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Pitfalls of creditor security in Indonesia

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The Indonesian market has always been very attractive for investors, both domestic and foreign. Statistics show that during the first quarter of 2018, investments in Indonesia reached Rp185.3 trillion (approximately \$13 billion). This year, the government has a focus on infrastructure development, including toll roads, MRT and many other infrastructure projects. These projects are expected to further boost foreign investment into Indonesia, either through foreign direct investment or through financing.

For the latter, apart from the financial terms, when a lender advances a loan to a borrower for a certain period, the protection that the credit requires and the mechanism for the repayment of the loan may take various forms. One of them is through creating security interest over the borrowers'/debtors' assets.

This article discusses types of security rights available under Indonesian law and the rights and protections granted by each type of Indonesian security interest and each enforcement process.

OPTIONS FOR CREDITORS

Security interests under Indonesian law vary greatly, spanning mortgage, fiduciary transfer and pledges for *in rem* security interest, to guarantees for personal security interest.

Indonesian security interests are unique in their characteristics and include a 'closed' security interest system, meaning that security interests are limited to those prescribed under law; and an 'accessory in nature', where the existence of security is subject to the validity of the associated underlying agreement and consequently, can only be created once the underlying obligation is legally created.

The key characteristic of an *in rem* security is that it gives a preferential right to its holder in the event of the debtor's bankruptcy, whereby the holder has the privilege to exempt the secured assets subject to the bankruptcy estate. *In rem* security interests can only impose upon assets and not agreements.

Personal security interest is enforceable against the guarantor and the lender may, working through government authorities, confiscate the guarantor's assets for public auction.

In practice, due to certain limitations in *in rem* and personal security

“ Indonesian security interests are unique in their characteristics

interests, practitioners have developed particular contractual arrangements in an attempt to have the same effect of 'step-in' rights security found in other jurisdictions. To name a few, these effects include: conditional assignment, the novation of contractual rights or the power of attorney to exercise contractual rights; the power attorney to sell and vote shares; the power of attorney to manage business; and the power of attorney to exercise rights of the project documents. This contractual security contains no preferential rights and is commonly found in a project financing rather than a traditional bilateral or syndicated loan financing. The enforceability of this contractual security is not beyond doubt, particularly due to a lack of precedence of enforcement and limited court cases.

HOW MORTGAGES, FIDUCIARY TRANSFERS AND PLEDGES WORK

Mortgages (Hak Tanggungan)

A mortgage covers the land described in the deed, buildings, fixtures and other immovable appurtenances to the land (including machinery affixed). The law allows the same object to be subject to subsequent ranking mortgages.

A mortgage only secures up to the amount specified in the mortgage deed (the Mortgage Secured Amount). The common practice for a Mortgage Secured Amount is normally 110% – 125% of the loan amount (in few cases it can be up to 150%).

A mortgage is established through the following procedures:

- The signing of an Indonesian-language deed before the appointed Land Officer (PPAT), whose jurisdiction covers the land/assets.

“ Similar to a mortgage, a fiduciary transfer only secures the amount specified in the fiduciary deed

- The registration of the mortgage deed with the Land Office (BPN); at this stage, the mortgage is legally created.
- The issuance of the mortgage certificate by the BPN, which proves the creation of the mortgage.

Fiduciary transfer

A fiduciary transfer is a transfer of ownership title for security purposes, whereby the ownership title will automatically return to the transferor upon full repayment or release of the fiduciary transfer. Unlike in a mortgage, there is no subsequent ranking in fiduciary transfer.

A fiduciary transfer can be imposed upon movable assets (whether tangible or intangible) and certain immovable assets (including buildings that cannot be the subject of a mortgage). The creation of a fiduciary transfer is done through an Indonesian-language notarial deed. Under Law No. 42 of 1999 concerning Fiduciary Security (the Fiduciary Law), a fiduciary transfer must be registered with the Fiduciary Registration Office. The fiduciary transfer comes into effect on the date of registration. To evidence the registration, the Fiduciary Registration Office issues a fiducia certificate.

Similar to a mortgage, a fiduciary transfer only secures the amount specified in the fiduciary deed (the Fiduciary Secured Amount). The range of the secured amount is similar to those in mortgage.

Pledge

A pledge can be created over tangible movable assets (machinery, vehicles and equipment) and intangible movable assets (shares and credit balance of a bank account).

Years ago, the fiduciary registration office issued a circular letter rejecting the registration of a fiduciary assignment over a bank account. This being the case, practitioners now create pledges for bank accounts. Due to the circular letter of the fiduciary registration office, the enforceability of a pledge over a bank account remains questionable and subject to arguments. If Indonesian courts share the same view as the fiduciary registration office, bank accounts could not be subject to a

pledge. This is important for investors because, pending precedence by Indonesian courts, there is currently uncertainty on the type of security for a bank account and its enforceability is not beyond doubt.

Indonesian law requires the pledgee (or its custodian/agent) to possess the pledged assets, hence removed from the pledgor's possession. In respect of intangible assets (such as shares), the requirement of “possession” or physical transfer means that the third party must be notified of the existence of the pledge. For example, in relation to a pledge of shares, the requirement of notification is generally considered to be complied with by registering the pledge in the shareholders' register of the company.

There is no formal legal requirement to have a pledge agreement in writing. However, it is standard practice in Indonesia that pledges are embodied in a deed of pledge agreement (notarised or executed privately).

HOW TO ENFORCE SECURITY

On default, the creditor holding a mortgage, fiduciary transfer or pledge is entitled to sell the property either by public auction or private sale.

In the event of a debtor's default, the mortgagee, fiduciary transferee and pledgee will have the right to enforce the security interest based on the right of direct execution (*parate eksekutie*) – meaning that the enforcement does not require a court order – or executorial title. For mortgage and fiduciary transfers, the executorial title is provided under the Mortgage Certificate and the Fiduciary Certificate.

The right of instant or direct execution entitles the mortgagee, fiduciary transferee and pledgee to sell the assets directly on their own authority through a public auction without the consent of the security provider, without the need of an executorial title and without having to obtain a writ of execution (*fiat executie*) from an Indonesian court.

In practice, *parate executie* has rarely been used since, among other reasons, the Indonesian State Auction Office will not allow an auction without an Indonesian court order.

Private sales are permitted if a higher sale price can be achieved

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for the benefit of the parties. In order to conduct the private sale, it is necessary that on default, the parties agree to a private sale. In the case of fiduciary transfers and mortgages, private sales can only be conducted one month after the date of written notification of the intended sale to

interested parties and once it has been published in at least two daily newspapers with circulations in the relevant area, so long as no third party has voiced an objection against the private sale.



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Luky Walalangi is an Indonesian qualified lawyer with nearly two decades of experience. He is listed among Indonesia's Top 100 Lawyers by Asia Business Law Journal and cited by Asialaw Profiles as 'one of the best corporate lawyers in Indonesia'. He is also rated as 'highly regarded' by the IFLR1000. He is a leading presence in M&A, banking, finance and real estate transactions.

Luky has an outstanding track record of advising on major strategic acquisitions in Indonesia across a variety of sectors, from traditional M&A deals to complex asset and portfolio loan acquisitions. He stands among the leading M&A and finance practitioners according to top legal surveys, with recognition by international law journals.



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Reta was a partner at one of the biggest firms in Jakarta before joining W&P. She has more than a dozen years of experience acting for both foreign and domestic lenders in high profile syndication financing, including the issuance of bonds and medium-term notes, convertible loans and subscriptions of convertible bonds in a publicly listed company.



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