CHRISTIAN TEO & PARTNERS
(in association with Stephenson Harwood LLP)

FINANCING INDONESIAN BUSINESSES AND PROJECTS – NEW CHALLENGE FOR LENDERS[1][2][3][4][5]

INTRODUCTION

A recent decision of Indonesia's Constitutional Court has created a potential new challenge to financing local businesses and projects, including those in the energy, infrastructure and mining industries. This new challenge is in the form of increased uncertainty about the practical enforceability of a traditionally favoured security right of lenders, being the Fiducia Charge.

This is a difficult time for the local energy, infrastructure and mining industries as well as, indeed, for the Indonesian economy as a whole. Accordingly, the last thing business owners and investors need at this juncture is anything that makes lenders even more reluctant, than they already are, to seriously consider providing new and additional financing for Indonesian businesses and projects.

Increased uncertainty about the practical enforceability of the Fiducia Charge is also singularly unhelpful for the Government as it seeks to improve the ease of doing business in Indonesia and thereby attract more foreign investment.

In this article, the writer will review the recent Constitutional Court decision and what its implications may be for both the willingness of banks to finance Indonesian businesses and projects as well as for foreign investors' perceptions of Indonesia as a desirable place to invest.

BACKGROUND

Financing businesses and projects in Indonesia, including those in the energy, infrastructure and mining industries, has long been a challenge for lenders. This is due to a variety of reasons including the difficulties often encountered by lenders in enforcing security for loans, following borrower defaults, given the widely recognized and serious deficiencies of the Indonesian legal system/court system.

Security enforcement is particularly problematic where (i) the lender is a foreign bank and (ii) the defaulting borrower is a well-connected and well-resourced Indonesian party. The enforcement problem encountered by lenders also typically grows exponentially if and when it is necessary for a lender to seek the assistance of the Indonesian Courts in enforcing its security.

---

[1] Bill Sullivan, Senior Foreign Counsel with Christian Teo & Partners and Senior Adviser to Stephenson Harwood LLP.

[2] Bill Sullivan is the author of "*Mining Law & Regulatory Practice in Indonesia – A Primary Reference Source*" (Wiley, New York & Singapore 2013), the first internationally published, comprehensive book on Indonesia's 2009 Mining Law and its implementing regulations.

[5] An earlier version of this article appeared in the February – March 2020 edition of Coal Asia Magazine.

Against the above unfortunate reality, it is easy to see why lenders to Indonesian businesses and projects would be likely to attach considerable value to security rights that they can enforce directly and without having to enlist the assistance of the Indonesian Courts. The Fiducia Charge was, traditionally, often believed (by some lenders and their professional advisers at least) to be one such security right.

When a Fiducia Charge is created over a particular asset, (i) ownership of the asset passes from the grantor to the grantee but (ii) the grantor retains possession of and the right to use the asset until such time as there is a default in respect of the obligation secured by the Fiducia Charge.

Fiducia Charges are often taken over tangible assets such as plant and machinery as well as over inventory and receivables/trade debts. Less commonly, Fiducia Charges are taken over shares in private companies.

Fiducia Charges must be registered, by grantees, at the Fiducia Registration Office which then issues Fiducia Certificates to the grantees as evidence of their rights as holders of Fiducia Charges.

In the event of a default in respect of the secured obligation, the grantee of the Fiducia Charge has the right to sell the fiducia object before applying the net proceeds of sale against the amount due in respect of the secured obligation. The balance, if any, remaining from the sale proceeds must subsequently be returned to the grantor of the Fiducia Charge.

Fiducia Charges are governed by Law No. 42 of 1999 re Fiducia Securities ("**Fiducia Security Law**").

Paragraphs (2) and (3) of Article 15 of the Fiducia Law ("**FL Article 15**") provide that:

> *"(2) Fiducia Certificates have the same power as enforceable court decisions that have permanent legal force.*
>
> *(3) If the debtor breaches the contract, the fiducia grantee has the right to sell the fiducia object on his own behalf."*

The Elucidation of Paragraph (2) of FL Article 15 explains that "*enforceable*" means:

> "*… directly enforceable without trial and final and binding on the parties to implement the decision.*"

Having regard to the seemingly clear wording of FL Article 15 and the presumed obvious intention of the drafters of FL Article 15, Fiducia Charges are classified as so-called "executory securities"; that is, security rights which, in the event of default in respect of the secured obligation, may be enforced directly by the grantee of the security right and by means of immediately requesting the State Auction House to sell the secured asset at public auction without needing to, first, obtain a court judgment. This is known as the process of "Parate Executie" and is to be contrasted with the process of "Fiat Executie" that applies to the enforcement of non-executory securities (such as Pledges of Shares in private companies) and in which case it is necessary for the grantee to, first and at a minimum, file with and have granted by the relevant District Court various petitions (including, most importantly, the so-called “Aanmaning Petition”) before having the fiducia object sold by the State Auction House.

Last November, the Constitutional Court handed down its Judgment No. 18/PUU-XVII/2019 dated 25 November 2019 (“**CC Decision**”).

ANALYSIS AND DISCUSSION

1. <u>**CC Decision**</u>

1.1 **Overview**: The CC Decision concerned an appeal from a lower court ruling regarding the repossession and attempted sale of a car by the grantee of a Fiducia Charge over the car, which repossession and attempted sale was challenged by the original buyer of the car who had used a loan, provided by the creditor/Fiducia Charge grantee, to fund the car’s purchase.

The Constitutional Court determined that, on the particular facts of the case, the creditor/Fiducia Charge grantee was <u>**not**</u> entitled to repossess and sell the car without, first, obtaining a court judgment.

Although the wording of the CC Decision is far from clear, the Constitutional Court highlighted that, if a creditor/Fiducia Charge grantee wanted to be able to take possession of and have the State Auction House sell the fiducia object, <u>**without first obtaining a court judgment**</u>, then the debtor/Fiducia Charge grantor had to <u>**both**</u>:

(a) acknowledge its default (“**First Requirement**”); <u>**and**</u>

(b) agree to the voluntary release/surrender of possession of the fiducia object to the creditor/Fiducia Charge grantee (“**Second Requirement**”).

The CC Decision does <u>**not**</u> make clear how the First Requirement and the Second Requirement can be satisfied.

Given its lack of clarity, the CC Decision is open to different interpretations of varying concern to lenders.

1.2 **Least Concerning Interpretation**: The least concerning interpretation of the CC Decision is that, given the particular facts of the case, the Constitutional Court was simply signalling its disapproval of (i) what are often very one-sided consumer financing arrangements and (ii) the use of heavy-handed debt collection tactics where the consumer falls behind in his loan repayments.

1.3 **More Concerning Interpretation**: The more concerning interpretation of the CC Decision is that it amounts to a broad re-thinking of the previously accepted position regarding the rights of the creditor/Fiducia Charge grantee as the holder of an executory security. Even if that is the correct interpretation, though, how much of a problem the CC Decision is going to be for lenders depends upon just what it takes to satisfy each of the First Requirement and the Second Requirement.

With regard to the First Requirement, (i) is it sufficient if the situations in which a default will be deemed to have occurred are carefully specified in the underlying loan agreement/deed of Fiducia Charge or (ii) once the creditor/Fiducia Charge grantee declares that an event of default occurs, does the debtor/Fiducia Charge grantor have to actually acknowledge/confirm that an event of default has, indeed, occurred? If (i) is correct, then this should not be a major problem for lenders as well drafted and arms-length loan agreements/security agreements will typically specify, in considerable detail, what constitutes an event of default. If, however, (ii) is correct, then this is, potentially, a material problem for lenders as it must be expected that most borrowers/debtors will be very reluctant to acknowledge/confirm that they are in default once an event of default is declared by the creditor/Fiducia Charge grantee. To believe otherwise is to deny human nature.

Turning to the Second Requirement, (i) is it sufficient if the underlying loan agreement/deed of Fiducia Charge specifically provides for the right of the creditor/Fiducia Charge grantee to take possession of the fiducia object if and when an event of default is declared or (ii) regardless of what is provided for in the underlying loan agreement/deed of Fiducia Charge, may the debtor/Fiducia Charge grantor still object to surrendering possession of the fiducia object once an event of default is declared and thereby prevent the creditor/Fiducia Charge grantee from immediately taking possession of the fiducia object? As with the First Requirement, if (i) is correct, this should not be a major problem for lenders as well drafted and arms-length loan agreements/security agreements will typically specify, in considerable detail, what are the rights of the creditor/Fiducia Charge grantee once an event of default occurs and how these rights may be exercised. If, however, (ii) is correct then this is, potentially, a material problem for lenders as it must be expected that most debtors/Fiducia Charge grantors will object to creditors/Fiducia Charge grantees taking possession of the fiducia object once an event of default is declared and the risk of losing the possession/use of the fiducia object becomes a very unpleasant reality for the debtor/Fiducia Charge grantor. Again, to believe otherwise is to deny human nature.

1.4 **Assessment**: The CC Decision is yet to be considered by other Indonesian courts generally and, more particularly, in the context of Fiducia Charge grantees seeking to directly enforce their security rights in commercial loan and project financing default situations rather than in consumer finance arrangements where a default has occurred. Accordingly, it is too early to express a definite view on how significant or otherwise is the CC Decision for creditors/lenders in the context of commercial loan and project financing transactions.

Given Indonesia is a civil law country, rather than a common law country, precedent also assumes less importance in Indonesia. For this reason, the CC Decision is not automatically binding on other Indonesian Courts although it will, inevitably, have considerable influence with all Indonesian Courts given that the Constitutional Court is Indonesia's highest court.

The lack of clarity as to just what the Constitutional Court meant in certain parts of its judgement may also leave the CC Decision open to "creative" interpretation in later Fiducia Charge enforcement proceedings.

The CC Decision has, however, inevitably cast doubt on the status of the Fiducia Charge as an executory security or, perhaps, more correctly on what is the real benefit, if any, of a Fiducia Charge being classified as an executory security rather than as a non-executory security.

Notwithstanding the foregoing, it must be acknowledged that debtors/security grantors in Indonesia have long had various advantages and available strategies, vis-à-vis creditors/security grantees, that have often made it difficult for a creditor/Fiducia Charge grantee to easily enforce its security rights without the cooperation of the relevant debtor/Fiducia Charge grantor. These advantages and available strategies very much predate the CC Decision.

First, Indonesian law does **not** allow “self-help”. This means that, regardless of what the underlying loan agreement/deed of Fiducia Charge may provide for in terms of the rights of the creditor/Fiducia Charge grantee should there be a default, the creditor/Fiducia Charge grantee **cannot** simply go on to the property of the debtor/Fiducia Charge grantor or a third party and seize the fiducia object over the objections of the debtor/Fiducia Charge grantor or the third party. If an event of default occurs, the creditor/Fiducia Charge grantee has always had to enlist the assistance of the court bailiff and/or the police in taking possession of the fiducia object when it is on the property of the debtor/Fiducia Charge grantor or a third party.

Second, if there is an existing dispute as to the (i) validity of the Fiducia Charge or of the underlying loan agreement or (ii) ownership of the fiducia object, it has typically been possible for a debtor/Fiducia Charge grantor to prevent the direct enforcement of the Fiducia Charge until such time as the existing dispute has been resolved. This has resulted in debtors/Fiducia Charge grantors and their legal advisors pre-empting anticipated Fiducia Charge enforcement actions by creditors/Fiducia Charge grantees through the strategy of filing what are often wholly spurious claims challenging the validity of the Fiducia Charge/underlying loan agreement or the ownership of the fiducia object. It is then usual for a debtor/Fiducia Charge grantor and its legal advisors to deliberately delay/frustrate the final determination of the claim/dispute, for as long as possible, so as to prevent the creditor/Fiducia Charge grantee proceeding with the enforcement of its security right.

Third, the existence of multiple levels of appeal from any initial District Court decision in favour of the creditor/Fiducia Charge grantee, with regard to the validity of the Fiducia Charge/underlying loan agreement or the ownership of the fiducia object, has also routinely hindered the timely conclusion of the exercise of creditor/Fiducia Charge grantee’s enforcement rights.

Having regard to the foregoing, it is questionable whether Fiducia Charges ever really lived up to the often unrealistic expectations of creditors/Fiducia Charge grantees as to the practical value of their Fiducia Charges in default situations and when faced with uncooperative debtors/Fiducia Charge grantors supported by “creative” professional advisers.

2. **<u>Ease of Doing Business Concerns</u>**

2.1 **Overview**: Successive Indonesian Governments have introduced numerous reforms and made commendable progress in many areas since the end of the New Order Regime in 1998. However, almost no progress has been made in addressing the long standing and widely understood deficiencies in the Indonesian legal system/court system. This is despite the fact that an independent and transparent legal system/court system, which facilitates cost efficient and timely enforcement of contracts, has long been recognized as an essential minimum requirement for any country wanting to realize its full economic potential.

2.2 **Ease of Doing Business**: The World Bank's Doing Business 2020 Report ranks Indonesia 73rd out of 190 countries in terms of ease of doing business ("**EODB**"). This puts Indonesia below a number of its ASEAN competitors in the World Bank's rankings with (i) Vietnam at 70th place, (ii) Thailand at 21st place and (iii) Malaysia at 12th place.

The World Bank's EODB Index measures a number of factors in arriving at a country's overall EODB ranking being (i) opening a business, (ii) getting a location to carry on a business, (iii) dealing with day to day operations, (iv) **<u>operating in a secure business environment</u>** and (v) **<u>accessing finance</u>**.

One of the two components of "operating in a secure business environment", that the World Bank takes into account, is the practical ability to **<u>enforce contracts</u>**. More particularly, the World Bank measures the enforceability of contracts in terms of (i) the number of days required to enforce a contract, (ii) the cost of enforcing a contract expressed as a percentage of the value of the relevant contract and (iii) the quality of the judicial processes involved in enforcing a contract.

According to the World Bank's Doing Business 2020 Report, Indonesia does (i) relatively well in terms of the time taken to enforce contracts with an average enforcement time of 390 days compared to an average time for East Asia & the Pacific of 581.1 days but (ii) very poorly in terms of the cost of enforcing contracts with an average enforcement cost equal to 74% of the value of the contract compared an average cost for East Asia & the Pacific of only 47.2% of the value of the contract. The World Bank ranks the quality of judicial processes in Indonesia as marginally better than the average for judicial processes in East Asia & the Pacific.

Indonesia's (i) extremely high cost of contract enforcement and (ii) the average quality only of its judicial processes no doubt largely explains why it is that, although Indonesia's overall EODB Index rating is 73rd out of 190 countries, Indonesia only ranks 139th out of 190 countries when it comes to enforcement of contracts.

The World Bank focuses on the time taken to enforce and the cost of enforcing general commercial contracts rather than the time taken to enforce and the cost of enforcing more specialized loan agreements and associated security agreements. Nevertheless, **<u>if</u>** the CC Decision means that the creditor/Fiducia Charge grantee must now, first, file with and have granted by the relevant court various petitions before being able to enforce the Fiducia Charge and take possession of/sell the fiducia object, the CC Decision is certainly going to be a negative development in terms of facilitating the ability of investors to operate in a secure business environment in Indonesia from a contract enforcement perspective. Materially complicating the Fiducia Charge enforcement process must be expected to increase both the number of days required to enforce a Fiducia Charge as well as the cost of enforcement of a Fiducia Charge. Likewise, making creditors/Fiducia Charge grantees more dependent upon the Indonesian Courts, in order to enforce their security rights, is going to mean that, going forward, the average/borderline quality of the country's judicial process will be an even bigger issue, from the perspective of being able to operate in a secure business environment, than it has been up to now.

Having regard to the foregoing, it is surely somewhat ironic that, in its Doing Business 202**<u>0</u>** Report, the World Bank indicates that Indonesia has actually improved contract enforcement as a result of introducing an electronic case management system for judges. This, presumably, impacts the perceived quality of the judicial process in Indonesia. The writer would surmise that the Doing Business 202**<u>0</u>** Report was actually prepared **<u>before</u>** the CC Decision became well known. It will be interesting to see then what the World Bank's Doing Business 202**<u>1</u>** Report says about the progress **<u>or otherwise</u>** Indonesia has most recently made in contract enforcement once the CC Decision is taken into consideration.

The CC Decision could also conceivably reduce the ease of accessing finance in Indonesia. Bankers may come to view the greater uncertainty, created by the CC Decision about the ability to enforce Fiducia Charges on a timely and cost effective basis, as increasing the associated lending risk they run in Indonesia. If that happens, it must be expected to have negative implications for the availability of/access to finance.

With potentially negative implications for two of the five factors measured by the World Bank, as part of the compilation of the EODB Index, the CC Decision **<u>cannot</u>** be good news for Indonesia's future EODB ranking.

SUMMARY AND CONCLUSIONS

Obtaining financing for businesses and projects in Indonesia has never been easy given the widely held perception of Indonesia as a high-risk jurisdiction for lenders, especially foreign lenders. This has often been particularly the case in capital intensive industries such as energy, infrastructure and mining.

The CC Decision is capable of multiple interpretations.

Fiducia Charges are a standard part of the security package for commercial loans/project financing in Indonesia regardless of the particular industry. Accordingly, the CC Decision has potential implications for the financing for business and projects in all industries and across all sectors of the Indonesian economy.

The CC Decision also comes at a bad time for the Government given its stated commitment to improving Indonesia's EODB ranking and thereby making Indonesia a more attractive destination for foreign investors. The Government's undoubted good intentions in this regard are being undermined by an unsatisfactory legal system/court system.

Regardless of how it is ultimately interpreted and applied, however, the CC Decision will certainly do **nothing** to improve lenders' risk perceptions of Indonesia.

The ability to readily enforce contracts, whether general commercial contracts or more specialized loan and security contracts, is a non-negotiable requirement if Indonesia is ever to realize its economic potential. It is unfortunate then that successive Governments have not been willing to embark on the undoubtedly hard and long process of reforming Indonesia's legal system/court system so as to bring the same into line with the needs of a modern economy. In the long run, it is all Indonesians who are the big losers as a result of this lack of reform of the legal system/court system. Lenders/security grantees, whether foreign or local, are just the "collateral damage".

****

This article was written by Bill Sullivan, Senior Foreign Counsel with Christian Teo & Partners and Senior Adviser to Stephenson Harwood LLP. Christian Teo & Partners is a Jakarta based, Indonesian law firm and a leader in Indonesian energy, infrastructure and mining law and regulatory practice. Christian Teo & Partners operates in close association with international law firm Stephenson Harwood LLP which has ten offices across Asia, Europe and the Middle East: Beijing, Dubai, Hong Kong, London, Paris, Piraeus, Seoul, Shanghai, Singapore and Yangon.

Get in touch

Bill Sullivan

T: +62 21 5150 280
M: +62 815 8506 0978
E: bsullivan@cteolaw.com

Christian Teo

T: +62 21 5150 280
M: +62 818 124 747
E: cteo@cteolaw.com

Claudius Novabianto

T: +62 21 5150 280
M: +62 818 0858 9235
E: cnbianto@cteolaw.com