companies, es. which it occurs en masse in an economic crisis, does not only concern the respective debtors and creditors, but affects the whole economy and society where such bankruptcy procedures and decisions are produce en masse (this account for our economic law

*) Chairperson, legislative team drafting of the bill on RDRC

approach rather than the private law approach such);

b. that bankruptcy should not be the end of one's or a companies' life (in the traditional calvinistic way of thinking), but that bankruptcy should be a means to start anew (of course in a moral and legally valid way);

c. that bankruptcy of companies should not lame (melumpuhkan) the national economy and become the source of general unemployment and other social problems, such as social unrest and upheaval;

d. that bankruptcy of local companies should not merely provide the opportunity for foreign investors to invest cheaply in the country and finally dominate the national economy, thereby in this age of globalization merely helping to make Indonesia the market for transnational corporations at the cost of local companies and human resources;

e. that law should always consider social and economic changes and not only provide channels and means to remedy (micro - and macro) economic and social problems, but (in this 21st country of accelerated change and globalization) invent new means and opportunities to help the economy to recover and continue its process of sustainable development, thereby ensuring balance, fairness and social justice to the people, as well as to foreign creditors and investors.

Hence our approach is not purely legal, let alone purely based on private law principles and norms, but we tend to also consider economic, social and international factors, making it a multidisciplinary - and transnational approach which also takes into consideration the economic - social and international reality.

SCOPE OF INSOLVENCY LAW REFORM

On the basis of the above presumptions our legislative drafting team views the insolvency law as covering three kinds of laws :

a. The law on Restructuring of Debts and Rehabilitation of Companies;

b. The Bankruptcy law;

c. The law on Liquidation.

Therefore the Indonesian Bankruptcy Law is or should be only a part of our Insolvency Law, so that we still need a law on RDRC and a law on liquidation to complete the entire procedure.

SYSTEM OF INSOLVENCY LAW

It is our stand, that RDRC should precede the procedure of bankruptcy, which in turn should be followed by liquidation. Hence, before one starts with the bankruptcy proceedings, one should first attempt to restructure the debtor's debts, with or without rehabilitation of companies.

Only if and in the case these RDRC attempts fail, either because no agreement has been reached or whenever the RDRC agreement failed to be implemented, then the creditors or the debtor (as the case may be) can file for bankruptcy.

In this case, because sufficient time has been provided and sufficient evidence exists of failure of the RDRC procedure, no further delay towards the courts decision for bankruptcy is necessary, so that parties need not go through the long, complete and painful procedure of bankruptcy, such as is done today.

The procedure of suspension of payments in the bankruptcy law can thus be omitted and deleted.

Finally, we still need a law on liquidation, which will hopefully be drafted in the near future.

PRINCIPLES OF THE RDRC BILL

1. Focus on Agreement between debtor and creditors;
2. Providing sufficient time for rehabilitation of the debtor's company, provided there exist sufficient elements that RDRC is feasible;
3. Minimizing the intervention of the courts and of the judge;
4. Minimizing possibilities of further delay and redress, once the court has issued a bankruptcy decision;
5. Simplify the bankruptcy procedures;
6. Bringing more legal certainty and fairer results in the negotiations and solution;
7. Simplifying the task of judges and the courts, whilst at the same time improving their expertise and reliability.

CONTENT OF THE BILL ON RDRC

The Bill consists of 20 Chapters and some 170 articles as follows:

Chapter I: General Provisions

- Part 1: Definitions
- Part 2: Objectives of the law
- Part 3: Principals

Part 4: Scope of the law

Chapter II: Forms of DRRC

Chapter III: Restructuring during an economic crisis

Chapter IV: Procedure towards a proposal for DRRC

Chapter V: Feasibility for DRRC

Chapter VI : The restructuring team/agent

Chapter VII: Request for a proposal for DRRC

Chapter VIII: Creditor's meeting

Chapter IX: The concept of a DRRC Agreement/com position

Chapter X : The Concept of a DRRC Alternative Agreement/Com position

Chapter XI: Conclusion and Registration of the DRRC Agreement/Com position

Chapter XII: The Standstill Period

Chapter XIII: Implementation of the DRRC

Chapter XIV: Default by the Debtor or a/the creditor(s)

Chapter XV : Bankruptcy of the Debtor

Chapter XVI : Civil Detention of the debtor and /or his guarantor(s) in a place paid by the creditor(s)

Chapter XVII: Sanctions

Chapter XVIII: Cross border DRRCs

Chapter XIX: Transitory Regulations

Chapter XX: Closing Regulations

CONCLUSIONS

By putting the RDRC before the bankruptcy procedure, we are convinced that we will be putting the horse before the cart, thereby not only helping the parties (debtor and creditors) to reach a fair and agreeable solution, but also:

a) to prevent our economy to develop bigger, graver and large scale socio-economic problems, such as large scale unemployment, starvation, ending into a social revolution.

b) and even to help our economy to recover in order to enable the Indonesian people to not only survive the economic crisis but also to enter into new ways of production, investment, distribution and other means of sustainable macro and micro economic growth, as well as social development, in a world of globalization, revolutionary technological change, and transnational companies dominating the Indonesian - as well as the world economy.

Thank you.

RECENT DEVELOPMENTS IN INSOLVENCY REFORM OF INDIA

BY

D.P. WADHWA,

JUDGE OF THE SUPREME COURT

INDIA

The Government of India on October 22, 1999 constituted a Committee on law relating to Insolvency of companies. The Committee was headed by Mr. Justice V. Balakrishna Eradi, a retired Judge of the Supreme Court of India. The task before the Committee was to examine and to make recommendations with regard to :

a. the desirability of changes in existing law relating to winding up of companies so as to achieve more transparency and avoid delays in the final liquidation of the companies;
b. the mechanism through which the management of companies will be conducted after the winding up of order is issued and the authority which will supervise timely completion of proceedings;
c. the rules of winding up and adjudication of insolvency of companies;
d. the manner in which the assets of the companies are brought to sale and the proceeds are distributed efficiently and;
e. a self-contained note of winding up of companies having regard to the Sick Industrial Companies (Special Provision) Act, 1985 and the Securities Contracts (Regulations) Act, 1956 with a view to creating confidence in the mind of investors, creditors, labour and other shareholders.

The latest developments and innovations in corporate laws required that the Companies Act, 1956 and other relevant laws relating to winding up of companies should be re-modelled in tune with the international practices in this field. The Committee examined not only the Companies Act, 1956 but also other relevant laws having a bearing on the subject such as Sick Industrial Companies (Special Provisions) Act, 1985 (SICA), the Recovery of Debts due to Banks and Financial Institutions Act, 1993 (RDB Act), UNCITRAL Model Law on Cross Border Insolvency, report of the International Monetary Fund "Orderly and Effective Insolvency Procedures – Key Issues" and also

comparative provisions of insolvency laws in various countries like UK, USA, Singapore and Malaysia. Indian Company Law closely followed the law on the subject of UK but now in UK there is separate UK Insolvency Act, 1986 which deals with individual bankruptcy as well as corporate insolvency as an integrated law on the subject. The Committee made recommendations regarding change in law in the Companies Act, 1956 and left individual bankruptcies to remain under the Provincial Insolvency Act and the Presidency Towns Insolvency Act.

The law of insolvency should not only provide for quick disposal of assets but in Indian economic scene, it should first look at the possibilities of rehabilitation and revival of companies. There are at present three different agencies – (1) High Courts which have powers to order winding up of companies under the provisions of the Companies Act, 1956 (2) Company Law Board set up under Section 10E of the Companies Act, 1956 to exercise powers conferred on it by the Act, or the powers of the Central Government delegated to it and (3) Board for Industrial and Financial Reconstruction (BIFR) under SICA which deals with references relating to rehabilitation and revival of companies. The Committee found the High Courts were not able to devote exclusive attention to winding up cases which is essential to conclude winding up of the company quickly. It also found that the experiment of BIFR for speedy revival of companies has not been encouraging. The Committee was, therefore, of the view of a need for establishment of a National Tribunal as a specialised agency to deal with matters relating to rehabilitation, revival and wing-up of companies. The Committee recommended that with a view to avoiding multiplicity of for a, The National Tribunal should be conferred with jurisdiction and powers to deal with matters under the Companies Act, 1956 presently exercised by the Company Law Board; jurisdiction, power and authority relating to winding up of companies vested with High Courts and power to consider rehabilitation and revival of companies presently vested in the BIFR. The Committee, therefore, suggested amendment of Part VII of the Companies Act and repeal of SICA and amending Section 10E of the Companies Act. It recommended that pending cases in the three authorities be transferred to the National Tribunal. The Committee also recommended that adaptation of UNCITRAL Model Law, as approved by the United Nations, in the Companies Act itself to deal with all cases of Cross Border insolvency. The Committee also recommended that the principles enunciated under legal framework of "Orderly and Effective Procedures" recommended by International Mon-

etary Fund be incorporated in the Companies Act.

In addition to various grounds for winding up of the companies, the Committee recommended additional ground for winding up of a company where the provision relating to the filing of the balancesheet and annual returns are violated by non-filing of such documents for the last three years. Various recommendations were made like maintenance of panel of professional insolvency practitioners to introduce an element of professionalism in winding up of companies; establishment of a Fund for revival and rehabilitation of companies and also for preservation and protection of assets of the company during wind up.

It may also be noted that the Committee has in principle decided to concentrate its efforts on insolvency of companies, though insolvency of individuals at times have linkage with the insolvency of companies. Not only Companies Act but SICA and RBD Act have also bearing on the subject of winding up of companies. The Committee examined in depth the working of BIFR and did not favour its continuance and suggested repeal of SICA. It said that facts and figures on working of BIFR speak for themselves and they place a big question mark on the utility of the institutions of the BIFR and SICA. The problem of endemic delays inherent in SICA procedures of revival and reconstruction is to a great extent exacerbated by the large scale abuse of the provisions relating to suspension of legal proceedings, suits and enforcement of contracts and other remedies contained in Section 22 of the Act. The decision of the Supreme Court in Rishabh Agro Industries vs. PNB Capital Services (2000 AIR SCW 1753) is an illustration of the point under discussion. The other criticism levelled against the BIFR and the provisions of SICA in the course of presentations before the Committee also deserve brief notice.

1. The main drawback of the SICA scheme is that it leaves the debtor company in possession of the assets which creates an asymmetry and imbalance between the debtor company and its creditors conferring on the inefficient or inept management an unmerited advantage. Indeed, there are judicial decisions in support of the proposition that the pendency of a reference under Section 16 of SICA does not create a legal bar to the sick company disposing of its assets during such pendency. (AIR 1995 SC 1484);
2. The debtor in possession allows the promoters to leverage information advantages and to create tailor made delays in the proceedings by taking recourse to the suspension of legal proceedings under the provisions of Section 22 of the Act;

3. The implementation by BIFR of the various steps and measures under the scheme sanctioned with reference to Section 18 or 19 of the Act in a sequential rather than concurrent manner is an additional contributory factor leading to long and avoidable delays in the disposal of cases and proceedings.

It, therefore, recommended that SICA by replaced by a more reformed and improved statue which would provide for an alternative Tribunal and more effective mechanism for faster revival of sick and potentially sick companies.

The Committee then also examined the extent of the enormous inroads which recent special statues have made on Part VII of the Companies Act. This is with special reference to the RDB Act. Under Section 34 of that Act the Debt Recovery Tribunal (DRT) and the Recovery Officer have exclusive and overriding jurisdiction over the debtor company in liquidation even though the same issues also arise for bankruptcy adjudication pending in the Company court. The proceedings before the DRT cannot be stayed by the Company Court as the RDB Act overrides Sections 442, 446 and 537 of the Companies Act.

The Committee laid two-way test for triggering insolvency proceedings:

1. Debt Default Criterion: Where the company is unable to pay it debts in the manner provided for in Section 434 (1) of the Companies Act. The existing limit of Rs. 500 if far too low and unrealistic and may be raised to Rs. 11 lakh. Apart from this debt default criterion as determined under Section 434, the other grounds as envisaged in Section 433 should be retained.
2. Incipient Sickness: Erosion in the net worth to the extent of 50% or more should be recognised as a ground for recommending revival and reconstructionist procedures and if they prove to be unavailing, the company should be ordered to be wound-up on just and equitable ground (on line similar to the provisions contained in Section 20 of SICA).

The Committee, however, did not agree that the definition of debt default should be based on the concept of non Performing Assets (NPA) as defined in the report of the National Task Force Committee.

The NPA can also arise due to some temporary liquidity crunch. Moreover, a NPA related debt default criterion may no doubt protect the interests of secured creditors but not those of unsecured creditors and labour. Further, the

priority of Government dues also requires to be kept in view while ordering winding up of a company.

It was the recommendation of the Committee that revival/rehabilitation plans should be included as integral part in the structure of Companies Insolvency Statue. Finally, the Committee accepted suggestion that SICA should be repealed considering the criticism of the working of BIFR under SICA by recommended that the ameliorative, revival and reconstructionist procedures obtaining under it should be reintegrated in a suitably amended form in the structure of Company Law. These procedures will be similar to the measures for Administration Order Procedure and winding up which are now provided integrally as part of U.K. Insolvency Act, 1986.

Though the Committee has gone by the terms of reference and did not go into the question of insolvency laws, in my opinion, the insolvency law should be comprehensive to include corporate insolvency as well as individual insolvency. England has done so and same is the law in the United States.