LEGAL ANALYSIS ON THE DEBT TO EQUITY CONVERSION IN SUKUK IJARA DEFAULT: A CASE STUDY OF THE DEBT RESTRUCTURING IN PT BERLIAN LAJU TANKER TBK

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THESIS ADVISOR RECOMMENDATION LETTER

This thesis entitled **"Legal Analysis on the Debt to Equity Conversion in *Sukuk Ijara* Default: A Case Study of the Debt Restructuring in PT Berlian Laju Tanker Tbk"** prepared and submitted by Rahadiyan Yana in partial fulfillment of requirements for the degree of Bachelor of Law in the Faculty of Humanities has been reviewed and found to have satisfied the requirements for a thesis fit to be examined. I therefore recommend this thesis for Oral Defense.

Cikarang, 22 January 2016

Dr. Edy Santoso

Adviser I

Dra. Fennieka Kristianto, S.H., M.H., M.A., MKn.

Adviser II

DECLARATION OF ORIGINALITY

I declare that this thesis, entitled **"Legal Analysis on the Debt to Equity Conversion in *Sukuk Ijara* Default: A Case Study of the Debt Restructuring in PT Berlian Laju Tanker Tbk"** is, to the best of my knowledge and belief, an original piece of work that has not been submitted, either in whole or in part, to another university to obtain a degree.

Cikarang, 22 January 2016

Rahadiyan Yana

PANEL OF EXAMINERS APPROVAL SHEET

The Panel of Examiners declares that the thesis entitled **"Legal Analysis on the Debt to Equity Conversion in *Sukuk Ijara* Default: A Case Study of the Debt Restructuring in PT Berlian Laju Tanker Tbk"** has been submitted by Rahadiyan Yana majoring in Law from the Faculty of Humanitieshas been assessed and approved to have passed the Oral Examination on 4 February 2016.

Dr. Edy Santoso

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ABSTRACT

Indonesia has been projected as the future largest market of Islamic finance. Since its incorporation of first Islamic institution in 90s, the government keeps being productive in preparing comprehensive legal frameworks to meet the market needs. However, the dispute settlement provision might have been missed the authority, causing uncertainty in the dispute in Islamic finance.

The first *Sukuk Ijara* default in Indonesia has drawn attention of Islamic financiers in the world. On the institutional level, various organization are addressing the issue, there are also tendencies towards standardization of Islamic debt restructuring. This phenomena are combining many aspects of law substance, culture and structure in many jurisdiction to for a new legal system, albeit one with particular characteristics. This system has matured sufficiently to merit categorization as a separate field of bankruptcy, insolvency and debt restructuring: a standard of debt to equity conversion in Islamic finance.

Therefore, to provide certainty in the Islamic finance specifically in the dispute settlement is integral, should be incorporated to meet the market needs.

Keywords: Sukuk to equity conversion, Islamic debt restructuring.

ABSTRAK

Indonesia telah diperkirakan untuk menjadi pasar terbesar untuk industry pembiayaan syariah. Sejak pertama kali berdiri insutitusi Syariah pada tahun 90an, pemerintah menjadi sangan produktif dalam membuat kerangka hukum negara yang lebih komprehensif untuk memenuhi kebutuhan pasar. Namun, ketentuan mengenai penyelesaian sengketa syariah mungkin saja dilewatkan oleh para pejabat berwenang, menimbulkan ketidakpastian hukum dalam industri pembiayaan syariah.

Cidera janji Sukuk Ijara pertama di Indonesia telah menarik perhatian banyak pihak pembiaya Syariah dunia. Pada tingkat institusi, telah banyak institusi yang menyuarakan permasalahan tersebut, termasuk adanya tendensi untuk membuat standardisasi restrukturasi hutang menurut syariah. Fenomena hukum ini melibatkan banyak aspek hukum, termasuk substansi, struktur dan kultur dari berbagai yurisdiksi hukum di berbagai negara, walaupun dengan karakteristik yang menyerupai. Sistem ini telah cukup untuk membentuk sebuah kategorisasi yang terpisah sebagai kepailitan, insolvensi dan restrukturasi utang: sebuah standar untuk konversi utang ke ekuitas dalam pembiayaan syariah.

Dengan demikian, untuk memastikan adanya kepastian hukum khususnya dalam penyelesaian sengketa pembiayaan syariah adalah sebuah hal yang integral, perlu dibentuk untuk memenuhi kebetuhan pasar.

Kata Kunci: Konversi Sukuk ke ekuitas, restrukturasi utang syariah.

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I learn, earn and return through this undergraduate thesis.

Rahadiyan Yana

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CHAPTER I

INTRODUCTION

1.1 Background

National legal instruments that ensure certainty, order, enforcement and legal protection possessing justice and the truth as the essence are expected to foster national economic development and growth and to safeguard and support the fruits of national development. One of the legal instruments that are required to support national economic development is bankruptcy.

The development of economy and trade and the effect of globalization on the business world and the fact that the majority of the capitals obtained by the entrepreneurs comes from various sources, including banks, investment, issuance of bonds and notes or other legally permitted sources, have results in many debt related problems among the society.

In Indonesia, the Bankruptcy regulatory frameworks have long existed. The Dutch colonial rulers, back then, introduced the first codified bankruptcy law in 190 named *Faillisementverordening, Staatsblad 1905 No. 217.*[1] After Indonesia became independent in 1945, these 1905 Bankruptcy Rules remained in effect until, in 1998, the Indonesian bankruptcy system was overhauled through the Government Regulation in Lieu of Law No. 1 of 1998 on Amendment of Bankruptcy ("**GR**"). According to GR's elucidation, the aim of the GR was to provide a more adequate and efficient system in bankruptcy proceeding.[2]

Today, bankruptcy issues are stipulated under Law No. 37 of 2004 dated 18 October 2004 on Bankruptcy and Suspension of Debt Payments Obligation

[1]Ahmad Yani and Gunawan Widjaja, *Seri HukumBisnis: Kepailitan*, Cetakan 1, (Jakarta: PT Raja Grafindo, 1999), page 3.
[2]Sutan Remy Sjahdeni, *HukumKepailitan, Memahami Faillissements verordening Juncto Undang-Undang No. 4 Tahun 1998*, page 35.

("**Law No. 37**"). The Law No. 37 replaces the GR. It provides several general changes to the Indonesian bankruptcy framework and attempts to provide a legal mechanism for settlement of debts through the courts in an effective way.

Insolvency, delinquency and even bankruptcy have been part of the business and financial mosaic of human society. With the complexities of the modern times, the issues have become a lot more challenging and elusive. The problems of insolvency and debt restructuring are integral of the conventional finance. Being closely tagged to its conventional counterparts, Islamic finance also has, comparable challenges. With higher expectation from the society and great scrutiny from the conventional counterpart, it is important to explore this challenge so that the contentions from the Islamic finance side and the methods and approaches to solving problems are grounded in both research and reality.[3]

In addition, upon a discussion with a professional from Indonesia Financial Services Authority ("**OJK**"), I understand that in the mean time, Islamic finance (specifically in capital market) has nearly 5% of the market share in general finance. However, the government is optimistic since there is a huge space of improvement. They are targeting up to 15% growth by 5 years development, especially in the Sovereign *Sukuk*. Therefore, it seems that government will develop a more comprehensive legal frameworks to accommodate the market needs. [4]

One of the instruments in Islamic finance that requires specific regulatory framework of bankruptcy anticipation and debt restructuring is Sharia Bond or *Sukuk*.

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[3]Farooq, M. O. (2013). Insolvency and Debt Restructuring in Islamic Finance. *Islamic Finance and Sharia Compliance: Reality and Expectations.* London: London School of Economincs.

[4] The discussion was attended by me and Muhammad Touriq, the Deputy Director of Sharia Capital Market Directorate, Indonesia Financial Services Authority on Friday, 15 January 2015 at OJK's Gedung Sumitro.

Sukuk is a Sharia compliant capital market instrument that is used by the Issuer to raise funds from regional and international investors. It typically pays a fixed or floating rate of profit to the investor, and is redeemed in a pre-prescribed tenor. Due to its nature, it can be comparable in some cases to conventional asset backed securities.[5]

The concept of *Sukuk* dates back to early Islamic civilization but only recently it has re-emerged as a modern Islamic finance structure. *Sukuk* can be issued using various structures. The most widely used and accepted currently are:

- *Sukuk Ijara*: this uses an underlying asset pool comprised of leased assets; and
- *Sukuk Musharakah*: this uses an underlying asset pool comprising a combination of capital and other physical.

In Indonesia, to ensure its compliance with Islamic principles, a *Sukuk* issuance requires fatwa and/or sharia endorsement (sharia opinion) from National Sharia Board ("**DSN-MUI**"). Several fatwas has been published by DSN-MUI regarding corporate *Sukuk* to set principle for different types of *Sukuk* structures, as well as its guidelines for transaction is capital market.[6] Some of them have been implemented to the transaction being discussed in this thesis, as follows:

- Fatwa No. 32/DSN-MUI/IX/2002 on Islamic Bonds, regulating type of *Akad* to be used in Islamic bonds issuance, general principle of Islamic bonds' features, compliance of Islamic principle with issuers' company business;
- Fatwa No. 40/DSN-MUI/X/2003 on Capital Market and General Guidelines for Implementation of Sharia Principle in Capital Market, covering the definition of entities in capital market, Sharia principle in capital market, required criteria for issuing companies,

[5] JP Morgan Chase & Co. (2014). *Islamic Finance Overview*. JP Morgan Chase Bank N.A Dubai Branch.
[6] The International Islamic Finance Market (IIFM). (2014). *Global Sukuk Market 4th Edition.*

type of Islamic securities, prohibited transactions, fair market price, reporting and disclosure of information; and

- Fatwa No. 41/DSN-MUI/III/2004 on *Sukuk Ijara*, regulating general principle in issuance of *Sukuk Ijara,* role of Sharia supervisory board, as well as underlying asset.

Apart from the debt restructuring frameworks, the government has provided the Sharia market with several regulations, which are claimed to cover all aspects of Sharia transactions, including but not limited to, from the issuance process until the settlement process. The details will be further elaborated in Chapter 3 of this undergraduate thesis.

By seeing on the above legal frameworks in Indonesia, the author can spot that the provision of debt restructuring is only available in the conventional way. As the economy grows more diverse and challenging, it might be happened that a Islamic debt in certain case might be also defaulted and required to be restructured. This fact leads to an ongoing case of PT Berlian Laju Tanker Tbk's debt restructuring process, which has an instrument of Islamic finance within the debt structure.

PT Berlian Laju Tanker Tbk is an Indonesia-based shipping company. Its main business is provisioning maritime transportation for liquid bulk cargo. Its business is classified into four operating segments: chemicals tankers; gas tankers, oil tankers and floating tankers. Its services include the provision of vessels chartering, vessels operation services and vessels agency services.[7]

After the Great Depression of 1930s, the world faced its most dangerous crisis in 2008. The spreading of this harmful crisis began with the decisive downward turn of home prices in the United States, spread really fast, first to the entire U.S. financial sector and then to financial markets overseas. The losses in the United States included: 1) the entire investment banking industry;

[7]Financial Times Portfolio, http://markets.ft.com/research/Markets/Tearsheets/Business-profile?s=BLTA:JKT retrieved on Sunday, 30 August 2015.

b) the biggest insurance company; 3) the two enterprises chartered by the government to facilitate mortgage lending; 4) the largest mortgage lender; 5) the largest savings and loan; and 6) two of the largest commercial banks.[8] Companies that normally rely on credits suffered heavily as financial sectors slaughtered. As a result of the 2008 global financial crisis and the heavy investment that came before it, global shipping lines are at risk of bankruptcy.

The force behind the financial crisis was subprime mortgages sold to a higher rating than what they should have been, creating solvency and liquidity problems for the banks and the financial sector.[9] It is reasonable to say the crisis started in the U.S., but it spread to other countries as well. The financial crisis led to a decline in world consumption, and thus world trade and the demand for shipping services decreased. The liquidity problems were faced by the shipping industry as well, with reduced attaining of debt due to interbank lending problems faced.

The sector has seen both freight and values for vessels decline, as it tried to absorb the huge number of new ships ordered during the boom period of 2007-2008.[10] Shipping companies around the world have experienced a significant drop in EBITDA[11] which has resulted in many company breaching liquidities and loans agreement with their lending institutions.

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[8] The Financial Crisis of 2008: Year In Review 2008. (2015). In *Encyclopædia Britannica*. Retrieved from http://www.britannica.com/topic/Financial-Crisis-of-2008-The-1484264 on Saturday, 12 September 2015.

[9] The Economist. "Crash Course: The origin of financial crisis," see: http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article retrieved on Saturday, 12 September 2015.

[10] Financier Worldwide Discussion. 2012. Financial Distress in the shipping sector: http://www.financierworldwide.com/financial-distress-in-the-shipping-sector/#.VfLCo0tW8pH retrieved Saturday, 12 September 2015.

[11] EBITDA means a company's earnings before interest, taxes, depreciation and amortization, an accounting measure calculated using a company's net earnings, before interest expenses, taxes, depreciation and amortization are subtracted, as a proxy for a company's current operating profitability.

In 2008, specifically in 20th of May, the Baltic Dry Index[12] hit its highest point of 11,793 points. But, six month later, as the global financial crisis hit, the Baltic Dry Index had dropped by 94% to 663 points.[13] Falling out of that unprecedented global crisis were numerous shipping restructures. As the industry has learnt to cope with the challenges it has faced over the previous seven years, a number of trends have emerged in the restructuring of distressed shipping company. One of the restructuring processes is carried out by PT Berlian Laju Tanker Tbk, a third world's largest chemical tanker based in Jakarta.

In 2007, when the shipping business was at the peak, PT Berlian Laju Tanker Tbk decided to perform the USD850 million acquisition of Marshall Islands-based chemical tanker company Chembulk Tankers LLC, through its subsidiary Asean Maritime Corporation[14], that was mostly financed through loans, which then left the company highly leveraged. The two companies combined became the third-largest owner of chemical tankers in the world with 54 ships and gave the Indonesian firm a presence in the U.S. market

The golden era of the PT Berlian Laju Tanker Tbk was also on the year of 2006 and 2007 or before the global crisis, where according to its annual report of 2009, the company recorded net income of USD107 million in 2006, and USD77 million in 2007. In 2008, the company's net income started to fell drastically, which was only USD25 million. The cause of the drastic decline was the surplus revaluation[15] worth of USD68 million, where on the first quarter 2009, the company experienced deficit revaluation amounted to USD166 million, so the gap was USD234 million.

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[12] The Baltic Dry Index (BDI) is a series of indices based on reports from independent and competitive shipbrokers. Its purpose is to provide the shippers and the ship-owners with unbiased information on freight rates, and it is thought to be one of the most accurate indicators of economic development in the shipping market. See further http://www.bloomberg.com/quote/BDIY:IND

[13] Eagle, Ryan. Sector Focus: Restructuring in the shipping industry. Ferrier Hodgson. 2014.

[14] The Jakarta Post, Berlian acquires Chmebulk Tankers, 2007, Jakarta http://www.thejakartapost.com/news/2007/10/18/berlian-acquires-chembulk-tankers.html retrieved on Saturday, 12 September 2015.

[15] Revaluation is the unreal income or the loss generated from most recent asset's value of the company.

As a result, the company had debt in excess of USD2billion comprising a senior secured syndicate of international banks, high yield USD Bonds, convertible bonds, IDR bonds, lease, derivative, trade claims and the *Sukuk*, in which we are going to explore more in this research.

In 2012, the Company had defaulted on its *Sukuk Ijara I* and *Sukuk Ijara II,* following the announcement of the debt standstill on 26 January 2012. Upon the events of default, the *Sukuk* holders submitted their respective claims under the PKPU.

According to its PKPU Amendment Plan, all of the outstanding scheduled *Sukuk* payments debt pursuant to the PKPU Amendment Plan under *Sukuk* shall be converted into shares in BLT pursuant to the debt to equity conversion under the Company Law and capital market rules.

Finally, this research will ensure the Converted BLT's Sukuk are sharia compliant and to examine whether BLT have complied with the prevailing capital market regulations relating to Sharia compliant securities, including ensuring that the debt to equity conversion has aligned with the provisions stipulated in the company law, bankruptcy law and other implementing regulations relating to suspension of debt payment obligation.

Considering the abovementioned matters, the author is interested to outline in thesis entitled:

"LEGAL ANALYSIS ON THE DEBT TO EQUITY CONVERSION IN SUKUK IJARA DEFAULT: A CASE STUDY OF THE DEBT RESTRUCTURING IN PT BERLIAN LAJU TANKER TBK"

1.2 Problem Identification

In accordance with the background described in the previous sub-chapter, the author highlighted the legal research on analysis the implementation of *Sukuk* restructuring in debt-restructuring transaction through debt to equity conversion method performed by PT Berlian Laju Tanker Tbk through the following questions:

1. How is the implementation of *Sukuk Ijara* restructuring process carried out by PT Berlian Laju Tanker Tbk?
2. How are Indonesia legal instruments implemented within the transaction?

1.3 Research Objectives

1.3.1 General Objectives

The research aims to identify the mechanism and implementation of the *Sukuk Ijara* to equity conversion in the debt restructuring proceeding carried out by PT Berlian Laju Tanker Tbk.

1.3.2 Specific Objectives

To analyze the compliance of *Sukuk Ijara* to equity conversion process with related implementing regulations from OJK, Bapepam-LK, as well as DSN MUI. This is also to see any possibility to adopt precedents in other jurisdictions.

1.4 Scope and Limitation

As mentioned in the background, the author will start the writing from the theory of suspension of debt payment obligation, then its debt restructuring process particularly through debt to equity conversion method. Considering that the instruments being defaulted are complex, the author will only focus on the implementation of the aforementioned things into an Islamic finance instrument called *Sukuk Ijara*.

In overall, the author attempts to examine whether all the process within the transactions has complied with the legal frameworks in Bankruptcy Law, the implementing regulations provided by Bapepam-LK, now known as OJK, the self regulatory body such as DSN MUI, and other international bodies whose the doctrines being imposed in Indonesia (particularly in the Islamic related regulations, Indonesia still uses many doctrines from International Body, such as AAOIFI).

1.5 Research Benefits

Although the focus of this research is to determine the case through legal outlook, the case in this research involves many aspects of business and commercial transactions. The author expects to contribute value of knowledge through legal insight. Besides, the author also set other expected benefits as follows:

1. For an academic purpose, this research is expected to be utilized as reference for future legal research by law students of President University in particular and all law students across the nations in general, specifically for those who concern with bankruptcy, suspension of debt payment obligations and methods in debt restructuring in Islamic finance.
2. In practical, this research is expected to provide the readers with exceptional information and knowledge about debt restructuring process with regard to the combination of legal compliance and commercial sense.
3. In specific, this research is also expected to give more fresh insights to the obligors involved in the debt restructuring transaction proposed by PT Berlian Laju Tanker Tbk.

1.6 Research Methodology

This research paper will use juridical normative method as the author utilizes literature sources in bankruptcy, debt restructuring, Islamic finance and general company. Besides, the type of this research paper categorized as descriptive analytic since the writing of this research will present a broader picture of debt restructuring in relation with Islamic finance institution in its implementation as well as its compliance with regulations in Indonesia.

The construction of thoughts will be adapting the Friedmann theory on structure, substance and culture of law approach.

Structure of law in Indonesia includes the structure or institutions that determine law enforcement. The structure described the machine. In terms of Sukuk, existence of an SPV is crucial to secure any transactions in relation with Sukuk. The structure of law approach will be used in this thesis to examine the author's hypothesis mentioned previously.

Besides, the substance of the law is the rules, norms and behavior patterns of real people who are in the legal system. The product of law making process is the substance of law. The author would seek clarification whether or not the prevailing laws and regulations have been sufficient to meet the modern needs.

Legal culture is a human attitude toward the law and legal system, beliefs, judgments and expectations of the legal community. In other words, culture is the atmosphere mind site and social forces that determine how the law is used, or even misused including the law enforcement itself. In relation with the Sukuk, this thesis will see how commercial judgment and Sharia judgment are met in a transactions, how they supersedes or override each other.

Research, in general, recognizes three types of data collections tools: documents study, research and observation, as well as interview. In this research, the author will utilizes the document study and interview to obtain relevant matters directly from the PT Berlian Laju Tanker Tbk and other relevant parties involved in the transaction. Data in this research will be collected from primary sources which is direct interview with the relevant parties from PT Berlian Laju Tanker Tbk, the restructuring consultant from Borelli and Walsh, the involved personnel from DSN-MUI, the independent Sharia consultant, the legal counsel for its Suspension of Debt Payment Obligation Process and its Sukuk Ijara restructuring, and authorized official from the OJK. Secondary sources are also utilized, consisted of text books, internet literature, journals, law and regulations, thesis, seminar material and other literature sources. To analyze and explore the data, the author will use qualitative method as the he will try to understand further – through in-depth interview and deep-analysis of company's transactional documents – the concept of debt restructuring, specifically in the method of debt to equity conversion which involved Islamic finance instrument in the implementation.

1.7 Writing Systematic

This thesis writing is divided into five chapters as follows:

Chapter I Introduction will elaborate the broad picture of the background, problem identification, research objectives, research benefits, research methodology and also this writing systematic.

Chapter II Bankruptcy, Insolvency and Debt Restructuring in Conventional and Islamic Law will elaborate the comparison between the concept of bankruptcy, insolvency and debt restructuring in conventional and Islamic principles, which is aimed to see how this two different notions are blended in the implementation in laws of Republic Indonesia.

Chapter III *Sukuk Ijara:* Overview, Default Anticipation and Restructuring Implementation, will specifically explain the general mechanics on how a instrument of *Sukuk* should be restructured and compare the implementation in several different countries.

Chapter IV The Discussion elaborates further on the debt restructuring transaction carried out by the company, including all the parties involved, the timeline from its suspension of debt payment obligations granted to the company until its proposal on restructuring. There will be also a juridical analysis whether the whole process of the transactions has met the legal requirements imposed in Indonesia and all jurisdictions where the transactions carried out.

Chapter V Closing contains the answers for the problem identification in this research based on the discussion in previous chapters, along with the suggestions from the author that is expected to bring betterments in the issues brought up in this research.

CHAPTER II

BANKRUPTCY, INSOLVENCY AND DEBT RESTRUCTURING IN CONVENTIONAL AND ISLAMIC LAW

2.1. Bankruptcy, Insolvency and Debt Restructuring in Conventional Law

2.1.1. The Origin of Bankruptcy

The term of Bankruptcy or Insolvency, or in Indonesia known as *Kepailitan*, inherently came from French word, *faillite*, which has the meaning of "halt" or "payment halt". While in Latin, it is known as failure and when in Dutch, it is used as *faiyit*, which then people construe this into *paiyit* and *faillisement*. Bankrupt or bankruptcy themselves were introduced by English speaking countries, which then being adopted by many countries.[16]

In the Roman history, Brunstad, G. Eric[17] reported that the treatment and judgment of the bankrupt debtor had been developing and diverse in types, from the simplest until the most complex one, from the humanly until the worst physical penalty. In Roman early history, from where Indonesian law arose, a debtor who failed to repay its debts are forced to be a slave for the creditor, brought to an open field, and tortured then killed. Even worse, this human meat was divided into parts and were distributed pro-rate with its creditors. By the time goes by, such kind of punishment are neglected and the bankruptcy laws in Roman empire developed from time to time, becoming more human-

[16]Viktor M. Situmorang and Hendri Soekarso, *Pengantar Hukum Kepailitan Indonesia*, (Jakarta, RinekaCipta, 1993), page 18.
[17]Brunstad, G. Eric, *Bankruptcy and the Problems of Economic Futility on the Unique Role of Bankruptcy Law*, The Business Lawyer, Vol. 55 February 2000. Retrieved from: http://www.jstor.org/stabe/40687935

friendly through a method called *cession bonorum*, which stipulates that to avoid a jail sentence to the debtor, he or she can submit all the assets secured to the *curator bonorum* to be sold for the interests of creditors. The bankruptcy law then developed again into a form called *dilation*, there the King of the Roman empire issued a decree to give such a moratorium phase for up to five years for the bankrupt debtor in order to enable the debtor to restructure its financial ability. Beside that, bankruptcy laws were also known in other forms such as *venditio bonorum* and *distractio bonorum*.

In *venditio bonorum*, a group of creditors may apply a petition to the *praetor* (*elected magistrate*) to seize the assets owned by bankrupt debtor and appoint *curator bonorum* to supervise the debtor concerned. The assets owned by that debtor then offered to *magister bonorum* to be distributed to the creditors. Yet, this procedure does not eliminate the obligations of the debtor to repay other liabilities. Similar to the *venditio bonorum*, *distractio bonorum* enables a group of creditors to instruct to sell the assets owned by debtor within certain period.[18]

2.1.2. The Definition of Bankruptcy

The Black's Law Dictionary defines bankrupt as the state or condition of a person (individual, partnership, corporation, municipality) who is unable to pay its debt as they are, or become due. The term includes a person against whom a voluntary petition has been filed, or who has been adjudged a bankrupt.[19]

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[18]Sejarah Hukum Kepailitan, *Undang-Undang Kepailitan dan Perkembangannya* oleh Emmy Yuhassarie, Prosiding Rangkaian Lokakarya Terbatas Masalah- Masalah Kepailitan dan Wawasan Hukum Bisnis Lainnya Tahun 2004, Jakarta, 26-28 January 2004. (Jakarta: Pusat Pengkajian Hukum, 2005). Page xvii.

[19]Bryan A. Garner, *Black's Law Dictionary*, (St. Paul West Group, 1999), page 141.

According to the definition given above, the meaning of bankrupt is connected to the inability from a debtor to pay its debts which are due. Such inability must be accompanied by a real action, a bankruptcy petition, either voluntarily be debtor or a request from a third party.[20]

In a law dictionary authored by R. Subekti, bankruptcy is defined as a state whereby a debtor decease to pay its debts after the debtor concerned, upon the request of its creditors or voluntary request, by the court is declared bankrupt. Accordingly, assets owned by debtors shall be possessed by *Balai Harga Peninggalan* as *curtirice* (trustee) in such bankruptcy to be utilized by all creditors.[21]

According to Munir Fuady, bankruptcy is a general confiscation of all debtor's assets in order to settle the relationship between debtor and creditor, so that the assets concerned might be distributed *pari passu* to all the creditors.[22]

R. Subekti opines that a bankruptcy constitutes any attempt to collectively receive the repayment *pari passu* for all the creditors.[23]H.M.N. Purwosutjipto also opines that bankruptcy as anything related to bankruptcy event, which is a condition of suspension of debt payment obligation.[24]

[20] Ahmad Yani and Gunawan Widjaja, *Seri HukumBisnis: Kepailitan*, 1st Print (Jakarta: PT Raja Grafindo, 1999), page 11.
[21] R. Subekti and Tjitrosoedibyo, *Kamus Hukum*, (Jakarta, PradnyaParamita, 1989) page. 85.
[22]Munir Fuady, *Hukum Pailit*, (Bandung, Citra AditryaBakti, 2002), page. 8.
[23] R. Subekti, *Pokok-pokok Hukum Dagang*, (Jakarta, Intermasa, 1995), page 28.
[24] H.M.N. Purwosutjipto, *Pengertian dan Pokok-Pokok Hukum Dagang*, (Jakarta, Djambatan, 1978), page 28.

According to Law No. 37 of 2004 on Bankruptcy and Suspension of Debt Payment Obligations ("**Law No. 37**"), bankruptcy shall mean general confiscation of all assets of a Bankrupt Debtor that will be managed and liquidated by a Curator under the supervision of Supervisory Judge as provided therein.[25] In relation with this definition, we can draw a conclusion that basically there are three elements of bankruptcy: (i) the existence of general confiscation, (ii) the settlement is carried out by curator under the supervision of Supervisory Judge, and (iii) has satisfied the terms and conditions stipulated in the Law No. 37 along with its implementing regulations.

The root of the bankruptcy law in Indonesia is actually stipulated in the Article 1131 of Indonesian Civil Code ("**ICC**")[26]: "Any property of the debtor, both moveable or immovable, either presently exist or will be exist in the future, become as collateral for any individual agreements." From this provision, we understand that any property shall become a security for the execution of the liabilities. The debtor's liabilities concerned not only directed to the certain creditor, but to all creditors. A person or legal entity can be bound not only to one creditor but it can be more than one. In conclusion, Article 1131 of ICC stipulates that whatever the form of the obligations or liabilities, either arise from the laws or agreements, either pledged or not, any property of debtor are security for the purpose of repayment.

Furthermore, the Article 1132 of ICC: "Such property become joint collateral of his creditors; the selling income of the estates is divided according to equivalence, which is in accordance to the proportionate of each credits, unless that among them, there is a

[25] Indonesia Law No. 37 of 2004 on Bankruptcy and Suspension of Debt Payment Obligation, General Provisions Article I point 1.
[26] Rany Mangunsong, *Indonesian Civil Code*, (Jakarta, PT Gramedia Printing), Article 1131 ICC.

valid reason to be given priority for the creditors. This article indicates that all creditors has prorate rights over the debtor's assets to guarantee that they would receive their rights. On the basis above, a bankruptcy status must be declared from the court.

2.1.3. General Principles of Bankruptcy Law

By understanding the history and the modern concept of bankruptcy that currently prevail, we may conclude that bankruptcy law consists of three basic principles: (i) debt collection, (ii) debt forgiveness, and (iii) debt adjustment.[27]

Debt collection constitutes a deliberate attempt by a business to collect an obligation that has become past due.[28] This is actually a concept whereby any creditor claims its rights towards the property of debtors. In ancient era, debt collection was manifested into a slavery, or even worse, distribution of debtor's body. Today, modern concept manifests bankruptcy law into a form of asset liquidation.

Debt forgiveness is manifested as asset exemption (some of the debtor's property are waived), relief from imprisonment (not going into the jail because of the default), and discharge of indebtedness (release of debtor or debtor's asset to repay the debts which really cannot be satisfied).

Debt adjustment is a bankruptcy law aspect, which is intended to amend the distribution of rights between creditors as a group. Implementation of this concept is a prorate distribution or structured pro-rate parte (distribution based on the class of

[27] *Prinsip Dasar Hukum Kepailitan*, Op.Cit. page xix.
[28] US Legal Definition, retrieved from http://definitions.uslegal.com/d/debt-collection/ on Sunday, 17 January 2016.

creditor). The concepts of reorganization and suspension of debt payment obligation are included in this aspect.

2.2. Suspension of Debt Payment Obligation in Indonesia

2.2.1. Definition of Suspension of Debt Payment Obligation

Besides the debt settlement through bankruptcy method, debtor and creditor are able to select an alternative debt-based dispute resolution by way of suspension of debt payment obligation ("**PKPU**"). PKPU, by nature, is aimed to conduct peace settlement between existing debtor or will be insolvent or bankrupt in the future from its creditors.[29] According to KartiniMulyadi, PKPU or Surseance van Betaling or Suspension of Payment is a grant of opportunities for the debtors to perform a restructuring towards its debts, which may include repayment for all or parts of the debts towards the concurrent creditor, therefore, eventually the debt able to settle its obligations and liabilities and sustain its business.[30]

Munir Fuady explains that suspension of debt payment obligations is certain period granted by law through commercial court decision to give opportunity to the creditor and debtor to discuss the debt payments solutions by giving repayment plan of all or part of the debts, and if required to restructure the debt concerned. Therefore, PKPU is actually a legal moratorium.[31]

In contrast with the implementation in bankruptcy where the debtor is not authorized to assign its assets, in PKPU, the debtor has the right to administer and assign the right over assets to the extent there is prior written consent from the administrator. This

[29]Sutan Remi Syahdeini, *Op. Cit*. page 328.
[30]Rudhy A. Lontoh, et. al. *Penyelesain Utang-Piutang: Melalui Pailitatau Pendundaan Kewajiban Pembayaran Utang*, (Bandung: Penerbit Alumni, 2001), page. 173.
[31]Munir Fuady.*Op. Cit.* page 177.

provision is stipulated in Article 240 (1) Law No. 37, which explains, during suspension of debt payment obligation, debtor without approval of the administrator may not take any management or ownership act of all or part of the assets.

In the process of PKPU, debtor may also propose a loan from the third party based on the authority granted from the administrator as long as such action will increase the value of the assets. It is stipulated in Article 240 (4) Law No. 37, upon approval from the administrator, the debtor may borrow money from the third party only to increase the debtor's asset value.

According to Kartini Mulyadi, during the PKPU process is run, debtor does not release the possession and rights over the assets, yet only release its full discretion since any action in relation with the assets, it has to obtain certain approval from the administrator.[32]

PKPU process is not intended only for the debtor's interest, but also the interest of creditor, specifically the concurrent creditor. PKPU is aimed to protect the debtor to not be declared bankrupt so that through the way of reorganization and restructuring, there is a high expectation that business would recover then it can utilize the proceeds for repayment. [33]

When a debtor who still has business prospects experiences liquidity problems, liquidating the debtor's assets could be the least favorable option for a creditor. The creditors may prefer to save the debtor but at the same time ensure that the debtor performs its payment obligations. PKPU could be the answer for the situation mentioned. The PKPU gives the debtor "breathing space" and

[32] Rudi A. Lontoh, *Op. Cit.* page 175.
[33] *Ibid.*page 131-142

allows the debtor to reorganize its debts to its creditors while at the same time continuing its business. Unlike a private restructuring, if a PKPU fails or the debtor fails to perform the agreed composition, it could lead to the debtor's automatic bankruptcy. The creditors are also involved in the debt reorganization process with the debtor. In practice, the creditors can negotiate the terms of the composition plan with the debtor. The creditors also have the power to approve or disapprove the composition plan proposed by the debtor. Furthermore, the Law No. 37 provides that the debtor has to finalize the composition plan, including obtaining the court's decision to ratify the plan, within 270 days. This provision is aimed at ensuring efficiency and prevents a debtor from abusing the PKPU proceedings.

From the perspective of debtor, it can hope for a fresh start through the PKPU proceedings. In suspensions of payment, the debtor will be provided with maximum legal protection of the reorganization and continuance of its business. At the beginning of the reorganization process of the debtor, who has a better understanding of its own financial condition, is free to propose the terms of its composition plan with its creditors. In a PKPU, every executor action against the debtor must be postponed and any court attachment against the debtor's assets is nullified when the court grants the PKPU. Further, the judges in non-bankruptcy related cases involving the debtor could postpone any of their decisions on the cases until the PKPUs ends. The other advantage of PKPU proceedings is that the debtor will have more relaxed voting requirements for the approval of a permanent PKPU and the composition plan. One specific characteristic of debt reorganization through PKPU is that when the composition plan has been approved by the creditors and ratified by the court, it will bind all of the creditors, including those who do not agree with it.

In conclusion, the PKPU is designed to achieve debt settlement between debtor and creditor that then realized in the form of mutual agreement over the PKPU Plan than can only be submitted by debtor and creditor based on Law No. 37.

2.2.2. Procedure of Suspension of Debt Payment Obligation

The petition of PKPU must be signed by the petitioner and its legal counsel admitted to practice before the court. If the petitioner is the debtor itself, the petition must be accompanied by a schedule comprising the nature of its debts/claims and the creditors to whom theses debts are owed (i.e the creditors' names and addresses, and the amount of receivables), as well as other relevant documentary evidence. If the petition is filed by a creditor, the court must summon the debtor (through the court bailiff) using registered mail at least seven (7) days before the hearing.

Under the Law No. 37, a debtor may also file a petition for PKPU after a petition for bankruptcy declaration has been filed against it. If petitions for both PKPU and bankruptcy are reviewed by a court at the same time, the petition for PKPU prevails and must be decided first. Although it is not a legal remedy as such (like an appeal or a civil review), a petition for PKPU will effectively postpone the bankruptcy process for a certain period of time.

2.2.3. Composition Plan and its Effectiveness

The Law No. 37 requires a debtor petitioning for the PKPU to submit its settlement or composition plan with its creditors at the time after the debtor files the petition for PKPU. A composition plan with creditors is an agreement made between the debtor and its creditors for the settlement or arrangement for a discharge of the

debts of the debtor. The composition plan should set out the proposed time-table under which the debtor will pay its debts and also state whether the debts will be fully or partially paid. The debtor and all of its creditors are free to agree to the terms of payment. The Law No. 37 does not contain any requirements for the contents of the composition plan.

The composition plan will be aborted automatically if after its submission but before its approval by the creditors, the PKPU is terminated (at the end of its intended period or earlier, by the court upon its own initiative, or upon request of either the Supervisory Judge, the administrator, or one or more of the creditors, on any of the grounds stipulated in Article 255 of Law No. 37. The PKPU may also be terminated by the court upon request of the debtor, on the grounds that the assets of the debtor are sufficient to allow it to pay its debts.

In order to be valid and effective, a composition plan must be approved in a creditors' meeting by:

- Affirmative votes of more than half (1/2) of the concurrent creditors which are present in the meeting, provided that the concurrent creditors voting in favor hold at least two-thirds (2/3) of all accepted or provisionally accepted unsecured claims held by the concurrent creditors present in the meeting; and
- Affirmative votes of more than half (1/2) of the secured creditors which are present in the meeting, provided that the secured creditors voting in favor hold at least two-thirds (2/3) of all claims held by the secured creditors present in the Please note that votes are taken only from the creditors present in the meeting.

The composition plan, once it has been ratified will bind all of the creditors. It also binds creditors who voted against the composition plan and creditors who were not present or represented at the voting hearing. Secured creditors who were present at the meeting and who voted against the composition plan will be compensated with the amount of the minimum value of their security.

One effect of a PKPU is that the debtor cannot be forced to pay its debts within the PKPU period. Unlike in a bankruptcy, a debtor in a PKPU may still manage or dispose of its assets and even obtain loans and secure its unsecured assets, provided that those acts have been authorized by the administrator and/or the Supervisory Judge.

2.3. General Overview of Debt Restructuring in Indonesia

2.3.1. A brief of Conventional Debt Restructuring

A debt restructuring constitutes any action that necessarily taken if a certain company does not have any capability or power to satisfy its commitments for the creditors. The commitment means fulfillment of the executed agreement, cannot be met therefore it leads to default.

Restructure consists of word *re-* which means return to previous state and *structure* which means any form, foundation, arrangement, thus restructure shall be construed as to arrange or return the existing form into the previous or new form.[34]

Joel G. Siegel and Joe K. Shim opines that debt restructuring is adjustment or re-arrangement of the debt structure that provides any opportunity to the debtor to re-plan its financial liabilities

[34] Peter Salim and Yani Salim, *Kamus Bahasa Indonesia Kontemporer*, (Jakarta, Modern English Press, 1991), page 876.

settlement.[35] While Tjiptono Darmaji defines debt restructuring as a process to restructure the debt of a debtor with purpose to make a better financial position of the debtor.[36]

The terms of debt restructuring in Indonesia were firstly commenced when, back then, in 1998 the economic crisis hit the nation and remained hundreds of companies highly leveraged, made them should perform a debt restructuring. In Indonesia legal framework, a debt restructuring has, actually, the same meaning given to the novation[37], only more technical and complex involving many financial engineering.

2.3.2. Conditions of Debt Restructuring

A debt restructuring is not performed if the grounds cause, or will logically cause, any loss to the creditors, for instance, to delay the repayment schedule or to avoid downgrade of debt quality. Debt restructuring can only be executed under following conditions:[38]

(a) Debtor is an national asset or has significant involvement of public interest thus must be sustained;
(b) Debtor's debt restructuring is an inseparable part of sovereign and private debt settlement entered into by the state and creditor;

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[35] Jae K. Shim and Joel G. Siegel, *CFO: Tools for Executive*s, (Jakarta: Elex Media Komputindo, 1994), page 129.
[36]Tjiptono Darmaji, *Restrukturasi: Memulihkan dan Mengakselerasi Ekonomi Nasional*, (Jakarta: Grasindo, 2001), page 69.
[37] Novation means legal process used in contract law to describe the act of renewing obligation. The Article 1413 of Indonesian Civil code defines the circumstances to cause novation: if a debtor, on behalf of creditor, executes a new contract of indebtedness, in substitution for the original one, which shall then be nullified, (ii) if the previous debtor who has been released from his contract by the creditor is substituted by a new debtor, or (iii) if, pursuant to a new contract, a new creditor replaces the previous creditor, in respect of whom the debtor shall be released from his contract.
[38]Arief T. Surowidjojo, *Restrukturasi Utang: Pelajaran Dari Krisis Moneter Indonesia*, in Emmy Yuhasarie, Edt, *Kredit Sindikasi dan Restrukturasi*: Proceedings Rangkaian LokakaryaTerbatas Masalah-Masalah Kepailitandan Wawasan Hukum Bisnis Lainnya Tahun 2004, Jakarta, 3-5 August 2004, page. 200-221

(c) Business sustainability of the debtor has promising return in the future;
(d) Recovery rate by way of restructuring considered better rather than bankruptcy proceeding or asset seizure;
(e) Support of the Government of Indonesia; etc

Besides the aforementioned above, debtor shall ensure itself that by the end of the debt restructuring process, it may transform the condition of the company from insolvent to solvent. Otherwise, it shall only be seen as benefiting one party, which is in this case a debtor. Therefore, a compliance assessment is designed to examine if both creditor and debtor are benefited through a debt restructuring.[39]

Prior to a debt-restructuring process, due diligence procedure shall be carried out by experts. Upon the due diligence process, the parties shall enter into a restructuring agreement, involving between creditor and debtor. This type of agreement shall be referred to Article 1388 ICC "Although there has been a levy or opposition, the payment made by a debtor to the creditor, is not valid against creditors who have executed the levy or an opposition; these persons, based on their rights, can force the debtor to pay once more, in such case without prejudice to the right of the debtor to reclaim against the creditor" and it is irrevocable unless with prior consent of both parties or other conditions stipulated by laws. This agreement shall also be referred to Article 1320 ICC on the validity of an agreement "For the validity of an agreement needs four qualifications: 1) the consent of those who bind themselves; 2) the capability to make an agreement; 3) a particular object; and 4) a lawful case."

[39] Eugene F. Brigham and Louis C. Gapenski, Financ*ial Management: Theory and Practice,* (Dryden, 1997), page 1039.

A restructuring plan shall be stipulated in the form of a restructuring deed which contains among others:

(a) Agreement on the new amount of the debt;
(b) The repayment structured agreed by parties;
(c) Adjustment of the security;
(d) Undertakings and Representations from parties;
(e) Default clause; and etc.

A debt restructuring shall also comply with the prevailing laws and regulations. In the event that the debtor is a public company, the parties are obliged to include capital market regulations. [40]

2.3.3. Types of Debt Restructuring

Planning and execution of debt restructuring is basically depending on the agreement between the debtor and creditor in preparing debt repayment agreement. None of the provisions of laws which regulate in detail the methods that must be implemented by debtor and creditor in the implementation of debt restructuring. In practice, there have been many methods developed by business dealer.[41]

The simplest method of debt restructuring to be implemented today is rescheduling, which constitutes changes in credit terms in relation with the repayment schedule or timeline.

The other way of debt restructuring is reconditioning, which means to alter part or all of the conditions in the facility agreement. The amendment of these conditions are not limited to the period only, but also other conditions to the extent it does not change the

[40]Sutan Remy Sjahdeni,*Op. Cit*. page 320.
[41]Johanes Ibrahim, *Cross Default & Cross Collateral Sebagai Upaya Penyelesaian Kredit Mace*t, (Bandung: PT RefikaAditama, 2004), page. 117.

amount of the facility or conversion of the debt.[42] Below are examples of reconditioning:

(a) Interest capitalization, conversion of the interest becomes debt;
(b) Suspension of interest payment until certain time;
(c) Decrease of the interest rate;
(d) Release of interest;

The other methods of restructuring are as follows:

(a) Fund injection;
(b) Conversion of parts or all the overdue becomes new debts;
(c) Conversion of debt to equity.

2.3.4. Benefits of Debt Restructuring

Once the debtor committed default in a certain transaction, the only way to keep the business sustained and prevent further disputes related to the dispute is to perform a debt restructuring. Otherwise, the debtor might at any time apply for a bankruptcy petition to the commercial court.

Through a debt restructuring, the debtor shall have more alternatives to settle and repay its debts. This debt restructuring shall be obtained from series of discussion and negotiation between creditor and debtor to achieve the so-called win-win solution for both parties. [43] The debt restructuring shall also enable opportunities to the debtor to sustain its business and improve its performance for the purpose of debt repayment.

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[42]Hermansyah, *Hukum Perbankan Nasional Indonesia*, (Jakarta: Penerbit Kencana, 2008), page 87.
[43]Lepi T. Tarmidi, *Krisis Moneter Indoneisa*; Sebab, dampak, peran IMF dan Saran. Retrieved from http://www.bi.go.id/ on 22 November 2015.

A debt restructuring provide an integrated debts of the debtor, meaning that several types of debts shall be merged into one or two types, accordingly, the legal documentations and securities or guarantees as well. By way of this method, it shall simplify the repayment method as well as its control over the debtor towards repayment schedule. Debt restructuring basically provides certain condition in which it enables the creditor to supervise directly the debtor.[44]

2.4. Bankruptcy, Insolvency and Debt Restructuring in Islamic Law

2.4.1. General Overview of Bankruptcy in Islamic Law

The essential baseline of any system that addresses distressed debt is an obligation to abide by debts in the first place.[45] Such a baseline appears in the Quran in multiple places and forms. The simples and most direct embodiment of this baseline, equivalent to the Latin *pacta sunt servanda*, appears in two words in the opening verse of the chapter called "The Table": "Oh, ye who believe! Fulfill obligations" (*'awfubul-uqud*).[46] Using the standard word for a binding contract, *akad*, derived from the root for "knot" or "tie" this piercingly simple phrase is the primary foundation for the law of contracts in Islam.[47] A similar sentiment is expressed in many other verses. As clear as this verse and others seem, two of the most prominent experts on Islamic commercial law have observed that the various injunctions to

[44]Arief T. Surowidhoho, Restrukturasi Utang: Pelajaran Dari Krisis Moneter Indonesia, dalam Emmy Yuhassarie, Edt.,KreditSindikasidanRestrukturasi: Proceedings RangkaianLokakaryaTerbatasMasalah-MasalahKepailitandanWawasanHukumBisnisLainnya. (Jakarta: PusatPengkajianHukum, 2005), page 221.
[45]Kilborn, Jason J., *Foundations of Forgiveness in Islamic Bankruptcy Law: Sources, Methodology, Diversity* (August 11, 2011), page 326.
[46] Quran 5:1.
[47] Noor Mohammed, Principles of Islamic Contract Law, in Understanding Islamic Law: From Classical to Contemporary, Hisham M. Ramadan ed. 2006, page 95-96.

fulfill one's contracts "fall short of a definitive obligation to observe promises," especially in light of the possibility that a debtor might intend to comply initially, but then subsequently find himself unable to do so.[48] The situation is addressed specifically in one tantalizingly ambiguous verse.

The well-known prohibition of usury (*riba*) is presented most forcefully within an extended discussion of spending, generosity, and charity at the end of the second and largest chapter of the Quran (entitled "The Cow"). Immediately following the condemnations of usury, the discussion concludes with several verses on burdens, both heavenly and temporal. As to the latter, the Quran directs creditors on how to deal with distressed debtors: "If the debtor is in a difficulty, grant him until it is easy for him to repay. But if ye merit it by way of charity, that is best for you if ye only knew."[49] The Arabic here is both particularly opaque and particularly rich. Most of the words in this verse require several English words to convey the meaning, and even then, the first sentence resists easy interpretation.

Four distinct concepts, and four key Arabic words, comprise this verse and the foundation for Islamic bankruptcy law. First, as for what we would call discharge, this notion appears only in the second, hortatory sentence. Voluntary remission is encouraged, but compulsory, coercive discharge of debt is not prescribed here. It would be best for creditors (if they only knew!) if they were to see the debtor's difficult situation and offer a remission of debt by

[48] Frank E. Vogel & Samual L. Hayes, III, Islamic Law and Finance: Religion, Risk, and Return, 1998, page 67.
[49] Quran 2:280

way of charity. Nonetheless, the Quran does not oblige creditors to remit debts, even if the debtor is "in a difficulty."[50]

The teaching in Quran on debt is clear as it states that when a debtor is in difficulty they should be given time to repay. Indeed, if the debt is forgiven as a charitable act, this will be best for the lender.

"And if the debtor is straitened circumstances, then (let there be) postponement to (the time of) ease; and that ye remit the debt as almsgiving would be better for you if ye did but know." (Quran 2: 280)

Islamic banks are not charities however, but commercial institutions with shareholders who are seeking dividends and capital gains, and depositors, including those with investment accounts, who are expecting profit sharing pay-outs. There is a conflict of interest between those being financed and an Islamic bank's owners and depositors. Debt forgiveness on a large scale will result in declining shareholder value and zero profits for investment account holders. Regulators will also be concerned with excessive debt forgiveness, as if the bank fails, in most jurisdictions governments will be obliged to bail our the bank using taxpayers money.

To understand the theory of bankruptcy and to develop models for bankruptcy resolution in Islamic finance clarity on the following aspects is essential: [51]

[50] Note that a parallel treatment applies to the Muslim equivalent of lex talionis, an eye for an eye. "And We prescribed…the eye for an eye… and the tooth for the tooth…. But *whososforgoeth* it (in the way of charity) it shall be expiation for him." Quran 5:45 (using the same verb, *tsaddawa*).
[51] Salman Syed, Ali. *Insolvency and Debt Restructuring in Islamic Finance*, IRTI, Islamic Development Bank, Jeddah, Saudi Arabia, on Harvard-LSE Workshop Insolvency and Debt Restructuring In Islamic Finance, 28 February 2013, page 11.

- Islam prohibits interests;
- Money is recognized as medium of exchange and a facilitator with no intrinsic potential to grow or increase in value by time;
- Debt is not prohibited but not encouraged. It does not mean a neutral stance towards debt. Debt is rather discouraged;
- Debt cannot be extinguished except by payment in full or b its forgiveness from the creditors. There is no other way to discharge debt;
- Justice and Benevolence are fundamental in all dealings. In debt contracts, it translates into insisting the debtor to keep his promise of timely repayment and encouraging the creditors to show leniency is case debtor is in financial difficulty to extend time and/or forgive full or part of the debt.

  Insolvency and debt-restructuring from an Islamic perspective can be viewed at two phases. First is the ex-ante phase in which entities decide on the levels of debt that they should have. Islamic laws and principles provide general guidelines that have implications on debt and the likelihood of insolvencies. The second is the ex-post phase which deals with issues related to the specific technicalities of what should be done when insolvencies occur and a need to restructure debt arises. [52]

It is important to note that while there are Islamic principles related to insolvency and bankruptcy, discussions on debt-restructuring are limited as creditors are asked to give respite to debtors if the latter are in difficulties. Furthermore, given that corporate entities are only

[52]Campbell, Jeffrey R. and ZviHercowitz, *Welfare implications of the transition to high household debt*", Journal of Monetary Economics, page. 56

recognized in Islamic commercial law during recent times, the implications of the concepts for corporations are scant, of not nonexistent.[53]

2.4.1.1. Ex-Ante Perspective in Islamic Law

As the probability of insolvencies and bankruptcies increases with the increase in the proportion of debt in capital structures, the ex-ante solution to have a lower frequency of insolvencies is to keep the levels of debt low. In this regards, there are guidelines that can be deduced from moral teachings in Islam.

While Islam does not prohibit debt, several sayings of the Prophet discourage Muslims to engage in excessive indebtedness. In one hadith, the Prophet seeks refuge from sins and debt, thereby implying negative attributes of both. In another hadith, the Prophet refused to lead the funeral prayer of someone who died indebted and did not have the means to repay it. The incident shows even though the deceased was a Muslim, the consequence of not repaying the debt was a serous enough factor that led him not to lead his funeral prayer. The implications that one can draw from these Prophetic sayings are the following: people should take on debt only if it necessary, the debt should of amounts that is within a person's capacity to repay, and once indebted people should strive to repay it back.

As indicated, an obvious ex-ante solution to avoid insolvencies is to reduce the proportion of debt in capital structures. This is not only supported by the moral

[53]Taleb, Nassim Nicholas and Mark Sptizagel, Time to tackle the real evil: too much debt, Financial Times, retrieved on 7 January 2016 from http://www.ft.com/intl/cms/s/0/4e02aeba-6fd8-11de-b835-00144feabdc0.html#axzz3zUBgqNOi.

teachings of Islam, but also goes back to the foundational discussions on Islamic economics what showed preference for equity modes of financing. A higher proportion of equity relative to debt based modes ex-ante would reduce the likelihood of insolvencies and bankruptcies are expected to decrease to great extents.

2.4.1.2. Ex-Post Perspective in Islamic Law

As the Islamic financial industry is modeled similar to the conventional financial sector, they predominantly finance using debt based modes. High levels of debt increases the probability of insolvencies when a negative shocks affect the economy. This would require debt-restructuring as Islamic debt arises from sale-based contracts there are certain restrictions in how debt can be restructured. Whereas the level of debt can be reduced by creditors and time of repayment extended, the amount owed cannot be increased. As mentioned, one Sharia compliant way to deal with insolvencies is to transform debt to equity.

Alternatively, Islamic financier may act like their conventional counterparts and try to increase the amount beyond that is owed to compensate for the longer time of repayment. While come Sharia compliant methods can be used to do restructure the debt, in substance this would be similar to *riba* whereby the amount owed is increased when the debtor fails to repay the debt on time. If non-debt modes are used for financing, the issue of restructuring payments becomes much easier. For example, if an asset is finance by *ijara*mode and the client is unable to pay the rent on the assets due to distress, then the length of the lease contract

can be extended. In this way, the financier will still be able to earn income for a period longer than that stipulated in the original contract.

2.4.2. The AAOIFI Standards on Bankruptcy ("AAOIFI Standard")

The Accounting and Auditing Organization for Islamic Financial Institutions ("AAOIFI") is an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Sharia standards for Islamic financial institutions and the industry. As an independent international organization, AAOIFI is supported by institutional members, including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry, worldwide. AAOIFI has gained assuring support for the implementation of its standards, which are now adopted in many countries.[54]

The objective of this Sharia standard is to introduce the Islamic legal principles to bankruptcy and their application to the business of modern Islamic financial institutions, as well as the companies or individuals that deal with such financial institutions. It is also interesting to note the difference between *iflas* and *taflis*given in Article 2 of the AAOIFI standard. It defines *iflas* as a situation where the current debts of the debtor are more than his assets. On the other hand, taflis as the ruling of as judge with regards the bankruptcy of the debtor preventing him from disposing his distinction, with particular reference to the former, represents the reference made earlier to prophetic him from disposing his assets. Through such ruling or judgment of the court, the bankrupt is prevented from managing his assets. This distinction, with

[54] See further on About Us page of AAOIFI, http://aaoifi.com/about-aaoifi/?lang=en, retrieved on 17 January 2016.

particular reference to the former, represents the reference made earlier to prophetic precedents. In this case, the debtor may be an individual or a corporation, which also includes an Islamic financial institution.

Article 3 provides for the applicable Sharia rules in bankruptcy issues. It is incumbent upon the debtor to refrain from any action that is detrimental to the creditor even if he has not been declared bankrupt by a competent court. The competent authorities saddled with the responsibility of bankruptcy proceedings must endeavor to establish that the debts of the debtor are more than his assets before placing a financial interdiction on his dispositions. Generally, the standard provides for the scope of the standard of bankruptcy (Art. 1), the definition of insolvency and bankruptcy in Islamic law (Art. 2), the Sharia principles on insolvency (Art. 3), different phases relating to insolvency (Art.4), effects of bankruptcy (Art. 5), right of recovery (Art. 5), right of recovery of a sold item from one who has been declared bankrupt (Art. 6), sale of the property of the bankrupt (Art. 5), right of recovery of a sold item from one who has been declared bankrupt (Art. 6), sale of the property of the bankrupt and what may be left for him (Art. 7), distribution of the assets of the bankrupt among the creditors (Art. 8), exclusive rules applicable to Islamic financial institutions (Art. 9) and discharge of a bankrupt (Art. 10).

2.4.3. Insolvency and Debt Restructuring in Islamic Law

2.4.3.1. Origin of Insolvency and Debt Restructuring

Islamic law has no procedure of "bankruptcy". Rather, bankruptcy in Islamic law is a concept (called generally *falas*), reflected in several different but closely related Arabic words commonly encountered in *fiqh* discussions.[55]

[55] Hans Wehr, A Dictionary of Modern Written Arabic, J. Milson Cowan ed. 4th ed 1979, page. 23.

Bankruptcy might describe either the condition (called *iflas*) of a distressed debtor (called *muflis*), or other official act (called *taflis*) of declaring the debtor to be in one of two distressed conditions.[56] The condition called "bankruptcy" might describe either simple balance-sheet insolvency (that the debtor's debts equal or exceed his assets)[57], or that the debtor has almost property at all, just a few of the *fils* (the smallest denomination of currency).[58] In any event, the condition of bankruptcy and its official declaration arise in the law only as par of the debt collection process in one of two ways.

First, the predicate for release from debtor's prison is a determination that the debtor totally lacks any non-essential assets. Second, if a debtor is insolvent, but he has some property that the refuses to sell to pay matured debts, the debtor's assets might be subjected to forced liquidation in a formal proceeding called interdiction (*hajr*).

2.4.3.2. Conditions of Debt Restructuring

Debt restructuring will be one of the crucial roles of the financial system to ensure that economy will not easily succumb by the financially distressed firms. Firms react by restructuring their assets or liabilities. Firms in financial distress tend to make several options such as debt restructuring, sale of assets, merger and capital expenditure reduction. However, firms with fewer tangible assets or less liquid assets, and lower capital prefer to use the debt restructuring.

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[56]Zuhayli, Fiqh , Financial Transacions in Islamic Jurisprudence, Mahmoud El Gamal), page 8
[57] Ibid.
[58] Ibid.

It is noteworthy that modern insolvency systems allow for rehabilitating financially distressed but viable enterprises, while enabling reallocation of assets to more efficient market user through efficient liquidation systems, thereby creating conditions contributing to preserve employment, a factor often absent in classical insolvency regimes. Collective restructuring schemes are considered improper under Sharia. Sharia compliant restructurings have generated a lot of attention not only because their large-scale nature was unprecedented but also because of the requirement for a majority of these restructuring to remain Sharia compliant. [59]

A key element to the success of Sharia compliant restructurings is the involvement and ongoing dialogue with, the relevant Sharia boards from the outset. It is clear from recent Sharia compliant restructuring that Sharia boards are willing to revisit the fundamental principles of current Sharia compliant financing arrangements and are open to considering other innovative structures. The key to all of them has been balancing the interests of multiple Sharia boards with sometimes competing interests of a diverse creditor group.

Therefore, it is fair o assert that, the shared value of risk sharing, ethical conduct and exercise of forgiveness proved a workable interface between insolvency regimes of Islamic financial transactions and conventional financial systems. It is also a shared interest between regulators, legislators, judges and creditors that mechanism for the orderly and

[59] Michael J.T. McMillen, An Introduction to Sharia to Sharia Consideration in Bankruptcy and Insolvency Contexts and Islamic Finance First Banktruptcy (East Cameron), page. 26

equitable resolution of insolvency of Islamic transactions and entities.

2.4.3.3. Types of Debt Restructuring in Islamic Law

The Sharia parameters on restructuring are generally governed by the rules of Islamic law pertaining to dealing with debt obligations whether through the selling of the debts obligations, using it as consideration and exchanging it against a commodity, swapping it with shares or even forgiving it partially or entirely. Although the development of viable instruments for debt restructuring in Islamic finance is still in its early stages, a number of alternatives were the points of strong difference of opinion among early Muslim jurist and still remain debatable among contemporary scholars. The following are some of these instruments that can be used in the restructuring process:

- Ibra (cancellation of debt);
- Hawala (transferring a debt liability to a third party);
- Voluntary deferment of debt obligation maturity without extracting benefit to the creditor;
- Creditor acceptance to forfeit some of the debt in exchange of an immediate payment or haircut;
- Conversion of debt liabilities into shares;
- Using debt obligations as a capital for a new venture; and
- Selling an asset portfolio with a unilateral promise to purchase it back.

In the sphere of Islamic finance vis-à-vis restructuring, there are several issues that may arise in the process of restructuring. Among others are:

- Whether the restructuring will be Sharia compliant or not. If the decision is to restructure the company to be Sharia compliant, then various considerations needs to be put to ensure that the restructure and the instruments to be used for restructuring are Sharia compliant.

If the restructuring is to be done on the instruments only, for instance, restructuring of Sukuk, then we need to consider various issues, including the existing Sukuk structure, and what is the proposed structure that is suitable for the restructuring exercise. The restructuring team may want to remain with the existing structure or to suggest new structure, depending on the suitability of the proposed instruments vis-à-vis the restructuring exercise.

CHAPTER III

SUKUK IJARAH: OVERVIEW, DEFAULT ANTICIPATION AND RESTRUCTURING IMPLEMENTATION

3.1. *Sukuk*: General Overview of Islamic Bonds

3.1.1. An Overview of Islamic Finance

All kind of financial relationships involving entrepreneurial investment is limitation to Islamic finance, save as to the moral prohibitions of: i) interest earnings or usury (*riba*) and money lending, ii) *haram* (sinful activity)[60], such us direct or indirect association with lines of business involving alcohol, pork products, firearms, tobacco, and adult entertainment, iii) speculation, betting, and gambling, including the speculative trade or exchange of money for debt without an underlying asset transfer, iv) the trading of the same object between buyer and seller, as well as v) preventable uncertainty, such as all financial derivative instruments, forward contracts, and future agreements. There are two Islamic sources predicated on the creation of an equitable system of distributive justice and the promotion of permitted activities (halal) and public good from which these distinctive properties are derived: i) the Sharia, which comprises the Quran and the sayings and actions of the prophet Muhammad recorded in a collection of books known as *Hadith*,[61] and ii) *Fiqh*, which represents Islamic jurisprudences based on a body of laws deducted from the Sharia by Islamic scholars. [62]

[60] Other, less relevant sinful activity under Islamic law in this context includes hoarding, miserliness and extravagance.

[61] In some countries, the Sharia touches almost every aspect of life including social policy, banking, commercial and economic relationships, while in others its primary influence lies in aspects of social policy, such as family law, with commercial codes governing business and contractual matters.

[62] Andreas Jobs, *The Economics of Islamic Finance and Securitization*, International Monetary Fund Working Paper, 2007, page. 4-5

Islamic finance is a form of banking or banking activity that is consistent with the principles of Sharia. For example, the prohibition of interest payments and excessive uncertainty or gambling. Instead, risks and rewards should be shared and the transaction should have real economic purpose without undue specification. Islamic banking involves banking, leasing, sukuk and equity markets, investment funds, insurance and micro finance. However, the banking and Sukuk assets account for about 95 percent of total Islamic finance assets. In recent years, the global market for Sharia compliant financial instruments has risen robustly.[63] For a clearer comparison, please see below figures retrieved from Maldives Islamic Bank:[64]

Conventional Banking	Islamic Banking
Money is a commodity besides medium of exchange and store of value. Therefore, it can be sold at a price higher than its face value and it can also be rented out.	Money is not a commodity though it is used as a medium of exchange and store of value. Therefore, it cannot be sold at a price higher than its face value or rented out.
Time value is the basis for charging interest on capital.	Profit on trade of goods or charging on providing service is the basis for earning profit.
Interest is charged even in case the organization suffers losses by using bankâ €™s funds. Therefore, it is not based on profit and loss sharing.	Islamic bank operates on the basis of profit and loss sharing. In case, the businessman has suffered losses, the bank will share these losses based on the mode of finance used (Mudarabah, Musharakah).
While disbursing cash finance, running finance or working capital finance, no agreement for exchange of goods & services is made.	The execution of agreements for the exchange of goods & services is a must, while disbursing funds under Murabaha, Salam & Istisna contracts.
Conventional banks use money as a commodity which leads to inflation.	Islamic banking tends to create link with the real sectors of the economic system by using trade related activities. Since, the money is linked with the real assets therefore it contributes directly in the economic development.

Overall, the different basic types of Islamic finance combine two or more contingent claims to replicate the risk-return trade-off of

[63] Indonesia Investment, Islamic Banking in Indonesia Explained: New Rules & Foreign Ownership, 8 July 2015, retrieved from http://www.indonesia-investments.com/news/news-columns/islamic-banking-in-indonesia-explained-new-rules-foreign-ownership/item5720 on Tuesday, 5 January 2016

[64] Maldives Islamic Bank, Difference between Conventional and Islamic Banking, retrieved from http://www.mib.com.mv/blog/guide-to-islamic-banking/difference-between-conventional-and-islamic-banking on Tuesday, 5 January 2016.

conventional lending contracts or equity investment without a contractual guarantees of investment return or secured payments in reference to an interest rate as time-dependent cost of funds. Such arrangements may become complicated in practice, once they are combined to meet specific investor requirements under Islamic law.[65] Although both Islamic and conventional finance are in substance equivalent to conventional finance and yield the same lender and investor pay-offs at the inception of the transaction, they differ in legal form and might require a different valuation due to dissimilar transaction structures (and associated legal enforceability of investor claims) and/or security design.[66] Most importantly, Islamic finance substitutes a temporary use of assets by the lender for a permanent transfer of funds to the borrower as a source of indebtedness in conventional lending. Retained asset ownership by the lender under this arrangement constitutes entrepreneurial investment. The financer receives returns from the direct participation in asset performance in the form of state-contingent payments according to an agreed schedule and amount.

3.1.2. Definition of *Sukuk*

The Arabic term of *Sukuk* is the plural of *sakk*, meaning "legal instrument", "deed" or "*cheque*". It is the Arabic name for what is known in conventional banking as "financial certificates", but more commonly refers to the Islamic counterparts of "bonds". In the medieval period of Islamic civilization, *sukuk* (which is cognate with the European root "*cheque*", from *Arabic sakk*, via Persian *chakk*) stood for any document representing a contract of

[65] El-Qorchi, M "*Islamic Finance Gears Up."* Finance and Development (December), International Monetary Fund (IMF), (2005), page. 46-49
[66] Jobst, A. "*Correlation, Price Discovery and Co-movement of ABS and Equity*." Derivatives Use, Trading & Regulations, Vol. 12, No. 1 (2006a), page 60-101.

transference of rights, obligations or monies done in conformity with Islamic law.

In Indonesia, under the Fatwa No. 32/DSN-MUI/IX/IX/2002 on the Sharia Bond dated 14 September 2002, a Sukuk or Sharia Bond is defined as a long-term Sharia based securities issued by the issuer to the Sukuk holders, which obliges the issuer to pay income to the Sukuk holders in the form of sharing/margin/gee and repay the fund of Sukuk on the due date.

Sukuk is Sharia compliant capital market instrument that is used by the Originator to raise funds from regional and international investors. It typically pays a fixed or floating rate of profit to the investor, and is redeemed in a pre-prescribed tenor. Due to its nature, it can be comparable in some cases to conventional asset backed securities. The concept of *Sukuk* dates back to early Islamic civilization but only recently it has re-emerged as modern Islamic finance structure.

*Sukuk*can be issued using various structures. The most widely used and accepted currently are: (i) *Sukuk Ijara*: this uses an underlying asset pool comprised of leased assets and (ii) *SukukMusharakah*: this uses an underlying asset pool comprising a combination of capital and other physical assets.

3.1.3. General principles of *Sukuk*

Islamic capital markets have witnessed the issuance of Sharia compliant financial instruments know as *Sukuk*. *Sukuk* investments represent a distinct class of securities issued by sovereign and corporate entities. They are investment certificates with both bond and stock-like features issued to finance trade or the production of tangible assets. Like bonds, *Sukuk* have a maturity date and holders are entitled to a regular stream of income over the life of the *Sukuk*

along with a final balloon payment at maturity. However, *Sukuk* are asset based rather than asset backed securities, with the underlying asset being necessarily Sharia compliant in both nature and use. The eligibility of *Sukuk* rests on identifying an existing or a well-defined asset, service, or project capable of being certified by a third party, and for which ownership can be recorded in some form. *Sukuk* holders might be responsible for asset related expenses, and the sale of *Sukuk* results in the sale of a share of an asset. Bonds, in contrast, are pure debt obligations issued to finance any activity and whose value rests on the creditworthiness of the issuer. *Sukuk* prices can vary both with the creditworthiness of the issuer and the market value of the underlying asset.

There are several key concepts of *Sukuk* to be noted:

- No security or foreclosure rights on assets used for structuring (unless specifically provided for): Investors do not automatically have foreclosure rights on the assets used for structuring (unless a security interest has been granted). The rights of investors would be similar to those of other unsecured creditors;
- Asset sale for restructuring purposes only: asset sale is for Sharia structuring purposes only and does not constitute a true sale;
- Balance sheet treatment same as conventional debt: the structure of Islamic facilities does not result in off-balance sheet treatment of assets and obligation created under Islamic finance facilities reflected as financial indebtedness on balance sheet;
- Similar treatment by rating agencies: rating agencies treat and rate Islamic facilities in a manner similar to conventional indebtedness.

3.1.4. Types of *Sukuk*

In general, there are two types of Sukuk: Islamic Bonds and Islamic Assets Securitizations. Islamic bonds are based, ultimately, upon the credit of an entity-issuer, guarantor, or other credit support provider, that is participating in the transaction, rather than on specific assets and cash flows derived from those specific assets. Securitization involve asset transfers from an originator into a trust or similar special purpose vehicle ("**SPV**") with *Sukuk* issuance by that SPV and payments on the *Sukuk* derived from the payments received in respect of those transferred assets. Most *Sukuk* offerings to date have been of the bond type, and the ultimate credit in most of those bond offerings has been a sovereign entity. There have been very few, if any, true asset securitizations, largely because of the inability to obtain ratings from major international rating firms (ratings have been obtained for the sovereign bond issuances based upon the rating of the sovereign credit).

The Accounting and Auditing Organization for Islamic Financial Institutions ("*AAOIFI*") has issued the Standard for Investment Sukuk ("*AAOIFI Sukuk Standard*").[67] Under the AAOIFI *Sukuk* Standard, *Sukuk* is defined as certificates of equal value put to use as common shares and rights in tangible assets, usufructs, and services or as equity in a project or investment activity.[68] It emphasizes that *Sukuk* are not debts of the issue, they are fractional or proportional interests in underlying assets, usufructs, services, projects, or investment activities. *Sukuk* may not be issued on a pool of receivables. Further, the underlying business or activity, and the underlying transactional (for example, the business or activity cannot engage in prohibited business activities).

[67] AAOIFI, Sharia Standards 1425-6 H, No. 17, page 296 (AAOIFI 2014).
[68] Ibid.

Based on the recourse over underlying asset, currently issued *Sukuk* can be classified into Asset-based and Asset-backed, which are semantically similar descriptions but mask significant differences in credit risk. [69]

- Asset-based *Sukuk*[70]

  Sukuk is structured such that investors have a beneficial interest only the cash flow generated by the underlying asset. Assets are usually sold by the originator to SPV (Special Purpose Vehicle) in the form of trust. The trustee issues certificates representing the investor's ownership interest, while the proceeds are used to purchase the assets. The investors receive a distribution income representing a proportion of the returns generated by the assets.

  In an asset-based *Sukuk*, it is clearly determined that the credit of *Sukuk* reflects that of the originator rather than the underlying assets. This is because the investors do not have any recourse to the underlying assets in the event of default. The *Sukuk* holders will ordinarily rank as senior unsecured creditors of the originator. They would rank *pari passu* with the other senior unsecured creditors of the originator company.

- Asset-backed *Sukuk*[71]

  Asset-backed *Sukuk* represent a true sale. The underlying asset has been validly transferred to the SPV on behalf of the investors. However, the underlying asset should generate income so the profit solely comes from the asset. In the event of insolvency of the originator, the underlying

[69]IbnuQizamet. al., Predicting Sukuk Default Probability and Its Relationship with Systematic and Unsystematic Risks: Case Study of Sukuk in Indonesia, International Journal of Research in Commerce, Economics & Management, 2013, page 15.

[70]IFSB Guidelines No. 2 (2005). Islamic Financial Services Board (IFSB)'s Capital Adequacy Standard for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services. Kuala Lumpur: IFSB.

[71] Abdul Aziz, Razi Pahlavi and Anne-Sophie Gintzburger (2009). Equity based, Asset based and Asset backed Transactional Structures in Sharia Compliant Financing: Reflections on the Current Financial Crisis. Economic Papers, Vol.28 (1): 270-278.

assets will remain completely separate from the originator. In addition, the risk of any insolvency proceedings being brought against SPV should be remote, while the investors have the full claim over the underling asset, without any risk of the sale subsequently being overturned by the local or Sharia courts.

Based on the *Sukuk* Structures, JPMorgan Chase Bank N.A. Dubai Branch categorizes types of Sukuk as follows:

- *Sukuk Ijara*: Sale and lease back of existing assets and fully tradeable;
- *Sukuk Musharakah*: Investors' funds combined with assets from Originator and invested, tradable once cash is invested (which is immediate under a *Sukuk* structure);
- *Sukuk Mudarabah*: Originator uses funds for investment in its own business activities; tradable once cash is invested (which is immediate under a *Sukuk* structure);
- *Sukuk Istisna*: Construction of assets, typically for project finance, and combined with *Sukuk Ijara*, tradeable once the cash is invested (can be structured to permit immediate tradability);
- *Sukuk Istithmar:* Sale of a mixed pool of assets, and lease back, tradable depending on components of asset pool;
- *Sukuk Murabaha*: funds used to enter into *Murabah* transaction (sale for deferred payment), not tradeable;
- *Sukuk Salam*: Future delivery of asset, not tradeable.

3.1.5. History of Indonesian Islamic Capital Market

History of Islamic Capital Market in Indonesia began with the issuance of Islamic Mutual Funds by PT Danareksa Investment Management on 3 July 1997. Furthermore, the Indonesia Stock Exchange (in the past was Jakarta Stock Exchange) in cooperation

with PT Danareksa Investmnet Management launched the Jakarta Islamic Index on 3 July 2000, which aims to guide investors who want to invest funds in Sharia. The Jakarta Islamic Index, since then, has provided the investors with shares that are in accordance with Islamic principles.

On 18 April 2001, for the first time, National Sharia Board issued a fatwa that are directly related to capital markets, namely Fatwa No. 20/DSN-MUI/IV/2001 on Guidelines for Implementation of Sharia Mutual Fund. Furthermore, the Islamic investment instruments in the capital markets continue to grow with the issuance of Islamic Bonds of PT Indosat Tbk in early September 2002.

History of Islamic capital market can also be traced from institutional developments involved in the Islamic capital market regulation. The development started from the MoU between Bapepam-LK and DSN on 14 March 2003. The MoU indicates the existence of an agreement between Bapepam-LK and DSN to develop sharia-based capital market in Indonesia.

From the institutional side of Bapepam-LK, the development of Islamic capital market is characterized by the establishment of Islamic Capital market Development Team in 2003. Subsequently, in 2004 the development of Islamic capital markets has also been marked by the inclusion of Islamic capital market unit in the organizational structure of Bapepam-LK. The unit was an Echelon IV level unit that specifically has a duty and function of developing Islamic capital market. In line with the development of existing industries, in 2006 the existing IV unit was then upgraded to Echelon III-level unit.

On 23 November 2006, Bapepam-LK issued a rule package of Bapepam-LK-related to Sharia Capital Markets. The rules package contains Bapepam-LK rule Number IX.A.13 concerning Sharia Securities Issuance and rule Number IX.A.14 concerning Covenants Used in the Issuance of Islamic Securities in Capital Market. Subsequently, on 31 August 2007, Bapepam-LK issued rule Number II.K.1 regarding Criteria and the Issuance of Sharia Securities List, followed by the launch of the first Sharia Securities List by Bapepam-LK on 12 September 2007.

The development of Islamic capital market reached a new milestone with the enactment of Law No. 19 of 2008 on Sharia Sovereign Bonds (SBSN) on 7 May 2008. This law is required as a legal basis for the issuance of Islamic securities or sovereign sukuk. On 26 August 2008, for the first time, the Government of Indonesia issued SBSN with serial number IFR0001 and IFR0002.
On 30 June 2009, Bapepam-LK has made revisions to Bapepam-LK rule Number IX.A.13 concerning Sharia Securities Issuance and II.K.1 concerning Criteria and Issuance of Sharia Securities List.

Further, on 24 April 2012, Bapepam-LK has revised Bapepam-LK rule Number II.K.1 concerning Sharia Criteria and Issuance of Sharia Securities List.

3.1.6. *Sukuk Ijara* in the Laws of Republic Indonesia

According to Law No. 8 of 1995 on Capital Market ("UUPM"), Capital Market is defined as an activity concerned with the public offering and trading of securities, the Public Company relating to the issuance of securities, as well as the institutions and professions related to securities.

Based on the above definition, the terminology of Islamic capital market can be defined as the activity in capital markets as provided for in UUPM does not against the Islamic principles. Therefore, the Islamic capital market is not a separate system to the capital market system as a whole. In general, Islamic Capital Market activity has no difference with the conventional capital market, but there are some special characteristics of Islamic capital market, which are the products and the transactions mechanism do not against Islamic principles.[72]

In Indonesia, there are basically three basic regulations stipulating provisions on Sukuk:

- Rule Number II.K.1 on Criteria and Issuance of Sharia Securities List;
- Rule Number IX.A.13 on Sharia Securities Issuance; and
- Rule Number IX.A.14 on Covenants (Akad) used in the Issuance of Sharia Securities.

3.2. *Sukuk Ijara* and its Composition Structure

3.2.1. Basic Concepts of *Sukuk Ijara*

Ijara is a term from Islamic jurisprudence which literally means "to give something on rent." While the sale and *Ijara* are similar, in a sale of property is transferred entirely to the end user, whereas with *Ijara* the corpus of the property remains with the transferor and only the usufruct transfer to the lessee or user. Over time, however, a conventional practice evolved, influenced by tax concessions, whereby the rental equipment to customers became a substitute for loan financing.

[72] The Basic Principal of Sharia Capital Market, OtoritasJasaKeuanganRepublik Indonesia, retrieved on Sunday, 6 December 2015 http://www.ojk.go.id/sharia-capital-id

Although Ijara and modern day leasing share many similarities, the differences are crucial to an understanding of how to make leasing finance acceptable to Islamic principles, clients and investors. The Sharia describes Ijara as a normal business transaction distinct from sale: neither a financing modality nor a type of "loan" transaction. Provided that no Sharia principles are contravened, however, Ijara may be utilized to achieve similar objective to pure equipment financing.

The following are basic characteristics of an Islamic lease:

- There is a contract between two parties whereby the owner of an asset transfers its usufruct to another person for an agreed-upon period for an agreed-upon consideration;
- The subject of the lease must have value and cannot be fully consumed during the lease, because this would be deemed a loan instead that would violate Sharia;
- Liabilities of ownership must remain with the lessor, and liabilities for use of the property are borne by the lessee;
- The lessor retain the risk of the leased asset throughout the lease term so that any harm or loss occurring from factors beyond the control of the lessee must be borne by the lessor. Hence, risk mitigation such as insurance remains the chief responsibility of the lessor;
- The lessee is liable for every harm or loss cause by its negligence or misuse of the asset and shall compensate the lessor accordingly;
- The rental must be established at the time of contract for the entire lease period. Although the rental may vary during different time frames, the lessor may not adjust the rental after the lease commences. Any unilateral changes in the rental or any clause allowing a price change at the discretion of the lessor would render the lease invalid;

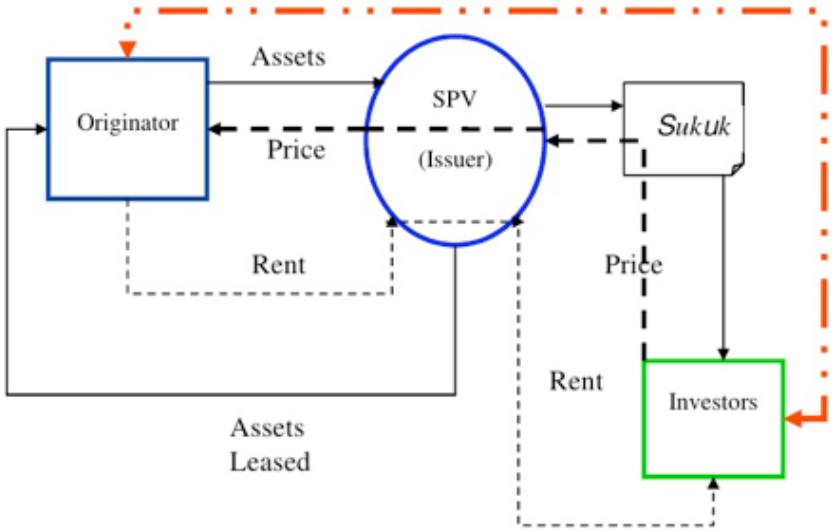
- The lease period shall commence on the date when the lease asset is delivered; hence no rental payments are due to prior to delivery. Sharia rules safeguard the interests of the lessee to avoid being charged rent in the absence of equipment. That rent would be viewed as purely interest charges related to an asset that the lessee does not own or possess; and
- If the leased assets have lost their function and no repair is possible, the lease must terminate on the day such loss was caused.

3.2.2. The Structure of *Sukuk Ijara*

In a typical Sukuk Ijara structure, the originator sells assets to the sukuk issuer, a bankruptcy-remote special purpose vehicle (SPV) created to act as a trustee for investors acquiring the assets.[73] The assets are then leased back to the *Sukuk* issuer for a stated period, with the agreement to sell the asset back to the lessee at the end of the lease period. At the same time, the SPV issues certificates of participation to investors representing undivided ownership in the underlying asset. Over the term of the lease contract, the trustee receives rental payments for the use of the asset and distributes them to certificate holders in proportion to their ownership stake. Upon expiry of the lease contract, the *Sukuk* holders' ownership claims cease and the payment flow halts. The principal is returned to the holder and asset ownership reverts to the lessee. If the asset has a market value, the *Sukuk* holder can realize a capita gain or loss. However, if the underlying is a public good for which there is no market, the *Sukuk* holder exercises an embedded put option whereby the originator buys back the underlying assets at face value.

[73]Iqbal, Z., and A. Mirakhor, 2007 An Introduction to Islamic Finance Theory and Practice. Wiley Finance Editions, John Wiley and Sons, Inc., Hoboken, New Jersey. Sharia scholars agree that ownership of an assets is possible with proper documentation, even if the title is not registered under the buyer's name. The common practice is to transfer beneficial title (not legal title of ownership) to avoid transfer taxes and other unfavorable costs.

Please see below table for the illustration of basic Sukuk Ijara structure:[74]



3.2.3. *Sukuk Ijara* in Indonesia

Sukuk Ijara has been globally used. *Sukuk Ijara* is quite different in Indonesia compared to what has been implemented in the global market. This matter will be further described hereunder:

One of the examples of *Sukuk Ijara* is the issuance of Qatar Global *Sukuk* by the Qatar Government to build a medical center known as Hamad Medical City. The government of Qatar, together with Qatar International Islamic Bank and HSBS, first established a joint venture company (acting as the SPV), which then purchased some plots from the Qatar government.

The SPV company sold the right to use the land to the investors by issuing *Sukuk*. The money from the sale was used to build Hamad Medical City. The land was leased to the government of Qatar,

[74]Rahail Ali, An Overview of the Sukuk Market, Hogan Lovells (Middle East) LLP.

which is obliged to pay the leasing fee. The leasing fee was then distributed by the SPV company to holders of Qatar Global *Sukuk.*

In the issuance of Qatar Global *Sukuk* as mentioned above, the following contracts were involved: (i) Contract of *Ijara* (lease) between the Qatar government and the SPV company as representative of holders of the Qatar Global *Sukuk*, (ii) Sale purchase contract between the Qatar government and the SPV company as representatives of holders of Qatar Global *Sukuk* and (iii) *Wakalah* Contract between holders of Qatar Global *Sukuk* and the SPV company.

Since at the end of the *Sukuk* period, land ownership will further be transferred to the Qatar government, the contract of *Ijara* being made shall be the contract of *Ijara* with option to buy the ownership at the end of the Ijara period. In this matter, the land utilized for Hamad Medical City is not used as guarantee to *Sukuk* holders since within the period of *Sukuk*, the land is actually under the ownership of the *Sukuk* holders through the SPV company, and the ownership will only be further transferred at the end of the *Sukuk* period after the option to own is exercised by the Qatar government.

The mechanism used in Qatar Global *Sukuk* will certainly be impossible if applied in Indonesia. Following the sale by the Qatar Government, the landowner is actually the holder of Qatar Global *Sukuk*. The holders of these *Sukuk* jointly become the landowners in accordance with the portion of *Sukuk* held. In other words, the holders of Qatar Global *Sukuk* are the beneficial owners of the land. But formally, the purchaser of the land is an SPV company. Therefore, the SPV company s the legal owner of the land. This differentiation is not recognized under Indonesian law.

Problems will also occur since the title conversion will be made twice: first, from the issuer of *Sukuk Ijara* to the *Sukuk Ijara* holders at the beginning of the issuance of the *sukuk*, and second,

from the *Sukuk Ijara* holders to the issuer at the end of the *sukuk* period. However, the problems posed by the above mechanism in issuing *Sukuk Ijara* by a limited liability company in Indonesia can be solved by applying the principle of free contract as provided in Article 1338 of the Indonesian Civil Code, but still in the corridor of Sharia principles. The solution is for the land to be formally owned by the limited liability company.

From the perspective of Islamic jurisprudence, the land shall be deemed to belong to *Sukuk Ijara* holder but is leased to the issuer of the *Sukuk Ijara*. The land will be used as guarantee, which will protect *Sukuk Ijara* holder from any breach of contract by the issuer of *Sukuk Ijara.* If at the end of the period, all obligations of the *Sukuk Ijara* issuer towards *Sukuk Ijara* holders have been complied with, then the ownership of the land will be returned to the Issuer without any further title conversion.

In Indonesia, the issuer shall not necessarily make prior sale over its assets to *Sukuk Ijara* holder to obtain funds and further leaseback from *Sukuk Ijara* holder as applied in *Sukuk Ijara* internationally.

If the mechanism of *Sukuk Ijara* as applied internationally is to be applied in the issuance of state commercial papers in Indonesia, another problem will arise since it is not possible to sell or guarantee state assets.

On the 4 March 2004, DSN issued Fatwa No. 41/DSN-MUI/III/2004 on *Sukuk Ijara*. The Fatwa not only provides reference over substance of the previous Fatwa on *Ijara*, but also provides among others, the following:

- Issuer in its position as *Sukuk Ijara* issuer may issue *Sukuk* for the existing assets or assets that will be provided for lease;

- *Sukuk* holders as owner of the asset or benefit must lease his or her rightful asset or benefit to the other party through the issuer as representative;
- Issuer may lease for itself or least to other party;
- If issuer leases for itself, then it shall pay the lease in agreed amount and period as compensation in the same amount as when the lease is being applied to the other party; and
- Ownership of *Sukuk Ijara* is transferable if agreed by the parties in the contract.

3.3. *Sukuk Ijara* Default and its Restructuring

3.3.1. *Sukuk Ijara* Default: Overview of its Dispute Settlement

The objective of any restructuring is twofold, firstly to ensure the fair treatment of tis creditors; and secondly, to ensure that the obligor can continue to operate as a going concern. Decisions as to whether to pursue a course of restructuring versus enforcing bankruptcy largely depend on how best to extract the highest value for the owed creditors.

Restructuring *Sukuk* from the perspective of the obligors is also preferable. It provides the obligors with the additional time to meet their obligations as well as to save the enterprise. Restructuring involves either extending the payment terms, conducting a debt for equity swap, agreeing to a profit haircut, or replacing the original *Sukuk* certificates with new certificates (usually involving a new asset sale transaction but at higher profit rates).[75]

One of the first key steps in any restructuring process is for the obligors to negotiate with the trustee and the *Sukuk* holders to determine: whether there is any potential event of default; whether a default has in fact occurred; and/or whether the situation can be resolved before making any official announcements.

[75] Dr. Mohd Daud Bakar. "Sukuk Restructuring: Issues and Challenges". Amanie Islamic Finance Consultacy and Education, LLC, DIFC.

3.3.2. *Sukuk Ijara* Restructuring Concepts

3.3.2.1. The *Sukuk* Trustee

To any kind of *Sukuk* restructuring, the existence of a Trustee is very essential, however, there are many scholars are still debating the power and authority given to them to represent *Sukuk* holders.[76] The trustee is limited both by the authority as set out in the *Sukuk* documentation[77] and by the constraints placed on it due to the particular *Sukuk* structure itself. Some have suggested using a third party delegate, in particular for enforcing any purchase undertaking or guarantees in the *Sukuk* structure. As the case may be, a meeting of the *Sukuk* holders and the trustee may have to be carried out. The objective of this meeting is to pass a resolution to allow the *Sukuk* to be amended. Amendments can include changes to the *Sukuk* payment terms, dates and processes. If a resolution is not agreed upon and passed, further negotiations are conducted until a revised resolution is agreed upon. Continued deadlock could lead to a formal default announcement and/or insolvency procedures.

A restructuring is devised through creditors' consent rather than through a court process. Therefore, the obligor engages with the *Sukuk* holders and other creditors through some form of coordinating committee. For conventional bonds, this is through a bond holders committee represented by the trustee. For *Sukuk*, this is through a *Sukuk* holders committee

[76]Hessam Kalantar and Owen Delaney. "Restructuring of Islamic Finance Transaction in the Middle East: A New Frontier for Practitioner, "Zawya Select 2010". Nov 30, 2010. Please see http://www.zawya.com/story.cfm/sidZAWYA20101130072143?q=Sukuk. Retrieved on Friday, 1 January 2016.

[77] The trustee may pursue the remedies available to it under document to enforce and accelerate the rights of the Sukuk holders.

represented by the trustee, or an appointed delegate acting on behalf of the trust.[78]

3.3.2.2. The Claims

Any restructuring would begin with an assessment of the claims against the obligors' financial status. For *Sukuk* holders, determining their exact status and interests vis-à-vis other creditors is vital. Are the *Sukuk* holders deemed secured creditors, unsecured creditors, preferential creditors or other?

Whether and how much a *Sukuk* creditor gets back of his investment and distributions depends on his ranking in the payment claims list. The obligors and the creditors will need to agree on the quantum, classification and ranking of the claims. Claims secured against particular assets would have preferential priority over those asset values. To make matters more challenging, the values of all the obligor's assets may have significantly changed since the start of the *Sukuk*.

Even in the event of bankruptcy, the priority of claims, along with the residual valuations of an obligor's assets, are highly contentious. Unlike conventional bond holders however, the rights and remedies of *Sukuk* holders can vary. Therefore, practitioners have to determine these with respect to the *Sukuk* by reviewing the terms and conditions of the *Sukuk* certificates, the trust deed and consider whether there is any purchase undertaking present by the obligor in factor of the trustee and its enforceability.

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[78] Presentation by DebashisDey, Capital Market Solutions to Restructuring Sukuk, 9th Annual Islamic Finance Summit, Euromoney Seminar, London 23-24 February 2010.

3.3.2.3. Restructuring of Asset-backed and Asset-based *Sukuk*

In asset-backed *Sukuk,* legal title of the underlying asset will, in most cases, have been transferred by the obligor into bankruptcy remote special purpose vehicle (SPV) or ring-fenced from the obligor. In securitization parlance, this is known as a true sale. In the use of an SPC, the trustee appointed over the SPV will hold the assets in trust for the *Sukuk* holders. In a default situation, pursuant to the trust deed in place, the *Sukuk* holders can make a claim on the issuer's legal ownership interest just to that asset. If the cash flow of that asset is insufficient to meet the claims of the *Sukuk* holders, they can dispose of the asset. However, they cannot claim against the obligors themselves.

In asset-based *Sukuk*, however, there was most likely only a beneficial ownership transfer or possibly no real transfer of the underlying asset(s). Here, *Sukuk* holders have at best a beneficial interest in the assets. However they do not have ownership of the asset, especially if there is a purchase guarantee in place. They will only have recourse to the obligor as an unsecured creditor with all other similar creditors.

Sukuk holders can determine whether their *Sukuk* investment is asset based or asset backed from the *Sukuk* prospectus, especially as highlighted in the risk factors section. Despite the availability of this information, many perceived their investment to be linked to the underlying asset performance, rather than simply being de facto debt instruments.

3.3.2.4. Security Interest

Relevant to arriving at a classification of secured versus unsecured claims is determining whether procedures relating to perfection of security have been duly undertaken.

Perfection of a security interest on the assets is important determinant in restructurings. Many *Sukuk* creditors mistakenly believed they had, in addition to a claim against the obligor, a security interest over the underlying *Sukuk* assets themselves. In other words, they deemed themselves to be a secured creditor.

If the security interest over the assets was not perfected in the name of the *Sukuk* holders, then the *Sukuk* holders may not have any security rights over them. In a number of *Sukuk*, perfection of the security interest was not made over the underlying assets. Jurisdictional impediments, such as the prohibition of foreign ownership of real estate assets in certain states, played a significant part in this failure to register the ownership. Besides, many investors were concerned that they were taking on additional risk (asset risk) along with credit risk. However, *Sukuk* holders will ultimately need to balance the objectives of what the Sharia is trying to achieve with that of their own investment risk criteria.

3.3.2.5. Cross Default

Once a *Sukuk* defaults, cross-default provision in the obligor's financial agreements may kick in. In other words, a payment obligation that is not met under a financial agreement may give rise to claims under other financial agreements. Such cross default scenarios may require renegotiating repayments with

all creditors together to avoid unfair preferential treatments.

3.3.2.6. Restructuring Options

Extending the payments is not always possible under *Sukuk* though a common tactic under conventional restructurings. It largely depends on the *Sukuk* structure used.

Restructuring of asset-backed *Sukuk*, especially when the underlying assets have been transferred on a true sale transaction, is not possible. Under Sharia, in the absence of any fraud or gross negligence, the terms of an asset sale cannot be renegotiated after the sale has already been concluded. Thus, the payment terms cannot simply be extended. Doing so could also mean that the issuance is no different from a conventional financial debt transaction. The easiest to restructure however is the *Sukuk Ijara*. The *Sukuk Ijara,* given its relative flexibility in terms of adjusting profit levels and repayment terms, as compared with other *Sukuk* forms.[79] Sharia permits with mutual consent of the parties, the extension of a lease period and the readjustment of the periodic rental payments. Furthermore, the parties can agree to replace the leased assets if required. Investors can exercise their rights on the leased assets. It is no wonder that this has been the favorite structure for most *Sukuk* issuances. However, the *Sukuk Ijara* does highlight some concerns on its own.

Another restructuring device available in *Sukuk* restructurings is that of a haircut. The concept of the investors taking a reduction on their investment in

[79] Mohammed Khnifer, Stand and Default, Islamic Business & Finance: CPI Financial. October 2010.

order to induce early repayment has been approved by AAOIFI.

3.3.2.7. Approvals

Sharia board approval of any restructuring plan is really critical, the fear being that what was once certified as Sharia compliant has become non-compliant post restructuring. In particular, compliance of any new amendments to financial documentation and the refinancing structure. Reliance on the issuer's appointed Sharia board is another issue. Some creditors may choose to rely on the issuer's board, while others may require independent Sharia verification.

CHAPTER IV

DISCUSSION: ANALYSIS ON THE SUKUK IJARA RESTRUCTURING IN PT BERLIAN LAJU TANKER TBK.

4.1. Implementation of *Sukuk Ijara* restructuring in PT Berlian Laju Tanker Tbk.

4.1.1. Case Position

PT Berlian Laju Tanker Tbk or BLT is an Indonesia-based shipping company. Its main business is provisioning maritime transportation for liquid bulk cargo. Its business is classified into four operating segments: chemicals, non-organic chemicals, vegetable oil and animal fats; gas tankers, providing maritime transportation for liquefied gas which includes propylene, propane, ethylene, liquefied petroleum gas (LPG) and liquefied natural gas (LNG), among others; oil tankers, providing maritime transportation for lubricating oil, crude oil and petroleum products, and floating production, storage and offloading (FPSO), providing floating tanker facilities for oil production, storage and offloading. Its services include the provision of vessels chartering, vessels operation services and vessels agency services.[80]

In 2007, when the shipping business was at the peak, PT Berlian Laju Tanker Tbk decided to perform the USD850 million acquisition of Marshall Islands-based chemical tanker company Chembulk Tankers LLC, through its subsidiary Asean Maritime Corporation[81], that was mostly financed through loans, which then left the company highly leveraged. The

[80]Financial Times Portfolio, http://markets.ft.com/research/Markets/Tearsheets/Business-profile?s=BLTA:JKT retrieved on Sunday, 30 August 2015.
[81] The Jakarta Post, Berlian acquires Chmebulk Tankers, 2007, Jakarta http://www.thejakartapost.com/news/2007/10/18/berlian-acquires-chembulk-tankers.html retrieved on Saturday, 12 September 2015.

two companies combined became the third-largest owner of chemical tankers in the world with 54 ships and gave the Indonesian firm a presence in the U.S. market.

In 2008, specifically in 20th of May, the Baltic Dry Index[82] hit its highest point of 11,793 points. But, six month later, as the global financial crisis hit, the Baltic Dry Index had dropped by 94% to 663 points.[83] Falling out of that unprecedented global crisis were numerous shipping restructures. As the industry has learnt to cope with the challenges it has faced over the previous seven years, a number of trends have emerged in the restructuring of distressed shipping company. One of the restructuring processes is carried out by PT Berlian Laju Tanker Tbk, a third world's largest chemical tanker based in Jakarta.

The Company's operations were underperforming mainly due to continued poor shipping market conditions since 2008. The Company's main Chemical sector was suffering as market freight rates were decreasing and were at a record low. Most chemical vessels were also due for docking during the year, chalking up higher operating expenses. Similarly, the Oil and Gas sectors were performing poorly due to drop in lucrative contracts. In general, rising costs of fuel and piracy impacted the industry as well. All sectors also faced higher idle days during the year 2008-2011 as the Company's fleet was not fully operating due to oversupply of vessels in the market.

As a result, the company had debt in excess of USD2billion comprising a senior secured syndicate of international banks, high yield USD Bonds, convertible bonds, IDR bonds, lease, derivative, trade claims and the *Sukuk*, which I will discuss further.

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[82] The Baltic Dry Index (BDI) is a series of indices based on reports from independent and competitive shipbrokers. Its purpose is to provide the shippers and the ship-owners with unbiased information on freight rates, and it is thought to be one of the most accurate indicators of economic development in the shipping market. See further http://www.bloomberg.com/quote/BDIY:IND

[83] Eagle, Ryan. Sector Focus: Restructuring in the shipping industry. Ferrier Hodgson. 2014.

The Company's Restructuring Plan was ratified by the decision of the Central Jakarta Commercial Court under Case No. 27/PKPU/2012/PN.NIAGA.JKT.PST, wherein all parties must abide by and perform the terms of the Restructuring Plan. The company will be discharged form the Suspension of Debt Payment Obligation (PKPU) Proceedings.

Following the ratification of the PKPU Plan on 22 March 2013, BLT has focused on improving its business performance and implementing the PKPU Plan. The details of the PKPU Plan is attached. BLT's restructuring initiative's including the rationalization of its fleet size and fleet composition have positively impacted its operational performance – BLT emerged from the restructuring with a younger fleet and optimized trade lanes to maximize profitability. Attached in Schedule is a summary of BLT's financial performance for the years 2012 to 2014 and the budget for 2015.

However, notwithstanding BLT's best efforts, the restructuring efforts have been impeded by a number of external factors including the following:

- Delayed recovery in the shipping market
  Whilst the market has been showing signs of improvement in space demand, there continues to be an oversupply of tonnage in the chemical tanker market which is delaying any market recovery. Seaborne trade with petrochemical products grew at 1% in 2013 and 2% in 2014 compared to the forecast assumptions set out in the PKPU Plan of 3% in 2013 and 4% in 2014.

- Either a delayed or lack of approval from the relevant secured creditors to sell loss-making vessels

BLT identified 4 vessels which have been laid up for the past few years and/or are loss-making for sale and have submitted over 30 good offers to the relevant Indonesian (non-MLA) secured creditors in an effort to obtain the necessary approvals to facilitate the sale. Most of these offers are at a price substantially above if not equivalent to the valuation of the respective vessels at that time. However, the delayed or lack of response/approvals from the relevant secured creditors have resulted in enormous costs being incurred by BLT in respect of vessel lay-up costs, deterioration in vessel values and interest due to the relevant Indonesian (non-MLA) secured creditor (which would not have incurred if BLT repaid the loan due to such relevant secured creditor from the vessel sale proceeds at that time). These unnecessary costs are estimated at USD 10m.

- Entry of new MLA Lenders

  Between February and August 2014, the existing MLA group of bank lenders sold all of their outstanding debts to new financial investors who have more actively pursued a restructuring of BLT than the prior lenders.

- Difficulty in obtaining fundraising

  The PKPU Plan was premised on a further fundraising. The lack of bank finance and investor interest for this industry at this time means that it is unlikely that BLT will secure the funding necessary to meet its payment obligations under the PKPU Plan.

- Risk of delisting by the IDX

  The IDX has indicated its intention to delist BLT if BLT fails to demonstrate any substantive plans by 30 June 2015 to resolve, amongst other things, its capital deficiency and such delisting will trigger a default under the MLA Facility documents

As a result of the various factors set out above, BLT would not be able to meet its principal repayment obligations to the MLA due in September 2015 (and potentially as early as June 2015). The MLA Lenders have advised BLT of their intention to enforce their security at the time. Such enforcement will mean the transfer of substantially all of the assets owned by BLT, including 27 vessels owned by BLT and its subsidiaries, 9 leased vessels, Teekay JV and Buana to the MLA Lenders without compensation. This would leave BLT with the MLA Deficiency Claims and outstanding debts of USD 1.1 Billion owed to the Plan Creditors (both secured and unsecured) respectively, with no realistic way to make any repayment to any creditors or distribution to equity.

Therefore, the restructuring plan is further amended and the current plan is till ongoing. The most crucial part of the instruments being restructured is in the Sukuk restructuring, as until the end of 2015, the settlement is not yet approved.

Back then, BLT issued a *Sukuk Ijara* in 2007 (the "2007 *Sukuk Ijara*") and *Sukuk Ijara* in 2009 *Sukuk Ijara* (the "2009 *Sukuk Ijara*"). On 14 March 2013, the requisite majority of the secured and unsecured creditors of BLT voted to approve a restructuring plan dated 13 March 2013 ("PKPU Plan") for the restructuring of BLT's debts pursuant to its *Penundaan Kewajiban Pembayaran Utang* ("PKPU") process, which include the restructuring of 2007 Sukuk Ijara and the 2009 Sukuk Ijara (the "2013 *Sukuk* Restructuring"). The PKPU Plan was subsequently homologized by the Central Jakarta Commercial Court ("Jakarta Court") on 22 March 2013.

As part of the 2013 *Sukuk* Restructuring, on 16 December 2013 the related documentation relating to the 2007 *Sukuk Ijara and* the 2009 *Sukuk Ijara* were amended, and which documents have been opined by DSN on 17 December 2013 to be in accordance with the fatwas of DSN and sharia

principles in general. Set out below are the details for the 2013 *Sukuk* Restructuring structure and documentation:

2007 *Sukuk Ijara* Documentation

1. Deed of the 2007 BLT *Sukuk Ijara* Trustee Amendment and Restatement Agreement No. 14 dated 16 December 2013 made by and between BLT and Trustee/ *WaliAmana*t) ("**2007 *Sukuk* Trustee Agreement** ")
2. Akad Ijara dated 16 December 2013 made by and between BLT and Chembulk Trading II LLC("**2007 *Sukuk* Head Lease Ijara**")
3. Akad Ijara in relation to the implementation of the settlement agreement and the 2007 BLT *Sukuk Ijara* Trustee Amendment and Restatement Agreement dated 16 December 2013 made by and between BLT and Trustee/ *WaliAmanat* ("**2007 S*ukuk Akad Ijara***")
4. Akad Wakalah in relation to the implementation of the settlement agreement and the 2007 BLT *Sukuk Ijara* Trustee Amendment and Restatement Agreement dated 16 December 2013 made by and between BLT and Trustee/ *WaliAmanat* ("**2007 *Sukuk Akad Wakalah***")

2009 *Sukuk Ijara* Documentation

1. Deed of the 2009 BLT *Sukuk Ijara* Trustee Amendment and Restatement Agreement No. 15 dated 16 December 2013 made by and between BLT and Trustee/ *Wali Amana*t) ("**2007 *Sukuk* Trustee Agreement** ")
2. Akad Ijara dated 16 December 2013 made by and between BLT and Chembulk Trading II LLC ("**2009*Sukuk* Head Lease Ijara**")
3. Akad Ijara in relation to the implementation of the settlement agreement and the 2009 BLT Sukuk Ijara Trustee Amendment and Restatement Agreement dated 16 December 2013 made by and between BLT and Trustee/*Wali Amanat* ("**2009 *Sukuk Akad Ijara***")

4. Akad Wakalah in relation to the implementation of the settlement agreement and the 2009 BLT Sukuk Ijara Trustee Amendment and Restatement Agreement dated 16 December 2013 made by and between BLT and Trustee/*WaliAmanat* ("**2009*Sukuk Akad Wakalah***")
5. Akad Kafalahin relation to the implementation of the settlement agreement and the 2009 BLT Sukuk Ijara Trustee Amendment and Restatement Agreement dated 16 December 2013 made by and between BLT and Trustee/*WaliAmanat* ("**2009 *Sukuk Akad Kafalah****")*

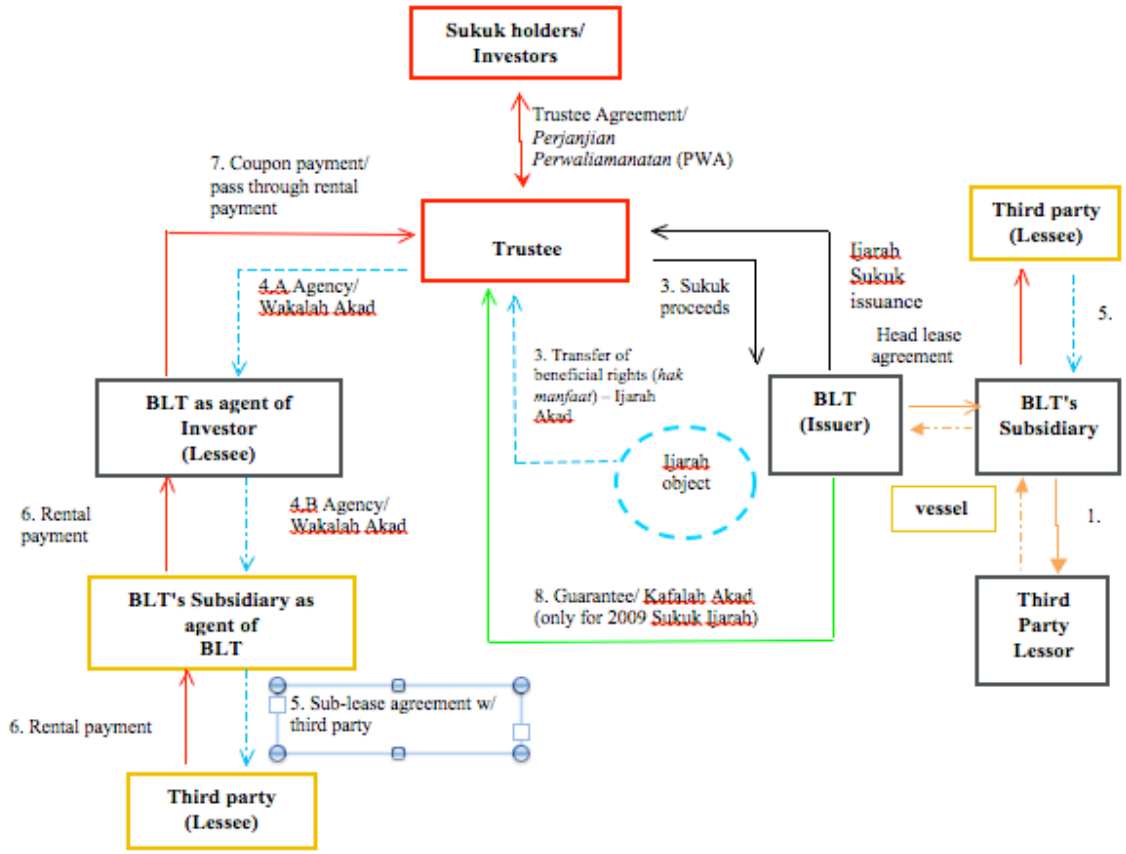
In the proposed settlement of 2007 *Sukuk Ijara* and 2009 *Sukuk Ijara*, basically all of the outstanding scheduled *Sukuk* payments debt pursuant to the PKPU Amendment Plan under the *Sukuk* shall be converted into shares in BLT pursuant to the debt to equity conversion. A contractual settlement of debt by set off is used as the basis of conversion. Under the set off, the outstanding principal debt under the *Sukuk* will be set off against the price consideration owed to BLT by the *Sukuk* holders for the issuance of new shares to them the set off will be stipulated in a settlement agreement. Upon the set off, the *Sukuk* documents will be terminated and, the rights of the *Sukuk* holders and the obligations of BLT under the *Sukuk* documents shall be released and discharged. Furthermore, all of the beneficial rights of the leased objects shall be transferred back to BLT.

After the conversion, the *Sukuk* holders will hold shares in a restructured BLT and will have the opportunity to get returns as the business of BLT improves, including return from the share ownership in NewCo and also the exercise warrant in NewCO. The (1) NewCo Redeemable Equity Interest in the NewCo, in which the shares will be redeemed by NewCo over a five (5) years period equal annual installments equal to one-fifth of US$10m or US$5m (depending on the completion time of the restructuring) after which such equity will be deemed extinguished; and also (2) NewCo Warrants to purchase up to 10% shares in the NewCo

(with an estimated value of USD 58.5m), are basically a reward from the MLA Lenders for doing the restructuring and settling the debt with the MLA Lenders.

Please see below figure for further reference[84]:

- Current Sukuk Structure



Remarks:

Ijara Object: beneficial rights from lease of vessel(s) owned by a third party (through BLT's subsidiary);

1. a Vessel Charter Agreement between a third party lessor to BLT's subsidiary.

2. Head lease agreement with a BLT's subsidiary, BLT owns beneficial rights (*hakmanfaat*) of the leased object.

[84] The figure is based on the Sukuk Restructuring Plan described in the PKPU Plan. It is made only for the purpose to an easier reference and not to be used as the most accurate data.

3. IjaraAkad: Trustee (on behalf of Investors) provides the Sukuk proceeds to BLT and in return BLT transfers the beneficial rights (*hakmanfaat*) of the Ijara Object to the Trustee. There is aIjara Object substitution mechanism, whether on force majeure event or not (other commercial reason), it is stated that the Ijara Object Substitute should have at least the same value with the Sukuk proceeds.

4.A. WakalahAkad: Trustee grants a specific powers/ authorisations (with substitution rights) to BLT to (as agent of the Trustee) lease the Ijara Object to a third party.

4.B. WakalahAkad: BLT grants a specific powers/ authorisations to BLT's subsidiary to (as agent of BLT) lease the Ijara Object to a third party.

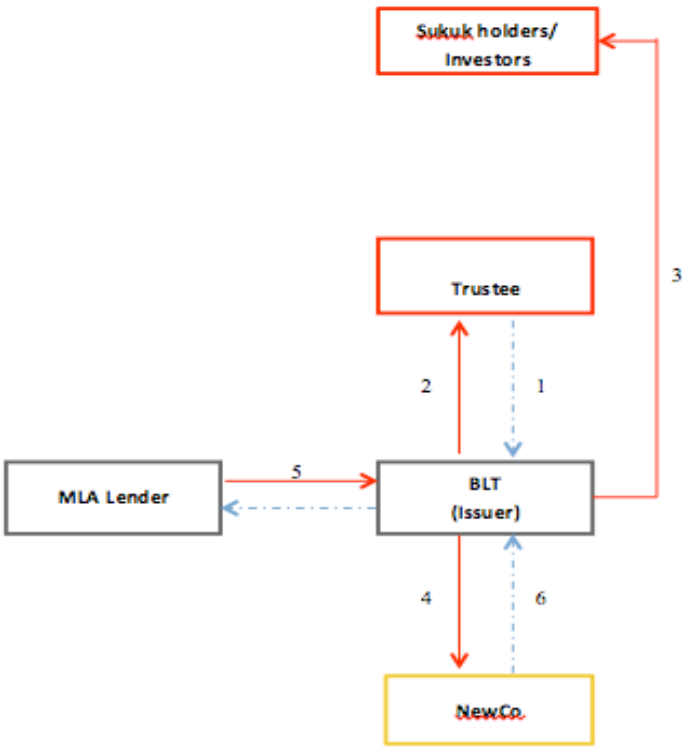
5. Sub-lease agreement: BLT's subsidiary (as agent of BLT) leases the Ijara Object to a third party lessee.

6. Rental payment from the third party lessee to BLT' (pass through from BLT's subsidiary).

7. BLT to further pass-through the rental payment of the Sub-lease agreement to the Trustee (equivalent to Sukuk coupon payment) up to the end of the Ijara term stated in the IjaraAkad.

8. KafalahAkad: In general, BLT guarantees its financial obligations to the Trustee, and in relation to the Ijara object, covenants that (i) it will substitute the Ijara Objects if there is a deterioration of value of Ijara Object and (ii) it will extend or renew the Sub-lease agreement if the Sub-lease agreement ends before the IjaraAkad ends.

- Proposed Settlement Structure



Remarks:

1. Trustee on behalf of the Sukuk holders set off the outstanding debt against the price consideration for the issuance of the converted shares
2. BLT set off the price consideration for the issuance of the converted shares with the converted shares
3. BLT issue shares to each Sukuk Holders
4. BLT transfer assets to NewCo.
5. MLA lenders forgiving all outstanding debt and reward BLT among others with warrant to purchase 10% shares in NewCo and with preferred redeemable equity interest in NewCo, which is controlled by NewCo in return for BLT transferring assets to Newco and for BLT restructuring the debt with the other creditors.
6. The shares will be redeemed by NewCo over a five (5) year period in equal annual installments equal to one-fifth of US$10m or US$5m (depending on the completion time of the restructuring), after which such preferred equity will be deemed extinguished.

In relation with the above restructuring plan, BLT has proposed the following mechanism:

- General Meeting of Shareholders of BLT to approve the issuance of new shares without pre-emptive rights for the unsecured creditors including the *Sukuk* holders;
- Plan Creditor's meeting to approve on the PKPU Amendment Plan;
- BLT to announce to public and to notify OJK on the implementation of the issuance of new shares without pre-emptive rights;
- Shares to be issued proportionately to the new unsecured creditors with a value equivalent to the outstanding debt of each of the unsecured creditor including the *Sukuk* holders;
- Payment of the share price for the *Sukuk* holders shall be agreed to be set-ff with the outstanding debt of the *Sukuk*;
- BLT to announce to public and to notify OJK on the result of the issuance of new shares without pre-emptive rights;
- All of the *Sukuk* documents shall be terminated and, the rights of the *Sukuk* holder and the obligations of BLT shall be released and discharged, and the beneficial rights of the leased objects shall be transferred back.

As mentioned previously in Chapter I, the author aims to discuss the transaction using the approach introduced by Friedman. Each point below will be examined by the theory of Friedman which consists of substance of law, structure of law and culture of law.

4.1.2. The *Sukuk* to equity conversion scenario proposed by PT Berlian Laju Tanker Tbk is Sharia Compliant

4.1.2.1. The conversion of *Sukuk* to equity is Sharia compliant.

4.1.2.1.1. Substance approach to the *Sukuk* to equity conversion.

In relation with the substance of law approach, Friedman has explained*" Another aspect of the legal system is its substance. By this is meant the actual rules, norm, and behavioral patterns of people inside the system… the stress here is on living law, not just rules in law books."*[85] From the above approach, the author would seek how the relevant regulations implemented into the transactions and to see whether any other influences outside the legal framework itself.

According to the author's opinion that at this moment, there is no specific fatwa from DSN restricting or permitting a transaction of restructuring in the form of *Sukuk* to Equity conversion. However, the author notes that under 2010 AAOIFI's Sharia Standard, a contractual set-off is permissible as long as the following conditions are fulfilled:

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[85] Friedman, L.M. (1998). *Some Thoughts on the Rule of Law, Legal Culture and Modernity in Comparative Perspective.* Toward Comparative Law in the 21st Century Tokyo, Chuo University Press: 1075-90.

- Each party should be a creditor of debtor simultaneously;
- The two parties should mutually consent to the set-off;
- The set-off should not be arranged in a manner that results in violation of a rule of Sharia, such as *riba* or a transaction potentially involving *riba*.

The first and second point above can be fulfilled by way of agreeing the price consideration owed to PT Berlian Laju Tanker Tbk by the *Sukuk* holders for the issuance of new shares to them to be set off against the outstanding debt under the *Sukuk* owed by BLT to the *Sukuk* holders.

As of the third point above, the author understands that there is a need to propose an opinion from DSN to ensure the proposed conversion structure would not constitute a *riba* or a violation of a rule of Sharia, therefore is Sharia compliant. Moreover, the role DSN MUI has been strengthened by the Memorandum of Understanding entered into by OJK and DSN MUI on Tuesday, 11 November 2015. However the goal of the MoU is not to give certain authority or power to DSN MUI, the purpose to involve DSN in the development and supervisory in Indonesia Sharia finance is a stepping-stone for a further cooperation.

Referring to the interview with Mr. Adhiwarman Karim, the chairman of DSN, the structure proposed might not be sharia compliant giving the reason that the creditor from having a claim will be having a liability since post-

restructuring, BLT will still have some remaining debts. However, the author does not share the same view on this just because the basic concept of limited liability company in general and under Indonesian company law in particular.

In a limited liability company the liabilities of the company is separate from its shareholders and therefore the liabilities of the limited liability company will not be the liabilities of its shareholders. Based on Article 3 (1) Law No. 40/2007 on Company Law, companies' shareholders are not personally liable for legal relationships entered into on behalf of the Company and are not liable for the company's losses in excess of the shares they own.

This concept is also recognized in Sharia law as shown by the 2010 AAOIFI's Sharia Standard. Under the standard, a stock company has a juristic personality through its incorporation by law. This separates the liability of the from its shareholders and also establishes for it a separate legal capacity as required for necessary legal arrangements, irrespective of the legal capacity of the shareholders.

According to some transaction precedents in the Gulf Cooperation Countries, the author found some opinions from the Sharia actors which hinted or stated the feasibility of debt to equity conversion under Sharia law. One of the example is the Investment Dar *Sukuk* which was restructured in 2011, in which the author understands part of the arrangement was to convert part of the claims of the creditors into equity. The other one is Dana Gas *Sukuk* which was restructured in 2012, in which part of the

original outstanding *Sukuk* amount is restructured into a new *Sukuk* consisting of two tranches being an ordinary *Sukuk* and convertible *Sukuk*.

Furthermore, based on the Fatwa No. 59/DSN-MUI/V/2007 on Convertible *Mudharabah Sukuk* , it can be concluded that basically *Sukuk* to equity conversion is permissible by DSN, since under the fatwa the *Sukuk* can be converted by the investors into shares of the issuer at the maturity date. It is worth to note as well that under the Indonesian Sharia Banking Law and OJK Regulation NO. 16/POJK.03/2014 dated 18 November 2014 on Sharia Banks and Sharia Business Units' Assets Valuation, temporary holding of shares by Sharia Banks and Sharia business units are permissible subject to certain requirement. However, this understanding is based on assumption that *Sukuk* can be converted as there has been similar conversion (in this case *Mudharabah Sukuk*), however, there is no certain Fatwa to regulate the transaction in *Ijara* structure specifically.

Although the transaction scenario of converting *Sukuk* to equity is might be permissible given the International practices and precedents, in Indonesia itself, there is insufficient legal framework and crucial problem with regards of the *Sukuk Ijara* practice.

To conclude with the substance approach of Friedman, the author agrees that during the transactions, the obligors to the transactions do not only directly implemented the prevailing laws and regulations, yet, there are still many

considerations outside the law including the living laws constructed by the DSN Opinion as well as the Sharia principles itself. However, the author notes that there is still a room of improvement in the legal framework so that these provide a more certain legal frameworks.

4.1.2.1.2. Structure approach to the *Sukuk* to equity conversion.

Friedman has explained that with the structure of law, it means how legislature is organized, in a way, is a kind of cross section of the legal system.[86] In relation with this approach, the author understands that there is an adjustment of the original structure of Sukuk Ijara issuance in Indonesia, due to the legal nature in Indonesia which derived from the Dutch law, while Sukuk Ijara is based on Islamic law. In this part, the author would like to compare the structure of Sukuk Ijara that used in international practice with the structured used in Indonesia and see how the adjustment there.

In relation with the original structure, as mentioned in Chapter 3 of this undergraduate thesis, we understand that there is a different implementation between the *Sukuk Ijara* transaction imposed internationally and implemented in Indonesia. The basis on why the internationally used structure is not acceptable in Indonesia is because there is no such separation of legal owner and beneficial owner.

According to the author's opinion that under International practice, there is a requirement to have a Special Purpose

[86] Ibid.

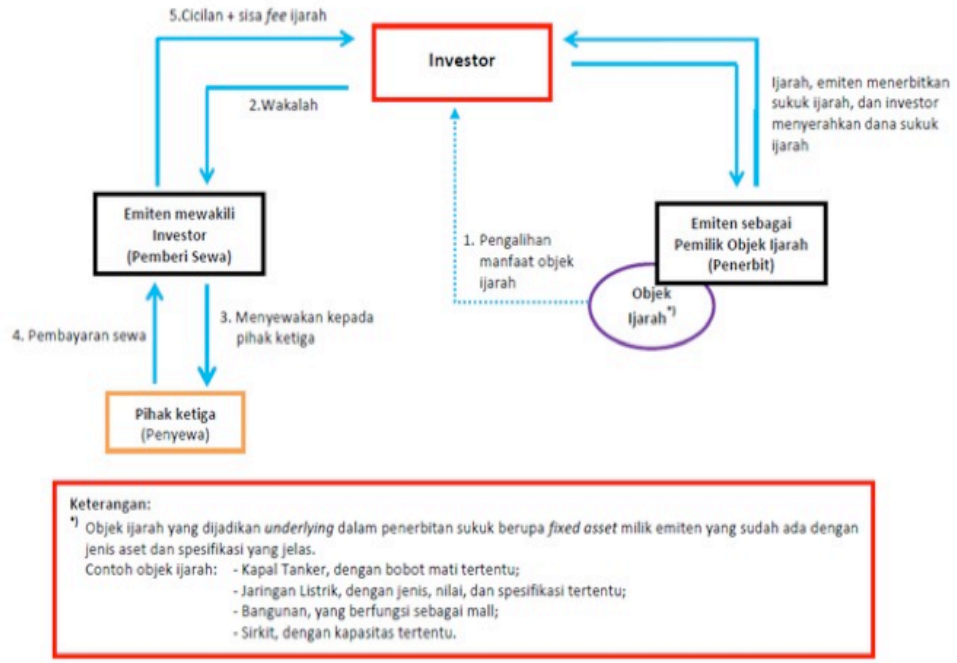
Vehicle (SPV), for which in the event that there is an event of default of the transaction, the SPV shall execute the security or assets derived from the underlying transactions. While in Indonesia, there is no such actual underlying transactions prior to the *Sukuk* issuance. In the author opinion, the underlying assets are still possessed by the issuer of *Sukuk* itself, making it less secured from the perspective of *Sukuk* holder. Under the Indonesian Law, such differentiation of legal owner and beneficial owner is not recognized.

However, under Article 1317 of Indonesian Civil Code, there is an indication that such institution might be established in Indonesia:

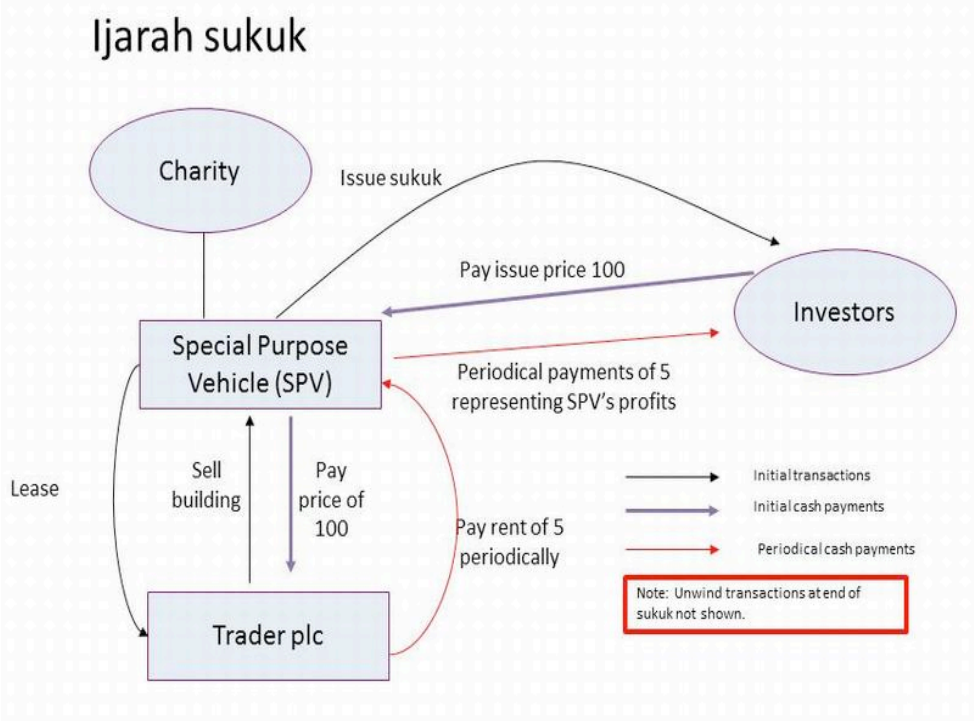
"Besides, it is allowed to request to establish a promise for the interest of a third party, if a confirmation of promise, that is made by a person for himself, or a conferral that made by him to the other person contains such promise. Whoever made such a promise cannot take it back, if such party has declared to use it."

Please see below figure for the comparison:

(i) The following figure is taken from the presentation delivered by Direktorat Pasar Modal Syariah Otoritas Jasa Keuangan, presented by Muhammad Touriq, the relevant director:



(ii) The following figure is taken from JP Morgan Chase Bank Dubai:



The author also notes the *Akad Ijara* entered into between PT Berlian Laju Tanker Tbk and the Trustee provides the *Ijara* Object substation mechanism, whether on force majeure event or not (other commercial reason), it is stated that the *Ijara* Object Substitute should have at least the same value with the *Sukuk* proceeds. Moreover in the *Kafalah Akad* entered in relation to the 2009 *Sukuk* issuance, in general BLT guarantees its financial obligation to the Trustee, and in relation to the Ijara object, covenants that (i) it will substitute the *Ijara* Object if there is a deterioration of value of *Ijara* Object and (ii) it will extend or renew the Sub-Lease Agreement if the Sub-lease agreement ends before the *Ijara Akad* ends.

However, in fact, the reality is that the company, PT Berlian Laju Tanker Tbk has defaulted five types of financing instruments, which amounted nearly USD 2 Billion. Since the *Sukuk* is said only 2% of the whole debts, the company has given this less priority, making most of the assets are transferred already to settle the bigger debts. In the end, the remaining assets (considering the significant slumps of the value) cannot repay the amount of the *Sukuk* proceeds.

Further, the author notes from the Article 15 of Deed No. 6 dated 1 April 2009 on *Perjanjian Perwaliamanatan Sukuk Ijarah Berlian Laju Tanker II Tahun 2009* (as attached), made before Robert Purba, Sarjana Hukum, Notary in Jakarta, there is no such undertaking to include the financial

crisis issue as a factor of *Force Majeure,* like or dislike, the company should perform a debt restructuring process, which will almost never, repay the amount of investment has been given bearing in mind that there is a significant slumps in the value of underlying assets.

In the author understanding, it can only be anticipated if since the beginning, there was a so-called Special Purpose Vehicle which acts as remote bankruptcy agent. In relation with that, Indonesia needs to have a more comprehensive approach in adapting the originality of the Sharia structure.

Based on the theory discussed in Chapter 3, we all understand that a *Sukuk Ijara* issuance under the International practice always required underlying assets from an underlying transaction (in the form of sale and purchase), while in Indonesia, especially in this case, there is no such underlying transactions as the assets are still possessed by the Issuer itself. The Indonesia legal experts says that it is impossible to adapt the Internationally imposed Sukuk structure as it is in the contrary with Indonesian Law, on the other hand, there has been a violation of Sharia principles which may lead into significant troubles, like the one occurred in PT Berlian Laju Tanker.

In relation with the structure approach of Friedman, there is an urgency to, as an obligation, incorporate a specific institution like SPV in order to anticipate further commercial risk. Friedman opines the through the structure, we would see a better procedures and distribution of jurisdiction. Therefore, an SPV should exist to perform a

better settlement procedure and in the event of bankruptcy, it has a full jurisdiction to do the resolutions.

4.1.2.2. The shares to be issued as part of the conversion shall be deemed as Sharia compliant.

Further, using the Friedman approach of substance, the author should also examine on how can the shares to be issued as part of the conversion be deemed as Sharia compliant.

Under the *Perjanjian Perwaliamanatan* and the data from PT Berlian Laju Tanker (as attached), the author is aware that some of the *Sukuk* holders are Islamic financial institution, and therefore one of the issues that needs to be considered is whether the proposed new shares will need to be Sharia compliant for them and how can it be deemed as such.

In order for the shares to be recognized as Sharia compliant under Indonesian Law, the shares and BLT would need to fulfill the requirement under the fatwas and the capital market rules.

For the requirements under the fatwas, DSN Fatwa No. 40/DSN-MUI/X/2003 on Capital Market and Sharia Principles Implementation in Capital Market ("Capital Market Fatwa"), stipulates that a securities (in this case shares) is deemed to be Sharia compliant if it has obtained such opinion from DSN.

One related point to consider under the Capital Market Fatwa is that, one of the business activities that are categorized as not sharia compliant is investing in a company, which at the time of the transaction has a conventional debt larger than its equity. Another point to consider under the Capital Market Fatwa is that the price of the shares will need to reflect the actual value of the

assets underlying the issuance of the shares and/or in accordance with efficient, fair and organized market mechanism without any engineering.

For the requirements under the capital market rules, Bapepam-LK Rule IX.A.13 stipulates that a sharia securities is a securities as meant under the capital market law and regulations, which *akad*, mechanics and business activities that forms the basis of the issuance are not in violation of the Islamic Law principles in capital market based on the DSN Fatwas as long as such fatwas are not in contradiction with the capital market rules issued based on DSN Fatwas.

Furthermore, in Indonesian capital market, there are indexes or lists ("**Daftar Efek Syariah**" or "**DES**") issued by OJK or a sharia securities index issuer, which would periodically list down the names of companies which have issued sharia compliant securities, particularly shares. For the DES issued by OJK, the inclusion of securities to the list is done by way of an OJK board of commissioner decree in which the shares will also be stipulated as a sharia securities. Under Bapepam-LK Rule II.K.1, it is worth to note that one of the conditions for inclusion of sharia securities in the form of shares in OJK's DES (for companies which has not stated in its articles of associations that its business operation and management is in compliance with sharia principles) is that in addition to having a sharia compliance line of business, the company fulfills the following financial ratios:

- Total interest based debt compared to total asset is not more than 45%; or
- Total interest based revenue and other non-halal revenues compared to the total business revenue and other revenues are not more than 10%.

Thus, if PT Berlian Laju Tanker wishes to have the conversion shares included in OJK's DES and for the BLT's shares to be deemed as sharia securities by OJK, the company will need to ensure that its current line of business is sharia compliant and the above ratios are met.

In relation with the above scenario, the author understand from its latest financial statement, PT Berlian Laju Tanker Tbk has debts for up to 50% of its total assets, also bearing in mind that the current price of its assets has significantly declined.

Besides, using the Friedmann approach of culture and structure, the author understands that since the beginning, Sharia Principles has been several times waived to accommodate the interest of Indonesian Law (like happened before in the *Sukuk Ijara* issuance). The author anticipates that there is further adjustment which might create further issues in the future.

4.1.2.3. Warrant in the NewCo and the preferred redeemable equity interest in the NewCo are Sharia compliant.

Further in the restructuring transaction, the author also has to examine whether the warrant in the NewCo and the preferred redeemable equity interest in the NewCo are sharia compliant.

With regards to warrant, the author notes that there is a DSN Fatwa No. 66/DSN-MUI/III/2008 on Sharia Warrant ("**Warrant Fatwa**"). However, the author understands that the fatwa is for warrant issued by a public listed company in Indonesia and only for shares which are listed in the DES. The author does note that some Sharia scholars have hinted as well that warrant in general is permissible.

Under the Warrant Fatwa, the Warrant can only be for sharia compliant shares and that the exercise price should reflect the actual value of the assets underlying the issuance of the shares and/or in accordance with efficient, fair and organized market mechanism without any engineering as per the Capital Market Fatwa. This being said, DSN when considering the compliance of the NewCo warrant and sharia compliance of the BLT shares might consider these factors to be fulfilled as well.

In the proposed restructuring structure, we understand that the warrants are granted in return for BLT completing the restructuring within the stipulated timeline. As such, It may be possible to construe the warrants and the redeemable equity interest as basically rewards for BLT for completing the restructuring plan in time. A reward under Sharia Law is allowed as shown by the following *hadits*. Abd Allah Ibn Umar reported that the Prophet Muhammad (SAW) once said, *"give gift, and you will love each other"*. There is also a record from Abu Hurairah ra that the Prophet Muhammad (SAW) once said: *"give gift, for a gift shall relieve hatred"*. This being said, the argument would be to say that the warrant is not a free warrant but a reward for completion of an undertaking.

In relation with the Preferred Redeemable Equity Interest, the author do es note that under the 2010 AAOIFI Sharia Standard, it is not permitted to issue preference shares that have special financial features leading to the granting of priority to these shares at the time of liquidation or the distribution of profits. What permissible is only the granting of certain shares features related to procedural or administration matters, like voting rights. Further, under Capital Market Fatwa, we note that sharia compliant shares does not include shares with special rights.

Furthermore, the author also understands that under the 2010 AAOIFI's Sharia Standard is not permitted to issue enjoyment shares (tamattu') which are shares that entitles the holder a participation in the net profit, but not toe vote and which are gradually redeemed before the termination of the company through distribution of profits.

The author understands that under the restructuring plan, in return of completing the restructuring plan, BLT will get NewCo Redeemable Equity Interest in the New Co in which the shares will be redeemed by NewCo over a five (5) year period in equal annual installments equal to one-fifth of USD10million or USD5Million (depending on the completion time of the restructuring). Based on these features and in light of the above explanation, there is no possibility that DSN might view the shares as shares with special rights which are restricted based on the above and therefore DSN might view the shares as haram or not Sharia compliant.

4.2 The implementation of Indonesia legal frameworks in the transactions.

4.2.1 The substance of law approach in relation with prevailing laws and regulations

The author understands that in relation with Capital Market, the government of Indonesia has granted special authority to OJK, through Law No. 21/2011 on Otoritas Jasa Keuangan. Specifically through its Art. 6 (b), the OJK is authorized to hold the regulatory and supervisory function in Capital Market since the transfer of power from its predecessor Bapepam-LK as of 31 December 2012.

To date, with regards to the regulatory of Sharia Capital Market, the author notes that there are several OJK Regulations that has been issued (as explained in Chapter 3). However, there are still some rooms of improvements to be noted.

For instance, in relations with the Principles of Sharia Capital Market, Bapepam-LK Rule IX.A.13 stipulates in its Art. 1(b) that *"Principles of Sharia Capital Market are principles in the Islamic law in the Sharia Capital Market activities in accordance with the Fatwa of Dewan Syariah Nasional Majelis Ulama Indonesia (DSN-MUI)", either any Fatwa which has been stipulated in Bapepam-LK Rules or Fatwas that has been issued prior to this regulation, as long as the fatwa itself is not in the contrary with this regulation and other Bapepam LK rules which are based on Fatwa DSN-MUI."*

Based on the abovementioned, the author understands that there will be confusion of which is higher than which. At some cases, Fatwa is used as the basis of the formulation of Sharia Capital Market regulation, however, the Fatwa itself shall not be in contrary with the prevailing laws and regulations. Further, there will be an assumption that a Fatwa (which contains of genuine Islamic principles) shall be adjusted to be accepted by Indonesian laws. This then might lead to the abuse of Sharia principles.

There is also no legal maxim stipulating the position of DSN Fatwas which is required in the transaction. Note that based on the Bapepam-LK Rule IX.A.13, any kind of business which is to be defined as Sharia in order to later issue a Sharia instrument, shall be examined by DSN MUI, and therefore a DSN Opinion is required. However, there is further position saying that a Fatwa/Opinion shall not be in contradiction with the Indonesian law or regulations which are relevant to the case. Given the fact mentioned, there is no further mechanism if the DSN Opinion is referring to the Sharia but then it is not approved under Indonesian law. Ideally, if such case occurs, then the

transaction shall be terminated. In the practice, most of the transactions are then adjusted to conform with any terms and conditions, neglecting the principles.

Back to the case, the author understands that DSN-MUI has given an opinion that actually the conversion of *Sukuk* to equity is not Sharia compliant. However, from the prevailing laws and regulations, no violations have been made to them. At the end, the transactions still cannot we performed well since there is a conflict.

Further, the author notes that Indonesian laws have been derived from the Dutch law which has different principles with Islamic law in nature. The homogenization of conventional and Islamic law in Indonesia has brought significant issues which should be taken into attention.

Referring from the case, the court decision to grant the BLT with Suspension of Debt Payment Obligation (PKPU) has been rendered through a commercial court, which is basically in accordance with conventional law. The decision has contained that all the debts to be restructured should be done through debt to equity conversion. In fact, there is one instrument, *Sukuk Ijara,* which should be restructured through debt to equity conversion, while in the reality, there is no regulations to govern such transaction. An assumption has been made to meet the instruction in the PKPU Plan.

From the discussion in point 4.1, the author may note that the proposed Sukuk to equity conversion is firstly based on an assumption that under Fatwa No. 59/DSN-MUI/V/2007 on Convertible *Mudharabah Sukuk*, a *Sukuk* can actually be converted. However, if we look further to the nature, the basic of the transaction is different. The once which is carried out by the PT Berlian Laju Tanker Tbk is *Ijara* transaction, which is not regulated in any fatwa of laws.

Therefore, the author would opine that there is an urgency to provide a certain line of institutions which governs Sharia matters. Only that way, there is no further confusion in the event Sharia transactions contradicting conventional law. One of the example is in this case, the author understands that the PKPU Plan is decided by the Commercial Court which is a conventional court. The decision is imposed to the company to all debts regardless there is an instrument which requires a special treatment, like Sharia bonds or *Sukuk*. This further creates confusion when the instruction of the PKPU is to convert all the debts to equity, and it never happens before in Indonesia, moreover there is no legal framework has been prepared for this.

4.2.2 The structure of law approach in relation with prevailing laws and regualtions

The author also understand that the legal frameworks in Indonesia are somehow not in accordance with the Sharia principles. The example is the elimination of SPV in *Sukuk Ijara* structure.

The author notes that actually under the Article 1338 of Indonesian Civil Code, "All agreements that are made legally shall apply as the law between the parties there to," can be used as the foundations to create any structure of transaction, save as all parties thereto agree to the structure of the transaction.

Further, the author understands that in Indonesia there is no such theory which separate the beneficial owner and legal owner. The author shall opine that in relation with the Sukuk Ijara structure, especially in relation with the Sharia compliant, Indonesia Government should act flexible and prepare a legal framework to stipulate such things. Further, there is such support in Article 1317 of the Indonesian Civil Code, *"Besides, it is allowed to request to establish a promise for the interest of a third party, if a confirmation of promise, that is made by a person for himself, or a conferral that made by him to the other person contains such promise. Whoever made such a promise*

cannot take it back, if such party has declared to use it," there is a possibility to establish such institution which is similar to an SPV in nature.

4.2.3 The culture of law approach in relation with prevailing laws and regulations

Further, using the culture of law approach of Friedmann, the author understands most laws or regulations in Indonesia are regulated while there is a significant case which arise an urgency to create a new law to later anticipate any similar case in the future, sometimes it is called a bottom up pattern. In relation with that, the author does note that Indonesia Government, are still requiring a more further regulations or guidelines to protect the interest of parties in the transaction. Such conversion of *Sukuk* to equity has been implemented many times in International transactions, so we have only to further adjust to be in accordance with the local condition.

From the above discussion, the prevailing laws and regulations are not well implemented due to the mixed practice of conventional and Sharia laws and regulations. The author further opines that there should be huge improvement in relations with the issues mentioned above.

CHAPTER V

CONCLUSIONS AND RECOMMENDATIONS

5.1. Conclusions

5.1.1. Using the substance of law approach, the Sukuk Ijara restructuring through *Sukuk* to equity conversion has been Sharia compliant if we see from the perspective of Sharia principles implemented in the international market (e.g. AAOIFI Standards). However, local prevailing laws and regulations do not provide specifically any provisions in relation the type of transaction which is used in this case. Further, an assumption is used to perform the transaction which will actually cause a legal uncertainty. In relation with the shares issued from the conversion process, the issue comes since the majority *Sukuk* holder is an Islamic Institution, which further makes the transaction cannot run well due to the prohibition of Islamic Institution to invest in a company which has ratio of debt larger than its assets. With regards to the grant of Warrant to the Company, there is a specific Fatwa which allows the said transaction, meanwhile, the preferred redeemable shares is not Sharia compliant under AAOIFI Standards.

In relation with structure of law approach, the elimination of SPV in the Sukuk Ijara transactions in Indonesia has become an issue in the event that a company should be declared bankrupt or granted by suspension of debt payment obligations. It would be an issue shall the relevant company has only one outstanding debts, however, it would be serious problem if the company has multiple debts which even regulated under multiple laws. Moreover, the elimination of SPV can be seen as Sharia violation as it cause no

underlying transactions and creates a bigger risk, which in the contrary with Sharia principles to remain justice between obligors.

5.1.2. The implementation of Indonesia legal framework in relation with the transactions has been mixed with living laws of Sharia (which are not stipulated under formal laws or regulations) and cultural market decision. The author would opines the this issue has been caused by the absence of clear and comprehensive laws and regulations to govern such specific transactions.

Further, in the author opinion, the combination of conventional and Sharia law with regards to the PKPU plan is not a good idea since they have different natures. This will create further complication in the implementation as we can see in the transaction above. The author understands that the homologation of the PKPU Plan is to further the plan agreed by parties involved in the restructuring. On the other side, a debt restructuring shall also comply with the prevailing laws and regulations. The fact that there is no such regulation to govern specifically the Sukuk to equity conversion in Indonesia might cause further issues, as what have been happening in the meantime.

Further, the author notes that the position of DSN MUI is still unclear, given the fact, Indonesian Government should provide a certain legal framework to recognize, in a very clear manner, the role of MUI and the authority of MUI in relation with any Sharia transactions. Indonesia government should also have given an absolute authority to DSN MUI in relation with a transaction which should be Sharia compliant.

5.2. Recommendations

5.2.1. A specific regulation to govern settlement of Islamic finance should issue to avoid future similar issue in the event a default shall arise. This regulation should also distinguish the implementation of each type of Islamic transactions (e.g. whether it is an asset-based or asset-backed, whether it is an *Ijara* or *Mudharaba*, etc).

5.2.2. In order to respond with the confusion of the transactions, there is an urgency to incorporate a separate set of institutions to govern any transactions which should be in accordance with Sharia principles. A separate settlement institution (apart from the conventional bodies) will make the process easier and less debatable.

5.2.3. The government, through Otoritas Jasa Keuangan, should reconsider to fully adopt the transactions structure as has been imposed internationally. The fact that there are still many issuance transactions which adapt international precedents is one of the reasons. The adjustment of such original structure might cause also to a Sharia principles violations.

5.2.4. Any new transactions, if it is not regulated by law, must be then used as a precedent considering that there is insufficient law in Indonesia. Once the transactions precedent is enough, it might be then compiled into law.

5.2.5. There is an urgency to provide a more comprehensive legal framework in Indonesia which accommodate the interest of Sharia market, including the authority of DSN MUI.

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APPENDIX

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