

No. 5
September 1999

Indonesian Bankruptcy Policy & Reform: Reconciling Efficiency and Economic Nationalism

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Published by
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World Wide Web: <http://www.iseas.edu.sg/pub.html>

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ISSN 0219-3213

This is based on the paper presented
by
Associate Professor David K. Linnan
at a Trends in Indonesia Seminar organized by the
Institute of Southeast Asian Studies
in Singapore on 21 June 1999.

A version of this paper was presented at a Conference entitled
Current Issues & Future Directions for Bankruptcy Reform in Indonesia:

International & Comparative Perspectives,

sponsored by

Tim Pengarah Pengadilan Niaga, Republik Indonesia,

AusAID, The World Bank and

The International Monetary Fund

in Jakarta on 29-30 April 1999.

The proceedings of which will appear as T. Lindsey (ed), Law Reform and
the Commercial Court in Indonesia, Federation Press, Sydney.

Its expanded version will appear as “Insolvency Reform and the
Indonesian Financial Crisis”, forthcoming in the Bulletin of Indonesian
Economic Studies.

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About the Speaker

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INDONESIAN BANKRUPTCY POLICY & REFORM: RECONCILING EFFICIENCY AND ECONOMIC NATIONALISM

The Indonesian government must ask itself three questions, the answers to which should determine its policy parameters for resolving private party insolvencies. First, should national entrepreneurs remain in control of entities, even if they are insolvent and leaving them in control requires abandonment of the rule of law? Second, what can be done under the current insolvency law system and still depressed economic conditions successfully to address private insolvencies? And third, given that emergency bankruptcy legislation Perpu No. 1/1998 is scheduled to be replaced by a new, comprehensive insolvency law soon, what approach should the new insolvency law take?

There are technical problems with Indonesian bankruptcy law, but the overriding issue is whether Indonesian society believes that functioning bankruptcy law serves Indonesia's interests rather than solely those of foreign creditors. Thus, we look first to nationalism and related concerns. After a brief review of insolvency law under Perpu No.1/1998, we work through the above questions in examining problems of valuation and the difficulty that owners of deeply insolvent businesses behave differently from those of a solvent enterprise (because they have the wrong incentives as optionholders). On the technical side, we advocate development of a stronger involuntary reorganization track within bankruptcy, seeing many of the current problems with Indonesian insolvency as resulting from a structural mismatch in Perpu No. 1/1998's retention of only two options: liquidation and a relatively weak form of debt compromise (neither of which contemplate creditors exchanging debt for equity, which approach would benefit Indonesia). Since the structure and rights under bankruptcy law also affect privately negotiated workouts, such changes are desirable even if the Indonesian government's ultimate goal is that private parties negotiate

reorganizations outside of court. Finally, we close on the dual note that creditor difficulties have contributed to insolvency problems at the same time as Indonesia's parallel banking crisis increasingly overlaps with private sector insolvencies.

Nationalism, Efficiency and the Rule of Law

Indonesians are deeply concerned about potential foreign control of the economy. Insolvency reform is presumed to benefit foreign creditors, and so discussions of that subject are perceived within Indonesia as shadow discussions about foreign "control" of the economy. Indonesian discourse on nationalism and foreign economic involvement was born in analyses of the Dutch colonial economic system (Hatta: 1923, 1926 and 1938), incorporates as part of Indonesian historiography deep-seated suspicion of economic "liberalism" tied to ideas about colonial domination (Pabottingi: 1991), proximately caused Article 33 of the 1945 Constitution's (UUD 1945) problematic economic emphasis on cooperatives and organization of the Indonesian economy with heavy government involvement plus under the "family principle" (Hatta: 1970 & 1977), bedevilled formal Indonesian economic policy since the 1950s with questions about the role of markets versus constitutional "anti-liberalism" (compare Widjojo Nitisastro: 1955 with Wilopo: 1955) and echoed in the June 1999 election campaign debates concerning the *ekonomi rakyat* or People's Economy.

The immediate connection to the current insolvency reform debate is the way in which Indonesian debtors commonly resist foreign creditor actions in claiming national for personal interest, while the theoretical connection is the idea that debtors thereby attack efficiency and property concepts buried in insolvency law (implicitly invoking the anti-liberal economic background of Article 33 UUD 1945, which instinctively concerns Indonesians contemplating structural reform under IMF conditionality). Before Indonesians can effectively embrace insolvency law as part of structural reform, they must resolve open questions about the relationship between nationalism, economic efficiency and rule of law concerns.

The efficiency argument for enterprise bankruptcy law is that it does not exist as a moral matter, but rather to serve allocative efficiency and minimize the social costs of failed enterprises. Indonesians may overlook this aspect given a tendency to view debts as moral obligations for religious reasons (at least among Indonesia's Islamic

majority), failure to pay which presumably might be justified on the basis of morality (because wealthy creditors will not miss their money). Nationalism is a legitimate non-efficiency based concept, but the linkage is that it can only be placed over efficiency interests at a very real economic cost (which dawning realization already informed Indonesian *globalisasi* discussions in the mid-1990s). Indonesians must ask themselves who would pay these costs likely encountered in the form of slower economic recovery and lower growth?

Perpu No. 1/1998 suffers from legitimacy problems beyond hidden nationalism concerns. Insolvency reform during the dark financial days of early 1998 was accomplished by a small group within government on an emergency basis. It was not subject to any broader public discussion; employing Indonesian terminology, the law was never “socialized” with the result that the broader public may doubt that it benefits Indonesia more generally (for example, as applied between purely domestic creditors and debtors). However, the case for insolvency law might be summed up as follows in Indonesian terms: elevating nationalism over efficiency concerns, or failing to enforce insolvency laws, may exacerbate economic democracy problems.

Without effective insolvency law lenders will ration credit (access to capital) through prohibitively high interest rates or otherwise. Newer Indonesian entrepreneurs may be closed out by high capital costs, so there is an implicit economic tension between Indonesian businessmen who prospered during the New Order and those starting out now. Ultimately, the country will suffer a second time if less competent businesspeople who captured control of assets during the New Order are favored, with the result that newer, more competent local entrepreneurs will be closed out when the cost of capital rises before they start their businesses. By favoring existing Indonesian debtor-equityholders, the government would disadvantage new and different Indonesian businessmen, creating further economic democracy concerns in Indonesian eyes. The traditional Indonesian response to any such perceived conflict involved redistribution of government funds to help weaker borrowers. However, this is an unsustainable option given the Indonesian government’s foreseeable domestic and foreign debt burden associated with recapitalizing the banking system.

There is an analogous “economic democracy” case to be made in Indonesian eyes favoring reorganizations in insolvency. Business divestitures in reorganizations

(deconglomeration) would represent a considerable benefit to competition policy, to the extent Indonesia finally shows serious interest in antitrust law under *reformasi*. If reorganization also involves debt-for-equity swaps, the process coincidentally can create publicly tradable securities in the reorganized entity. The creation of new securities would directly benefit Indonesian capital markets, to the extent trading volume and actively traded issuers have decreased substantially as a result of the financial crisis. Lenders capturing continuing enterprise value through equity interests in debt-for-equity swap reorganization will dispose of them in the markets quickly because they are not longterm equity investors, thus broadening ownership. Unlike current controlling equityholder-managers, it is in the government's interest to force reorganization with the effect of broadening public ownership and bringing about divestitures.

Judging by past country workout situations, from an economic point of view the Indonesian government eventually must face squarely nationalism arguments regardless of political discomfort. The difficulty is that Indonesian debtors, particularly the pribumi conglomerate community visible through KADIN, initially argued in every possible political forum that effective insolvency proceedings themselves represent selling out national interests to foreigners. The problem is that this political position is an outright appeal that the rule of law should not apply and priority rules should be suspended because they disadvantage debtor-equityholders. Such a populist argument resurfaces occasionally in all countries, since debtors typically outnumber creditors in the voting booth. However, the special twist under Indonesian circumstances is twofold. First, its proponents are not arguing for a temporary relaxation of normal legal strictures but rather for continuing absence of the rule of law. Second, while couched in the language of populism, the appeal is being made on behalf of major business empires rather than hard pressed small businessmen or farmers. There is a further political undercurrent to the extent the Chinese business community is notable mostly for its silence on the issue, presumably a calculation that they lose more than they would gain in disregarding rule of law considerations at this juncture. Ultimately, Indonesia needs to decide which is more important to its development: the rule of law, or the interests of existing debtor-equityholders?

How Existing Indonesian Insolvency Law Came to Be

Pre-Perpu No. 1/1998 bankruptcy law was formally pro creditor in orientation to the extent its emphasis lay in liquidation rather than reorganization of debtors (Dutch Colonial 1906 *Faillissements-Verordening*). However, its enforcement through the court system was so bad that, in a country of 200,000,000 inhabitants, only 120 bankruptcy cases were brought during the five years preceding Perpu No. 1/1998. Creditors did not give serious thought to pursuing debtors in court, given a common perception that any such proceeding would be drawn out and full of irregularities.

Insolvency reform only commenced in early 1998 on the programmatic level as part of IMF conditionality, and on the practical level as an attempt to force Indonesian debtors to deal with foreign creditors. The terms of Perpu No. 1/1998 were hammered out when the rupiah was in freefall, promulgated in decree form by President Suharto April 22, 1998. Bank Indonesia was still struggling to identify Indonesian borrowers of foreign currency, since the government's traditional position had been that private sector foreign borrowings were not its concern. The Indonesian government subsequently created voluntary mechanisms for facilitation of debtor-creditor reorganization negotiations at the June 1998 Frankfurt meeting and under the September 1998 Jakarta Initiative. However, thus far it does not appear that the Jakarta Initiative is markedly more successful than INDRA, which Indonesian corporates originally rejected. Early government statements to the effect that Indonesian debtors need not adopt either debt restructuring scheme (*Asia Pulse* 10/27/98) seem an admission in Indonesian terms that they were not working. Almost two years into the financial crisis there are relatively few large reorganizations in an advanced stage (Bakrie and Astra), and it is difficult to claim them as "pattern deals".

Already in July 1998, Minister of Justice Muladi surfaced issues of *kepastian hukum* (legal certainty, or the rule of law) and insolvency reform in a surprisingly candid fashion before the DPR select committee examining the emergency bankruptcy legislation. He admitted that neither Indonesian society nor foreign investors had any faith in national law, above all not in Indonesian courts (*Kompas* 7/17/98). He raised the political ante considerably by casting the emergency insolvency law reform itself in terms of convincing society and foreign investors that the rule of law does apply in

Indonesia. As a result continuing problems with insolvency law are commonly perceived as a continuation of the traditional weakness of the rule of law in Indonesia.

Perpu No. 1/1998's Structure. There are two basic conceptual options in insolvency proceedings under the emergency statutory scheme, namely liquidation in bankruptcy and a relatively weak form of reorganization through court-supervised voluntary compromise of debt under a plan prepared by the debtor and approved by unsecured creditors (under Perpu No. 1/1998 Article 212, in general terms an application to suspend payment obligations under a voluntary composition plan, which can be filed only by the debtor). Liquidation in bankruptcy proceedings can be filed by a debtor or creditor if the debtor has two or more creditors and has failed to pay at least one debt which is due and payable (Perpu No.1/1998 Article 1). It can also be brought by the Public Prosecutor in the public interest, and requires the approval of Bank Indonesia for a bank and of Bapepam or the Capital Markets Supervisory Agency for a securities company.

To address fears of delay, the new scheme mandated fast judicial action more to pressure debtors into negotiation than with a view to realistic procedure. Collapsing various procedural time periods, admissibility of an application for liquidation in bankruptcy must be decided within 30 days of its filing, subject to an accelerated appeal to the Supreme Court which must be decided no later than 38 days following the lower court opinion (resolving the putative bankrupt's status within 68 days of the original bankruptcy filing). The voluntary compromise procedure for rewriting debt obligations is more detailed. Following a provisional suspension of debt obligations upon filing it ultimately requires approval of an unsecured creditor meeting (one-half of the creditors, holding two-thirds of the unsecured debt represented). The first proceeding permitting a vote of creditors must be scheduled within 45 days of the filing (Perpu No. 1/1998 Article 214(3)), and the statute generally permits termination of debt suspensions for bad faith and similar non-complying debtor activities (Perpu No. 1/1998 Article 240), but in any case the voluntary compromise must be approved within 270 days from the original filing or automatic conversion into a bankruptcy liquidation proceeding occurs (Perpu No. 1/1998 Article 217(4)).

Under both liquidation in bankruptcy and voluntary debt compromise, assuming adequate protection secured creditors are subject to a stay upon filing but are permitted

to execute on their collateral 90 days into the bankruptcy process (Perpu No. 1/1998 Articles 56 & 56A), but not during the pendency of a provisional suspension of debt obligations in the voluntary compromise proceedings (translating into permitting execution sometime between 90 and 270 days, depending upon when unsecured creditors accept or reject the debtor's proposed compromise). Both proceedings also provide for an election by supervisors of the business to assume executory contracts, subject to offering adequate protection (Perpu No. 1/1998 Articles 36 & 234, liquidation in bankruptcy and voluntary compromise respectively).

The statute also provides for invalidating debtors' legal acts and the claw-back of assets under circumstances roughly equivalent to fraudulent transfer principles in Anglo-American bankruptcy proceedings. Thus, transfers may be set aside if a debtor knew or should have known they would prejudice creditors, and contracts may be voided if debtor obligations greatly exceed a counterparty's. Acts may also be voided if they constitute a payment of, or security for, a debt not yet due and payable, together with contracts with related entities and family members as measured under a variety of interlocking ownership and directorate tests plus adoption and consanguinity up to the third degree (Perpu No. 1/1998 Articles 41-43). All of these were potentially significant, given widespread concerns about mobile assets given Indonesian conglomerates' character as a mix of private and listed entities controlled by founding shareholders as well as outright asset-stripping.

Problems of the New Commercial Court. Perpu No. 1/1998 established an entirely new commercial court for insolvency cases (*Pengadilan Niaga*, initially in Jakarta) staffed by judges drawn from existing courts of general jurisdiction given special training (Perpu No. 1/1998 Articles 280-83). The choice made to staff the court with ordinary judges lacking substantial business experience contrasted sharply with the parallel decision to introduce commercially sophisticated supervisors and administrators for debtors (and already may be subject to reversal, *Jakarta Post* 3/6/99). The first set of 32 commercial court judges graduated from their IMF-supported special course staged by the Ministry of Justice just in time for the August 20, 1998 effective date of the new bankruptcy law. Those close to the process originally distinguished two concerns as applied to the new judges. The first was the new judges' ability to function in a specialized commercial court, admitting that

initially they would lack sufficient experience in a commercial setting to deal with the complicated valuation and business decisions implicit in insolvency law, which Indonesian bankruptcy practitioners have since confirmed (*Jakarta Post* 1/29/99). The second involved concerns about existing corruption within the Indonesian court system. In response, a conscious effort was made to select “clean” judges in the reform image of an independent judiciary, but questions have since been revived by frustrated creditors’ legal counsel at a loss to explain certain court decisions (*Asian Wall Street Journal* 3/26/99 & 2/9/99).

To address the judiciary’s relative lack of commercial sophistication, the emergency bankruptcy law intended that appointed private supervisors of the insolvent estate (*kurator* or receiver for liquidation in bankruptcy, *pengerus* or administrator for the voluntary compromise of debt) replace traditional civil servant insolvency supervisors (*Balai Harta Peninggalan* staff). The initial problem was perceived as the extent to which judges would largely follow the lead of receivers and administrators, given very tight deadlines on judicial decisions and their admitted lack of commercial sophistication. As practice developed, however, the judges’ lack of familiarity with commercial practice was rarely ameliorated by *kurator* or *pengerus*. Prior to receivers’ and administrators’ involvement, problems arose when judges made what were generally considered to be commercially unreasonable determinations in support of initial rejections of bankruptcy petitions.

Liquidation proceedings under the emergency bankruptcy statute contemplate an optional unsecured creditor committee to advise the receiver, while voluntary debt compromise proceedings require an unsecured creditor’s committee, and unsecured creditors could remove the administrator through voting. Supervisory personnel in both categories may borrow money and conduct business on behalf of the insolvent business, but are subject to personal liability for negligence in such dealings. Given that few petitions for bankruptcy or voluntary debt compromise were granted, anticipated issues about debtor operations within bankruptcy have not yet developed.

Criticism of Perpu No. 1/1998. International bankruptcy professionals judge Perpu No. 1/1998’s details as follows. The time periods involved in the bankruptcy and voluntary debt compromise proceedings are unreasonably short, since an outside receiver or supervisor placed in charge of a troubled business requires considerable

time just to identify its assets, liabilities and creditors. By comparison, consider the amount of time outside auditors required to review the lending portfolios of a small number of individual troubled banks for the Indonesian Bank Restructuring Agency or IBRA. However, the extremely tight deadlines were inserted more with a view to preventing cases from disappearing within the judicial system, rather than following a determination of how much time would be desirable in a well-functioning court system. As matters developed, the tight deadline problem seemed beside the point to the extent judges refused to admit bankruptcy petitions on a variety of theories viewed by international bankruptcy professionals as sharing little more than a guarantee of positive outcomes from the debtor perspective.

Further, as a result of the decision only to make minimal changes to older law in lieu of full modernization, Perpu No. 1/1998 accepted secured creditors' rights to execute on collateral at an early stage of insolvency proceedings. This confusion of priority issues potentially raises transaction costs and lowers the value to be realized from an intact business. It does not distinguish between granting adequately secured creditors priority among creditors and granting them an immediately enforceable foreclosure right to a specific asset, rendering reorganizations more difficult on the margin. However, once again anticipated concerns did not develop to the extent bankruptcy petitions were rarely admitted by judges in the first place and so the process did not get that far.

Perpu No. 1/1998's voluntary compromise of debt track is a weak version of a reorganization in legal terms. It aims conceptually at the slow paying debtor rather than the deeply underwater debtor as the current Indonesian problem. The voluntary compromise of debt is limited as a formal matter to just that, with a court authorized only to rewrite the contractual terms of its debt obligations on the basis agreed to by debtor and creditor. There is no legal authority to redistribute equity interests in the debtor as part of a reorganization plan, or take other measures such as fixing title in disputed assets via court order with disappointed claimants treated as unsecured creditors by analogy to rejected executory contracts. The problem of miscast statutory categories can be heard in practice to the extent debtors and creditors in Indonesia both talk about *restrukturasasi*, but have two different pictures in mind. The deeply underwater debtor follows the language of the voluntary debt compromise track in

discussing only a settlement of (foreign currency) debts, while creditors are talking about reorganizing companies in terms of shedding businesses and recasting debt as equity. The weak reorganization track might be adapted to “legalize” a debt and equity reorganization plan already negotiated between sophisticated debtors and creditors, as the Jakarta Initiative intends. However, such prepackaged insolvency filings are still largely unknown in Indonesia. The few reorganizations thus far involve debt reschedulings incorporating little in the way of debt-equity swaps.

Intercreditor relations within insolvency proceedings are also unnecessarily difficult to the extent creditor committee structures formally include only unsecured creditors (although secured creditors were thought to have parallel unsecured status to the extent they were undersecured, although recent judicial decisions undercutting secured creditor rights cast doubt on the entire area). Perpu No. 1/1998 also did not address significant potential issues created by the absence of clear property or enterprise liability rules. Given Perpu No. 1/1998’s procedural bias, they include obvious issues like substantive consolidation (*e.g.*, whether the “debtor” is a single legal entity within a broader corporate family, or is instead the entire corporate family based upon tracing funds moved to and from affiliated companies under standard Indonesian conglomerate behavior). These concerns arise in particular in connection with insolvency law provisions directed at fraudulent transfer activity (assuming complete business records and a clear paper trail to document intracorporate family transfers, which seems optimistic at best). The issue of overlapping creditor claims within the same corporate group has already led to judicial problems. The division of creditors into two undifferentiated groups is particularly problematic in the context of the substantive consolidation issues posed by Indonesian conglomerates, to the extent that forecloses treating any substantively consolidated family of entities as a differentiated capital structure with many classes of claimants.

Policy Prescriptions for Improving Indonesian Insolvency Law

Perpu No. 1/1998 was approved by the DPR subject to an express promise that it would be replaced by a new, comprehensive insolvency law within twelve months (*Kompas* 7/22/98 & 7/25/98). Now that preparation of the new statute is underway (*Jakarta Post* 3/6/99), the single most important step the Indonesian government could take would be

to step back and articulate clear bankruptcy policy in economic terms (employing bankruptcy policy in the sense of Jackson (1986)). The two paramount concepts considered should be absolute priority and valuation, although the devil is in the details.

Absolute Priority and General Valuation Issues in Reorganizations. The concept of absolute priority involves articulating property rights under which a hierarchy guaranteed by the rule of law is established from the most senior to the most junior class of interestholders in an enterprise, encompassing debt and equity (conceived of as holders of the residual interest in enterprise earnings, together with control). The rule of absolute priority represents the skeleton of past property rights remaining when *ex post* enterprise value must be reallocated to take into account the decrease from enterprise value *ex ante* under conditions of insolvency. No claimant of a financially distressed entity should receive any consideration for their claim unless and until more senior claims are fully satisfied (Blum & Kaplan, 1974).

Valuation of the business underlying the financially distressed enterprise should occur on the basis of discounted present value methodology based on future operating earnings without regard to underlying capital structure. Bankruptcy administration then consists of allocating the value determined starting from the most senior claim on the financially distressed enterprise, fully satisfying senior claims as you proceed down the hierarchy, stopping at whatever level of junior claim at which the business' value runs out (meaning in the case of deeply underwater debtors that equityholders and some junior creditors may come away with nothing). The question of liquidation versus reorganization should be treated separately from issues of priority and valuation, and can be resolved in a unitary proceeding commenced by either debtor or creditors. Further, in the case of a reorganization in lieu of liquidation, it will be necessary to recast the enterprise capital structure so that at least some junior claimants become equityholders (receiving the residual claim in the business, regardless whether they were originally contract creditors with fixed claims).

The point in using a discounted present value approach is to capture the going concern value of the business, as opposed to its liquidation value. The goal is to maximize value realized from the business as a whole with the target of minimizing social losses. This is why secured creditors should not have the ability automatically to execute on their collateral, to the extent that renders it more difficult to continue as a

going concern. Subject to minor qualifications, the rule for determining when financially distressed enterprises should be liquidated as opposed to reorganized is that liquidation should only occur if the anticipated going concern value of the business minus the costs of reorganization is less than its liquidation value net of liquidation costs. Primary responsibility for the liquidate-versus-reorganize decision should be fixed on a bankruptcy receiver's presentation to a judge, subject to creditors' ability to challenge valuation and similar matters in terms of forcing liquidation. The direct costs of bankruptcy are substantial, and there are cost efficiencies in terms of size, which will lead to differences in the reorganize-versus-liquidate decision for financially distressed businesses depending upon their individual circumstances (Warner: 1977).

Having stated general principles, three matters must be addressed. First is the very practical problem of determining value that bankruptcy professionals struggle with everywhere. Second are more philosophical issues concerning whether bankruptcy might interfere unduly with party expectations such as involuntarily remaining claimants with recast interests in a reorganized enterprise in lieu of being cashed out upon liquidation. Third is the peculiar problem in the Indonesian setting of how to deal with optionholder incentives (manager-controlling equityholders of deeply underwater debtors).

Special Valuation Problems Under Severe Economic Conditions. Valuation of a financially distressed business is always difficult even in normal economic times. There are uncertainties estimating the indirect costs of insolvency proceedings (for example, customers no longer place orders and suppliers no longer sell on credit in anticipation of possible liquidation). Under present value methodology, substantial uncertainties attach to estimation of a future stream of income and determination of the proper discount rate. Its variance as a function of the changing yield curve over time may substantially increase or decrease the present value of a given income stream at different points in time. These difficulties are compounded in the present Indonesian situation given a distinctive time period problem attached to depression conditions.

From the viewpoint of business enterprises troubled due to foolish individual financing decisions,¹ it is doubly difficult to overcome poor business results in an economy contracting strongly. From the systematic viewpoint of insolvency proceedings, depression-like conditions introduce a substantial valuation issue in

individual proceedings. Under a best case scenario, entity earnings or cashflow, hence any going concern valuation, of insolvent businesses would be seriously depressed even without regard to capital structures incorporating excessive indebtedness. Under a worst case scenario, disregarding for the moment potential investors not affected by depressed local conditions (here foreigners), valuation of an enterprise is extremely subjective to the extent there are no buyers at any price, ultimately a market failure argument (or, as a liquidity problem *per se*, the risk premium becomes extremely high presumably as a result of ill-defined property rights). In the alternative, disregarding exchange rates, in a high interest rate environment risk-free rates of return in the short term on government debt instruments like SBIs are so high that the discounted present value of a stream of income or cash already depressed by a general failure of demand approaches zero (even disregarding increase of enterprise liabilities given continuing accrual of interest on unpaid interest and principal).

The key to understanding the valuation problem in the insolvency context is the period nature of the problem linked with uncertainty. Assuming better economic times in period two eventually follow depression conditions in period one, at some point in time income or cashflow of the underlying business will increase (and presumably interest rates raised to defend the currency will fall, leading to lower discount rates thus boosting present value). From the viewpoint of those valuing an enterprise during period one, whether debt or equityholders of the insolvent enterprise or third parties interested in acquiring the underlying business, uncertainty concerning the duration of period one renders valuation a largely arbitrary decision (effectively approaching zero if period two comes late, but yielding a positive value if period two comes soon). Whether considered a problem of market failure or uncertainty, such a valuation problem is the linchpin for understanding both the normative question in a legal setting of when an insolvent business should be liquidated as opposed to reorganized in insolvency proceedings and the positive issue of what is actually happening with Indonesian debtors.

The market failure claim views the problem as one that depressed conditions mean there are no willing buyers (so current prices, to the extent there are any, are treated as artificially depressed and simply “wrong”). Thus, looking at the worldwide depression of the 1930s, one answer to this perceived quandry in large scale

reorganizations was to rely primarily on government agencies to determine enterprise values for an insolvency court (addressing particularly the history of U.S. railroad reorganizations under the Interstate Commerce Commission, and of public companies under the Securities and Exchange Commission, see Fuller (1940)). Probably not coincidentally, the average period successfully to complete these complicated reorganizations under depressed economic conditions was quite long, averaging 12.2 years with debtholders recovering on average about half the amount of principal plus back interest (Warner: 1977, 249). However, this New Deal approach involved a truly worldwide economic crisis so that no unconstrained investors were available to make a market. The presence of foreign investors as potential buyers despite regionally depressed circumstances renders the market failure argument doubtful at best for Indonesia. This assumes a basic government decision that faster economic recovery is more important politically than excluding foreign investors to satisfy nationalist sentiments.

The uncertainty argument speaks rather to the problem that value determination may be so arbitrary given the period problem, or may produce such a wide range of values, that one fears fixing value at any given point in the process (compare Gilson, Hotchkiss & Ruback 1998). There are two common responses, which are not mutually exclusive. Using a probabilistic approach, it is always possible to develop expected value using alternate scenarios. An alternate approach is to employ contingent value instruments in reorganizations to distribute the final “layer” of value. For example, one can reach further down the hierarchy of junior claimants if a relatively uncertain, higher valuation within a range of values is posited. You provide the lowest class of claimants with contingent value instruments like “out of the money” warrants, as long as the claimants do not also receive control of the enterprise. Those who fall at the margins of valuation only share in the reorganized enterprise’s value if the period of depressed conditions ends relatively quickly. The practical constraint arguing for the probabilistic over contingent value approaches is that it deals with the uncertainty problem in a fashion that facilitates closure in reorganization negotiations and avoids potential arguments between interestholder classes about post-reorganization conduct of the business.

Recasting Interests in “Involuntary” Reorganizations. We now address the second issue, that of philosophical objections made to “rewriting” party contracts through an involuntary reorganization. At one level this objection is already overcome under Perpu No. 1/1998’s voluntary debt compromise approach to the extent it does not require unanimous creditor consent. A non-consenting creditor in the minority is already bound by majority approval of a “voluntary” debt compromise plan. Beyond this, the typical case assumes a contract containing an *ipso facto* clause or similar terms accelerating payment of a debt obligation’s full principal and interest, or otherwise changing relationships if bankruptcy occurs. Thus, the disappointed intent will be that the contractual relationship should change at bankruptcy. There are really two issues here. First is the problem of whether it is fair in terms of imputed intent to the parties if unaltered contracts continued in force under a realistic reorganization scheme. The second is to what extent the nature of the continuing interest in the reorganized business changes.

The common explanation for acceleration clauses is a defensive one, that no single creditor wants to be disadvantaged vis-a-vis other creditors (*e.g.*, if other creditors accelerated their debt but the creditor in question did not) and thus maximizes his present claim. To the extent the viability of the reorganized entity is reasonably secure, however, it does not disappoint the creditor’s original investment intent to exchange his contractual claim negotiated with the viable pre-reorganization entity for a similar claim in a viable post-reorganization entity. The point is that the creditor’s real expectations would only be disappointed to the extent he is disadvantaged vis-a-vis other creditors, which is not the case if the reorganization is organized on the absolute priority and valuation principles initially discussed.

The second issue is addressed by mandating that, to the maximum extent practicable the post-reorganization claim should be similar to the pre-reorganization claim. This traditionally translates into providing a similar level of security and maturity for debt obligations, but not necessarily the same interest rate, while executory contracts are dealt with under their separate scheme. However, even duration may be unimportant to the extent there is a public market in which creditors may sell their new interests received in a reorganization. As a corollary, reorganization should not take place to the extent senior creditors, whose obligations presumably are secured, would

not receive adequate security in the reorganized enterprise for their obligations. Thus, secured creditors should not be entitled to treat the original security for their obligations as theirs to liquidate at will in bankruptcy, but they would never lose the benefit of adequate dedicated collateral (limitation of cram-down provisions aimed at senior creditors).

This brings up a second, hidden valuation problem of reorganizations, to be faced where the capital structure of the financially distressed entity itself must be recast as part of the process. The difficulty is the extent to which the absolute priority rule establishes the value creditors may claim, but not the precise nature of their new interests following reorganization. Employing the example of a financially distressed enterprise originally with four levels of claimants (secured debt, senior unsecured debt, trade creditors and equity), assuming a reorganizable but deeply underwater debtor the original equity owners would probably be substantially wiped out as lowest claimants in the hierarchy.

As previously indicated, secured creditors presumably retain security in some form. The real issue concerns what interests in the reorganized enterprise the two middle claimant classes receive, since trade creditors defined in our example as the surviving class lowest in seniority will by default likely inherit the role of residual claimants of the reorganized enterprise's earnings. In a word, they become the new equityholders and accede to voting control of the enterprise to the extent economics recommends that control be vested in holders of the residual interest. What the pre-reorganization senior unsecured debt claimants should receive as replacement interests is an open question, subject to the idea that the value of the new interests as a class should equal as closely as possible the pre-insolvency value of the old interests for which they will be exchanged. Otherwise, the rule of absolute priority and property rights would be subverted in value being transferred between classes of claimants.

There is a practical limitation to wiping out all original equityholders, given that creditors probably desire to retain senior management in Indonesian companies as management of the reorganized enterprise. Creditors' options in insolvency proceedings are typically either to liquidate a business by selling off assets piecemeal with the result that value received will be less than going concern value under normal circumstances, or to sell the debtor's business to a third party as a going concern

(dividing the proceeds among creditors, leaving rationalization of the business to the new buyer), or to capture the going concern value themselves by taking equity ownership of the debtor's business but "re-hiring" the former controlling equityholder-manager to run the business as the person most knowledgeable about it (with creditors divesting their new equity interests in the stock market or via private placement to recoup loan losses whenever the reorganized enterprise again becomes viable). Under the third option, which may be most suited to Indonesian circumstances, the original debtor-management will be left typically with operating control of the business and compensation in differing form depending upon the industry. For a relatively straightforward business like real estate, the debtor-management may be retained on a purely contractual basis (*e.g.*, paid as an office building manager). However, in more complex business settings he is often "paid" with a greatly reduced equity position to ensure alignment of former controlling equityholder-management and former creditor, now equityholder interests in the reorganized company. This kind of implicit agency and monitoring costs analysis may be present in the settlement of Bank Indonesia liquidity facility claims against Bank Danamon leaving former controlling equityholder-managers with at best 5% of equity in the recapitalized bank.

There is an implicit issue presented by current Indonesian insolvency law, which separates the world of creditors only into secured and unsecured priorities. Do you help or hinder resolution of insolvencies by limiting the number of claimant classes? In limiting classes to two (or arguably one, since only unsecured creditors have a legal right to representation on the creditor committee) reorganization becomes more difficult because you have denied potential claimant classes the right to "negotiate" relationships which establish differentiated property entitlements binding upon insolvency via the absolute priority rules. Meanwhile, strategic behavior concerns are buried in pretending that all creditors in a very broadly defined interest class share the same interests. This in turn increases collective action problems, to the extent any single agent appointed to bargain on behalf of the broadly defined interest class must be "disloyal" to portions of a class with divergent interests. Thus, Indonesian insolvency law should recognize more interest classes under an absolute priority rule hierarchy while providing through committee structures for agent representation to avoid collective action problems.

It is not substantially more complicated to devise and justify to differing claimant classes proposed interests in a reorganized capital structure than it is to develop a voluntary compromise plan reducing indebtedness. Further, regardless whether characterized as “voluntary” or “involuntary”, reorganizations in practice become extended negotiation exercises among claimants. More often than not, regardless who pens the plan of reorganization, it is largely “voluntary” to the extent it is bargained out under duress with claimant classes (typically via agents representing creditor committees). The role of the bankruptcy receiver and any legal power to impose a plan is addressed to controlling strategic behavior when the approach of insolvency causes differing interests within the enterprise capital structure to develop widely differing incentives just at that point when contractual guaranties of party bargains fail (given limited liability rules and the lack of value to support civil liability as a means of controlling renegeing on agreements).

The transaction cost problem is that, under conditions already incorporating considerable legal and economic uncertainty which itself effects debt claim valuation (Warner: 1977, 267-72), Indonesian controlling equityholder-managers are not clearly confronted with an involuntary reorganization structure which contemplates exiting some businesses completely while recasting equity interests too. There is another structural mismatch involving current law’s exclusive focus on a single legal entity as debtor in disregard of the manner in which Indonesian conglomerates conducted business (a hidden substantive consolidation issue). Large-scale corporate reorganizations involving creation of new capitalization structures and business spin-offs are such complicated exercises anyway that, absent workable legal frameworks to overcome collective action problems and divergent claimant interests, transaction costs in reorganization will seem prohibitive from the perspective of a single lender. Disregarding current problems with Perpu No. 1/1998’s implementation, creditors might dispossess controlling equityholder-managers through liquidation proceedings even under present law, but that is a hollow threat if creditors would only obtain depressed liquidation value (unless they are the buyers and seek to accomplish the business divestiture task and creation of new capitalization structures, raising the problem again of prohibitively high costs for individual creditors). Even if Indonesia hopes only to force negotiated creditor-debtor solutions instead of legal proceedings,

since bankruptcy entitlements set the parameters for private negotiations changes are advisable to revive a flagging process.

Deeply Underwater Debtors, Optionholders and Creditor Issues

Thus far we have treated the problem of private sector insolvencies as divorced from debtor and creditor behavior. We now look to explanations for current behavior to understand why Indonesian restructurings are still making slow headway.

The underlying problem with Indonesia's deeply underwater debtors may be that their manager-controlling equityholders 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* optionholders. A cursory glance at Jakarta Stock Exchange-listed issuer common stocks now trading at prices below 350 rupiah reveals the kind of enterprises now controlled by optionholders, which judgment may apply to affiliated companies from the same conglomerate family not trading in public markets (reflecting peculiar Indonesian corporate organization, under which founding family shareholders typically retain controlling equity interests in their publicly listed entities, while carrying on business in parallel in unlisted entities). While shares in such enterprises may have been sold to the public in a range of US\$1.00-2.50 during the 1990s, their current trading prices below US\$.05 belie their legal character as shares of common stock as opposed to their economic character as "out of the money" options. Once his equity interest loses substantially all its value, the manager-controlling equityholder has all the wrong incentives from a creditor perspective as long as he is protected by the insolvent corporation's limited liability shield (assuming substantive consolidation is not at issue). There is no immediate economic loss to the extent pending reorganization there is no substantial residual value to be captured by his equity interest. His 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 optionholder, adopting too risky strategies, or less favorably as a potential corporate looter stripping assets for his personal benefit.

How can the agent be motivated to resolve the financially distressed status of the enterprise, which step benefits Indonesia but not the agent personally? From the Indonesian government perspective there are at least two potential solutions, each of

which suffers shortcomings. The first approach is to restore value arbitrarily to the agent's equity stake (*i.e.*, a government bailout), with the result that the agent no longer worries about losing control and his residual claim. This might happen for general enterprises were the rupiah to strengthened sufficiently to shrink the value of foreign debt on enterprise balance sheets, frozen at attractive exchange rates if debtors opt into INDRA (which strategy seemed possible following the rupiah's lightening recovery in October 1998, with 7500 IDR = U\$1 proposed as a permanently available fixed rate by a BI Managing Director, *Asia Pulse* 10/27/98). Under such a scenario financially distressed debtors simply externalize (nationalize) the currency risk, so they benefit at the enterprise level from improved revenues associated with what may be inevitable subsequent inflation or improved export performance based on rupiah weakening. For bank recapitalizations and compromises with debtors owing funds to state banks, the issue lies hidden in their terms for repayment or repurchase of securities. While nationalizing risk arguably is justifiable for the greater good (resembling New Deal measures during the 1930s or modern banking system rescues), it ultimately looks more like a national champion strategy which negatively affects the emergence of new local entrepreneurs. This also increases the moral hazard problems inherent in operating in a weak rule of law environment, given that existing entrepreneur-agents furiously lobbied for the government to solve their problems (for example, debtors argued early on that the Indonesian government should decree the currency crisis to be *force majeure* hence releasing them from contracts). Ultimately, the nation as a whole pays for these problems such as in the banking system where at least partial *de facto* nationalization is already underway.

The second approach involves government influence directly on controlling equityholder-managers, either via jawboning (apparent intent of the Jakarta Initiative) or more coercive means. Government behavior as a creditor is notable for reliance on non-market incentives in the absence of enforceable contracts under the rule of law (*e.g.*, do the right thing or you will be arrested). For example, to recover circa U\$8 billion in Bank Indonesia liquidity credits, Indonesian government threatened criminal prosecution of offending debtors' directors and commissioners for prudential regulatory violations.

Less visible but nonetheless present is one step down the Public Prosecutor's power to file bankruptcy proceedings "in the public interest", or to adopt a criminalization strategy to force repayment of private debts. Government possibilities to influence debtors run the gamut from jawboning to the criminal law, with the caveat that the greater government pressure becomes favoring private creditors, the more likely it would be that debtors resist by wrapping themselves in nationalism's flag. This seems the best explanation for government behavior favoring criminalization threats against recalcitrant debtors owing money to Bank Indonesia (as money owed to "the public"; similar problems are now brewing for insolvent debtors owing money to state banks), showing relative indifference to similar claims of private domestic creditors (as money owed to wealthy locals, excepting domestic banks effectively nationalized), but seemingly downplaying help to foreign creditors even when settlement of their debts would benefit Indonesia economically (as money owed to wealthy foreigners). The best achievable approach would be to reformulate Indonesian insolvency laws to contemplate involuntary reorganizations, including recasting capital structures, allowing the government to distance itself somewhat from nationalist attacks while signaling its intentions to controlling equityholder-managers.

Four final comments are necessary to explain still halting progress on Indonesian reorganizations. Not all the problems have been on the debtor side. There is a continuing shortage of work-out personnel particularly within Asian creditor institutions. During the "Asian Miracle" years memories of business downturns faded, creating a skills shortage on the creditor side. Similarly, the Indonesian private sector's largest creditors were Japanese and Korean banks, which have suffered their own difficulties due to banking problems brought on in their home jurisdictions by the Asian financial crisis.

Significant write-offs would have unacceptably affected such banks' capital adequacy ratios; thus, a significant creditor group has sought to delay loss recognition. This helps to explain both the slow progress in reorganization negotiations as well as the predominant pattern in the few reorganizations to date (debt rescheduling preserving an apparent promise to repay substantially all amounts owed, in lieu of debt-equity swaps or loan write-offs). However, debt reschedulings may only delay rather

than resolve problems since the enterprises in question remain heavily leveraged in a difficult operating environment.

Further, the private sector debt crisis increasingly overlaps with Indonesia's parallel banking crisis. The government through IBRA is now a meaningful creditor in most significant potential reorganizations. It is unclear whether it will ultimately behave like a commercial creditor or under governmental powers. The key question is whether the Indonesian government itself concludes that its banking crisis cannot be resolved in the absence of effective insolvency law. The expected cost of bank deposit guarantees and bank recapitalizations had already mounted significantly beyond original projections by the June 1999 elections (Standard and Poor's estimate was US\$87 billion, or 82% of GDP, *Asia Pulse* 6/10/99), while subsequent political uncertainties have triggered recent rating agency estimates in excess of US\$100 billion (Moody's, *Business Times*, 9/18/99).

As of August 1999, IBRA became embroiled in the so-called "Baligate" scandal. Indonesia's banking system reform efforts have come to an effective standstill while authorities sort out the alleged diversion of significant funds via a politically connected broker from Bank Bali undergoing recapitalization (as part of a "broker's fee" exceeding US\$75,000,000 for securing payment on a central bank guarantee of funds owed to Bank Bali). Multilateral agencies are pushing for a thorough investigation, while indicating that the Bank Bali behavior may be representative of broader problems with banking system reform efforts (*Business Times*, 9/2/99).

Finally, there are concerns about how government policy makers currently view revision of the emergency insolvency legislation. Announced intentions are to amend the emergency insolvency legislation in small ways, and subsequently to create a separate parallel statute incorporating modern reorganization provisions. Provisions amending the emergency legislation itself went to the DPR just in time to make Justice Minister Muladi's promised one-year resubmission deadline. However, the fast-approaching end of the current DPR's term means that any legislative action is unlikely before 2000 under Indonesia's next president (and Indonesia's new government may have other priorities). Concerning the separate reorganization statute, early indications are that, following KADIN's ideas, it contemplates simply a refinement of the debt compromise model already available under the existing legislation. This may represent

economic nationalism leaking into the reform process (upholding Indonesian equity ownership against creditors presumed to be foreign), but concurrently disadvantages the Indonesian government acting through IBRA in banking system reform. Regardless of its rationale, that approach does not address the underlying priority issues (that diminution of enterprise value should affect equityholders before debtholders under absolute priority rules). Currently contemplated changes to insolvency law are unlikely either to accelerate private sector reorganizations, or to contribute to resolution of Indonesia's banking sector crisis. Economic circumstances may force Indonesia's next government to rethink approaches in the medium term.

NOTES

- 1 Since the financial crisis began Indonesian debtors have maintained that currency rate changes were unforeseeable, which is not borne out by an examination of financial behavior in Jakarta during the mid-1990s and does not explain why Indonesian debtors were so heavily leveraged before the crisis began (Linnan: 1999).

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