

Nam, Ilchong; Oh, Soogeun

**Research Report**

## Bankruptcy of Large Firms and Exit Mechanisms in Korea

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Research Monograph | 2000-01

# **Bankruptcy of Large Firms and Exit Mechanisms in Korea**

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## **KDI Research Monograph 2000-01**

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## Preface

Exit mechanisms have long been criticized by many to be the root cause of many economic problems in Korea. In fact, it would be difficult to deny that the bailouts of large firms that had gone on for several years on a large scale played a crucial role in bringing about the recent economic crisis, from which Korea has yet to recover completely. In retrospect, exit mechanisms have rarely worked smoothly for large *chaebol* firms in Korea. Before the Kim Yong Sam administration, virtually all bankruptcy cases involving large firms had been handled by the administrative branch of the government in the context of industrial, or *chaebol* policies. Under the Kim Yong Sam administration, prevailing policy toward large, ailing firms was simple bailouts. However, as losses from bad loans exceeded the depths of financial institutions' pockets, the system collapsed. In the meantime, formal bankruptcy proceedings had not been given a fair chance to develop into a reliable mechanism.

The efficiency of exit mechanisms has become even more important since the onset of the crisis, as roughly one-third of the *chaebol* firms went bankrupt. While it was widely believed that exit mechanisms in Korea had serious deficiencies, there has not been a rigorous and comprehensive analysis of exit mechanisms in Korea. This monograph, written by Il Chong Nam of KDI and Soogeun Oh of Ewha Womans University, is the result of the first such attempt at finding the major weaknesses in exit mechanisms in Korea and the probable causes of those weaknesses.

This monograph offers a comprehensive view of the exit mechanisms in Korea, from the main features of the Corporate

Reorganization Act, the Composition Act, and the Bankruptcy Act to the details on how workout programs function, to the rationalization measures that had been widely used in the past. It contains not only analyses of the various institutional arrangements concerning ailing firms, which lead to a list of structural problems that the authors identify, but also a set of tentative solutions that the authors think are necessary to make the system function more effectively. The authors go on to ask why the system does not work, and what caused the plethora of bankruptcies among the large *chaebol* firms, and attempt to give answers. This monograph also contains a chapter that provides a comparative analysis of the bankruptcy proceedings of six Asian countries.

I find this monograph not only useful for economists and policy makers, but also intellectually stimulating. I hope that the readers will share my view. Finally, I would like to gratefully acknowledge the support of the OECD for its assistance with parts of the research.

**Jin Soon Lee**

President

Korea Development Institute

December 2000

Seoul

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## Summary

This report deals with two fundamental questions that face the Korean economy: why did so many large firms go bankrupt, and what is wrong with the insolvency mechanisms in Korea? Roughly one third to one half of the medium-sized *chaebols* went bankrupt or fell into deep financial trouble after the onset of the crisis. In addition, essentially all of the firms belonging to the Daewoo group, one of the top five *chaebols*, went bankrupt. Some firms affiliated with the other top five *chaebols* have also fallen into financial difficulties. Massive bankruptcy of *chaebol* firms led to deep financial difficulties of banks and non-bank financial institutions, which in turn resulted in a massive injection of public funds. Even after the outbreak of the crisis, lack of confidence in the court-supervised bankruptcy proceedings led to the wide use of so-called workouts. The laws on court-supervised bankruptcy proceedings have recently been revised twice, but have not been able to gain full confidence of market participants.

Officially, there are three mechanisms that parties with interests in a bankrupt firm can resort to: bankruptcy (forced liquidation), reorganization, and composition. However, these court-supervised proceedings have not been used much in the past when it comes to large insolvent firms. Before the onset of the crisis, financial difficulty of large firms had traditionally been handled by the administrative branch of the government in an industrial policy context. The focus on such government-led mechanisms, often called rationalization measures, centered around the survival and continued operation of the firms

involved. The rights and interests of the creditors, especially those of banks, had been largely ignored. As a consequence, formal bankruptcy proceedings have not had a chance to develop into well-functioning exit mechanisms.

The court-supervised bankruptcy mechanisms suffer from several shortcomings. The composition procedure allows only the management of the bankrupt firm to initiate the proceedings, and at the same time gives management the exclusive right to draw up the plan. This proceeding is suitable for relatively small firms with relatively simple debt structures and has originally been introduced to handle bankruptcy of such debtor firms. However, The composition proceeding was frequently used by dominant shareholders of bankrupt firms as a way to bypass reorganization or forced liquidation during the period from 1997 to 1999.

The reorganization proceeding, on the other hand, allows both the creditors and the management of debtor firms to initiate proceedings and leaves the power to draw up reorganization plans in the hands of a court-appointed trustee. The reorganization proceeding allows the court to nullify shares held by dominant shareholders when the court finds that these shareholders are primarily responsible for the demise of the firm. Nonetheless, it was frequently abused by the dominant shareholders of bankrupt firms, mainly as a way to avoid liquidation or to extract concessions from creditors needed to keep their firms afloat.

Prior to the crisis, the reorganization procedure tended to be too lenient in granting reorganization. The court also tended to passively authorize reorganization plans that had been agreed upon by creditors and the bankrupt firms, even when it was quite clear that liquidation was a more efficient alternative, or when the rescheduled debt payment plans were impossible to achieve. The reorganization procedure also suffered from the lack of proper corporate governance structures in bankrupt

firms. Court appointed trustees faced a reward system that gave them little incentive to try to increase the value of firms under their control. They sometimes colluded with the dominant shareholders and helped them to continue indulging in asset-stripping activities.

The bankruptcy proceeding, which deals with liquidation of debtor firms forced and supervised by the court, has rarely been relied upon as a way to deal with bankrupt firms. In fact, liquidation has almost never been considered as a practical option to resolve bankruptcy of large firms by anyone in Korea until very recently.

Two revisions made after the outbreak of the crisis required that the court use an economic criterion in determining whether a firm should be granted reorganization and that the court should not allow composition for large firms. Thus, large firms were limited to reorganization if they chose to remain as going-concerns. The court also changed its attitude toward the bankrupt firms and nullified most of the shares owned by dominant shareholders of bankrupt firms that applied for reorganization. As a result of these and other reforms, the probability of reorganization being granted to only the firms whose going-concern values exceed the liquidation values increased substantially.

However, sizable room appears to exist for improvement of reorganization proceedings. Unsecured creditors are allowed to use holdout tactics in order to extract concessions from secured creditors. Such tactics could lead to inequitable and inefficient outcomes. Corporate governance structures of the firms under court receivership failed to make management objectives clear or to align incentives of managers with performance of the firms. The proceeding also appears to allow management of bankrupt firms to indulge in a wide range of asset-stripping activities, both before and after firms enter reorganization procedure.

The authors claim that the most important factor behind the

malfunctioning of bankruptcy proceedings in Korea is the lack of proper corporate governance in financial institutions and large firms. Banks in Korea have been run as if they were government businesses; and as a consequence, they have not been supervised by a proper governance structure that is profit-oriented. Lack of proper governance was the main reason that banks did not act properly as creditors in bankruptcy proceedings and passively followed initiatives of debtor firms and the government.

Non-bank financial institutions are privately owned and managed. However, most were associated with *chaebols*, and hence, did not operate as profit-seekers in a normal sense and frequently served as cash vaults for the *chaebol* firms in the real sector. They too failed in responding properly as creditors to bankrupt debtor firms. Prudential supervision was also not effective.

Lack of proper governance structures in banks and large firms was also a main reason for the plethora of bankruptcies of large firms in Korea. For the past three or four decades, the Korean government has relied upon the *chaebol* system for fast industrialization. Under the *chaebol* system, the government forced banks to make loans to the large firms controlled by *chaebols* and let them use the money in ways that lacked accountability and transparency. Such a policy induced *chaebol* firms to borrow heavily from banks and other financial institutions. *Chaebols* ended up being able to control huge amounts of assets with only a small amount of their own funds. Lack of accountability and transparency in using the borrowed money, coupled with high leverage of *chaebol* firms and absence of proper governance structures, finally led to the massive failure of large firms in Korea.

This monograph also contains a chapter focusing on a comparative analysis of bankruptcy proceedings of the following six East Asian countries: Singapore, Malaysia, the Philippines,

Thailand, Indonesia, and Korea. The comparative analysis generally confirms that Singapore and Malaysia are equipped with superior institutional infrastructures concerning corporate governance of large firms and reallocation of resources from bankrupt firms, compared to the other four countries that have been adversely affected by the economic crisis. The monograph concludes with a set of proposals that the authors believe is needed to improve the efficiency of bankruptcy proceedings in Korea.



## I. Introduction

Several authors have suggested that lack of a market-based economic system was the fundamental cause of the economic crisis of Korea as well as the other East Asian countries such as Indonesia and Thailand.<sup>1</sup> Among the institutional arrangements that constitute a market-based economic system, insolvency mechanisms received particular attention, as crisis-stricken countries experienced massive bankruptcies of firms and financial institutions. In Korea, lack of well-functioning exit mechanisms for large firms has long been identified as one of the major drawbacks of the Korean economy. In fact, this deficiency has been closely associated with the economic crisis that started in 1997.

The cases of Hanbo and Kia led to suspicions in the financial market concerning the ability of the system to handle large bankrupt firms in Korea. Both firms were known to have much more debt than they could service, but continued operations as if nothing had happened. Creditors kept extending fresh loans to keep them afloat, while neither the firms nor their creditors filed for court-supervised bankruptcy or reorganization procedures. The financial regulatory authority did little to correct the situation either. As a result, large-scale asset stripping continued until the insolvency of these two firms was finally acknowledged in the early stage of the economic crisis.

As the financial crisis unfolded, it was revealed that Hanbo and Kia were not alone, and that there were plenty of other large

---

1. For instance, see Rajan and Zingales (1998), Peek and Rosengren (1998) or Calomis and Ramirez (1996).

firms that had much more debt than they could handle. Moreover, there was no system in place that could be trusted to handle bankrupt or nearly bankrupt firms in a reasonably efficient manner. Roughly one-third of *chaebol* firms went bankrupt, or fell in deep financial trouble, in the two and a half years since the beginning of the crisis, and the costs associated with bankrupt or financially troubled large firms continued to increase. For instance, creditors of Dong-A Construction, which had been in a workout program since 1998, have recently concluded that the firm was merely wasting more resources in the workout process, and finally decided to put a stop to the workout. The firm subsequently filed for a court-supervised reorganization proceeding. Daehan Tongwun, the largest trucking and transportation firm in Korea, also filed for the same proceedings as it had cross-shareholdings with, as well as loan guarantees to, Dong-A Construction.

Daewoo Motors, which, according to an official examination conducted in the middle of 1999, had 13 trillion won of debt against an asset value of less than 6 trillion won, subsequently entered a workout program, and after approximately one year, its debt increased by more than 2.4 trillion won. Basically, all the extra loans that were extended by creditors during the workout program were used to cover the cost of operations, which heavily outweighed Daewoo Motors revenues. Creditors of Daewoo Motors filed for court-supervised reorganization after deciding to stop the workout program and declined to extend additional credit.

In the past, court-supervised proceedings have not been trusted by many to be able to efficiently handle the cases of large bankrupt firms. The court had been widely criticized as being too lenient toward bankrupt firms and their managers, while lacking the expertise and experience needed to efficiently reallocate the resources of large bankrupt firms. Inability of the court to establish its credibility in handling the cases of large bankrupt firms

led the parties involved to bypass court-supervised proceedings, and in many instances, opt for workouts instead. However, there is no guarantee that workouts are efficient alternatives to court-supervised proceedings, as the cases of Dong-A and Daewoo Motors illustrate.

The sheer number of large firms that essentially went bankrupt points to the root cause of the plethora of bankruptcy of large firms in Korea, virtually all of them *chaebol* firms. There was a time when the *chaebol* firms, the main force behind the rapid growth of the Korean economy, were considered to be competitive in the world market. However, it was revealed in the course of the economic crisis that many of the *chaebol* firms had been in severe financial difficulties, to an extent regarded as well beyond the state of bankruptcy in most western countries, even long before the onset of the crisis. Most *chaebol* firms shared the following three common characteristics: high debt/equity ratios, large amounts of debt, and low profitability. In fact, the size of the bad debts was so large that many of the financial institutions themselves became bankrupt or near bankrupt. Many banks and financial institutions were eventually closed, while many others survived only due to a massive injection of public funds. The financial restructuring process is still unfolding and is far from over.

This report was motivated by two questions about the Korean economy: What is the source of the inefficiency in the exit mechanisms for large firms in Korea? And, why did so many large firms, especially *chaebol*-affiliated firms, become bankrupt or near bankrupt?

To answer these questions, we first describe how various insolvency proceedings work and then analyze their properties. We focus on the Corporate Reorganization Act and the workout programs that have been most widely used, although we also touch briefly on the other two proceedings, composition and liquidation. We also analyze behavior of large firm and financial

institution in financial transactions and bankruptcy proceedings. As we will show later, inefficiencies in the financial market and bankruptcy proceedings have more to do with the characteristics of debtor firms and creditors than the drawbacks of the proceedings *per se*.

Unlike in countries with a longer history of capitalism, firms and financial institutions in Korea cannot be regarded as profit-seeking entities. Banks and other financial institutions in the past made loan to large firms without due screening and credit evaluation. Further, they normally paid significantly less attention to debtors after making loans than their counterparts in more advanced countries. They also have been slow in acknowledging financial difficulties of the debtor firms, and often failed to react properly even when they found the debtor firms in deep financial turmoil. The behavior of large firms in Korea is also quite different from large firms in western countries, in that they usually exhibit very high debt/equity ratios, risking high probability of bankruptcy, and poor earnings capabilities. Thus, the question arises as to why so many large Korean firms borrowed so heavily to finance projects that too often turned out to be money-losing businesses, and thus ended up facing bankruptcy.

To answer these questions, we look into the governance structures that lie behind such behavior of firms and financial institutions. We will try to show that corporate governance of large firms had serious flaws that were rooted in the *chaebol* system, and that corporate governance of financial institutions was not profit-oriented. Weaknesses in corporate governance of *chaebol* firms and financial institutions lead one to ask why these are so severe in Korea compared to more mature economies. We attempt to trace the root of the problem of corporate governance in large debtor firms and creditor institutions to the industrial policies of past governments. We will argue that many of the problems can be linked to industrial policies that depended on the use of “the *chaebol* system,” by which we mean a system of

economic policies that utilize a handful of families as artificial corporate governance agents. The *chaebol* system entailed heavy government intervention in the financial market as the government needed free access to financial resources in order to pump money into the firms run by the *chaebols*.

There have been significant changes in bankruptcy proceedings in Korea since the onset of the crisis. The Reorganization Act has been revised twice. In addition, large-scale informal workouts have been introduced to handle cases involving most of the large, financially troubled firms. However, it is hard to say that insolvency mechanism reform is satisfactory. The cases of Daewoo Motors and Dong-A Construction provide clear evidence that workouts can be very costly. Court-supervised proceedings have not been fully tested, nor are they widely trusted yet. Also, they are not free of the old problems that have plagued the past, most serious of which is the failure to install a new corporate governance structure based upon profit incentives in a bankrupt firm. Thus, it appears that there is much room for improvement in the institutional arrangements concerning insolvency of large firms in Korea.

This book proceeds as follows. In the next chapter, we summarize the extent of the debt crisis in recent years. We also show that many large firms in Korea suffered from high debt/equity ratios and poor profitability long before the onset of the crisis. Chapter III presents an economic analysis of the insolvency proceedings. We explain the role of bankruptcy proceedings in both *ex ante* as well as *ex post* senses, key decisions involved in bankruptcy proceedings, and the difference between various formal and informal proceedings. In chapter IV, we summarize and analyze the main features of bankruptcy proceedings in Korea: reorganization, composition, and liquidation. Chapter V contains an analysis of informal workouts, which have been widely used to deal with large insolvent firms since the onset of the crisis.

Chapter VI deals with the nature of the players in the game

in which loans are made and retrieved. Our focus is on the corporate governance of large firms and financial institutions in Korea. We will explain what they look like, as well as why they took their current forms. In Chapter VII, we explain other measures taken by the government or creditors that affect the industrial organization of the relevant industries, including the rationalization measures of past governments. Chapter VIII presents a comparative analysis of six East Asian countries: Korea, Thailand, Philippines, Indonesia, Singapore, and Malaysia. The first four countries suffered from the economic crisis that recently swept through East Asia, while the other two were not seriously affected. Chapter IX contains a summary of remaining issues.

## II. Extent of the Debt Crisis

The Hanbo and Kia groups became virtually bankrupt long before the onset of the crisis. In fact, many other *chaebol* companies experienced serious financial difficulties prior to the crisis. <Table II-1> below summarizes the average debt/equity ratio for the 30 largest *chaebol* groups. Halla and Jinro groups showed negative net asset values in 1996. The debt/equity ratios of Hanjin, Hanwha, Anam, Haitai, and NewCore groups were close to or exceeded 1000 percent. It is obvious that the creditors of these *chaebols* did not act properly. The debt/equity ratios of the remaining *chaebols* were generally in the range of 400 to 500 percent, much higher than the debt/equity ratios of large firms in almost all industrialized countries.

Normally, one would expect a higher than normal rate of return on the average from firms with such high debt/equity ratios and a resulting high probability of bankruptcy. Data show that this has not been the case with most of the large Korean firms. Most did not earn enough profit to justify high risks. <Chart II-1> and <Table II-2> below show the trends in the interest payment coverage ratio (IPCR) of large firms in Korea according to the size of the *chaebol*.

The top 5 *chaebols* as well as the next 6 - 64 *chaebols* all earned operating profits that, on average, were enough to cover interest payments before 1996. However, the average ratio dropped to below 1 around 1997 for top 6 to 64 *chaebol* companies, implying that their operating profits were not enough to cover even the interest payments. In fact, the weighted average of the interest coverage ratio at the end of the first half of 1998 was merely 0.04.

&lt;Table II-1&gt; Top 30 Chaebols' Debt/Equity Ratios

(Unit : %)

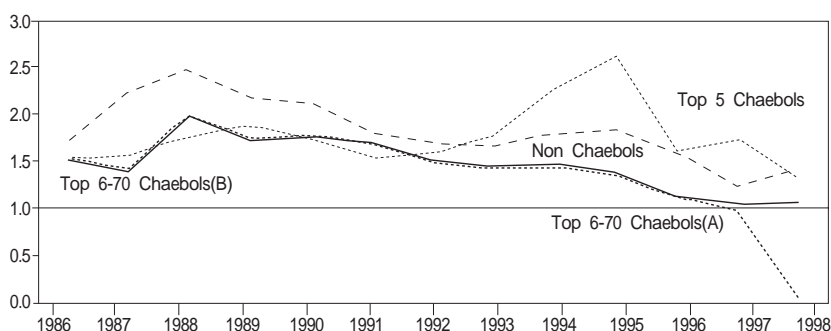
1997		1998		1999		2000	
Chaebol	Debt/Equity Ratio	Chaebol	Debt/Equity Ratio	Chaebol	Debt/Equity Ratio	Chaebol	Debt/Equity Ratio
1. Hyundai	578.7	1. Hyundai	316.0	1. Hyundai	283.1	1. Hyundai	152.0
2. Samsung	370.9	2. Samsung	355.0	2. Daewoo	354.9	2. Samsung	146.2
3. Daewoo	472.0	3. Daewoo	252.1	3. Samsung	252.1	3. LG	147.6
4. LG	505.8	4. LG	315.6	4. LG	314.4	4. SK	133.4
5. SK	468.0	5. Hanjin	458.3	5. SK	240.2	5. Hanjin	183.9
6. Hanjin	907.8	6. SK	249.8	6. Hanjin	457.9	6. Lotte	76.3
7. Ssangyong	399.7	7. Ssangyong	1,402.8	7. Ssangyong	1403.3	7. Daewoo	impaired capital
8. Hanwha	1,214.7	8. Kohap	impaired capital	8. Hanwha	332.5	8. Kumho	221.7
9. Kumho	944.1			9. Kumho	557.9	9. Hanwha	131.8
10. Dong-A	359.9	9. Hanwha	327.1	10. Lotte	117.8	10. Ssang-yong	633.6
11. Lotte	216.5	10. Kumho	558.0	11. Dong-A	898.5	11. Hansol	198.1
12. Halla	impaired capital	11. Dong-A	625.4	12. Hansol	346.1	12. Doosan	158.7
		12. Hyosung	281.2	13. Doosan	331.8	13. Hyundai Oil	374.8
13. Daelim	513.6	13. Daelim	335.8	14. Daelim	345.9	14. Dong-A	1212.3
14. Doosan	590.3	14. Anam	8,550.7	15. Dongkuk Steel	198.4	15. Dongkuk Steel	136.9
15. Hansol	399.9	15. Dongkuk Steel	198.8	16. Dongbu	266.3	16. Hyosung	131.7
16. Hyosung	465.1	16. Doosan	331.7	17. Halla	impaired capital	17. Daelim	179.0
17. Kohap	472.1	17. Shinho	impaired capital	18. Kohap	impaired capital	18. S-Oil	269.0
18. Kolon	433.5			19. Hyosung	281.3	19. Dongbu	183.6
19. Dongkuk Steel	323.8	18. Hansol	458.7	20. Kolon	335.2	20. Kolon	150.5
20. Dongbu	338.4	19. Kabul	impaired capital	21. Tongyang	303.2	21. Tongyang	229.7
21. Anam	1,498.5	20. Dongbu	267.5	22. Jinro	impaired capital	22. Kohap	858.4
22. Jinro	impaired capital	21. Kolon	334.6	23. Anam	8354.1	23. Cheil-Jedang	101.1
23. Tongyang	404.3	22. Jinro	impaired capital	24. Haitai	impaired capital	24. Daewoo Elec.	impaired capital
24. Haitai	1,501.3	23. Dongkuk	impaired capital	25. Saehan	276.9	25. Hyundai Dev't	186.3
25. Shinho	676.8			26. Kangwon Industry	441.5	26. Anam	4234.3
26. Daesang	647.9	24. Haitai	impaired capital	27. Daesang	268.3	27. Daehan	244.5
27. NewCore	1,784.1	25. Woobang	impaired capital	28. Cheil-Jedang	133.2	28. Jinro	impaired capital
28. Keopyeong	438.1	26. Tongyang	306.0	29. Shinho	impaired capital	29. Shinseggye	187.6
29. Kangwon Industry	375.0	27. Saehan	276.7	30. Samyang	207.3	30. Young-pung	88.8
30. Saehan	419.3	28. Byucksan	655.4				
		29. Shinwon	impaired capital				
		30. Kangwon Industry	441.6				
Total	519.0		369.1		306.6		218.7

Source : Fair Trade Commission.



It should also be noted that <Chart II-1> is based upon the accounting records of the firms and is likely to overestimate the profitability. Thus, the true interest coverage ratios will be lower than what they appear in the chart.

**<Chart II-1> Interest Payment Coverage Ratios**



Note : *Chaebols(A)* include all subsidiaries of top 6 to 64 *chaebols*. *Chaebols(B)* excludes Kia and Asia automobile companies.

Source: National Information and Credit Evaluation Inc. Excerpted from Nam et al. (1999b)

<Table II-2> also shows the significance of financial trouble in the corporate sector before and after the financial crisis in terms of the interest coverage ratios.<sup>2</sup> In 1995, when the Korean economy was booming, 11% of the firms surveyed earned operating profits that fell short of the interest payments. The proportion of firms whose interest payment coverage ratios fell below 1 grew progressively to 18% in 1996, 25% in 1997, and 31% in 1998. Interest payment coverage ratios provide only a limited amount of information regarding the performance of firms and do not give an accurate picture of the profitability and stability of firms by themselves. However, the trend clearly shows that profitability and

2. Joon Kyung Kim originally provided <Chart II-1> and <Table II-1> and some other related empirical analyses on financial market in Korea in Nam et al. (1999b), from which this report borrows heavily.

&lt;Table II-2&gt; Deteriorating Corporate Performance

		Interest Payment Coverage Ratio							
		1995		1996		1997		1998	
		1	< 1	1	< 1	1	< 1	1	< 1
Number of Firms	Top 5 <i>Chaebols</i>	56	4 (7%)	52	8 (13%)	52	9 (15%)	46	14 (23%)
	Top 6~70 <i>Chaebols</i>	127	15 (11%)	114	28 (20%)	96	46 (32%)	67	58 (46%)
	Non- <i>Chaebols</i>	288	42 (13%)	288	61 (18%)	279	87 (24%)	233	86 (27%)
	Total	497	61 (11%)	454	97 (18%)	427	142 (25%)	346	158 (31%)

Note: Figures in parentheses indicate the share of firms in each categorized group.  
Source: National Information and Credit Evaluation Inc. Excerpted from Nam et al. (1999b).

financial stability of Korean firms had been deteriorating at a steep rate from 1995 until 1998, the year Korea was hit by the financial crisis.

It is interesting to note that the IPCR of non-*chaebol* firms has always been higher than that of the largest 6 - 64 *chaebols* and have been higher than that of the top 5 *chaebols* except for the period from 1994 to 1996. The IPCR of non-*chaebol* companies has almost always been higher than that of the top 5 *chaebols* when we exclude semiconductor companies. The IPCR of non-*chaebol* companies did not fall below 1 and rebounded somewhat after 1997. Thus, it appears that *chaebol* companies generally fared worse than non-*chaebol* companies.

The sudden drop in the average IPCR of *chaebol* companies as seen in <Chart II-1> and their inability to turn the trend around seems related to the improved accounting standards and the corporate and financial restructuring that occurred in the wake of the crisis. Banks had to officially recognize that some of the large debtor firms could not service their debts. Consequently, they had to either send them into court-supervised insolvency

proceedings, or enter them into workout processes. Analyses of the financial states of these firms reveal that there had been serious flaws in their accounting books. In the case of Daewoo Motors, the discrepancy between the accounting book value of the firm and the asset value assessed by outside auditors turned out to be in the range of several trillion won

The financial difficulties of many *chaebols* became more severe in the wake of the economic crisis as the financial crunch became widespread. Many *chaebols* subsequently went officially bankrupt and applied for court-supervised procedures, while many others entered workout programs. Of the well-known *chaebols*, Keopyeong, Nasan, NewCore, Daenong, Sami, Jinro, Chunggu, Tong-il, Halla, Hanbo, Hanil, and Kia entered into court-supervised proceedings such as reorganization or composition. Some of the companies belonging to Keopyeong, Anam, Ssangyong, Kohap, Kabul, Byuksan, Shin-dongbang, Jindo, Saehan, Miju, Dong-A, and most of the Daewoo companies entered workout programs. Some of the companies that initially entered workout programs were moved to court-supervised proceedings, as creditors refused to keep extending further credit to keep them afloat. Daewoo Motors and Dong-A Construction are the two best-known examples.

The economic crisis affected not only the *chaebol* companies, but virtually all firms in Korea, thus increasing the number of bankrupt firms. <Table II-3> below summarizes the number of incidents of *boodo* or dishonored checks each year during the period 1996 to 1999. The number of large firms that experienced *boodo* jumped from 7 in 1996 to 58 in 1997, an increase of more than 800 percent. This is in sharp contrast to the number of SMC's that experienced *boodo*, which increased roughly by only 100 percent. The number of firms that experienced *boodo* in 1998 is still much higher than before the onset of the crisis.

We can infer from these statistics and <Table II-1> that bankruptcy of many of the large firms had been deliberately avoided

&lt;Table II-3&gt; Incidents of Boodo or Dishonored Checks

(Unit : number of firms)

		Large firms	SMC's	Unincorporated firms	Total
1996(yearly)		7	5,150	6,432	11,589
1997(yearly)		58	8,160	8,942	17,168
	11	17	697	755	1,469
	12	19	1,540	1,638	3,197
1998(yearly)		39	10,497	12,292	22,828
	1-3	16	4,275	5,158	9,449
	4-6	8	2,847	3,502	6,357
	7-9	8	2,031	2,182	4,221
	10-12	7	1,344	1,450	2,801
1999. 1-9		7	2,486	2,578	5,071
	1-3	2	925	1,005	1,932
	4-6	3	801	858	1,662
	7-9	2	760	715	1,477

Note: 1) Small and medium sized firms are defined here to be those firms that have less than 300 employees. Large firms are defined to have 300 or more employees.

Source : Bank of Korea.

before 1998 by creditors, who kept extending more loans to keep them from officially going bankrupt. Many of these ailing firms went bankrupt, as creditors who fell in deep financial trouble themselves ran out of money. It should also be noted that the decrease in the number of large firms that experienced *boodo* in 1999 is, to a large extent, the result of workouts. Had creditors decided not to bail out financially troubled debtor firms, the number of large firms that experienced *boodo* would have increased.

The increase of firms experiencing *boodo* led to an increase in court-supervised insolvency cases. <Table II-4> summarizes the number of cases of three types of court-supervised insolvency proceedings: corporate reorganization, composition, and bankruptcy. Note that bankruptcy here means liquidation forced and supervised by the court. As can be seen from the table, the num-

**<Table II-4> The Number of Bankruptcy<sup>1)</sup> Cases in the Last 5 Years**

(unit : number of firms)

	1995	1996	1997	1998	1999
Corporate Reorganization	79	52	132	148	37
Composition	13	9	322	728	140
Bankruptcy <sup>2)</sup>	12	18	38	467	733
Total	104	79	492	407	910

Note: 1) Bankruptcy here includes corporate reorganization, composition and bankruptcy.

2) Bankruptcy here means forced liquidation by the Bankruptcy Act.

ber of court-supervised insolvency cases increased dramatically in 1997 and 1998. The sharp fall in the number of corporate reorganization cases in 1999 can partly be explained by the court's decision to penalize dominant shareholders of the firms that apply for reorganization, which gave managers of financially troubled firms an incentive to opt for composition instead of reorganization.

Many financial institutions, including some banks, became bankrupt as a result of the bankruptcy of debtor firms. This is a notable event as no bank had ever been closed before 1998. <Table II-5> below summarizes the result of the first round of financial restructuring, which was implemented to handle the bankruptcy of financial institutions. As of June 1999, five banks, sixteen merchant banks, three securities companies, one investment trust company, and four insurance companies were permanently closed. In addition, the operations of one investment trust company and three securities companies were suspended. If mutual savings, finance companies, and credit unions were included, the total number of financial institutions either closed or suspended would reach 74. Another 143 financial institutions have either merged with others or dissolved.

Note that this measure did not completely solve the financial institutions' problems that were caused by bad debts. There are

&lt;Table II-5&gt; Closed or Suspended Financial Institutions

(As of June, 1999)

	Total No. of Institutions (end-1997)	License Revoked	Suspended	Merger/ Dissolution	Subtotal
Banks	33	5	-	4	9
Merchant Banks	30	16	1	1	18
Securities Companies	37	3	3	-	6
Insurance Companies	50	4	-	1	5
Investment Trust Companies	6	1	1	-	2
Mutual Savings and Finance Companies	230	25	14	2	41
Credit Unions	1,666	1	-	130 <sup>1)</sup>	131
Leasing Companies	25	-	-	5	5
Total	2,077	55	19	143	217

Note: 1) Includes bankruptcy and dissolution.

Source: Financial Supervisory Commission.

indications that the size of the remaining bad debts is still high, and that some banks are still suffering from large amounts of non-performing loans. Huge amounts of public funds have been injected to re-capitalize the bankrupt financial institutions or to cover the deficits of bankrupt financial institutions that were to be closed.

There also are some large firms that are suffering from financial difficulties, but have not officially been recognized as being unable to service their debts. Hyundai Construction is probably the best known example.

Financial difficulties of many of the banks ultimately resulted in the injection of an astronomical amount of public funds. As of the end of 1999, public fund expenditures spent to cover of losses of financial institutions amounted to 93.7 trillion won. <Table II-6> describes the details of the expenditures.

Infusion of public funds of such size inevitably led to a sharp increase in shares of affected banks held by the government, and virtual nationalization of many banks in Korea. <Table II-7>

**<Table II-6> Public Fund<sup>b)</sup> Expenditure (1997.11~1999.12) Used to Recapitalize Financial Institutions** (Unit : 100 million)

Classification	KDIC	Equity Participation	Contribution	Underwriting NPLs	Insurance Payout	KAMCO	MOFE	Equity Participation	Capitalization (sub	bond) Bank of Korea	Total
1997.11~1998.12											
Bank	120,650	62,860	57,790	-	-	167,279	163,279	106,069	58,210	-	451,169
Nationwide	120,650	62,860	57,790	-	-	125,965	58,676	15,000	43,676	-	305,291
Local	-	-	-	-	-	14,219	7,944	-	7,944	-	22,163
Special	-	-	-	-	-	27,056	96,659	90,069	6,590	-	123,715
Merchant Bank	126,942	421	-	-	126,521	17,555	-	-	-	-	144,497
Securities Company	140	-	-	-	140	563	-	-	-	-	703
Insurance Company	11,534	-	11,534	-	-	13,715	-	-	-	-	25,249
Investment Trust Co.	-	-	-	-	-	-	-	-	=	-	0
MSFC	19,072	101	-	-	18,971	-	-	-	=	-	19,072
Subtotal	278,338	63,382	69,324	-	145,632	199,073	163,279	105,069	58,210	-	640,690
1999.1~1999.12											
Bank	161,007	85,484	38,279	37,244	-	27,640	14,500	9,000	5,500	7,000	210,147
Nationwide	161,007	85,484	38,279	37,244	-	24,436	1,000	-	1,000	-	186,443
Local	-	-	-	-	-	2,989	4,500	-	4,500	-	7,489
Special	-	-	-	-	-	215	9,000	9,000	-	7,000	16,215
Merchant Bank	-	-	-	-	-	-	-	-	-	-	-
Securities Company	4	-	-	-	4	-	-	-	-	-	4
Insurance Company	53,922	51,447	2,475	-	-	-	-	-	-	-	53,922
Investment Trust Co.	-	-	-	-	-	-	9,000	9,000	-	-	9,000
MSFC	22,611	-	-	-	-	1,051	-	-	-	-	23,662
Subtotal	237,544	136,931	40,754	37,244	-	28,691	23,500	18,000	5,500	7,000	296,735
Total											
Bank	281,457	148,344	96,069	37,244	-	194,880	177,779	114,069	63,710	7,000	631,316
Nationwide	281,457	148,344	96,069	37,244	-	150,401	59,676	15,000	44,676	-	491,734
Local	-	-	-	-	-	17,208	12,444	-	12,444	-	29,652
Special	-	-	-	-	-	27,271	105,659	99,069	6,590	7,000	139,930
Merchant Bank	126,942	421	-	-	126,521	17,555	-	-	-	-	144,497
Securities Company	144	-	-	-	144	563	-	-	-	-	707
Insurance Company	65,456	51,447	14,009	-	-	13,715	-	-	-	-	79,171
Investment Trust Co.	-	-	-	-	-	-	9,000	9,000	-	-	9,000
MSFC	41,683	101	-	-	41,582	1,051	-	-	-	-	42,734
Total	515,882	200,313	110,078	37,244	168,247	227,764	186,779	123,069	63,710	7,000	937,425

Note: 1) includes government guaranteed bonds (non-performing asset resolution fund and deposit finance fund) and other suspended funding.

Source: KDIC, KAMCO, MOFE.

below summarizes the ownership distribution of Korean banks. As can be verified by the table, the government has a controlling interest in most of the commercial banks in Korea.

**<Table II-7> Ownership Distribution of Commercial Banks in Korea (as of the end of 1998)**

(Unit : 100 million won, %)

	Authorized Capital	Total Government Investment	Share of Government Ownership	Remarks
Banks with Government Preferred stocks	27,836	100,253	36.8	
Shinhan	11,690	2,925	25.0	98.6 assumption of Donghwa
Hana	8,662	4,728	54.6	98.6 assumption of Chungchong 99.1 assumption of Boram
KorAm	7,484	2,600	34.7	98.6 assumption of Kyonggi
New Government Banks	89,638	83,765	93.4	
Korea First	16,000	15,000	93.8	
Seoul	16,000	15,000	93.8	
Hanvit	34,350	32,642	94.8	99.1 Commercial merger 99.1 Hanil merger
Chohung	23,188	21,123	91.1	99.5 Chungbuk merger 99.9 Kangwon merger
Existing Gov't Banks	97,964	75,376 (4,965)	81.1 (82.0)	
Kookmin	13,815	970 (2,000)	8.2 (21.5)	
H&C	7,427	719 (2,965)	16.1 (49.6)	98.6 Assumption of Daedong 99.1 Long-term Trust merger
Industrial Development	18,247	17,842	97.9	98.6 Dongnam merger
Export & import	41,1717	41,717	100.0	
	16,758	14,108	84.2	
Total	215,438	159,141 (15,218)	97.4 (80.9)	

Note: Figures in parentheses are government's preferred stock investment and its share.



### **III. Main Issues in the Law and Economics of Insolvency**

#### **III-1. The Role of Insolvency Mechanisms**

Firms often fail to pay their debts for a variety of reasons. The need for the state to intervene and provide solutions when corporate failures occur has long been recognized. In the early days, debt collection was the solution to corporate failures. However, the pivotal role of firms in modern economies and the prevalence of limited liability companies necessitate that insolvency mechanisms be distinct from debt collection mechanisms. Insolvency mechanisms allow the possibility that individual debt collection by creditors is prohibited.

An insolvency mechanism is usually superior to individual debt collection mechanisms because it can lead to an increase in the economic value of a bankrupt firm that can be distributed to creditors and debtors by limiting creditors' ability to collect their claims individually. Even when the debtor firm is to be liquidated, an orderly liquidation by an insolvency mechanism is likely to be superior to individual debt collection in terms of costs and equitable distribution of the liquidation value among interested parties.

Insolvency mechanisms could be especially superior to individual debt collection mechanisms when the value of the debtor firm as a going concern exceeds the liquidation value. In such a circumstance, an efficient solution would be to reorganize the debtor firm and distribute the firm value to various stakeholders, including creditors. It is important to recognize that reorganization implies that creditors should be prohibited from taking

actions that would lead to the dissolution of the debtor firm. Thus, at the heart of the corporate reorganization procedure lies restriction on the rights of individual creditors. In the liquidation procedure, creditors eventually can exercise their rights, even though there might be temporary restriction.

There are several notions of efficiency that the study of insolvency mechanisms should take into account. *Ex-post* efficiency implies the following two conditions. First, when a firm is to be liquidated, it should be liquidated in a way that maximizes the liquidation value, and when it is to be reorganized, it needs to be reorganized in a value-maximizing way. Second, an insolvent firm is to be liquidated if, and only if, the liquidation value is greater than its going-concern value.

This concept of *ex-post* efficiency has an important implication - that is, the decision regarding the fate of an insolvent firm should be independent of both the ability of the firm to eventually pay its debt and the relative magnitude of the firm value and the size of debt. This point, although obvious to most experts, has been overlooked by practitioners and institutional arrangements in many developing countries.

In reality, however, the decision-making process determining the fate of an insolvent firm and the division of the firm value could affect *ex-post* efficiency. When a bargaining process such as the one prescribed by the U.S. Chapter 11 is used, *ex-post* efficiency could be affected by the incentives of some stakeholders to hold out in order to extract concessions from other stakeholders more adversely affected by protracted bargaining. Typically, small creditors have strong incentives to hold out. In addition, shareholders or managers of a debtor firm also have incentives to hold out when the firm value is small compared to the size of debt.

Division of the economic value of the firm among creditors, shareholders (managers) and other stakeholders does not affect *ex-post* efficiency *per se*, as it involves only the distribution of

wealth. However, it significantly affects the behavior of creditors and debtors in the lending stage, and thereby, the conditions for lending. More generally, how the value of an insolvent firm is divided among various stakeholders in the bankruptcy state, together with what may happen to the firm itself, determines *ex-ante* efficiency in several ways.<sup>3</sup>

First, what happens to the debts once insolvency occurs determines the degree of risk sharing by lenders and equity investors at a stage at which decisions on lending and equity participation are made. A loan contract that stipulates payments independent of the performance of a debtor firm cannot be executed in insolvency states and will be replaced by the outcome of an insolvency mechanism that governs the parties involved once insolvency occurs. Of course, what a creditor receives from a bankrupt debtor firm through an insolvency mechanism generally differs from the terms of the original contract and usually depends upon the performance of the firm. Consequently, insolvency proceedings affect the supply of credit in financial markets, and thereby the equilibrium prices for credit.<sup>4</sup>

Second, insolvency mechanisms affect the behavior of creditors and debtors, particularly in terms of limited liability. The screening activities of lenders at the lending stage as well as the monitoring after the lending takes place are affected by what would happen in the bankruptcy state. Shareholders and managers also have incentives to choose their actions based upon the outcomes expected to be realized in the bankruptcy state. They have incentives to gamble on an “all-or-nothing” strategy when they expect very bad payoffs in the bankruptcy state as compared to a non-bankruptcy state. Managers may also try to take actions

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3. Stiglitz (1999) gives a good review of the literature relevant to the efficiency of insolvency mechanisms.

4. Similarly, insolvency proceedings will affect the supply of equity investment in the financial market.

that would make themselves more indispensable in the bankruptcy state.

### **III-2. Three Fundamental Ex-Post Decisions**

Any insolvency mechanism must address the following three fundamental issues: 1) what to do with the firm itself (i.e., whether to liquidate or restructure the firm), 2) how to restructure (liquidate) the firm if it is to be restructured (liquidated), and 3) how to divide the economic value of the firm among various stakeholders upon liquidation or during restructuring.

The choice between liquidation and restructuring is critical because the value of the firm that can be divided among the stakeholders is generally different in each alternative case. In principle, it is desirable to liquidate a firm when the liquidation value is greater than the going-concern value and vice versa. How to restructure or liquidate an insolvent firm is also an important issue because it is desirable to maximize the value of the firm regardless of the choice between restructuring and liquidation. In fact, the actual modality of restructuring or liquidation critically affects the value of an insolvent firm, and hence, provides a basis for the choice between liquidation and restructuring.

Division of the pie is relatively simple when the firm in question is to be liquidated. Assets of the firm are auctioned off and the proceeds from asset sales are distributed to the stakeholders according to a pre-fixed rule. It appears that the absolute priority rule enjoys wide support in this case, although one can argue that imposition of the absolute priority rule in liquidation would give shareholders (managers) wrong incentives.<sup>5</sup>

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5. Managers and shareholders of the debtor firm will have an incentive to hide the financial difficulty in order to delay liquidation as well as to indulge in asset-

If the firm in question is to be restructured, division of economic value is achieved basically through debt-equity swaps. When a firm cannot pay all of its debt, debt reduction must occur in order for the firm to survive. Creditors generally receive shares of the firm in return for forgoing part of the loans. A simple deferment of payments that does not require losses to any creditors is a trivial case whereby no debts are given up and shares are also not given. Debt reduction that accompanies a debt-equity swap generally increases the gross economic value of the firm.

A creditor who participates in debt-equity swaps receives the part of the increase in the firm value that corresponds to the shares of the firm that it owns as a result of the debt equity swap. The old shareholders end up owning a smaller share of the firm that now has a larger economic value. The efficiency and fairness of a debt-equity swap thus depend critically on the conditions of the swap.

There are conflicting views on the principles governing conditions of debt-equity swaps. The absolute priority rule is certainly appealing, as it preserves the order of priority given by the original contracts. However, as noted above, it is likely to induce shareholders (managers) to behave in ways that would dissipate the value of the firm. Many countries give some breaks to original shareholders during reorganization by granting them shares that are substantially larger than the shares dictated by the absolute priority rule, although the degree of deviation differs across countries.

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stripping activities that would benefit shareholders and managers at the cost of creditors when the liquidation value is relatively small compared to the size of the debt.

### **III-3. Decision-Making Process**

The most popular mechanisms used in the real world are structured bargaining games supervised by the court, and informal bargaining games, such as the “London Approach”. In some countries, the government makes key decisions concerning the fate of bankrupt firms and their debts single-handedly. Let us summarize the nature of these three mechanisms as well as that of an alternative mechanism that has been proposed by some economists. We start by considering a simple mechanism that gives power to a single authority in order to make fundamental decisions on insolvent firms. This mechanism provides a benchmark against which properties of the other mechanisms can be compared.

#### ***1) Regime 1: Decision by a Single Authority***

Suppose that the government has the best information about the economic environment surrounding an insolvent firm and that its objective is to maintain economic efficiency. In such an ideal world, it would be best to give the government the power to make the three fundamental decisions previously mentioned.

The government would proceed with the following steps. First, it would determine the optimal strategy for both restructuring and liquidating the firm in question, with the objective of maximizing the firm’s value. The maximized value corresponds to the going-concern value and the liquidation value, respectively. Second, the government would then decide between liquidation and reorganization based upon the results of the valuation in the first step. Third, the government would implement an optimal restructuring plan, if restructuring were chosen, or an optimal liquidation process otherwise. Last, the government would divide the value of the firm between various stakeholders according to a given rule. The division rule would be determined by the govern-

ment as a solution to a larger optimization problem that takes into account of both *ex-ante* and *ex-post* efficiency.

The insolvency mechanism described above is efficient in the given setting. Furthermore, since it is immune to haggling and time-consuming negotiations by various stakeholders, it is likely to be more efficient in terms of cost than the other insolvency mechanisms that involve bargaining by stakeholders. Time is crucial in insolvency proceedings as the value of an insolvent firm can deteriorate rapidly.

One of the major weaknesses of this mechanism is the unrealistic assumption regarding the government. Few would agree that the government has the best information, or even better information than any other key players. Furthermore, even the assumption that the objective of the government is to maximize economic efficiency cannot be taken for granted. In reality, the government is not a single agent with a well-defined objective function of its own. Rather, it is closer to a loose collection of politicians and bureaucrats who pursue their own objectives. It is also difficult to presume that the government knows the best way to liquidate or reorganize an insolvent firm. Consequently, there is no guarantee that giving the government the power to make fundamental decisions on insolvency mechanisms will lead to an efficient outcome.

Valuation is the most problematic issue here as it provides the basis for choosing between liquidation and reorganization as well as the conditions for debt-equity swaps. Thus, valuation determines the fate of the firm itself as well as the distribution of wealth among stakeholders. In normal situations, the valuation of an asset is determined in the market as a result of profit-seeking activities of investors who bet on assets with their own money. However, in the above setting, valuation is left to a third party that does not have any earthly interest in the firm. As a consequence, there is no guarantee that the third party's valuation coincides with the true value of the firm. Further, it will be impos-

sible to convince every stakeholder that the outcome of the valuation reflects the true value.

Nonetheless, this mechanism may be appealing to developing countries that are not equipped with well-developed legal infrastructures with respect to insolvency proceedings.<sup>6</sup> In particular, when a large number of firms simultaneously become insolvent, a bargaining process similar to the one envisaged in U.S. Chapter 11 is likely to entail too heavy a cost for the economy to bear.

## ***2) Regime 2: Formal Bargaining Games***

Another way of making a decision on an insolvent firm and the division of its value is negotiation or bargaining by creditors and shareholders (managers), subject to some rules and restrictions.<sup>7</sup> This type of conflict resolution typically consists of procedures concerning protection of the firm's assets from debt collection attempts by individual creditors, classification of creditors according to some priority ordering, drawing up of plans for reorganization, voting mechanisms, and the authority of the mediator, which is usually a court.<sup>8</sup>

Three fundamental decisions regarding an insolvent firm are made as an outcome of bargaining games that are played by the creditors and shareholders (managers) of the firm according to

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6. Nam (1993) and Nam and Kang (1999) proposed mechanisms for Korea that can be classified as belonging to Regime 1.

7. Bargaining over an insolvent firm and its economic value almost never proceeds without some rules provided by the state. If there are no rules governing the liquidation or reorganization process of insolvent firms in a country, bargaining will proceed based upon other parts of the legal infrastructure, such as debt collection proceedings and the general clauses concerning property right protection.

8. In some countries, agencies belonging to the administrative branch of the government are charged with the supervisory role. However, most countries that have this type of proceeding give the authority to the court, although the nature of the court and the degree of discretion given to the court vary across countries.



the rules set by the formal insolvency proceedings. Players try to maximize their respective objectives in a non-cooperative way, taking into account the fact that the others are doing the same.

A notable feature of this type of bargaining is the possibility that some players threaten to veto a plan in an attempt to extract concessions from the other players. If the players advancing such threats have the ability to veto a plan, and if they have more to gain once the plan is vetoed, their threats are clearly credible. In such a case, their share of the firm value needs to be increased in the final proposals for voting in order to ensure that the reorganization plan is approved. In situations where players are expected to lose as a result of vetoing a plan, the credibility of their threats is not well established, although this may not prevent the veto power from being exercised. Whether the insolvency mechanism should allow the stakeholders to hold out in such a situation is also an important issue that must be addressed by an insolvency mechanism.

Formal bargaining proceedings have some advantages compared to Regime 1 in that decisions are not made by a third party, but by stakeholders. Thus, it appears that the implicit valuation behind a liquidation/reorganization decision under Regime 2 is more likely to reflect the true value of the firm than in the case of Regime 1. There is no guarantee, however, that the decisions will always be more efficient or fairer under Regime 2 than under Regime 1 because of the heterogeneity of information and attitudes towards risks among stakeholders.

Thus, there are possibilities that firms end up liquidated even if the going-concern value is greater than the liquidation value, or vice versa. Furthermore, it may be very difficult to design a bargaining process that guarantees that the division of the pie will satisfy the optimal division rule most of the time, even if a society agrees on an optimal division rule. In addition, formal bargaining games tend to take too much time, resulting in the dissipation of a firm's value. This dissipation can at times be substantial in both

absolute amounts and in relation to the asset value or potential economic value of the firm. Negotiation among a large number of creditors and shareholders who do not have the same information and financial positions simply cannot be done without substantial costs. The possibility of haggling and strategic maneuvers described above makes it even more time consuming and costly.

In spite of these deficiencies, formal bargaining proceedings have evolved to play a central role in dealing with insolvent firms in many advanced countries. They also provide a backdrop for the informal bargaining mechanisms in which stakeholders bargain over a set of packages that are Pareto superior to what they would receive under formal bargaining proceedings. In less developed countries, formal bargaining proceedings do not exist, or where they do exist, they often play only a secondary role.

### ***3) Regime 3: Informal Bargaining Games***

Creditors and shareholders of a firm can always agree to bypass the formal bargaining proceedings in place and instead, try to find resolution outside of the formal bargaining process. Informal bargaining games are, however, constrained by formal bargaining games in the sense that no stakeholder would agree to a proposal that would give him a payoff worse than what he would expect to receive in formal bargaining proceedings. Thus, agreements made through informal bargaining games are superior to those made through formal bargaining games, if they are made at all. The surplus that participants could create by entering informal bargaining games would depend on the degree of inefficiency in formal bargaining proceedings.

The Pareto superiority of the informal bargaining games is particularly meaningful when the firm is likely to be restructured. Division of the firm value in such a case takes the form of debt-equity swaps as we have observed earlier. Informal bargaining games have been used in many countries, and in some countries,

have played a more important role than formal insolvency proceedings.<sup>9</sup> However, informal bargaining games share most of the deficiencies of formal bargaining games listed above, although to a lesser degree.

#### ***4) Regime 4: Recent Proposals That Do Not Depend on Bargaining***

Recently, some economists have proposed insolvency mechanisms designed to bypass the problems inherent in the bargaining game approaches. These proposals commonly separate the decision concerning the firm itself from the decision on the division of the firm's value. Typically, debt-equity swaps take place according to some given rule, which does not require bargaining by stakeholders, but reflects the valuation of stakeholders more accurately. After the debt-equity swaps, the firm becomes financially healthy, and former creditors become shareholders. The future of this born-again firm is determined by the new decision-makers. If the going-concern value is smaller than the liquidation value, the new decision-makers will liquidate the firm. If the going-concern value is greater, the new decision-makers will try to explore the best modality of restructuring in order to maximize the value of the firm.

Debt-equity swaps critically depend on two factors: valuation of the firm and priority ordering of the claims among various stakeholders. Since it is generally impossible to assign an objective value to a firm, valuation is generally conducted through one of the following two ways. The first way is to use the estimate of a third party.<sup>10</sup> This method resembles Regime 1 in spirit, with

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9. For instance, most of the large insolvency cases that occurred during the recent economic crisis have been dealt with by workouts rather than by U.S. Chapter 11-style formal bargaining proceedings in Korea and Indonesia.

10. For instance, the methods in Aghion, Hart, and Moore (1992) that depend on the third party's decision fall into this category.

similar strengths and weaknesses. Successful valuation under this scheme requires procuring an able and impartial third party and giving the party a proper incentive to produce best estimates. A mechanism of this kind will also need to include an appeals process in order to deal with cases where some stakeholders do not agree with an estimate given by a third party.

Another way is to use the incentive of stakeholders to maximize their wealth.<sup>11</sup> In the Bebchuck scheme, all debts are cancelled and converted into equities according to an option scheme based upon the absolute priority rule. All the equities are given to the most senior creditors, while junior creditors are given the option to buy equities from senior creditors at a price that equals the sum of all debts that were held by creditors senior to them. The amount paid by those creditors who exercise their options is used to buy the matching number of shares from some creditors at prices that are at par with their original debt amounts. Old shareholders are the most junior stakeholders in terms of priority, and are given only the option to purchase the shares from the most junior creditors at a price that equals the sum of all debts. Finally, creditors and shareholders can trade equities and options before options are exercised and debt-equity swaps take place.

This procedure needs no bargaining, since valuation of the firm is determined by the actions of various stakeholders who decide on whether to exercise their options based upon the relative magnitude of their firm value estimates, and the sum of all debts that have priority to its claim. Thus, there should not be any dispute as to the condition of debt-equity swaps as long as stakeholders do not face liquidity constraints. Liquidity constraints could be alleviated to some extent by trading of equities and options. However, creditors and shareholders will, in general, be subject to some degree of liquidity constraints due to imperfections of the financial market, which make it difficult for junior

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11. See Bebchuck(1988) for a detailed explanation of his scheme.

creditors and shareholders who wish to exercise their options, but face a shortage of cash to borrow from the financial market. Consequently, in an imperfect financial market, the Bebchuck scheme is biased in favor of senior creditors against junior creditors and old shareholders.

It should be noted that this bias does not cause any new problems to *ex-post* economic efficiency. Furthermore, if the financial market is reasonably efficient, interest rates of various types of loans with differing seniority will adjust to reflect the conditions for debt-equity swaps *a la* Bebchuck in bankruptcy states. The Bebchuck scheme also has an advantage over the bargaining approaches described above in that it does not require too many judges or a high degree of expertise from the judges handling bankruptcy cases.

Although the original Bebchuck scheme assumes the absolute priority rule, one can modify the rule to give some room to shareholders as an incentive not to behave in a value destroying way. This scheme will work well in countries in which the financial market is fully developed. However, in countries with underdeveloped financial markets, this scheme could lead to concentration of ownership of bankrupt firms in the hands of a few banks. In countries where most banks fall into bankruptcy themselves and become nationalized, the Bebchuck scheme may lead to nationalization of most bankrupt firms.

## IV. Formal Bankruptcy Proceedings

The Korean word for bankruptcy is '*boodo*', literally, the non-payment of checks or promissory notes. Checks and promissory notes are the major tools of payment for commercial transactions in Korea. They are usually endorsed and transferred several times from debtors to creditors before they are due for payment. Default on payment for checks or promissory notes will result in the issuer of dishonored checks or promissory notes being severely restricted in conducting financial transactions. For example, banks will refuse to deal with the issuer, and the issuers' properties will be subject to public auction for payment of debt to check- or note-holders through a judicial enforcement process. However, most *boodo* cases are settled through private arrangements between the debtor and creditors for payment. Only a handful of *boodo* cases go as far as involving court intervention.

Korea has three statutes on insolvency: the Bankruptcy Act ('BA' hereafter), the Composition Act ('CA' hereafter), and the Corporate Reorganization Act ('CRA' hereafter). The BA deals with the liquidation of individuals and corporations. The CA provides composition (arrangement) proceedings for individuals and companies. The CRA covers the reorganization process of joint stock corporations. The statutes were first enacted in 1962 and there were no significant amendments until 1998.

These insolvency laws had rarely been applied before the economic crisis in 1997 and the concept itself was not familiar to many lawyers, not to mention the general public. It was said that a judge handled one insolvency case on average during his tenure. There were several reasons for the unpopular use of insol-

vency laws. The Civil Procedure Act was usually used for debt collection on an individual basis. In most cases, collective collection measures were not necessary because assets of a debtor were already subject to a mortgage or security in most cases. Secured creditors collected their portion of the proceeds from the sales of secured assets according to the order of priority. In most cases, unsecured creditors received almost nothing because the asset value was usually smaller than the amounts of secured loans.

Further, before 1990, most of the insolvency cases of large debtor firms had been handled directly by the government, in the context of the industrial policies. Only a handful of insolvency cases, involving mostly small and medium sized firms, were filed and processed through the court. Article 7-3 of the Act on Special Measures for Unpaid Loans of Financial Institutions worked as a crucial, additional impediment to a wider use of judicial insolvency procedures. The article gave the Korea Asset Management Corporation (KAMCO) the exclusive authority to hold an auction on a defaulting corporation's assets before the corporation is given a chance to restructure itself. This provision virtually paralyzed the Corporate Reorganization Act; without consent of KAMCO, reorganization procedures could not take place because auctions were initiated by KAMCO.

In 1990, the Constitutional Court of Korea declared this provision unconstitutional and made the reorganization proceeding a more practical alternative. Although reorganization cases increased since then, the reorganization proceeding had been widely criticized to be incomplete and too lenient in granting rehabilitation. In fact, few firms emerged as viable after reorganization. In 1992, the Supreme Court tightened the process by enacting the Rule on Corporate Reorganization Procedure ("1992 Rule"), which provided detailed requirements for initiating the reorganization process and for approving reorganization plans. The 1992 Rule established the following three requirements for granting the corporate reorganization proceeding: high social

value, financial distress, and possibility of rehabilitation. It also gave detailed description on the factors to be considered for each requirement.

The second bankruptcy of Non-No, which had already been in the reorganization process, led the Corporate Reorganization Act to face public criticism again. Primarily as a result of this incident, the Supreme Court amended the 1992 Rule to strengthen the monitoring function of the court on corporations in the process of reorganization in 1996. The 1996 Rule also mandated the court to wipe out shares owned by controlling shareholders responsible for mismanagement of debtor firms.

The 1996 Rule, however, essentially removed any incentive for the incumbent controlling shareholders and management to seek court-supervised reorganization proceeding. Many firms that became insolvent filed for composition instead of reorganization in 1997 and 1998 during the economic crisis as can be seen

<Table IV-1> Number of Cases under Insolvency Laws

Year	<i>Boodo</i>	Bankruptcy	Composition	Reorganization
1983	U/A	U/A	U/A	47
1984	U/A	U/A	2	52
1985	U/A	12	2	40
1986	U/A	11	-	26
1987	U/A	26	-	30
1988	U/A	20	-	26
1989	U/A	37	2	27
1990	4,107	27	-	15
1991	6,159	16	-	64
1992	10,769	14	-	89
1993	9,502	26	-	45
1994	11,255	18	-	68
1995	13,992	12	13	79
1996	11,589	18	9	81
1997	17,168	38	322	151
1998	22,828	467	728	65
1999	6,718	733	140	37

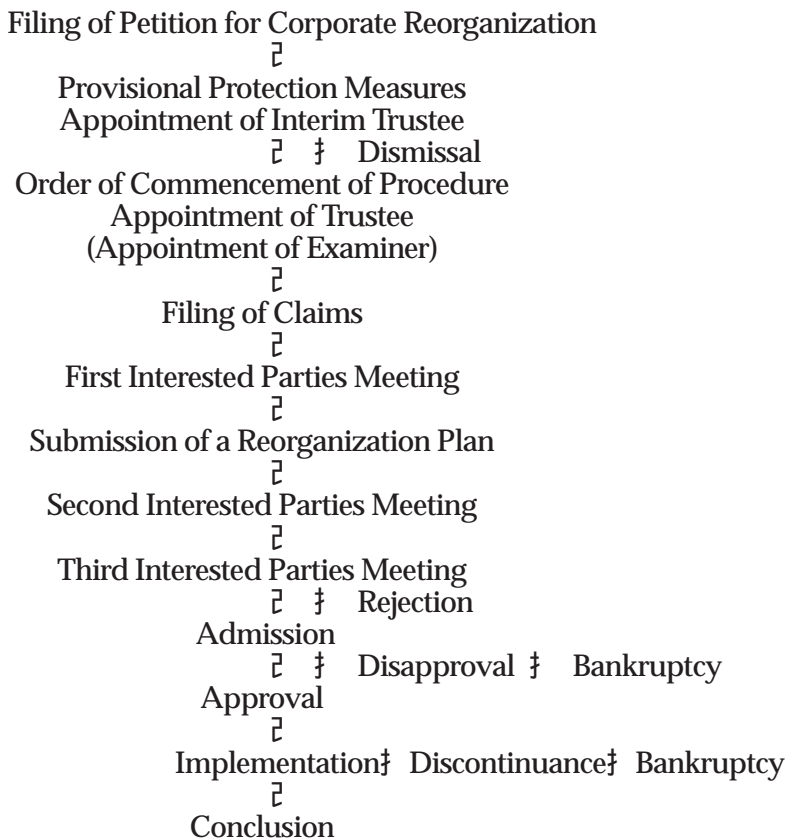
Source: Court Administration Agency (1999), Bank of Korea (1999).



from <Table IV-1>. Dominant shareholders of these firms preferred composition, which would allow them to maintain their ownership and control, to reorganization. Although the composition proceeding was originally intended for small firms, the court somehow granted petitions for composition by large firms in 1997 and 1998.

## **IV-1. Corporate Reorganization**

### ***1) Basic Procedure***



## **2) Filing**

Article 30 of the Corporate Reorganization Act stipulates two causes for commencement of the reorganization proceedings: inability to repay the debt without incurring significant hindrance to the continuance of the business, and apprehension of bankruptcy. The insolvency laws do not give a definition of bankruptcy. The Bankruptcy Act states that the court may declare a debtor firm bankrupt when the debtor cannot repay (BA Art. 116) and when the total amount of petitioner's debt is larger than the total amount of the corporation's assets (BA Art. 117).

The corporate reorganization procedure is normally initiated when the insolvent corporation files a petition for commencement to the relevant court. This process is for joint stock corporations only. The petition may also be filed by at least one of the creditors whose claims against the corporation are no less than 10 percent of the corporation's equity capital, or by shareholders who hold no less than 10 percent of the issued shares of the corporation (CRA Art. 30). The court that has venue on the main office of a corporation has exclusive venue on a corporate reorganization case (CRA Art. 6).

The Act does not penalize a late filing. This means that a debtor corporation does not have a legal obligation to file a corporate reorganization petition under the Act. Members of the board of directors, however, have duty of care or fiduciary duty in a general sense under the Commercial Code, which covers corporate matters. Thus they could be liable for any damages to the corporation resulting from a late filing caused by directors' negligence of duties.

The Corporate Reorganization Act does not allow automatic stay. Usually the applicant simultaneously files a petition for issuing a provisional protection order, whereby an interim trustee is appointed, disposal of assets and repayment of debt by the insolvent corporation are prohibited, and/or other enforcement proce-

dures are stopped (CRA Art. 37, 39). Without this provisional protection order, the reorganization proceedings cannot be effective because most creditors will attempt to collect claims individually. The court issues a provisional protection order after reviewing petition documents and interviewing applicants. The court shall hear the opinion of the management committee when issuing the order. If the court turns down or dismisses the application for the provisional protection order, it also dismisses the application for the commencement of the corporate reorganization process.

The interim trustee acts as the legal representative of the insolvent corporation and performs the daily functions of the corporation (Art. 39-3, 53). In other words, the incumbent members of the board of directors lose their function. As the interim trustee's authority is almost the same as that of the incumbent trustee, most provisions for the latter are applied to the interim trustee. Commercial banks, merchant banks, and trust companies, as well as individuals may be appointed as the interim trustee. The interim trustee must obtain the approval of the court to perform certain actions specified by the court, such as disposing of the corporation's assets.

Under the provisional protection measures, the court deliberates whether to render the order of commencement of the reorganization process. Without an order of commencement, the reorganization procedure does not start. When the court dismisses the petition, the court cancels the provisional protection order as well.

***The court shall reject any petition for the commencement of proceedings in the following cases (CRA Art. 38):***

- a. where expenses for reorganization proceedings have not been paid in advance;
- b. where a creditor or shareholder has acquired the claims or stocks in order to file a motion for commencement of proceedings;
- c. where the petition is made primarily with the intention of evading bankruptcy or financial obligations;

d. where bankruptcy proceedings and composition proceedings are pending before the court, and the general interests of the creditors are served by following those proceedings;

e. where it becomes evident that the liquidation value of a corporation is greater than its going-concern value; and

f. where the petition is made primarily with the intention of evading a tax obligation or obtaining some benefit from the fulfillment of a tax obligation

Among the items listed above, the most interesting one seems to be e, which is usually called “the Economic Criterion Test” in Korea. This condition was introduced by the 1998 amendment in an attempt to screen out those debtor firms for which liquidation is clearly a better alternative. This criterion does not exist in formal insolvency proceedings of the other countries, as far as the authors know. The 1999 amendment changed the way the court implements this criterion and gave the court a even larger role in applying the Economic Test Criterion.

Before the 1999 Amendment was made, the court deliberated on whether to render the order of commencement of the reorganization process while the interim trustee took charge of the debtor firm. The court rejected any petition for the commencement of proceedings when one of the prescribed negative conditions existed. The most important factor among these negative conditions was the comparison between liquidation value and going-concern value. The court-appointed examiner performed due diligence and estimated liquidation value and going-concern value. It took several months for the court to decide commencement based on the opinion of the examiner.

The 1999 Amendment, however, changed condition requirements and the process. The court now dismisses the petition in cases where it is clear that liquidation value is greater than going-concern value, and the court does not appoint the examiner. Moreover, the Act mandates that the court shall decide the order

of commencement within one month from the petition (CRA Art. 45-2). It seems that the Act's intention here is to ensure that the decision of the commencement shall be made based on formal review rather than deliberation on merit.

An estate is not created in the corporate reorganization procedure, unlike in the bankruptcy procedure. The provisional protection order and the ensuing order of commencement protect the assets of the applying corporation from the enforcement of creditors or arbitrary payment by the debtor.

By the 1998 Amendments, a management committee was established to assist the court in corporate reorganizations. The committee has a twofold purpose: to provide expert testimony to the courts, and to help courts with routine managerial work. The management committee consists of three to fifteen members, each of whom, according to the Act, must be either a licensed attorney, a certified public accountant or someone who has served as an officer in a listed company, or for over 15 years in a financial institution (CRA Art. 93-4). The committee advises the district court on matters concerning the debtor company, and is expected to play a substantial role in managing the day-to-day affairs of each proceeding.

***The management committee is also empowered (subject to court supervision) to:***

- a. serve as examiner as well as the trustee for small and medium-sized companies (CRA Art.95-2);
- b. review the suitability of the draft reorganization plan and coordinate the provision of information to creditors (CRA Art. 93-3 );
- c. approve certain ordinary actions of the trustee that currently require the court's approval (CRA Art.54-2);
- d. conduct an annual review of the firms in reorganization process and report findings to the court (CRA Art. 247 ); and
- e. recommend to the court as to whether the plan should be concluded or discontinued (CRA Art. 247 ).

### **3) Commencement**

When ordering the commencement of reorganization proceedings, the court also appoints one or more trustees (*kwan-ri-in*) and fixes the period for the filing of claims, the date of the first meeting of interested parties, and the date for examining the claims (CRA Art. 46). The trustee has full authority to manage the corporation (CRA Art. 53). He must also report the relevant information on the firm that he obtains to the court and the management committee, including the liquidation value and going-concern value (CRA Art. 179).

The court may appoint the examiner (*josa-wewon*) to hear opinions on the evaluation of corporate assets, financial statements, and suitability to the requirements of the proceedings (CRA Art. 181-2). The most important mission of the examiner is to calculate the liquidation value and going-concern value of the firm.

All creditors are required to file their claims within the period fixed by the court, which should be no less than two weeks and no more than four months. The court, together with the chairman of the board of directors and the trustee, will then examine each of the filed claims. If claims are established after the filing period, they shall be filed within one month from the date of origin.

Without filing claims, creditors cannot exercise their voting power. They are excluded in the distribution under the reorganization plan, and ultimately, they lose their claims. On the contrary, failure to file claims in the composition process does not result in the loss of claims.

Under reorganization proceedings, creditors are classified into three categories according to priority: 1) common benefit claims, 2) secured claims, and 3) unsecured claims. Common benefit claims are to be repaid irrespective of the reorganization plan and have priority over secured claims and unsecured claims. Art.

208 describes common benefit claims to include administrative fees for the procedure, employee salary and retirement allowance, and claims which occur after commencement under the approval of the court. Unsecured claims and secured claims, however, are subject to the corporate reorganization plan except when the court approves separate payments.

***The trustee under the reorganization proceedings has the authority to set aside the following transactions that would cause harm to its creditors (CRA Art. 78):***

a. acts that the corporation undertook knowing that they would cause harm to its creditors, except when the beneficiary of such an act did not know at the time of the act that it would cause such harm;

b. the provision of security, discharge of a debt or other acts by the corporation harmful to its creditors which took place after the suspension of payments or the filing of the petition for corporate reorganization or bankruptcy, except where the beneficiary of any such act did not know at the time of the act that there was a suspension of payments or filing of such petition;

c. the provision of security or discharge of a debt by the corporation which took place either after, or within 60 days of, the suspension of payments or the filing of the petition for corporate reorganization or bankruptcy when the corporation was not obligated to do so. This should not apply where the creditor did not know at the time of the act that there was suspension of payments, or filing of such a petition, or that the act would cause harm to the other creditors of the corporation; and

d. acts by the corporation without compensation, or with only nominal compensation, which took place either after, or within six months of, the suspension of payments or the filing of the petition for corporate reorganization or bankruptcy.

The trustee also has the authority to decide whether to per-

form or terminate any executory contract under which obligations remain to be performed by the counter party. This means that the trustee has the power to either terminate or seek action on an executory contract. He/she may exercise this power in such a manner as to allow contracts that are advantageous to the insolvent corporation and terminate those unfavorable to the corporation, generally known as 'cherry picking'. The CRA does not have a provision specifically mentioning derivatives, therefore, derivatives are handled in the realm of executory contracts.

***Creditors are entitled to set off debt owed to the corporation against their claim to the corporation except in cases prescribed in Art. 163:***

- a. where the creditors' debt to the corporation was incurred after the commencement of the corporate reorganization proceeding;
- b. where the creditor acquired a third party's claim against the corporation after the commencement of the reorganization proceeding; and
- c. where the creditor acquired a claim knowing that there was a suspension of payment by the corporation, or a petition for reorganization proceeding was filed, unless the claim was acquired by operation of law or is based on a cause that arose prior to the creditor's becoming aware of the suspension of payment or the filing of the petition; or is based on a cause that arose one year or more prior to the commencement of the reorganization proceeding.

The creditor's right to set off under reorganization proceedings, however, must be exercised on or before the last day of the period specified for filing creditor claims.

Insolvency is not criminal, and managers of insolvent companies are not considered criminals. Neither the CRA nor the Criminal Code orders any criminal investigation upon the com-



mencement of corporate reorganization procedure. Criminal charges against corporate directors have been unusual in Korea even in a bankruptcy situation. But, if evidence of embezzlement or breach of trust is revealed the prosecutor may bring an indictment against managers. The situation for insolvency proceedings is almost the same for the normal business process as far as criminal matters are concerned.

Directors are to be sued by their own corporation if they act against their duty or the law and cause damages to the corporation (Commercial Code, Art. 399). Derivative suits may be brought by the shareholder(s) with 3 percent or more of issued shares (0.01 percent for listed corporations) if the corporation does not exercise its claim.

The CRA stipulates a summary procedure called “assessment” against a director who is liable for damages to the corporation (Art. 72). When the court discovers damage to the corporation caused by the director, the court orders the director to pay damages to the corporation, bypassing much time and expense involved in a regular damage recovery suit.

Civil and criminal charges against directors have not been exercised often. This is particularly true of large companies, including listed companies. But the crisis in 1997 has changed the situation to some extent. The rights of minority shareholders have become an important agenda item in citizen activism. An activist group brought a derivative action against the former president and directors of Korea First Bank and the local court ordered the bank to pay compensation of US\$33 million for damages incurred. This was the first derivative suit concerning a listed corporation in Korea. It is doubtful that the accused directors can pay the damages, because they do not have liability insurance or sufficient property to use as recompense. However, legal actions with respect to responsibilities of directors are expected to increase as shareholder activism has grown more prevalent after the crisis.

There has been much criticism that the information on an applicant corporation does not flow effectively among interested parties in a reorganization process, including the creditors, the trustee, the corporation, and the court. As the trustee is responsible to the court, not to the creditors, creditors did not have an appropriate way to communicate with the court or the trustee. To improve this situation, the 1998 Amendments established a creditors conference.

Within a week of receiving the notice of commencement of the corporate reorganization process, the management committee (or the court) organizes a creditors conference, which consists of up to ten major creditors. The conference is a channel between the court and creditors. It may disseminate information among creditors and render creditors' opinions on major processes, including appointing trustees, payment approval, or other matters requested by the court.

The trustee is another bridge between the court and the corporation. The court obtains the information on the firm mainly through documents submitted by the trustee. In addition, the court may question the trustee on any issues. The examiner also provides basic financial information to the court. The district court can allow creditors to have access to the information necessary to determine whether the corporation is appropriate for the corporate reorganization procedure.

#### ***4) Reorganization Plan***

Based upon the confirmed claims and the result of due diligence, the trustee drafts the Reorganization Plan ("the plan"). The plan shall be presented to the court within the period prescribed by the court. The period shall not exceed four months from the last day of the period for filing claims. The prescribed period may be extended within two months. For small- and medium-sized companies, the extension shall not exceed one month. The Act

entitles the corporation's creditors and shareholders to submit the plan as well. However, few cases have yet been reported in which the plan was drafted by anyone other than the trustee.

Before 1998, reorganization plans usually consisted of rescheduling of debt payments with only small haircuts. Debt equity swaps were almost never used. Since most firms that applied for reorganization proceeding had more debts than assets or future earnings, such reorganization plans were frequently unrealistic. In other words, many of the debtor firms were unable to service their debts as required by the reorganization plans. However, creditors frequently agreed on such plans because by doing so they could avoid officially writing off large amounts of non performing loans, which could trigger a financial difficulty of their own organizations. Dominant shareholders of debtor firms were happy with such plans because they could maintain control of the debtor firms.

After the financial crisis of 1997 and two revisions of the Corporate Reorganization Act, the situation has changed considerably. The court is much more reluctant to authorize reorganization plans that appear unrealistically optimistic. Further, debt equity swaps are now widely used. As a result, dominant shareholders of the firms under reorganization frequently lose their dominant position by reorganization plans that require debt equity swaps. Further, the debt equity ratios of the firms under reorganization are now much healthier than in the past as a result of both larger haircuts and debt equity swaps.

Shareholders' rights are usually restricted during the corporate reorganization procedure, with their voting rights frozen. Art. 221 authorizes the court to amortize over one-half of the outstanding shares in cases where the total debt exceeds total assets. The court is authorized to amortize over two-thirds of the stocks in cases where the owners are responsible for mismanagement.

***The Act classifies creditors and shareholders according to their priority as set by Art. 159:***

- a. Secured creditors;
- b. Creditors with general priority;
- c. Creditors other than those referred to in subparagraphs b and d;
- d. Creditors with junior claims;
- e. Stockholders possessing preferred stocks in the distribution of the remaining property; and
- f. Stockholders other than those referred to in subparagraph

Art. 228 provides that there shall be fair and equal discrimination among creditors of these six categories. In practice, however, most reorganization plans apply the following categories only: secured creditors, unsecured creditors, and shareholders.

In the normal debt collection process, the claimants with senior priority are fully paid before those with junior priority. Thus, shareholders take nothing before unsecured creditors are fully paid. Priority among creditors and shareholders is strictly observed in the normal judicial enforcement process. The plan, however, usually allows junior claimants to be paid even if senior claimants have not acquired full payment.

Creditors are grouped into several categories according to their nature as creditors as well as the seniority of their claims. It is useful to note that there usually are several subcategories under each category. For instance, a typical category of creditors, which includes financial institutions with unsecured loans, is usually further divided into 1) primary financial institution creditors, such as commercial banks versus the secondary financial institution creditors, including investment banks; 2) principle creditors versus surety creditors; and 3) commercial creditors versus financial creditors. The payment schedule might be slightly different from one subcategory to another. The plan is usually drafted reflecting inflation, so it normally adds expected inflation rates to

the estimated growth rate of sales. The following statistics, obtained from a sample of 46 cases, show that debts were to be repaid in a 20 year period and that trade credits receive more favorable treatments than loans from financial institutions.

The plan is to be deliberated on and admitted to by creditors and shareholders at the interested parties meeting. There is usually a series of three meetings: The first meeting is for presentation of the trustee's report on the corporation's financial condition and examination of the filed claims. The second meeting is for deliberation of a draft reorganization plan. The third meeting is for the resolution of the draft reorganization plan. Usually the second and third meetings are held at the same time. Admission of the plan requires consent of over three-quarters of secured creditors, two-thirds of general creditors, and a majority of shareholders.

Once a draft reorganization plan has been consented to at the meeting of interested parties, the court determines whether or not to approve it. The consent of the employees is not required for the approval of the plan by the court. Public interests are not a factor to be considered either. Instead, the court shall examine whether the draft reorganization plan satisfies all the statutory requirements as follows (CRA Art. 233):

**<Table IV-2> Payment Period in Recent Cases (1996.1.1 ~ 1998.3.31)**

Claims	5years	7years	10years	15years	20years	Total
General	6(13%)	1(2%)	19(41%)	9(19%)	11(24%)	46
Secured	5(11%)	4(9%)	20(43%)	10(22%)	7(15%)	46

**<Table IV-3> Payment Ratio in Recent Cases (1996.1.1 ~ 1998.3.31)**

(%) Unsecured creditors	Up to 10%	Up to 30%	Up to 50%	Up to 75%	Up to 100%
Financial Institution	3(7.9%)	0	1(2.5%)	2(5%)	33(84.6%)
Commercial Transactions	5(18%)	0	0	2(7%)	21(75%)

- a. The reorganization proceedings or the plan conforms to provisions of the Act;
- b. The plan is fair, equitable, and feasible;
- c. The resolution was made in a faithful and fair manner;
- d. If the plan contains a merger, the shareholders' meeting of another corporation has issued a resolution for the approval of the merger contract; and
- e. If the plan determines matters requiring the permission, authorization, license or other disposition of the administrative authority, it does not contravene in an important respect the opinion of the administrative authority as prescribed in Art. 194

The most frequently visited requirements are fairness and equality. In recent rulings, the Supreme Court found the reorganization plan lacking these requirements, and thus reversed an appellate court's decision with respect to the plan's different payment schedule for damage claimants.<sup>12</sup> The Supreme Court made a similar reversal with respect to unfair and inequitable early payments and higher interest rates as applied to a state-owned bank.<sup>13</sup>

The CRA has a provision authorizing the court to approve the plan even in the event that a category of claimants fails to reach an agreement on the proposed reorganization plan, but only under the condition that the court determines the necessary clauses to protect the rights of interested parties. The Act enumerates the possible methods of protecting the rights of interested parties as follows (CRA Art. 234):

- a. to maintain the collateral for the secured creditors;
- b. to sell the collateral or corporate assets and distribute the proceeds to the secured creditors, unsecured creditors and shareholders respectively; and

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12. In re Korea Takoma, 92Kue10, 1992.6.15

13. In re Samik, 98Kue11, 1998.8.28

c. to pay fair values to claim holders

Although Art. 234 provides the basis and method of cram-downs, they have not been widely utilized in insolvency procedures. The reason is not clear.

The absolute priority rule is not stated in the Act, nor is it accepted in practice. The normal reorganization plan allows junior claimants to be paid even if some of the senior claimants have not been fully paid. Why senior claimants consent to a plan with such distribution rules is not clear.

The best interest test is used in the United States as mechanism to protect the dissenting creditors. This means that the dissenting claimants are guaranteed to receive the amount that they might receive in liquidation. The CRA does not explicitly provide this rule. However, the liquidation value will be preserved in practice because the total value distributed in the reorganization process shall be larger than the liquidation value if distribution is fair.

The feasibility test can be applied throughout the whole process from the filing of the petition to the successful conclusion of the plan. If the court discovers that there is no possibility of rehabilitation before issuing a provisional protection order or commencement order, it shall dismiss the petition. Even before a reorganization plan is adopted at the interested parties meeting, the court shall discontinue the process if it recognizes that there is no possibility of rehabilitation (CRA Art. 272 ). Feasibility is one requirement for the approval of the plan by the court (CRA Art. 233). Even after a plan is authorized by the court and is in implementation stage, the court shall discontinue the procedure if the plan becomes infeasible (CRA Art. 273, 276).

### ***5) Post-confirmation Procedures***

Once a corporate reorganization proceeding begins, the

authority to manage the operation and assets of a corporation is vested exclusively with the trustee, subject to court supervision. Although the Act did not formally exclude the incumbent management or major shareholders as a trustee in the reorganization process, the 1992 Rule clearly stated that any attempt for the former dominant shareholder to regain control of the firm should be blocked. The Rule reflected public sentiment that someone should be held responsible for the failure of the corporation. Retired officers of financial institutions were often appointed trustees because the creditors' opinion was receptive to the court.

The 1998 Rule repealed the provisions and recommended that the court appoint the trustee with due consideration given to the opinions of the corporation, the management committee, and creditors' conference. Though it does not exclude the former manager from being a candidate for trustee, it is still so cautious as to suggest that a co-trustee recommended by the creditors conference be appointed in cases where the incumbent manager is named as the trustee.

In addition to the regular salary, the court may allow the trustee a special bonus or stock option as compensation for his/her achievements. According to the Seoul District Court's internal guidelines, the special bonus can amount to up to one hundred million Korean won.

The trustee has no fixed term in a normal reorganization plan. The court supervises the trustee in a general sense. The trustee shall manage the firm with the care of a good manager and is liable for any damages that he causes by neglecting his duty of care (CRA Art. 98-4). The court is entitled to dismiss the trustee in cases of sufficient cause (CRA Art. 98-5). It is generally understood that 'sufficient cause' means negligence as well as bribery or false reporting.

Once the court approves the reorganization plan, the trustee implements the plan under court supervision. If the plan has been implemented completely, or it is deemed certain that the



plan will be successfully implemented, the court may conclude the reorganization proceeding. As a reorganization plan is usually organized for a duration of 10 years, it takes several years for complete implementation. A merger and acquisition (M&A) would be a common cause for early conclusion of a plan. Upon conclusion of the process, the managing authority of a corporation reverts to the corporation's directors.

If, on the other hand, it becomes apparent, either before or after the approval of the reorganization plan, that the corporation cannot be rehabilitated, the court may decide to discontin-

**<Table IV-4> Duration from the Order of Commencement to Conclusion in Cases where the Reorganization Process was Concluded in the Last 5 Years**

	Number of Cases	3 years	5 years	7 years	10 years	15 years	20 years
1993	4	0	1	1	2	0	0
1994	9	0	0	1	4	4	0
1995	5	1	0	0	0	3	1
1996	8	0	0	1	1	5	1
1997	5	3	0	0	1	1	0
1998	2	1	0	0	0	1	0
Total	33	5	1	3	8	14	2

**<Table IV-5> Duration from the Order of Commencement to Discontinuance in Cases where the Reorganization Process was Discontinued in the Last 5 Years**

	Number of Cases	3 years	5 years	7 years	10 years	15 years	20 years
1993	12	6	2	2	2	0	0
1994	16	6	2	1	6	1	0
1995	24	5	8	7	0	4	0
1996	18	5	6	3	0	4	0
1997	15	5	5	0	3	2	0
1998	6	3	1	1	0	1	0
Total	91	30	24	14	11	12	0

ue the reorganization proceeding. In this case, the court shall declare the corporation bankrupt as in the case of disapproval of the plan (Art. 23). Even with the cessation of the procedure, the change of claims or discharge according to the plan will still be effective. The cessation of the procedure does not have a retroactive effect.

<Table IV-4> and <Table IV-5> show duration from the commencement to the conclusion or discontinuance of the reorganization procedure.

## **6) Problems and Analysis**

Before the onset of the economic crisis, the corporate reorganization proceeding had been the most heavily used among the three court-supervised proceedings for handling large bankrupt firms. Large firms had rarely, if ever, been subject to forced liquidation through the bankruptcy act. The composition act had been in existence for quite a while, but in practice had rarely been used prior to the economic crisis, as can be seen from <Table IV-1>.<sup>14</sup> The corporate reorganization act and the way the court handled the reorganization cases had been subject to heavy criticism even before the onset of the crisis. Aspects of the reorganization proceeding that had been criticized frequently by the experts can be summarized as follows:

1. Courts handled the reorganization cases too slowly.
2. The reorganization proceeding was too lenient to debtor firms and their shareholders.
3. Reorganization proceedings had been abused by the firms for which liquidation was clearly a more efficient alternative than rehabilitation as a way to evade liquidation.
4. Court receivership itself was inefficient and could not increase the economic value of the firms under the control of the

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14. Probably because few lawyers understood the composition act at the time.

court.

5. The court did not have sufficient number of judges who had the expertise and experience to handle reorganization cases competently.

Few had confidence in the court-supervised reorganization proceeding as the main mechanism to resolve the bankruptcy of large firms when the financial crisis developed in 1997 and 1998. Responding to the economic crisis, the Korean government revised the insolvency laws in 1998 and again in 1999. In addition, the court devised a set of rules aimed at improving the efficiency of the reorganization proceeding. The Supreme Court has issued new guidelines for the corporate reorganization process along with a set of guidelines for the composition proceeding. Furthermore, some local courts with insolvency jurisdiction have put in place internal rules on insolvency case management in an attempt to improve the efficiency of the proceeding.

Revisions led to impressive improvements on several fronts. The amount of time needed for a reorganization case has been shortened by at least several months. The court is not required by the revised corporate reorganization act to make a commencement decision within 2 weeks of filing for corporate reorganization. Approval of the reorganization plan now normally takes place within 1 year from commencement. The court now also plays a much more active role than managing the bargaining process of stakeholders. The revision requires that the court must reject an application for corporate reorganization if it finds that the going concern value of the firm is smaller than its liquidation value. The court also must sentence forced liquidation by the bankruptcy act in such cases in order to induce a prompt reallocation of the resources of the firm.

Further, the court is now much more active in trying to induce the stakeholders to agree on a reorganization plan that is feasible and efficient. The court tries actively to persuade the

creditors to agree to reduce the size of debt to a level that is feasible for the firm to repay within the time framework dictated by the plan. If debt equity swaps are necessary to reduce the debt to such a level, the court asks the creditors to participate in debt equity swaps. The court is believed by some experts to have made sizable improvements over the management of firms under court receivership.

However, reorganization proceedings are still plagued by several fundamental shortcomings. First, the reorganization process still suffers from distortion in corporate governance of creditor institutions. Few banks in Korea, if any, have a governance structure that is based upon profit orientation. Many banks face financial difficulties themselves as the bad debt problem is far from over. Weak governance and weak financial positions of banks give their employees an incentive to agree to a reorganization plan that leaves most debt intact, even when they know well that such a plan is not feasible. Lack of profit incentives within banks also lead to inefficient lending decisions as well as ineffective monitoring of debtor firms by bank employees, resulting in a high incidence of bankruptcy.

Second, the reorganization process suffers heavily from poor accounting standards in Korea. In most reorganization cases, a significant amount of time is needed merely to fix the creditors and their loans as accounting books frequently omit liabilities and loan guarantees. The real value of assets frequently deviates from the value in the accounting books. False accounting statements were not vigorously sought and punished in the past. Regulations on accounting standards became tighter in the past three years. It is not clear, however, whether the strengthened standards are vigorously enforced. There is no strong evidence that accounting books of the firms, particularly of the bankrupt firms, are now trustworthy.

Third, weak corporate governance of large firms - almost all of them are affiliated with *chaebols* - and poor financial states of

bankrupt firms work as both a main cause of the plethora of bankrupt firms and a barrier to more efficient resolution of bankruptcy. Dominant shareholders of *chaebol* firms have been able to exercise near full control of the firms even though their own shares are relatively small. They have frequently used strong control over the firms in ways that are beneficial to them but detrimental to other shareholders. Further, dominant shareholders of *chaebol* firms had sought rapid expansion through heavy borrowing before the onset of the crisis, resulting in very high debt equity ratios. When some of these firms subsequently went bankrupt, their net firm value was negative or close to zero in most cases.

Dominant shareholders of such firms found themselves in a peculiar situation. They were in control of bankrupt firms with large asset values, but the net value of the firms accrued to them was zero or insignificant. It seems clear that they have little incentive to try to maximize firm value. Instead, they would have strong incentive to try to hold on to control of the firm for as long as possible, and use this control in their own interests. Dominant shareholders of bankrupt *chaebol* firms thus frequently attempt to hide financial difficulty of their firms, to delay the proceedings when the bankruptcy of their firms gets eventually revealed, and to resist resolutions that would require them to relinquish control of the firms.

Fourth, although no reliable statistical study of the reorganization cases exists, scattered evidence as well as discussions with practicing lawyers and judges suggest that the absolute priority rule has been violated in most of the reorganization cases. Before 1998, debt equity swaps were rarely, if any, used, and reorganization plan usually focused on unilateral debt reduction. Thus, shareholders were given more favorable treatment than that mandated by the absolute priority rule. After 1998, debt equity swaps have been widely used. However, a reorganization plan allowing the old shareholders to maintain around 10% of shares even when net firm value is deep into red appears to be a com-

mon practice.

Finally, the reorganization proceeding is inefficient in that it gives the court control of the firms for which reorganization plans were approved. The court exercises its control for many years, as a reorganization plan is usually drawn up for a ten-year period now, and for up to a twenty-year period before the revision in 1998. While the court appears to have good intentions in running the firms under court receivership, it lacks the expertise and proper profit incentives needed to run a commercial business successfully. Court appointed trustees have little incentives to try to maximize firm value, and are frequently criticized for showing little interest in selling firms that they manage on behalf of the court to a third party. They are reluctant to sell these firms that they manage because the bonuses that the court gives them for selling the firms is not enough to compensate the loss from losing their jobs. In other words, the governance structure of the firms under court receivership has structural flaws.

## IV-2. Composition

### 1) *Basic Procedure*

The composition procedure process is similar to that of corporate reorganization, as shown in the following flowchart.

Filing of Petition with the Condition of Composition

⌋

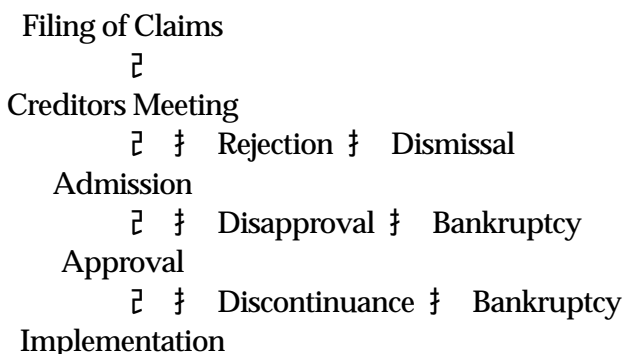
Provisional Protection Measures Appointment  
of Interim Administrator

⌋ ‡ Dismissal

Order of Commencement

Appointment of Administrator

Appointment of Examiner



## **2) Filing**

Only the debtor is eligible to file a composition petition. An individual as well as the firm may be a petitioner. If the debtor is a firm, board members' consent is required. However, the court may dismiss the petition of a stock corporation in cases where the amount of assets and debts is large and the number of interested parties is large (CA Art. 19-2). Composition has long been considered a proceeding for individuals or enterprises of relatively small sizes. A debtor is allowed to file when a cause of bankruptcy exists or when a debtor can show that such circumstances may occur (CA Art. 12).

A petition for commencement of composition should state the terms and conditions of a composition ("the condition of composition") such as the method of payment and the provision of collateral (CA Art. 13). The condition of composition can be modified under the approval of the court. The petitioner shall also submit to the court a detailed statement of assets and a list of creditors and debtors.

Automatic stay is not allowed in the composition procedure. Before deciding on a petition for commencement of composition, the court may provide a temporary protection order, appointing an interim administrator, and/or prohibiting asset disposal and

debt repayment by the debtor (CA Art. 20). The court does not allow an order to stop other enforcement procedures in the composition, although the composition act does not mention orders to stop other enforcement procedures.

An interim administrator (*bojunkwanjaein*) can be appointed at the time when the court issues the provisional protection measures. This interim administrator has virtually the same powers as those granted to the administrator who is appointed following commencement and who is entitled to monitor the activities of the debtor.

### **3) Commencement**

The Composition Act stipulates the conditions on which the court shall or may dismiss the petition (Art. 18, 19 and 19-2). The court may order the debtor firm to provide personal or material security, including the shares of major shareholders, through collateral to the creditors as a precondition to commencement of the composition procedure. Commencement shall be decided within three months from the filing with the possibility of a one-month extension.

Upon issuing the order of commencement of composition, the court sets the period for filing claims and the date for the creditors meeting. It also appoints both an administrator and an examiner on the commencement of composition. All such information regarding commencement of composition shall be made public. Known creditors and other concerned parties are notified.

Claim filing in the composition process has a different meaning from that in the corporate reorganization process. Creditors file their claims in order to exercise their voting rights at the creditors meeting. Even though a debtor does not file claims by the fixed date, and the claims are not included in the list of claims, the debtor does not lose the claims. Filing is just for participation in the creditors meeting and for exercising voting rights. There is no



process for the confirmation of claims. Priority claims that are superior to general claims are not subject to composition proceedings. Thus, secured claims are out of the scope of the composition procedure.

Under the Composition Act, creditors have the right to set aside any acts of a debtor that took place after petition filing and are not in the ordinary course of business. The creditors may also set aside any acts taken by the insolvent firm after the commencement of the proceeding without the required consent of the administrator. These rules apply only if counterparts of such transactions are aware of the situation (CA Art. 33).

Provisions on the management commission and creditors conference as detailed in the Corporate Reorganization Act are applied to the composition procedure as well.

An administrator (*kwanjaein*) in the composition procedure does not have the full authority of a trustee in the corporate reorganization procedure. The appointment of an administrator in the composition procedure does not affect the power of the debtor to manage and dispose of assets. The administrator has authority to monitor the activities of a debtor. Transactions outside the scope of the ordinary course of business are subject to the consent of the administrator, and even transactions falling within the scope of the ordinary course of business may not be undertaken if the administrator raises an objection (CA Art. 31, 32).

#### ***4) The Condition of Composition***

The creditors meet on a date fixed by the court and review the reports and opinions of the administrator and the examiner on the condition of composition. The creditors then vote on the proposed condition of composition. The consent of the condition of composition requires affirmative votes by a majority (in number) of the creditors present, representing three-fourths or more of the total amount of unsecured claims filed (CA Art. 53:

Bankruptcy Act. Art. 278).

The condition of composition consented to at the creditors meeting will be examined by the court to see if it satisfies all the legal requirements. Art. 55 lists occasions when the court may disapprove the composition. Negative requirements include those where the composition procedure or consent does not conform with the provisions of the Act, where the consent is done in an illegitimate manner, and where the consent goes against the general interests of the composition creditors. If the condition is found satisfactory, the court will approve the plan. The court may decide to discontinue composition proceedings if the debtor wishes to do so before the creditors vote on a plan, or if it does not receive an affirmative vote on the plan within two months of the first creditors meeting.

Creditors with priority claims are not subject to the approved composition. A creditor with secured claims, for example, may foreclose his collateral at any time. For this reason, a debtor usually tries to involve priority creditors in the composition plan.

The debtor runs the business without interference by the court after composition approval. Implementation of the conditions set by the plan is placed in the hands of the debtor. Following approval of the composition, the debtor corporation must report to the court every six months with respect to its payment under the plan (CA Art. 62-2). The court has the discretion to discontinue the composition proceedings if it finds that the debtor has not met, or in the future may not be able to meet, repayment obligations according to the condition. In case of discontinuance, disapproval or cancellation of the composition, the court shall, *ex officio*, adjudicate bankruptcy of the debtor (CA Art. 9).

### **5) Problems and Analysis**

The Composition Act was derived from private arrange-

ments among a small number of creditors and a debtor, and had long been thought to be unsuitable for large firms. In fact, it was rarely used by bankrupt firms prior to the onset of the economic crisis. However, the economic crisis led to excessively large number of composition cases as dominant shareholders of many large firms that fell into financial difficulties preferred composition proceedings to reorganization, because the former allowed them to maintain control of their firms, while the latter penalized dominant shareholders.

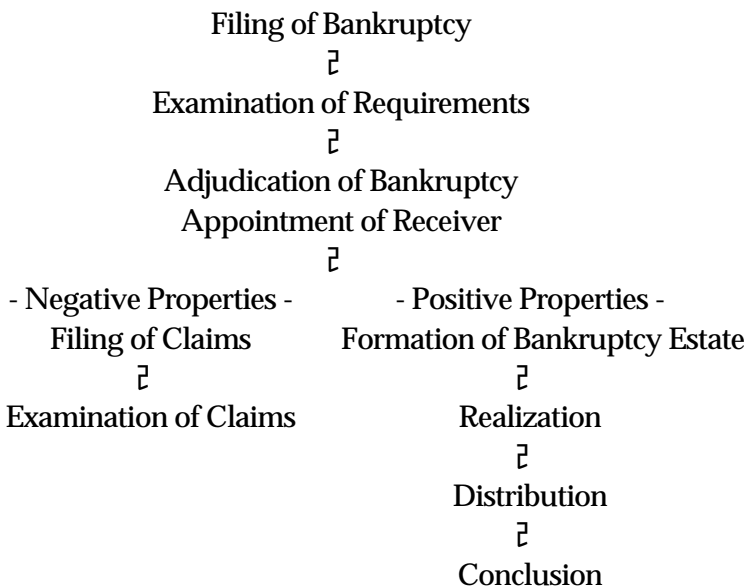
Dominant shareholders and major creditors shared a common interest in agreeing on a composition plan that is unrealistically optimistic and that requires minimal debt reduction. Dominant shareholders of the bankrupt firms with large debts and little, if any, net values put priority in maintaining control of the firms. Managers of financial institutions, most of which were under the threat of liquidation or a forced merger by the government, as they were in deep financial trouble themselves, also had incentives to acknowledge bad debt as little as possible. The plethora of composition cases in 1997 and 1998 was the results of implicit collusion between dominant shareholders of bankrupt firms and managers of financial institutions. Many firms which were granted composition became financially ill again within a relatively short period of time as the composition plans did not require enough debt reduction needed for the firms to turn around.

The Supreme Court finally recognized that the composition proceeding was improperly used by dominant shareholders of *chaebol* firms as a way to circumvent reorganization proceeding and prohibited large firms from applying for the composition proceeding in the 1999 Guideline. Many experts, including some judges, go further and argue for the abolition of the composition proceeding, as they believe that there is little advantage in having the composition proceeding separate from the reorganization proceeding. The fate of the composition proceeding will be the

one of the key issues in the future discussion of the reform of bankruptcy proceedings in Korea.

### IV-3. Bankruptcy

#### 1) *Basic Procedure*



#### 2) *Filing*

Bankruptcy proceeding aims at the collection of debtors' assets and distribution of realized assets to creditors in a collective manner in the event of insolvency. The debtor may be any form of legal entity, including individuals and legal persons. In general, bankruptcy requires the debtor's inability to pay debts. A suspension by the debtor of overdue payments is presumed to demonstrate inability to pay (BA Art. 116). A corporation may be

declared bankrupt when its liabilities exceed its assets (BA Art. 117).

A bankruptcy petition may be filed by a debtor, the debtor's creditor, or by a third party. A corporate director may also file the petition on behalf of the corporation. When a bankruptcy petition is not filed by a debtor, or by all directors of an incorporated body, the applicant shall establish *prima facie* evidence of valid grounds for bankruptcy (BA Art. 122 through 128).

When such a petition is filed, the court may issue an order temporarily suspending the disposition of the debtor's assets except as permitted by law or by the court. Upon review of a petition for bankruptcy, the court adjudicates the debtor bankrupt if it determines that grounds for bankruptcy exist based on the information included in the petition and further examination by the court. Otherwise, the court will dismiss the petition.

### **3) Commencement**

At the time of adjudication of bankruptcy, the court appoints a receiver (*pasankwanjaein*) with the consultation of the management committee (BA Art. 147). It also sets the period for filing claims, the date of the first meeting of creditors, and the date of the examination of claims (BA Art. 132). All such information regarding an adjudication of bankruptcy shall be made public, and the creditors, debtors, and other concerned parties are notified (BA Art. 133).

The court shall notify the appropriate government office or agency, where relevant, of the adjudication of bankruptcy, as well as the public prosecutor. Anyone having a legal interest may appeal the court's decision adjudicating bankruptcy within 14 days of public notice of bankruptcy.

Upon the court's adjudication of bankruptcy, the bankruptcy estate (*pasanjaedan*) is established with all properties of the debtor (BA Art. 6). The right to manage and dispose of the bankruptcy

estate is vested exclusively in the receiver, subject to court supervision (BA Art. 7). The receiver, immediately upon assuming the office, shall take possession of and manage the bankruptcy estate (BA Art. 175). The receiver shall have all properties in the bankruptcy estate appraised in the presence of a court clerk, bailiff, or notary public, make an inventory list and a balance sheet, and submit these items to the court. Interested parties have the right to inspect such documents (BA Art. 178, 179).

The Bankruptcy Act authorizes the receiver to set aside transactions in bankruptcy proceedings. Art. 64, which lists the avoidable transactions, is very similar in substance to the Art. 78 of the Corporate Reorganization Act. The receiver's power to terminate executory contracts (BA Art. 50) is the same as the trustee's power to terminate executory contracts under the CRA (CRA Art. 103).

All creditors are required to file their claims within the period fixed by the court, which shall be no less than two weeks and no more than four months. The hierarchy among creditors can be summarized as follows:

a. Secured claims: Secured creditors can proceed against their security on the same terms as would be available if a debtor were not bankrupt.

b. Estate claims (*jaedanchaekwon*): Estate claims are senior to all unsecured claims and can be paid by the receiver at any time regardless of the bankruptcy procedure (BA Art. 40, 41). Estate claims constitute, in nature, administrative costs for the bankruptcy procedure. Art. 38 lists various estate claims.

c. Claims with preference: The most significant example of such claims is claims for unpaid wages to employees, which are superior to any bankruptcy claims.

d. Bankruptcy claims (*pasanchaekwon*): Bankruptcy claims are the credits against the bankrupt incurred before the adjudication of bankruptcy, which are not included in other categories (BA Art. 14). These claims cannot be exercised outside of the bank-

ruptcy procedure.

e. Subordinated claims: Subordinated claims are inferior to bankruptcy claims. They include interest accrued after the adjudication of bankruptcy, damages and penalties resulting from a failure of performance after adjudication of bankruptcy, and costs of participating in bankruptcy proceedings (BA Art. 37).

As is similar in the case of creditors in the corporate reorganization, the creditors have the right to set off their debt to the insolvent corporation under the Bankruptcy Act (Art. 89 through 95). One procedural difference between the two cases, however, is that the creditor's right to set off under the CRA must be exercised on or before the last day of the period specified for filing claims for all creditors. There is no such time limit in the case of the creditor's right to set off under the Bankruptcy Act.

#### ***4) Claims and Distribution***

At the first creditors meeting, the receiver reports on the circumstances that led to the adjudication of bankruptcy, interim developments, and the present status of the bankrupt and the bankruptcy estate (BA Art. 183). The validity of claims filed by creditors can be examined at the first creditors meeting. If the receiver or any creditor does not object to a filed claim, it will become conclusive (BA Art. 215). If the receiver or any creditor oppose a filed claim, the holder of the claim may bring action to obtain a court judgment.

A resolution at the creditors meeting requires that the majority of the creditors present vote for the resolution, and the claims of creditors voting for the resolution must exceed 50 percent of the claims amount of all creditors present at the meeting (BA Art. 163). If the resolution adopted at the creditors meeting is contrary to the general interests of the creditors, the court may prohibit implementation of the resolution (BA Art. 168).

Immediately after the general examination of claims, the

receiver shall distribute money whenever he or she recognizes any money appropriate for distribution (BA Art. 228). The receiver distributes proceeds from the bankruptcy estate to creditors in proportion to their claims according to the distribution schedule prepared by him or her, and inspected by auditors (BA Art. 229 through 231). Permission from the court is required for final distribution.

### **5) Conclusion**

A bankruptcy proceeding is concluded with a court decision after the receiver has made the final distribution and presented a report at the creditors meeting. The court may also discontinue a bankruptcy proceeding in the following cases: 1) when the bankrupt applies for discontinuance under the agreement of creditors, 2) when the court acknowledges that the value of the bankrupt estate is smaller than the amount of expenses for the bankruptcy proceeding.

### **6) Problems and Analysis**

Many lawyers think that bankruptcy proceeding is not an efficient process for insolvent firms. One reason is that foreclosure serves a similar function. In the process of foreclosure, the court distributes the proceeds of debtors' properties to creditors on a *pro rata* basis regardless of who seized the properties first, meaning that collection and distribution in a collective manner is possible even in the foreclosure process in Korea. Creditors do not have to apply for bankruptcy to participate in collection and distribution. Instead, they may simply file their claims and apply for distribution in the foreclosure process.

The other reason is that insolvent firms usually do not have assets for general creditors because most properties serve as loan collateral. Being insolvent, most firms do not have substantial



properties for unsecured creditors. In some cases, they do not even have enough assets to pay fees for the bankruptcy process. For these reasons, insolvent business firms are usually out of the realm of bankruptcy proceedings. Major applicants for bankruptcy proceedings are consumers, who seek exemption from liability, and firms, which seek official winding-up. After the crisis, financial institutions have applied for bankruptcy proceedings without exception because bankruptcy proceedings are mandatory according to the statutes.

#### **IV-4. Comparison and Transferability between Proceedings**

As the corporate reorganization process and the composition process aim at rehabilitation of a debtor, these two processes cannot be engaged while bankruptcy proceedings are undertaken. In the case whereby the court dismisses, disapproves or discontinues the composition process, the court shall declare the debtor bankrupt (CA Art. 9 ). However, it is not mandatory for the court to declare bankruptcy in the corporate reorganization process. Art. 23 of the CRA authorizes the court to declare bankruptcy in cases where the reorganization process has been dismissed, disapproved, or discontinued.

There is no barrier between reorganization and composition. Thus, the debtor can file a petition of composition after the application for corporate reorganization is dismissed, and vice versa. The following <Table IV-6> shows the comparison of the three processes.

&lt;Table IV-6&gt; Comparison of Three Insolvency Processes

	Bankruptcy	Composition	Corporate Reorganization
Eligibility for Proceeding	Individual, corporate And other legal persons	Individual, corporate and other legal persons (certain large-size stock companies may not be eligible)	Stock corporation
Applicant	Debtor, creditor	Debtor	Debtor, qualified creditor(s), qualified shareholder(s)
Business Operation and Disposal of Assets	Receiver	Debtor (under the supervision of interim administrator and administrator)	Interim trustee, trustee
Qualification of Trustee/ Administrator	Individual	Individual	Individual or financial institution
Foreclosure of Mortgages and Other Security Interest	Foreclosure may not be stayed	Foreclosure may not be stayed	Foreclosure is stayed
Execution of Judgment	Stayed	Stayed	Stayed
Compulsory Redemption of Shares without Compensation	Not applicable	Redemption of shares is not required	Redemption of all or part of outstanding shares without compensation is mandatory in certain cases
Filing Proof of Claims	Mandatory	Not mandatory (if not filed, the creditor loses only voting rights)	Mandatory
Suspension of Litigation	Suspended	Not suspended (diversity of opinion in practices)	Suspended
Submission of Plan	Not applicable	Composition condition should be submitted at the time of petition for commencement of procedure (but the plan may be changed)	Plan is submitted after the commencement of the procedure
Repayment Period	Not applicable	No restriction (usually, 4- 8 years)	Up to 10 years from the approval of the plan
Court Involvement	Until completion of distribution	Until approval of condition	Until successful conclusion or discontinuance of the case

Source: Chiyong Rim.

## **V. Workouts**

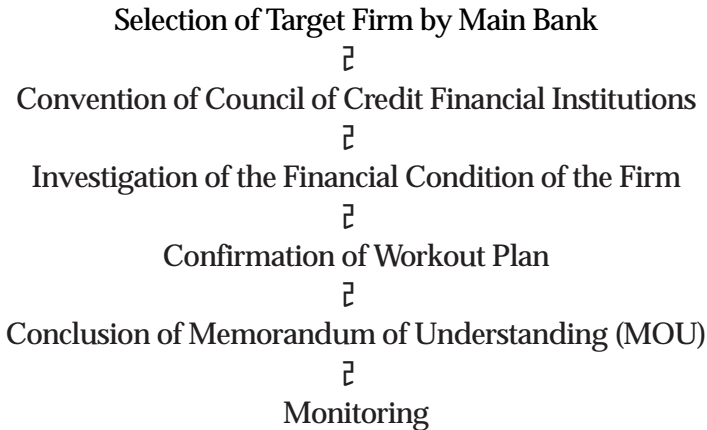
### **V-1. Legal Basis for Workouts**

The workout program was chosen in 1998 as an attempt to prevent systemic corporate bankruptcies amid mounting non-performing loans in the aftermath of the economic crisis. It was conceived partly out of the concern that the existing formal insolvency proceedings were not fully developed and efficient enough to handle such a large number of bankruptcy cases brought about by the economic crisis. The workout program is based on the Financial Institutions Agreement for Promotion of Corporate Restructuring (“Corporate Restructuring Agreement”) signed on June 25, 1998 by all major financial institutions, including commercial banks, investment trust corporations, and merchant banks. It was supposedly modeled after the London Approach, in which the central bank plays an arbitrator’s role in the voluntary negotiations between debtor firms and their creditors.

The Korean program, however, differs from the London Approach in several respects. First, every financial institution was urged to participate in this agreement, including insurance companies and security brokerage companies. Second, the Financial Supervisory Commission (FSC) has, in effect, assumed a central role in the process since it is in charge of both corporate and financial sector restructuring, even though the Corporate Restructuring Committee is the official arbitrator according to the agreement. Third, the government retained another way to directly influence the process, as it was the majority shareholder of many of the largest commercial banks. The government

became the absolute majority shareholder of many commercial banks as a result of the restructuring of the financial market in the wake of the crisis. The workout program is implemented according to the following flow chart.

**<Chart V-1> Flow Chart of Workout Procedure**



## **V-2. Process of Workout**

### ***1) Selection of Target Firms and Formation of the Council of Creditors***

The workout procedure is initiated when the main bank of either a debtor firm, or financial institutions having loans amounting to more than 25 percent of the firm's total credit, selects the firm as a target for workouts and calls for a council of creditor institutions. The targeted firms are supposed to be economically viable although they are temporarily suffering from financial distress. Whether the firm will ultimately be covered by the workout program is determined by the relative magnitude of the going-concern value and the liquidation value of the firm, which are calculated later. However, at the initial stage, there is no

criterion that distinguishes economically viable firms from those less fortunate in an objective way. The initial selection process appears to depend heavily on the discretion of the main bank.

When the main bank selects a target firm and notifies creditors of the firm, the creditors form the council of financial institutions. When the council of financial institutions is formed, debt collection on the loans made by the financial institutions joining the council is immediately suspended for a maximum of six months.

## ***2) Investigation of Target Firms***

The council of creditors assesses the going concern value of the debtor firm as well as its liquidation value. Usually, the council commissions a study by a consulting or accounting firm. The council generally requires that the going concern value exceed the liquidation value for the firm to be eligible for a workout program. Thus, the report prepared by the advisor who conducts the study or investigation of the firm is crucial in determining whether the firm will be allowed to benefit from a workout program. Hence, the advisor that conducts the investigation appears to play a decisive role in determining the fate of the firm. Advisor firms are selected through a competitive bidding process, which is deemed to be fair and transparent. However, the contracts generally do not subject the advisor firm to be liable for inaccurate reports. This has led some experts to suspect that an advisor firm, once winning the contract, does not have strong incentives to accurately report the true state of the firm and consequently tends to submit a report that is biased in favor of the firm.

## ***3) Confirmation of Workout Plans***

If it is determined that the going concern value exceeds the liquidation value, the main bank prepares a workout plan to be

reviewed and negotiated by the council of creditors. The plan generally includes a wide range of restructuring measures: debt rescheduling, interest reductions, additional financing, dissolution of cross-loan guarantees in the case of conglomerates, debt-equity swaps and capital reduction, asset and business sales, injection of fresh capital from outside investors, and management reshuffling.

After the workout plan is finally prepared, the council of creditors votes on the plan. The plan is approved when it receives 75 percent or more of the votes, in terms of the amount of the loans, in the first round of voting. If the plan fails to attract 75 percent or more of the votes, it will be subject to two additional rounds of voting. If it fails to get the approval of 75 percent of the creditors in all three rounds of voting, the main bank may request arbitration by the Committee of Corporate Restructuring.

#### ***4) Conclusion of Memorandum of Understanding (MOU)***

Once the plan is approved, the main bank concludes a Memorandum of Understanding (MOU) on corporate restructuring with the targeted firm. The MOU must include and specify self-rescue plans such as asset sales plans, reduction of capital and adjustment of personnel. In concluding the MOU, the main bank must specify the management target with quantitative and qualitative measures and the time schedule to achieve the target.

#### ***5) Monitoring***

After conclusion of the MOU, the main bank establishes and dispatches a management team to monitor the targeted firm. In addition, the main bank may construct a regular reporting system, appoint and dispatch an independent director, and construct a committee to assess the management and monitor the process of executing the MOU.

### V-3. Scope of Workouts

Little is known about the details of the workouts as most of the information on crucial aspects, such as the contents of the report by advisory firms, the magnitudes of debt to be converted into equities, and conditions for debt/equity conversion, is not publicly available. As of October 1999, a total of 93 firms, of which 54 belong to the top 6 - 64 *chaebols* and 39 not affiliated with the top 64 *chaebols*, were in workout programs. Of the 93 firms, a total of 81, consisting of 43 belonging to the top 6 - 64 *chaebols* and 38 not affiliated with the top 64 *chaebols*, had an approved workout plan. The total amount of loans held by the 81 firms was 38.4 trillion won. There were 9 firms that had sought and were denied a workout program.<sup>15</sup> Of the 9 firms, 5 belonged to top 6 - 64 *chaebols*.

<Table V-1> Contents of Debt Restructuring by Workout Plans as of June 2000

#### Firms Affiliated with 64 *Chaebols*

(Unit : 0.1 billion Won)

<i>Chaebol</i>	<i>Chaebol</i> Affiliated Firms	Classi- fication	Debt Rescheduling					
			Defermet		Debt/ Equity Swaps	Others	Total	New Money
			Reduction in Interest	Normal Interest				
Keoppyung Group	Korea Sygnetics	Workout Plan	260	1,637	214	-	2,111	-
		Realization	189	1,524	214	-	1,927	-
Sepoong Group	Sepoong	Workout Plan	1,136	117	2,998	381	4,632	-
		Realization	1,072	117	-	40	1,229	-
Kangwon Industries Group	Kangwon Ind.	Workout Plan	9,885	2,717	2,500	-	15,102	1,050
		Realization	9,885	2,717	2,500	-	15,102	1,050

15. Presumably because their going concern value was determined to be smaller than their liquidation value.

Chaebol	Chaebol Affiliated Firms	Classifi- cation	Debt Rescheduling					
			Defermet		Debt/ Equity Swaps	Others	Total	New Money
			Reduction in Interest	Normal Interest				
Kangwon Industries Group	Sampyo Ind.	Workout Plan	2,304	-	278	374	2,956	265
		Realization	2,304	-	-	388	2,692	183
Anam Group	Anam Semicon- ductor	Workout Plan	14,671	11,180	2,500	-	28,351	500
		Realization	1,938	1,526	2,347	22,540	28,351	-
	Anam Environ- ment	Workout Plan	130	-	-	93	223	-
		Realization	130	-	-	93	223	-
Ssangyong Group	Ssangyong Construc- tion	Workout Plan	4,555	4,356	5,000	1,398	15,309	856
		Realization	2,119	3,811	5,000	1,439	12,369	797
	Namkwang	Workout Plan	553	789	636	502	2,480	-
		Realization	345	584	636	507	2,072	-
Kabul Group	Kabul	Workout Plan	2,632	572	3,735	-	6,939	-
		Realization	2,614	572	1,241	22	4,449	-
	Kabul Textile	Workout Plan	2,159	-	5,313	-	7,472	190
		Realization	2,085	-	2,019	74	4,178	121
Byucksan Group	Byucksan Const.	Workout Plan	2,047	3,765	1,600	-	7,412	500
		Realization	1,637	3,392	1,499	884	7,412	1,271
	Byuksan	Workout Plan	1,595	717	-	-	2,312	-
		Realization	882	408	-	1,022	2,312	-
	Tongyang Mulsan	Workout Plan	-	1,636	-	-	1,636	-
		Realization	-	944	-	692	1,636	85
Shinho Group	Shinho Paper	Workout Plan	7,622	1,741	2,913	-	12,276	-
		Realization	7,021	1,741	2,913	601	12,276	-
	Shinho Petro- Chemical	Workout Plan	491	30	400	-	921	-
		Realization	882	30	-	9	921	-
	Dongyang Steel	Workout Plan	1,122	25	676	-	1,823	-
		Realization	1,074	25	676	48	1,823	-



Chaebol	Chaebol Affiliated Firms	Classifi- cation	Debt Rescheduling					
			Defermet		Debt/ Equity Swaps	Others	Total	New Money
			Reduction in Interest	Normal Interest				
Dongkook Group	Dongkook	Workout Plan	11,773	-	3,600	-	15,373	-
		Realization	11,197	-	3,635	541	15,373	1,307
Kohap Group	Kohap	Workout Plan	33,276	-	21,741	-	55,017	1,184
		Realization	33,276	-	-	-	33,276	1,089
Shindong- bang Group	Shindong- bang	Workout Plan	3,789	-	2,916	-	6,705	914
		Realization	4,332	-	2,127	246	6,705	914
	Coco's	Workout Plan	878	-	-	-	878	-
		Realization	889	-	-	-	889	-
Daewoo Group	Daewoo Co.	Workout Plan	258,637	-	9,344	-	267,981	19,819
		Realization	258,637	-	425	-	259,062	12,288
	Daewoo Teleco.	Workout Plan	8,344	336	13,451	181	22,312	3,155
		Realization	8,344	336	3,299	181	12,160	2,461
	Diners Club	Workout Plan	12,376	-	-	-	12,376	-
		Realization	12,376	-	-	-	12,376	-
	Daewoo Electro.	Workout Plan	41,806	3,525	11,876	181	57,225	1,696
		Realization	41,806	3,525	-	181	45,349	1,684
	Daewoo Elec. Component	Workout Plan	1,245	3,525	-	-	1,600	-
		Realization	1,245	3,525	-	-	1,600	-
	Daewoo Heavy Ind.	Workout Plan	70,411	355	13,746	25,230	109,387	920
		Realization	70,411	355	-	23,134	93,545	831
	Daewoo Auto.	Workout Plan	63,776	-	33,012	6,239	103,027	24,640
		Realization	63,776	-	-	6,239	70,015	17,207
	Daewoo Auto. Sale	Workout Plan	-	-	-	-	5,387	-
		Realization	-	-	-	-	5,387	-
	Kyungnam Ltd.	Workout Plan	976	791	1,340	2,532	5,639	100
		Realization	976	791	730	2,511	5,008	-

Chaebol	Chaebol Affiliated Firms	Classifi- cation	Debt Rescheduling					
			Defermet		Debt/ Equirty Swaps	Others	Total	New Money
			Reduction in Interest	Normal Interest				
Daewoo Group	Orion Electro.	Workout Plan	12,298	1,494	-	-	13,792	680
		Realization	10,984	1,494	-	1,314	13,792	417
	Ssangyong	Workout Plan	15,869	-	1,300	189	17,358	5,100
		Realization	14,727	-	1,212	1,419	17,358	2,321
	Daewoo Capital	Workout Plan	47,903	-	1,780	-	49,683	-
		Realization	47,462	-	-	441	47,903	-
Jindo Group	Jindo	Workout Plan	7,318	362	3,240	495	11,415	-
		Realization	7,318	362	-	495	8,175	-
Woobang Group	Woobang	Workout Plan	7,983	621	1,731	2,178	12,513	-
		Realization	6,920	621	-	2,178	9,719	-
Dong-A Group	Dong-A Construc- tion	Workout Plan	39,781	6,705	830	806	48,122	1,600
		Realization	39,264	6,705	802	751	47,522	1,563
Shinwon Group	Shinwon	Workout Plan	4,007	914	3,096	-	8,017	-
		Realization	3,951	914	669	166	5,700	-
Sub-Total		Workout Plan	693,608	49,772	151,766	40,616	935,762	63,169
		Realization	672,068	37,881	31,944	67,993	809,886	45,589

### Firms Not Affiliated with 64 Chaebols

(Unit : 0.1 billion Won)

Firms	Classification	Debt Rescheduling					
		Defermet		Debt/ Equirty Swaps	Others	Total	New Money
		Reduction in Interest	Normal Interest				
Yoojin Tour.	Workout Plan	647	300	-	-	947	61
	Realization	647	300	-	-	947	-
Dongwha D.F.	Workout Plan	2,485	-	110	-	2,595	544
	Realization	2,595	-	-	-	2,595	544

Firms	Classification	Debt Rescheduling					
		Defermet		Debt/ Equity Swaps	Others	Total	New Money
		Reduction in Interest	Normal Interest				
Dongwha Devel.	Workout Plan	718	29	-	74	821	816
	Realization	678	29	-	114	821	10
Dongbang	Workout Plan	493	919	60	175	1,647	50
	Realization	352	919	60	124	1,455	30
Dongbang T&C	Workout Plan	701	595	268	388	1,952	224
	Realization	425	595	268	320	1,608	170
Choongnam Spinning	Workout Plan	1,561	666	707	-	2,934	-
	Realization	1,561	666	-	-	2,227	-
Choongbang Co.	Workout Plan	24	101	-	60	185	-
	Realization	24	101	-	60	185	-
Peeress	Workout Plan	663	-	50	-	713	-
	Realization	663	-	50	-	716	-
Shinwoo Indusries	Workout Plan	612	-	-	-	612	-
	Realization	432	-	-	180	612	-
Mijoo Co.	Workout Plan	382	172	120	171	845	180
	Realization	347	167	120	211	845	121
Mijoo Steel	Workout Plan	695	77	296	106	1,174	61
	Realization	654	76	296	148	1,174	141
Mijoo Metal	Workout Plan	47	45	-	2	94	-
	Realization	40	45	-	9	94	-
Shinwoo	Workout Plan	1,681	516	596	136	2,929	264
	Realization	1,681	516	400	136	2,733	264
Maxon Electro.	Workout Plan	1,686	-	2,798	-	4,484	-
	Realization	4,400	-	-	84	4,484	-
Ildong Pharm.	Workout Plan	372	1,036	-	52	1,460	-
	Realization	539	785	-	93	1,417	-

Firms	Classification	Debt Rescheduling					
		Defermet		Debt/ Equity Swaps	Others	Total	New Money
		Reduction in Interest	Normal Interest				
Sungchang Co.	Workout Plan	2,001	-	-	-	2,001	146
	Realization	1,934	-	-	-	1,934	146
Youngchang Piano	Workout Plan	774	1,208	-	-	1,982	302
	Realization	774	1,208	-	-	1,982	302
Shinsong Food	Workout Plan	276	-	-	-	276	10
	Realization	235	-	-	41	276	10
Shinsong Ind.	Workout Plan	278	-	-	-	278	10
	Realization	212	-	-	27	239	10
Daehyun	Workout Plan	471	75	-	85	631	50
	Realization	471	75	-	85	631	-
Dongbo Construction	Workout Plan	2,283	-	-	-	2,283	318
	Realization	2,012	-	-	271	2,283	676
Hanchang Co.	Workout Plan	2,256	-	-	-	2,256	60
	Realization	2,218	-	-	38	2,256	60
Eyes Vision	Workout Plan	597	-	379	564	1,540	-
	Realization	597	-	-	564	1,161	-
Trad Club	Workout Plan	305	198	-	-	503	-
	Realization	250	196	-	57	503	-
Seshin	Workout Plan	581	-	-	-	581	55
	Realization	581	-	-	-	581	55
Korea Industries	Workout Plan	739	191	-	424	1,354	-
	Realization	739	191	-	424	1,354	-
Muhack	Workout Plan	-	90	-	815	905	-
	Realization	-	90	-	658	748	-
Seohan	Workout Plan	960	806	350	60	2,176	80
	Realization	1,380	27	350	419	2,176	80

Firms	Classification	Debt Rescheduling					
		Defermet		Debt/ Equity Swaps	Others	Total	New Money
		Reduction in Interest	Normal Interest				
Whasung Ind.	Workout Plan	3,371	1,777	300	871	6,319	350
	Realization	2,280	1,400	300	635	4,615	-
Samil Kongsu	Workout Plan	290	151	-	123	564	42
	Realization	287	134	-	143	564	42
Namsun Alum.	Workout Plan	602	924	450	-	1,976	240
	Realization	602	924	450	-	1,976	218
Daekyung Steel	Workout Plan	759	190	-	14	963	-
	Realization	759	190	-	14	963	-
Sub-total	Workout Plan	29,310	10,066	6,484	4,120	49,980	3,923
	Realization	30,372	8,634	2,294	4,855	46,155	2,933
Total	Workout Plan	722,918	59,838	158,250	44,736	985,742	67,092
	Realization	702,440	46,515	34,238	72,848	856,041	48,522

Note : \* Debt/Equity swaps & CB conversion

Source: Lead Bank

<Table V-1> above summarizes some of the key financial information on the workout plans as well as the realized outcomes for 68 firms that were in workout programs as of June 2000. The table enables us to have a good grasp on how the loans are treated in the workout program. The table also appears to support the claim raised by some economists that workout programs generally fail to induce injection of enough new money needed to turn the firm around. As can be seen from the table, in many cases no new money has been injected. Further, less amounts than planned have actually been injected in some cases. It is hard to draw further implications from the numbers in the table as the other key information, such as profitability, cash flows, the amount of new money needed to maximize the firm value, and so on, is not included.

## **V-4. Problems and Analysis**

As mentioned earlier, the workout program was chosen to prevent the systemic collapse of the corporate sector that in turn would lead to the collapse of the financial sector. The workout program appears to have succeeded in preventing the systemic collapse. However, the workout program has some fundamental flaws that led to inefficient outcomes. The biggest advantage of the workout program lies in the ability of the creditors and the debtor firms to bypass the costly formal bargaining process governed by the three insolvency-related acts. However, by foregoing court-supervised proceedings, the workout program also increased the incentive of some of the creditors to behave as free riders and hold out in order to extract more concessions from the other creditors.

Workouts are based on a private contract, the CRA, that constrains only the signatories to the agreements and does not bind the other creditors such as trade creditors and foreign financial institutions. As a consequence, trade creditors and foreign creditors were generally given more favorable treatment than domestic financial institutions. Such an outcome clearly deviates from the absolute priority rule. Further, it appears that the agreement also failed to solve the free rider problem among the domestic creditor institutions. The CRA stipulates that a signatory that refuses to carry out the contents of an approved plan could be subject to harsh monetary penalties. However, there has been virtually no report of cases in which such penalties were actually imposed even though there are instances in which some creditors appeared to have failed to carry out their share of sacrifices required by an approved plan.

The workout program has also been hampered by weakness in the corporate governance of banks and debtor firms. Employees of banks, which themselves were experiencing financial trouble, were more interested in minimizing the amounts of

loans that they had to write off on their books than in maximizing the expected value of the loans that they could eventually retrieve. Dominant shareholders of the debtor firms were mainly interested in maintaining control of the firms. They had an incentive to oppose a large-scale debt/equity conversion that would strip them of controlling shares even when it was necessary for the firm to turn around. Thus, both the creditors and debtors shared a common interest in not acknowledging the true state of the financial difficulty of debtor firms and in not choosing actions that were necessary to induce an efficient outcome. However, it must also be acknowledged that this problem is not unique to the workout program and is present in court-supervised proceedings as well.

## VI. Governance of Debtor Firms and Creditors, Markets for Ailing Firms

As mentioned earlier, efficiency of bankruptcy proceedings depends on the corporate governance of debtor firms as well as that of creditor institutions. Creditors are the most important players in the resolution of corporate insolvency. The *ex-post* efficiency of an insolvency mechanism critically depends on the ability of creditors to maximize their share in the division of the firm's value.<sup>16</sup> Further, *ex-ante* efficiency in the financial market at the lending stage clearly requires well-managed, profit-oriented financial institutions that are also subject to effective prudential regulation. Indeed, the most crucial factor behind the plethora of bankruptcies and inefficient handling of bankrupt firms is the unique way the Koreans designed their financial sector.

The government interfered heavily with the banking sector in order to direct financial resources to the sectors that it targeted for development. Furthermore, as the banking sector was under direct control of the government, prudential regulation had little chance of becoming effective. In the non-bank financial sector, the government allowed private ownership and management. However, most of the NBFIs were owned and controlled by *chaebol* families, who had incentives to divert funds from the NBFIs under their control to the firms also under their control. Financial

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16. It should also be noted that *ex post* efficiency of an insolvency mechanism depends in part on the ability of the mechanism to restrain the strategic behavior of some creditors aimed at extracting concessions from the other stakeholders and thereby increasing their wealth. However, to the first order approximation, the profit-oriented management of creditor institutions is a dominant variable in any effective insolvency mechanism.



regulation was not effective in maintaining reliable firewalls between NBFI's and the firms affiliated with the same *chebol*. Thus, many NBFI's failed to act as profit seeking lenders in the proper sense.

Although the governance structures of banks on the one hand, and NBFI's, on the other, differed, the results were the same. They made huge amounts of loans to large firms without due screening, which prudential lenders would not have made. They failed in monitoring the financial states of their debtor firms once they made loans and failed to act decisively to retrieve their loans even after it became obvious that some of their large debtor firms were *de facto* bankrupt. Often, they kept injecting more loans to the ailing debtor firms, which already had huge amounts of loans that they could not pay back. Finally, they colluded implicitly with the managers of the bankrupt debtor firms that went into court-supervised proceedings in drawing up and agreeing to the reorganization plans that were clearly infeasible.

Corporate governance of large firms is also an important factor in the bankruptcy proceedings in Korea. Their seemingly reckless behavior in choosing financial and business portfolios needs explanation as well as their behavior in a bankrupt situation, which almost always leads to further asset stripping. In this chapter, we analyze the governance of financial institutions and large debtor firms in Korea before the onset of the economic crisis. We start by looking at the corporate governance of large firms. The most salient picture of the corporate sector of Korea is the dominance of *chaebols*.

## **VI-1. Corporate Governance of Large Firms and *Chaebol* Problems**

Before the onset of the crisis, all of the large firms, except possibly the firms belonging to Kia Group, were controlled by *chaebol*

<Table VI-1> In-group Shareholding Ratio of the 30 Largest *Chaebols*

(Unit: %)

	1987.4	1990.4	1992.4	1993.4	1994.4	1997.4
In-group shareholding ratio	56.2	45.4	46.2	43.4	42.7	43.0
Largest shareholder and related parties	15.8	13.7	12.8	10.2	9.6	9.3
Subsidiaries	40.4	31.7	33.4	33.2	33.1	33.7

Source : Korea Fair Trade Commission.

families. A *chaebol* family owns an average of 10 percent of shares of affiliated firms. However, cross-shareholding by other affiliated firms that own an additional 30 percent of shares enables the largest shareholder to control the firms, as can be seen in <Table VI-1>. Even though banks and other financial institutions hold more than 20 percent of shares, they have not engaged in corporate governance for two reasons. First, until recently their voting was regulated so as not to affect other shareholders' votes. More fundamentally, banks in Korea have been under a poor governance structure and could not properly exercise their rights as shareholders. Individual shareholders are mostly small shareholders and could not play a meaningful role in the corporate governance of large firms.

In-group shareholding ratios for 34 *Chaebol* groups are summarized in <Table VI-2>. The figures in the table confirm that dominant shareholders of chaebol companies depended heavily on cross-shareholdings of the affiliated companies. For instance, the dominant shareholder of the Samsung Group, one of the largest *chaebols* in Korea, controls more than 46 percent of companies' shares, even though his personal shares are only around 4 percent. Many of the *chaebols* in the table went bankrupt, technically bankrupt, or fell into financial trouble in 1997 or 1998. They include Kia, Ssangyong, Hanwha, Halla, Dong-A, Dongkuk, Haitai, NewCore, Anam, Hanil, Keopyung, and Shinho

High concentration of corporate ownership and control of

&lt;Table VI-2&gt; In-group Ownership Concentration

(Unit: %)

	1995	1996	1997
1. Hyundai	60.4(15.8)	61.40(15.60)	56.2(14.6)
2. Samsung	49.3( 3.1)	49.01( 3.29)	46.7( 4.2)
3. LG	41.4( 6.7)	39.88( 6.73)	40.1( 6.1)
4. Daewoo	39.7( 6.8)	41.69( 6.80)	38.3( 7.1)
5. SK	51.2(17.7)	48.64(16.53)	44.7(14.6)
6. Ssangyong	33.1( 4.2)	37.03( 4.36)	42.0( 4.5)
7. Hanjin	40.3(22.1)	41.19(21.06)	41.4(21.1)
8. Kia	21.9(17.7)	25.59( 4.55)	30.6(21.0)
9. Hanwha	36.7( 5.5)	32.83( 6.63)	33.0( 6.3)
10. Lotte	22.3( 3.5)	22.20( 3.39)	22.8( 3.4)
11. Kumho	40.3( 2.6)	41.86( 2.45)	40.1( 2.3)
12. Halla	57.8(30.5)	55.56(22.74)	49.5(19.0)
13. Dong-A	40.1(20.1)	42.38(16.54)	54.2(12.0)
14. Doosan	51.6(14.6)	48.99(14.30)	49.7(13.8)
15. Daelim	37.6( 9.3)	33.90( 9.35)	34.2( 9.1)
16. Hansol		54.27( 8.97)	37.3( 4.1)
17. Hyosung	43.6(14.3)	44.01(14.56)	44.9(14.2)
18. Dongkuk	46.6(15.5)	50.30(17.95)	51.0(18.5)
19. Jinro	47.2(15.5)	45.58(15.67)	45.8(17.5)
20. Kolon	47.6(12.1)	49.66(11.62)	45.1( 8.6)
21. Kohap	46.7( 6.0)	46.05(10.01)	39.4( 8.6)
22. Dongbu	40.4(15.5)	43.83(13.33)	47.8(14.6)
23. Tongyang	46.1( 7.9)	53.06( 3.53)	50.1( 6.1)
24. Haitai	34.0( 5.3)	30.48( 3.91)	30.9( 6.0)
25. Newcore		99.38(35.55)	98.7(36.4)
26. Anam			42.0(10.0)
27. Hanil	43.1(16.2)	36.29(11.10)	37.4(12.2)
28. Keopyeong			59.0(17.5)
29. Miwon	49.8(18.9)		52.5(16.3)
30. Shinho			36.9(13.6)
* Sammi	30.9(13.7)	28.36(15.59)	
* Kukdong	25.0( 8.8)	26.48( 8.95)	
* Byucksan	41.3(15.1)	36.19(14.98)	
* Hanbo	88.3(88.2)		
Ave	43.3(10.9)	44.14(10.82)	43.0( 9.3)

Note : 1) 'In-group Ownership' is a weighted average of family ownership shares plus those of subsidiaries, for each group.

2) Ranking as of 1997.

3) Figures in parentheses are the sum of the ownership by the controlling shareholder and related family members.

4) For Kia, the largest shareholder is Kia Motors.

Source : Korea Fair Trade Commission.

corporations by families in Korea have led to governance structures that enable the dominant shareholding families to make key decisions on their own. Board member appointments are almost entirely at the hands of those families in control of the firms. Thus, there is a possibility of conflict of interests between dominant shareholders/managers and minority shareholders. In fact, episodes of expropriation are abundant. Even the biggest and most successful corporations that also have significant foreign ownership were engaged in questionable practices. Considering that foreign investors have a much louder voice than domestic investors do in Korea, we expect higher incidences of expropriation by dominant shareholders in corporations with smaller foreign ownership.

The distorted governance structure of *chaebol* firms led the controlling shareholders, the *chaebol* families, and the managers under their control, to choose financial and business portfolios of large firms that are not compatible with value maximization. It appears that the *chaebol* families in the past had pursued maximizing the size of the resources that they control. Such behavior can be rational from the perspective of *chaebol* families who ended up wielding near perfect control of firms which borrowed heavily from banks, but in which they put in only a small amount of their own money. In a sense, they used the firms under their control as a window of access to financial resources. Given the behavior of the financial institutions that allowed lenient lending to *chaebol* firms, maximization of the size of the resources that they control could be compatible with the maximization of the wealth of *chaebol* families.

*Chaebol* families not only forced the firms under their control to borrow heavily and invest in risky projects, many of which turned out to be so unprofitable later, but they also frequently directed the firms to take actions that expropriate the welfare of minority shareholders. Simple diversion of funds by a dominant shareholder from a firm under his control was not uncommon. In

< Table VI-3> 30 Largest *Chaebols* : July 1997

(Unit: Billion won)

	Total Assets	Total Sales	Number of Subsidiaries	Number of Listed Subsidiaries
1.Hyundai	59,325(7.25%)	69,798	57	20
2.Samsung	82,438(10.08%)	75,605	80	16
3.LG	45,482(5.56%)	48,635	49	11
4.Daewoo	37,497(4.58%)	38,620	30	10
5.SK	23,998(2.93%)	26,797	46	6
6.Ssangyong	18,305(2.24%)	20,157	25	11
7.Hanjin	17,594(2.15%)	9,972	24	9
8.Kia	14,508(1.77%)	12,038	28	6
9.Hanwha	14,388(1.76%)	10,088	31	7
10.Lotte	7,925(0.97%)	7,209	30	4
11.Kumho	8,551(1.05%)	4,834	26	4
12.Halla	6,657(0.81%)	5,297	18	4
13.Dong-A	8,873(1.08%)	5,416	19	4
14.Doosan	6,402(0.78%)	4,046	25	8
15.Daelim	6,810(0.83%)	4,970	21	5
16.Hansol	6,431(0.79%)	2,700	23	7
17.Hyosung	6,131(0.75%)	5,478	18	2
18.Dongkuk	6,764(0.83%)	3,487	17	7
19.Jinro	3,881(0.47%)	1,391	24	4
20.Kolon	4,638(0.57%)	4,471	24	4
21.Kohap	3,810(0.47%)	2,563	13	3
22.Dongbu	6,233(0.76%)	4,856	34	6
23.Tongyang	9,558(1.17%)	3,602	24	4
24.Haitai	3,398(0.42%)	2,716	15	3
25.Newcore	2,803(0.34%)	2,279	18	0
26.Anam	2,792(0.34%)	1,995	21	2
27.Hanil	2,599(0.32%)	1,277	7	2
28.Kupyung	4,963(0.61%)	1,387	22	5
29.Miwon	2,235(0.27%)	2,116	25	5
30.Shinho	2,237(0.27%)	1,223	25	6
	425,226(51.98%)	385,023	819	185

Note: Figures in parentheses are the share of total assets of the corporate sector in Korea (818 billion won) in 1996.

Source: Fair Trade Commission.

addition, transactions and loan guarantees between the firms under the same control of a *chaebol* were widely used to divert resources of the *chaebol* firms to the uses preferred by the *chaebol* owners.

Widespread use of loan guarantees resulted in bankruptcies of many firms, which were successful in their industries and which would have had no financial problems had they not made loan guarantees to some of the firms under the control of the same dominant shareholders. The best known example is Daehan Tongwun, a leading transportation company, which became bankrupt when Dong-A Construction, for which it made loan guarantees of large amounts, went bankrupt. The following two tables summarize the extent of loan guarantees among the top 30 *chaebols*.

Inefficient investment of the borrowed money in large risky projects, as well as other more onerous uses, led many of the large firms to become insolvent or bankrupt and eventually cost the lending institutions and taxpayers an unprecedented amount. High leverage combined with poor profitability of large firms in

**<Table VI-4 > Trend of Cross-loan Guarantees among the 30 Largest *Chaebols***

(Loan guarantee/ equity capital: %)

1993	1994	1995	1996	1997
469.9	258.1	161.9	105.3	91.3

Source : Fair Trade Commission and the Federation of Korean Industries

**<Table VI-5> Summary of Cross-loan Guarantees among the 30 Largest *Chaebols*: April 1997**

(Loan guarantee/ equity capital: %)

5 largest <i>Chaebols</i>	6-10 <sup>th</sup> largest <i>Chaebols</i>	11-30 <sup>th</sup> largest <i>Chaebols</i>
58.9 (64.7)	153.9 (150.3)	207.1 (200.0)

Note : Figures in parentheses are for April 1996.

Source : The Federation of Korean Industries.

Korea may also have aggravated the agency problem *vis-a-vis chaebol* families. As many of the firms under their control were heavily indebted and experienced huge losses, the net values of the firms under their control shrunk quickly, as did the net worth of their shares. Although no accurate figures are available, we conjecture that the net worth of the shares of many *chaebol* families in Korea may be negligible, or considerably small, compared to the amount of capital that is under their control today.

Nonetheless, these dominant shareholders are still tightly in control of large firms and huge amounts of financial resources, most of which came from loans that banks and other financial intermediaries made to the firms under their control. The dominant shareholders that wind up in such circumstances may find it even more attractive than before to divert resources from firms under their control.

## VI-2. Corporate Governance of Financial Institutions

In 1961, the military government nationalized all major banks in Korea. Since then, banks have been run as a device of government to channel financial resources from the private sector to the sectors targeted by the government. Most large firms started up using bank-funded loans through an above-mentioned government-directed banking system. Although the government privatized several banks in 1982 and allowed more private banks to be established since then, it did not allow shareholders of privately owned banks to participate in bank management. Instead, it continued to control the banks by appointing and firing top managers. It also intervened in many key decisions, such as those concerning large amounts of loans.

The government directed the banks to make loans to *chaebol*-controlled firms so that the money could be invested in the sectors that it targeted. Such policy loans were directed at many

firms covering many different industries. But, the most widely known example is the heavy and chemical industries that became the recipients of favorable loans during the 1970s. According to Cho and Kim (1995), policy loans in Korea constituted about half of the total credit by domestic financial institutions in the 1970s during the so-called heavy and industrial drive. Policy loans fell gradually to about 30 percent of the total credit in the 1980s, with the expansion of NBIF's, which were not required to extend policy loans.<sup>17</sup>

Policy loans became less important and less formal as industrial policies targeting industries to be promoted by government intervention in the banking sector waned during the 1990s. However, banks continued to supply credits to firms controlled by *chaebols* under a governance structure that was heavily influenced by the government. Some banks were owned mostly by a collection of *chaebols* since their privatization in 1982. However, it was ownership without control. During privatization of the banks in 1982, the government imposed a ceiling of 8 percent on individual ownership of nationwide commercial banks in order to prevent any single shareholder from exerting excessive influence on a bank's management. This restriction was further strengthened as the ceiling was lowered to 4 percent in 1994, when financial liberalization made progress.

As of the end of 1996, there were 10 shareholders, on average, who each owned more than 1 percent of the total voting shares for the nationwide commercial banks. Their combined shares accounted for 39.3 percent of the total. An average of 3 shareholders had an ownership of 4 percent or more, accounting for 24.3 percent of total shares. If similar statistics are calculated for all Commercial banks, including local banks whose owner-

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17. See Cho and Kim (1995) for an extensive analysis of government's intervention in the financial market of Korea aimed at supporting fast industrialization.



ship structure is much more concentrated than nationwide banks due to a higher ceiling, the combined shares of the 12 largest

<Table VI-6> Large Shareholders' Ownership of Banks

(As of the end of 1996)

Classification		Large Shareholders Over 1%		Large Shareholders over 4%		Ownership Share by 5 Largest Shareholders (%) (by 3 largest Industrial Capital)
		Number	Ownership Share (%)	Number	Ownership Share (%)	
5 Largest Nationwide Banks	Chohung	11(4)	45.7(14.7)	5(2)	32.4 (10.0)	32.4(12.8)
	Commercial	10(3)	35.1( 9.3)	5(1)	27.4 (7.0)	27.4( 9.3)
	Korea First	13(5)	35.6(15.7)	2(1)	12.5 (5.5)	22.4(12.5)
	Hanil	14(5)	45.5(15.8)	4(1)	20.8 (4.8)	24.6(11.4)
	Seoul	12(6)	30.6(14.2)	2(1)	12.0 (4.6)	20.3(10.3)
Average		12(5)	38.7(13.9)	4(1)	21.3( 6.5)	25.6
Nation Wide Banks	Korea exchange	9(2)	59.0( 2.1)	1(-)	47.9(-)	54.6(n.a.)
	Kookmin	9(1)	48.5( 2.0)	3(-)	37.2(-)	43.4(n.a.)
	Shinhan	6(2)	16.4( 4.5)	1(-)	- (-)	15.3(n.a.)
	KorAm	9(6)	70.4(45.6)	5(3)	64.4 (41.1)	79.9(41.1)
	Hana	16(5)	54.6(19.4)	5(2)	28.5 (11.0)	28.5(14.5)
	Boram	17(5)	52.9(26.0)	5(3)	31.4 (20.8)	31.4(20.8)
	Donghwa	10(2)	14.9( 2.3)	- (-)	- (-)	8.7(n.a.)
	Daedong	3(-)	17.1(-)	2(-)	15.2 (-)	n.a.(n.a.)
	Dongnam	7(-)	20.0(-)	2(-)	13.8 (-)	17.8(n.a.)
	Peace	9(1)	49.0( 1.3)	6(-)	42.2 (-)	37.0(n.a.)
Average		10(2)	39.3(10.7)	3(1)	24.3( 5.4)	-
Local Banks	Daegu	15(3)	40.6( 8.6)	4(1)	22.9( 5.7)	25.6( 8.6)
	Pusan	14(3)	52.0(28.8)	2(1)	31.8(23.9)	40.4(28.8)
	Chungchong	14(5)	63.9(27.7)	3(1)	36.2(16.5)	43.0(23.3)
	Kwangju	13(2)	41.7( 9.5)	3(1)	21.7( 7.9)	28.6( n.a.)
	Cheju	10(4)	51.8(31.7)	3(1)	36.6(26.5)	42.1(30.6)
	Kyonggi	13(5)	42.6(20.6)	3(2)	21.6(14.3)	28.7(17.7)
	Jeonbook	15(4)	59.4(24.3)	6(3)	41.8(23.1)	37.3(23.1)
	Kangwoon	17(3)	57.0(14.5)	4(1)	31.2(11.9)	34.9(14.5)
	Kyungnam	16(4)	50.4(20.5)	2(1)	19.4(11.6)	29.7(18.2)
	Chungbuk	16(5)	54.1(11.3)	4(1)	29.7( 4.7)	33.4( 9.3)
Average		14(4)	49.7(18.5)	3(1)	27.6(13.5)	33.0
All Average		12(3)	40.9(11.9)	3(1)	24.8( 6.6)	-

Note: Figures in parentheses indicate the number and ownership share by private industrial capital (including affiliated financial institutions).

Source: The Bank Supervisory Board.

**<Table VI-7> Share of Banks Owned by the Top 25 Chaebols**

(As of the end of 1996, Unit: %)

Conglomerates	Ownership Share
1. Hyundai	Korea First (2.20), Hanil (2.00), Seoul (1.99), Kangwon (11.89)
2. Samsung	Chohung (2.81), Commercial (7.03), Korea First (3.96), Hanil (4.76), Seoul bank(3.77), Korea exchange (1.05), Shinhan (3.36), KorAm (18.56), Hana (3.42), Peace (1.28), Dae gu(5.65), Pusan (1.02), Kyonggik(1.57), Jeonbook (1.20), Kangwon (1.22), Kyung nam (2.38)
3. LG	Korea First (3.03), Hanil (2.47), Boram (7.58), Cheju (1.80)
4. Daewoo	KorAm (18.56)
5. SK	Kyonggi (3.42)
6. Ssangyong	Chohung (1.98), Korea exchang (1.04), Hana (1.52), Kookmin (1.96)
7. Hanjin	Kyonggi (5.63)
8. Kia	Korea First (1.04)
9. Hanwha	Chungchong (16.49)
10. Lotte	Pusan (23.93)
11. Kumho	Kwangju (7.87)
12. Doosan	Boram (11.34)
13. Daelim	Hanil (3.57)
14. Hanbo	
15. Dong-A	Seoul (1.50), Cheju (2.31)
16. Halla	
17. Hyosung	Kyungnam (11.57)
18. Dongkuk Steel	Seoul (1.27), Pusan (3.85), Kyungnam (3.92)
19. Jinro	Hana (3.51)
20. Kolon	Boram (5.80)
21. Tongyang	Donghwa (1.03)
22. Hansol	
23. Dongbu	Cheju (1.06), Chungbuk (1.74)
24. Kohab	
25. Haitai	

Source : The Bank Supervisory Board

shareholders accounts for more than 40 percent of the total. <Table VI-6> shows the ownership distribution of banks in more detail.

<Table VI-7> indicate that chaebols were the major, and in fact dominant, shareholders collectively. However, there was no clear single shareholder that could claim that it had the majority

shares, as the government did not allow it. Ownership was considerably concentrated as well. However, the government somehow prohibited the shareholders from exercising their shareholder rights properly and took control of the banks. Furthermore, the board of directors of banks has not been in a position to check the management in an independent manner. Typically, the board of directors was not comprised of representatives of shareholders, but rather of insiders and the CEO, who exercised virtually full power in the nomination of directors. Non-executive directors were neither given a clearly defined role nor provided with necessary information for monitoring. The CEO and the other top managers, were appointed by the government.

One may wonder why *chaebols* invested in the shares of the banks that apparently did not give them control that normally entails ownership. But one should also note that *chaebols* got what they wanted in the end, whether they had control of the banks or not. *Chaebols* were able to extract large amounts of loans from the banks through the decisions of the government. It is worth noting that *chaebols* probably bought the bank shares with the money heavily borrowed from the banks.

Without suitable profit incentives, banks had been operating inefficiently, as lending decisions tended to be centralized in senior management, while internal risk control as well as credit analysis skills and procedures were underdeveloped.. As a result, credit decisions tended to rely on collateral and cross-debt guarantees among affiliates of business groups rather than on projected cash flows. Loan review processes and management information systems were rudimentary too. In sum, financial liberalization has expanded the controlling power of bank managers, but the lack of proper governance structure, both internal and external, increased the possibility of exploitation and misuse of the expanded power.

Unlike banks, NBFI's were free of ownership restrictions, except for life insurance companies and investment trust compa-

nies. As a result, many NBFIs are currently owned and actually controlled by *chaebols*. <Table VI-8> below summarizes the links between NBFIs and *chaebols* through ownership. As of 1997, the 70 largest *chaebols* owned a total of 109 financial affiliates - an average of five financial affiliates in the case of the 5 largest *chaebols*. Note that on average, top five *chaebols* maintained a much more visible presence in the financial sector than smaller *chaebols*.

The NBFIs affiliated with *chaebols* had extensive transactions with the other firms affiliated with the same *chaebol*. There is a possibility that those NBFIs gave affiliated firms subsidies through direct provision of funds, priority underwriting of securities issued by related subsidiaries, management of related firms' shares and their prices, and exercise of control of other firms via stock holdings on behalf of the controlling shareholders. Some of

<Table VI-8> Number of NBFIs Owned by the Top 70 *Chaebols*<sup>1)</sup>

(Unit: Number of firms as of the end of 1997)

	Top 5 <i>Chaebols</i>	Top 6-30 <i>Chaebols</i>	Top 31-70 <i>Chaebols</i>	Non- <i>Chaebols</i>
Merchant Bank (29) <sup>2)</sup>	3	7	4	14
Securities (26)	6	5	1	12
Investment Trust Company (14)	2	2	1	5
Life Insurance (31)	2	4	8	14
Fire & Marine Insurance (13)	2	3	0	5
Installment Credit (26)	2	7	3	12
Mutual Saving & Finance (219)	1	5	12	18
Venture Investment (56)	3	4	6	13
Card (7)	3	1	0	4
Finance & Factoring (46)	3	4	5	12
Total(477) <sup>3)</sup>	27	42	40	109

Note: 1) Ranking of *chaebol* is based on total borrowings.

2) The figures in parentheses represent the total number of financial institutions in each category.

3) Leasing companies (a total of 39) are excluded because they are owned by banks.

Source: National Information and Credit Evaluation Inc.

such transactions could be conflicting with the sound corporate governance of the lending institutions. For example, some *chaebols* have been using their affiliated merchant banks, especially their overseas branches, and to a lesser extent affiliated insurance companies, to finance the activities of other subsidiaries.

### VI-3. Markets for Ailing Firms and Their Assets

The Korea Asset Management Corporation (KAMCO) is the government's agency mandated to acquire and dispose of non-performing loans (NPL's) in Korea's financial sector. KAMCO was established in April 1962 as a subsidiary of the Korea Development Bank to dispose of assets which financial institutions acquired from their insolvent debtors. In the wake of the financial crisis in late 1997, KAMCO was mandated to acquire and dispose of non-performing loans in the financial sector.

The Non-performing Assets Management Fund of 33.5 trillion won was set aside to acquire NPL's of distressed financial institutions, as shown in the following table. The fund plays a crucial role in enhancing liquidity and restoring stability in the financial sector. A major portion of the fund came from the issuance of KAMCO bonds. KAMCO is authorized by the National Assembly to issue up to 32.5 trillion won worth of bonds. As of the end of June 1999, KAMCO had issued bonds

<Table VI-9> Funding Sources of KAMCO as of June 30, 1999

(Unit: Billion won)

Funding Sources	Authorized Amount	Disbursed Amount
Contribution from Financial Institutions	573.4	573.4
Borrowing from KDB	500	500
KAMCO Bonds Issuance	32,500	19,359
Total	33,573.4	20,432.4

Source: KAMCO.

worth over 19 trillion won.

Since being reestablished in November 1997, KAMCO has purchased about 46 trillion won of non-performing loans from 71 financial institutions. Approximately 80 percent of acquired NPL's came from the banking sector while the remainder was from other financial institutions, including merchant banks, insurance companies, and securities companies.

KAMCO has been disposing of its assets through various methods, such as individual REO property sales, foreclosure auctions, portfolio sales, equity partnerships and ABS issuance.

**<Table VI-10> Status of NPL's Purchased as of June 1999**

(Unit: Billion won)

Date	Designated Institution	Loans Purchased	Acquired Price
Nov. 26 1997	Korea first Bank, Seoul Bank	43,943	29,103
Nov. 28 1997	30 Merchant Banks	26,988	17,555
Dec. 15 1997	30 Banks	39,510	24,743
Sub Total ('97)		110,441	71,401
Feb. 19 1998	2 Insurance Companies	28,166	4,121
Jul. 23 1998	Seoul Bank	10,400	4,989
Jul. 31 1998	Korea first Bank	11,335	6,066
Sept. 29 1998	23 Banks, 2 Insurance Companies	230,136	90,850
Nov. 6 1998	Kwangju Bank, Jeonju Bank, etc.	4,969	2,616
Dec. 29 1998	5 Special Banks	45,308	19,030
Sub Total ('98)		330,314	127,672
Feb. 12 1999	Chohung Bank	876	428
Mar. 31 1999	Chungbok Bank	78	25
May 19 1999	P.B.O. Bonds of 5 Banks	17,514	2,804
July.7 1999	Korea first Bank	43,624	8,970
Sept. 18. 1999	Seoul Bank	45,593	11,543
June 30 1999	KorAm Bank, 50 Mutual Credit Associations	2,110	1,134
Sub total ('99)		20,578	4,391
Total		461,333	203,464

Note: P.B.O. stands for Put Back Option.

Source: KAMCO.

&lt;Table VI -11&gt; Disposal of NPL's

(Unit: Billion won)

Category		Face Value	Sale Value
Liquidation of Asset	98-1 (Distribute Residential Interest)	207.5	25.4
	98-2 (Equity Partnership)	541.2	201.2
	99-1 (Outright Sales)	772.4	123.8
	ABS 99-1 (Domestic ABS Issues)	300.7	320.0
	Secured NPL 99-1 (Outright Sales)	1,038.8	524.9
Sub Total		2,860.6	1,195.3
Asset Sale	Foreclosure Action	1,878.0	953.7
	Public Sale	261.1	119.3
Sub Total		2,139.1	1,073.0
Voluntary Repayment		1,143.9	1,121.3
Total <sup>1</sup>		6,143.6	3,389.6

Note : Estimated price.

Source : KAMCO.

KAMCO disposed of NPL's worth 3.4 trillion won as of July 1999.

## VI-4. Vulture Funds

The market for the assets of insolvent firms has recently risen in prominence, as restructuring in the corporate and financial sectors has made the management of assets of insolvent firms a major issue. Vulture funds, or companies specializing in corporate restructuring, were not fully utilized in Korea before the economic crisis. After the onset of the economic crisis, the government introduced the Industrial Development Act that allowed the establishment of vulture funds in February 1999. By September 1999, eleven vulture funds and one association had been established in Korea. The market for insolvent assets seems to be growing based on domestic capital.

The main function of a vulture fund is to acquire those firms in need of restructuring through a stock-purchase, merger, or

transfer of operation, and to sell them again after normalization.<sup>18</sup> In addition, a vulture fund can buy assets of financially troubled firms, such as real estate, that the firms are willing to sell in order to reduce their debts. A fund can also buy insolvent assets owned by financial institutions or the Korea Asset Management Corporation, mediate M&A's between firms, and conduct agency business of reorganization, composition, and bankruptcy procedures.

Firms considered in need of restructuring<sup>19</sup> are defined as those that went into bankruptcy more than once in the past three years, filed for reorganization, composition, or bankruptcy in court, or were declared in need of management normalization by the council of creditor financial institutions. A vulture fund can set up an association with other investors to finance restructuring. Mandatory investment of the vulture fund is required here to prevent conflicts of interest between the vulture fund and the association.<sup>20</sup> Such an association is defined as a legal entity under the Civil Code. The Civil Code applies to this organization except for cases as specified in the Industry Development Act. In September 1999, First Komet M&A Ltd. was enlisted as an association for corporate restructuring.

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18. The obligation to sell off acquired firms within five years of the acquisition is imposed on vulture funds. A delay is allowed for a period no longer than one year (Industrial Development Act, Art.17).

19. A vulture fund can conduct restructuring operations for only those "firms to be restructured" as specified in Article 14 of the Industrial Development Act.

20. The minimum size of the restructuring is 10 percent of the association's total investment fund.



## **VII. Other Measures Taken by the Government or Creditors**

### **VII-1. Rationalization Measures of the 1970s and 1980s**

Thus far, we have considered court-supervised proceedings and workouts that are based upon agreements among major creditors and debtor firms. These four types of proceedings are playing predominant roles in reallocating resources of bankrupt firms in Korea today. However, heavy reliance on these institutional arrangements is a relatively new phenomenon in Korea. Before the onset of the crisis, official bankruptcy of large firms rarely took place, even though many large firms fell in deep financial trouble that would have sent them to court-supervised proceedings such as Chapter 11 in the United States. Instead, financial trouble of large firms has usually been handled by the administrative branch of the government.

At the outset, it is helpful to look at the institutional arrangements dealing with insolvency problems in Korea from a historic perspective. Before the modernization drive began in the 1960s, there were few firms in Korea to talk about. Relatively large-sized firms appeared as a result of the rapid industrialization policy of the Park Chung Hee government, which pushed for investment into many industries that the government believed were necessary for Korea's development.

Park's government heavily intervened in the financial market in order to direct credits to the industries and the projects that it wanted to develop. Most financial intermediaries were forced to lend money to the firms in those industries the government sought to develop. Lending to such projects by banks owned and

operated by the government, such as the Korea Development Bank, was not uncommon either. Such heavy involvement in the financial market by the government naturally led it to consider corporate bankruptcy as a policy issue that should be addressed in the context of its industrial policies. Thus, the government tackled the insolvency of large firms by using a set of measures generally called "rationalization measures" rather than letting it be resolved through formal proceedings supervised by the court.

The Park government implemented rationalization policies in two waves. Between 1969 and 1971, a total of 112 firms were designated as failing firms and became targets of rationalization policies. The Korea Development Bank, a state-owned bank, handled the cases along with some of the commercial banks that were major creditors of the target firms. The measures consisted of debt reductions, forced sales of firms and their assets, and liquidation in some cases.

The second wave of rationalization came in 1972. In the 8.3 measure of 1972, (so called because it was announced on August 3), the Park administration introduced a wide range of policies for a total of 61 industries that included steel, shipbuilding, electronics, PVC, chemical fertilizer, and other industries important to the Korean economy at the time. In addition to the measures that are similar to the ones used in the first wave of rationalization, the 8.3 measure included tax benefits for target firms, and forced specialization of some firms. Further, Park's emergency decree nullified all existing debt contracts, except in the cases of small amounts, and substituted those with contracts that were much more favorable to debtors. The 8.3 measure was an all-out response by the Park administration to an economic crisis in which many of the firms that had been created as a result of industrial policies aimed at rapid industrialization became insolvent.

Overall, rationalization measures more closely resembled restructuring of financially troubled firms and debt restructuring

necessary to keep the firm in operation. Liquidation was rarely used. It is also important to note that rationalization went beyond restructuring of individual firms as it aimed at restructuring the target industry. Rationalization frequently entailed mergers and other forms of competition reducing actions, which resulted in significant changes in the industrial organization of the industry in which the bankrupt firms operated.

The government's command of the financial sector continued under Park's successors, although the industrial policies aimed at developing target industries lost much of their steam by the 1980s. Rationalization measures continued to be employed by the Chun Doo Hwan government as a major response to the insolvency problems of large firms. There were three waves of rationalization under the Chun administration. The set of measures called the "Adjustment of Investment in Heavy Industries," was implemented in 1982 and targeted electricity-generating facilities, manufacturing, construction, heavy equipment, automobiles, electronic equipment, diesel engines, and copper refining industries.

The second wave of rationalization measures of 1984-1985 called "Rationalization of Depressed Industries" targeted marine transportation and the overseas construction business. During 1986-1987, 57 financially troubled firms were reorganized while 21 were liquidated in the last wave of rationalization by the Chun administration. The measures used were similar to those used by the Park administration.

It is noteworthy that under the Park and Chun administrations, rationalization measures were taken unilaterally by the administrative branch of the government, and often lacked firm legal grounds or legally adequate procedures. All key decisions were made by the government, including those of whether to liquidate or restructure the firm, and the terms of restructuring or mergers when mergers were a part of the package. In fact, there were no principles or guidelines governing the rationalization

measures.

On the surface, banks were the biggest losers as they were forced to absorb most of the losses involved. But since banks virtually operated as government businesses and their losses were eventually covered by public funds, it was the general public who ultimately paid for the losses. In fact, the Bank of Korea, which is the Korean central bank, frequently provided special loans at favorable conditions to the banks whose financial health was seriously undermined by massive writing-off of loans made to the firms targeted by rationalization measures.

Rationalization policies became more formal after 1986 as the Industrial Development Act was introduced. The Act specified the conditions for the rationalization measures to be applied and the types of measures that could be employed. The key cases to which the Act was applied involved the automobile, heavy construction equipment, diesel engine, and electronics industries during the 1986-1989 period. Compared with the rationalization measures of the Park and Chun administrations, the rationalization policies under the Industrial Development Act put more emphasis on limiting competition in the industries to which target firms belonged. Measures such as forced specialization of firms, preferential treatment in procurement, and bans on additional capacities, as well as the scrapping of existing capacities, were employed in order to limit competition in target industries and thereby improve the profitability of target firms.

Rationalization policies based on the Industrial Development Act became insignificant in the 1990s as successive administrations put less emphasis on the kind of industrial policies aimed at developing target industries that had been actively pursued by the Park government. However, as a result of Park's rapid industrialization policies and financial market policies of successive administrations, most large firms were heavily indebted and highly exposed to the risk of becoming bankrupt, even in the 1990s. This, combined with the government's continued domina-

tion of the financial market, left the door wide open for government intervention in the event that large firms became bankrupt.

## **VII-2. " Big Deals " of 1998**

In 1998, the government announced plans for mergers by large firms in several industries, called " big deals, " as a part of the emergency measures at the height of the economic crisis. The plan was based on agreements by the firms involved and did not officially involve the government. However, some believe that the government played a role in setting up the " big deals ". <Table VII-1> summarizes the " big deals " plan announced on October 7, 1998. The industries covered by the plan share the common characteristic that they require a large amount of initial investment to start a business, and that a large proportion of initial investment becomes a sunk cost once the investment is made.

Assuming that the Korean government implicitly had interest in seeing some of the proposed big deals go through, one is naturally led to ask why a government would be interested in successful mergers and acquisitions between firms with sizable market shares. Normally, a government would be interested in deterring mergers and acquisitions that would significantly harm competition.

Another crucial question relevant to the arguments concerning big deals is why we have not observed efforts by the firms involved aimed at mergers that could increase combined firm value, before the big deals were proposed. The most common criticism directed at big deals is that they would severely reduce competition in the relevant industries. If big deals indeed reduce competition severely and increase the combined value of the firms to be merged, the firms must have an incentive to merge. However, mergers are not only rare in Korea. Further, even attempted mergers were rare before the onset of the economic cri-

sis.

The main reason why the Korean government may be interested in big deals is that the firms in question are heavily indebted and cannot pay back their debts. As the dominant shareholder of several banks, some of which have recently been effectively nationalized in the course of restructuring since the onset of the

< Table VII-1> “ Big Deal ”Plan

Business Line	Plan of the Deal	Controlling Body
Semiconductors	Samsung Electronics Co.	Samsung Electronics Co.
	Hyundai Electronics Ind. LG Semiconductor Co.	Hyundai Electronics Ind. (Decided in March 1999)
Power- Generation Equipment	Hyundai Heavy Industries Co. Korea Heavy Industries & Construction Co. Samsung Heavy Industries Co.	Korea Heavy Industries & Construction Co.
Petrochemicals	SK, LG, Daelim, Lotte, Hanwha	Joint ownership and control
	Samsung General Chemical Co. Hyundai Petrochemical Co.	Unclear
Aircraft Manufacturing	Korea Air Line Co.	Korea Air Line Co.
	Samsung Aerospace Industries Co. Daewoo Heavy Industries Co. Hyundai Space & Aircraft Co.	Unclear
Railway Vehicles	Hyundai Precision & Ind. Co. Daewoo Heavy Industries Co. Hanjin Heavy Industries Co.	Joint ownership and control (Share ownership ratio: 4:4:2)
Ship Engines	Hyundai Heavy Industries Co.	Hyundai Heavy Industries Co.
	Korea Heavy Industries & Construction Co. Samsung Heavy Industries Co.	Korea Heavy Industries & Construction Co.
Oil Refining	SK, LG, Ssangyong	Unclear
	Hyundai Oil Co. Hanwha Energy Co.	Hyundai Oil Co.

Note: On December 7, 1998, the swap between Samsung Motors and Daewoo Electronics was announced as an additional big deal plan.

Source: Financial Supervisory Commission. 1998.12.

crisis, the government was, and still is, keenly interested in minimizing the losses of the banks. In other words, the government could have a reason to hope for a successful merger between ailing firms with huge amounts of debt if the merger increases the combined profit streams as a way to minimize the losses to the banks. Further, mergers could lower the probability of the bankruptcy of the debtor firms if they lead to significant increase in profitability of the firms involved.

However, such a merger would require a dominant shareholder of one of the firms targeted by the proposed merger to relinquish its ownership and control of a large firm, which it has controlled with little of its own at stake. Furthermore, in cases where the net value of firms after debt is negligible or negative, the controlling shareholder would have no incentive to hand over shares under its control because it would receive little in return for giving up control over huge amounts of assets. Under such circumstances, it would be difficult for a dominant shareholder of a firm to agree on a merger. In fact, big deals have not been proceeding smoothly precisely for this reason.

Even if a big deal goes through, as has been the case with semiconductors, the question remains as to whether the profitability would indeed be improved significantly as a result of the merger. Further, even if a merger significantly increases profitability, positive effect from the increase in profitability needs to be weighed against the loss of efficiency from reduced competition. In the semiconductor industry case, few experts believed that the merger would substantially reduce competition in the market because the relevant market is the world market. It was not clear whether the merger would increase profitability either.

Our final comment on big deals is that the Korean government could have followed an alternative path in coping with firms that were included in big deal proposals, namely workouts. A more standard way of dealing with large ailing firms has been workouts, in which creditors give up some of the loans that they

made to the firms in return for shares of debtor firms. Had the government chosen this path, the creditors of firms that were big deal targets would have become the new owners. The new owners of the firms then could voluntarily decide whether to merge their firms and negotiate the terms of the merger. If they were to agree on a merger, it should then be up to the Fair Trade Commission (FTC) to determine whether to allow the merger based upon efficiency criteria.

### **VII-3. More Discussion on the Role of the Government**

There are at least two reasons why the government wants to play a role in bankruptcy mechanisms even in a country that is equipped with a relatively well-established court system. First is the possibility of a systemic crisis. It may be too costly to let the court handle cases when a large number of firms fall into financial trouble simultaneously. Furthermore, in countries where financial markets are not well developed, serious financial difficulties for major financial institutions and a severe credit crunch could be caused by the bankruptcy of even a couple of large firms, which in turn could precipitate the collapse of the other firms and financial institutions. The government should try to stop this vicious cycle and contain bankruptcy to isolated cases.

Most Asian countries, except Japan and Singapore, appear to fall into the category of developing countries in which financial markets are underdeveloped compared to the real sector. Furthermore, most Asian countries have seen an influx of capital from the international financial market. A sudden reversal of foreign capital flows could trigger a financial crisis that may well send even the largest firms and financial institutions into deep financial trouble. Combined, these two factors - the underdevelopment of financial markets and heavy reliance on foreign capital - could trigger a systemic bankruptcy relatively easily compared



to more mature economies.

Concerns over such systemic crises are believed to lie at the heart of government initiatives in various forms of informal proceedings. However, it should be clearly understood that the effects of insolvency proceedings in which the government plays a role are not limited to the macro-performance of an economy. Government intervention affects efficiency and fairness at the micro level, and in effect, determines the incentive structures faced by various economic agents, including firms and financial institutions, their shareholders and managers, and even ordinary taxpayers.

Second, there is a possibility that the government is linked to insolvency of large firms in a more systematic way. The industrial policy or development strategy of a country can be a crucial factor in determining the state of insolvency proceedings as well as the state of the financial market in some countries. Many countries which embarked on industrialization relatively late had, or still have, political systems that give more discretion to the administrative branch of the government than most advanced countries that have longer histories of democracy and capitalism. In some of these countries, past or present governments have pursued rapid industrialization through a hybrid economic system. Such a policy often entails heavy intervention by the government in the financial market because the government needs money to support target industries or target firms.<sup>21</sup>

Often, some of the projects that were financially supported by the government turn out to be money losing businesses and end up bankrupt. The government has a strong incentive to intervene in handling bankruptcies of such firms for two reasons. First, when the government intervenes heavily in the financial

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21. The industrial policies aimed at promoting an industry ultimately lead to subsidies to firms. It is very difficult to distinguish the policies designed to support firms from the policies aimed at developing industries in many cases.

market, all the major problems of the financial market become business of the government. This is especially true when a large number of financial institutions become financially troubled as a result of a bad lending decision for which the government is ultimately responsible. Second, the government sometimes wants to continue to promote industrial policies for the industries in which the bankrupt firms operate.

Thus, there is a possibility that insolvency cases are handled by the government as part of an industrial policy in combination with financial market policies designed to support the industrial policy. This kind of policy mix has far-reaching implications not only with respect to insolvency mechanisms, performance of financial markets, and insolvency of financial institutions themselves; but also a wide range of economic issues, including corporate governance of firms and financial institutions, competition policies, and fiscal policies.

## **VIII. Comparative Analysis of the Bankruptcy Proceedings of Six Asian Countries**

In this chapter, we compare bankruptcy proceedings as well financial market conditions in six Asian countries: Korea, Indonesia, Philippines, Thailand, Malaysia, and Singapore. This chapter consists of two parts. Section VIII-1 below contains an analysis of the characteristics of financial markets and corporate governance structures in the six countries. This part attempts to characterize the key players in the processes involving bankrupt firms in these countries: financial institutions, shareholders and managers of debtor firms, and the government. Subsection VIII-2 deals with insolvency proceedings. This part summarizes the salient features of formal insolvency mechanisms of the six countries and also compares the differences across countries.

Generally speaking, Singapore is far ahead of the other five countries in overall quality of legal infrastructures governing economic activities, including insolvency mechanisms as well as institutional arrangements concerning financial markets. Malaysia is also equipped with reasonably well functioning infrastructures concerning bankruptcy and financial markets. In the other four countries, neither the financial markets nor the insolvency mechanisms worked properly before the onset of the crisis. Many reform measures have been introduced since 1997 regarding financial markets in general, and insolvency mechanisms in particular. It is too early to evaluate the effectiveness of the reform measures with any precision at this point.

## **VIII-1. Creditors, Debtors, and the Government**

### ***1) Financial Markets***

It is difficult to compare the financial markets of the six Asian countries with any precision based upon objective criteria. However, scattered pieces of information, casual observation, as well as OECD country reports (1999, Seoul)<sup>22</sup> suggest that prior to the crisis, Indonesia, Korea, the Philippines, and Thailand generally failed in inducing efficient corporate governance structures of financial institutions and establishing effective prudential supervision; Singapore, and perhaps Malaysia, fared significantly better.

The role of the government as a corporate governance agent in the banking industry was strong in Indonesia and Korea; and relatively weak in Singapore, Malaysia, and the Philippines. In Korea, the government allowed private investors to purchase up to 8 percent of a bank's shares, but prohibited private shareholders from taking control of bank management. The government interfered heavily with key decisions concerning the governance of banks, such as selection and dismissal of top managers. It also affected major management decisions through influence on top managers. In Indonesia, state banks were run by management vulnerable to meddling by politicians. Thus, bank decisions on lending were generally not profit-oriented. In the other four countries, the proportion of state banks was not a significant factor.

In all of the countries except Korea, ownership and control by private shareholders was allowed. In Indonesia, the Philippines, and Thailand, the majority of private banks were

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22. See Malaysia government (1999), Nam et al. (1999a), Nam et al. (1999b), Saldana (1999), and SFC (1999),

owned and controlled by the same families with controlling interests in conglomerates. Such joint ownership and control of banks and firms by the same shareholders is not a prevalent feature in Malaysia and Singapore.

The corporate governance of non-bank financial companies is not much different from that of banks. Most non-bank financial companies are privately owned and controlled, as is the case with the banks in these countries. In Indonesia, the Philippines, and Thailand, most non-bank financial companies are owned and controlled by families that have controlling interests in conglomerates. In Korea, too, private ownership and control of non-bank financial companies was allowed, unlike in the instance of banks. As in Indonesia, the Philippines, and Thailand, chaebol families with controlling interests in conglomerates dominated the majority of non-bank financial companies.

Prudential supervision was relatively effective in Singapore and Malaysia, but was ineffective in the other four countries. Although Thai banks and NBFIs were, on the surface, somewhat restricted in directly holding shares of listed non-financial business firms, they were able to, and indeed did, hold a controlling share in listed companies through their equity shares in holding companies which are not subject to investment restrictions. The investment records of Thai banks also revealed extensive investments in unlisted companies.<sup>23</sup> In short, financial institutions faced a conflict of interest as creditors in these countries. There is evidence that lax regulation by the authorities, together with policies that gave strong tax incentives to offshore borrowing, led to a

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23. Korean banks have been subject to a restriction that limits their holdings in listed non-financial companies. The ceiling was 10 percent before the onset of the crisis, which was later relaxed to 15 percent in order for the banks to be able to participate in debt-equity swaps involving bankrupt debtor firms. As mentioned above, banks in Korea did not have dominant private shareholders and as a consequence were not subject to the kind of conflicts of interest that the banks in the above three countries faced.

sharp increase in lending by Thai financial companies to the real estate and property sector, mainly financed with borrowing from abroad.

In Indonesia, lax regulation along with continued government subsidies to financially troubled banks gave distorted incentives to bank managers.<sup>24</sup> In Korea, weak prudential supervision, coupled with the *chaebol's* domination of NBFI's, resulted in the collapse of many NBFI's and signaled the start of the economic crisis. In the Philippines too, weak prudential supervision and ownership and control of banks by conglomerates resulted in many banks becoming the cash vaults of conglomerates.

The situation in Singapore and Malaysia appears to be much better than in the other four countries. Prudential supervision seems to have resulted in reducing the possibility and scope of conflict of interests to tolerable levels. In Malaysia, only a few are controlled by conglomerates. In addition, prohibition on loans to related parties and stringent enforcement of this rule by the central bank have greatly reduced opportunities for business groups to avail themselves of easy loans through their close ties with banks. In Singapore, legal infrastructure regarding the operation of banks is well established and enforced. MAS (Monetary Authority of Singapore) has been effective in conducting judicial reviews of various bank activities. It has also been quite effective in performing regulatory supervision of the activities of financial institutions related to corporate governance. For example, it maintains the right to approve director appointments on the boards of financial institutions

In short, joint ownership and control of banks and debtor firms, combined with lax prudential supervision, generally led to inefficient management of lending institutions in Indonesia, Korea, Thailand, and the Philippines. In particular, large amounts

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24. See, for instance, Corsetti et al (1998).

of loans were made by the financial institutions to firms under the control of the same families as the lending institutions. In Korea, where private control of banks was prohibited, lack of adequate governance structures and intervention by politicians in bank management led to massive amounts of loans to unprofitable projects.

Problems with the corporate governance of banks and NBFIs and lax prudential supervision not only led to improper lending decisions as stated above, but also resulted in inefficient outcomes once insolvency occurred. Banks and NBFIs in Indonesia, Korea, the Philippines, and Thailand have all tended to refuse to both acknowledge the financial difficulties of their debtors, and initiate insolvency proceedings to resolve the situation.

In Korea, banks often kept pumping money into large, ailing debtor firms, just to keep them afloat, as we mentioned in earlier chapters. These firms had already taken out excessive amounts of loans and were viewed as unable to pay back existing debts. Banks in Indonesia and Thailand, which were owned and controlled by private shareholders, also shared the tendency to refuse to officially accept debt reduction when facing insolvency of debtors, even when it was obvious that firm value was smaller than the amount of loans. In sum, many lending institutions that fell into deep financial trouble themselves as a result of reckless lending, also frequently indulged in asset-stripping activities as they found little incentive to reveal their debtors' problems and engage in bankruptcy proceedings that would only bury them.<sup>25</sup>

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25. Two examples seem to aptly illustrate this point. A major bank that fell into financial trouble in 1998 as a result of the bankruptcies of its debtor chaebol companies offered a very high interest rate in a desperate attempt to attract savings and avoid bankruptcy. This method cost the bank heavily, and the bank eventually went under. In a parallel example, Daewoo Motors introduced a large discount on its automobiles, which was viewed by creditors as an asset-stripping marketing strategy aimed at temporary relief from liquidity problems in the final days before bankruptcy was officially acknowledged.

Ineffective governance structures and inadequate prudential supervision in Indonesia, Korea, and Thailand ultimately resulted in massive amounts of non-performing loans. The proportion of non-performing loans held by commercial banks in Korea was estimated to be 22.7 percent as of December 1997, and 58 percent in Indonesia as of December 1998. In contrast, the proportion was 7.3 percent in Malaysia as of December 1998, up from 3.2 percent for the same month in 1997. Thus, while Malaysian banks clearly suffered from the economic crisis that hit the region, they were in a much healthier condition than their counterparts in Indonesia and Korea. These findings are consistent with the state of corporate governance and prudential supervision in the three countries. Consequently, many banks and NBFIs were closed in Indonesia, Korea, and Thailand.

The final point we wish to make concerning the financial markets in Asia is that they are still underdeveloped in most countries. The markets for mergers and acquisitions are generally very thin. The market for various claims to insolvent firms is also very thin or nonexistent. Consequently, trading of claims on financially troubled firms rarely takes place in the financial market. This market has been dominated by government businesses, such as DANAHERTA of Malaysia and KAMCO of Korea.

## ***2) Corporate Governance***

It is well known that conglomerates dominate the corporate landscape in Asia, and that, except in Japan, Singapore, and Hong Kong, conglomerates are tightly controlled by families.<sup>26</sup> Dominant families have been using schemes such as cross share-holdings and cross-loan guarantees in acquiring and maintaining control of multiple firms in diverse industries. Self-dealing and

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26. For details on ownership distribution and concentration of control in Asian firms, see Claessens et al. (1998) and La Porta et al. (1998).



the simple diversion of funds by dominant shareholders (managers) from firms under their control was quite widespread in four of the six Asian countries, excluding Singapore, and possibly Malaysia. It is true that these countries have laws and regulations designed to guarantee minority shareholders certain rights to information and participation in decision-making.

However, when control is concentrated, rights of access to information and participation in decision-making may not be sufficient because dominant shareholders could override the opinions of minority shareholders by vote. Thus, the effectiveness of remedial measures available to minority shareholders is crucial when dominant shareholders or managers act against the interests of the firm or shareholders in general. Previous studies generally conclude that remedial measures are not effective in these countries.<sup>27</sup> Further, regulations concerning the accuracy of financial information provided by firms was also not satisfactory. Most of the above countries have introduced a wide range of reform measures to deal with corporate governance problems since the onset of the crisis. However, there is no evidence that the newly introduced reform measures are rigorously enforced.

It is hard to tell how the presence of such dominant families affects the behavior of a firm in reporting financial difficulties and in responding to bankruptcy situations in general. Nonetheless, it is reasonable to expect that a group of firms, under unified control of a dominant family and interconnected by cross shareholdings and cross-loan guarantees, is more likely to hide adverse financial information and resist entering insolvency proceedings. The dominant family has too much to lose by admitting difficulties, or by agreeing to a reorganization plan that is acceptable to creditors. This is especially true when the firms, as a group, have excessive debt compared to equity.

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27. See, for instance, Nam et al (1999).

Cross shareholdings and cross-loan guarantees could work in favor of dominant shareholders as they can give temporary assurance to creditors, however false these assurances turn out to be later on. However, the same strategies could send the whole group of firms into bankruptcy when only one or two firms perform poorly in their respective industries. This is devastating not only to shareholders and managers of most firms in a conglomerate, but also to creditors as well as the court and the government. As what could have been an isolated incidence of insolvency quickly spreads into full-blown bankruptcy of a string of large firms with diverse stakeholders, the problem becomes much more difficult and costly to solve. In most developing countries, bankruptcy of a major conglomerate is often more than enough to cause an economy-wide crisis.

Dominant shareholding families of Indonesia, Korea, the Philippines, and Thailand face the incentives described above, as the legal infrastructures concerning corporate governance in these countries are not well established, although the degree of the problem varies across countries. It should also be noted that the conflict of interest that arises at the lending stage due to common ownership and control of firms and banks by the same dominant family extends into the monitoring and bankruptcy stages.

Dominant shareholding families in the four countries are likely to be an obstacle to the speedy and efficient resolution of insolvency problems. As majority shareholders of the firms under their control, the families usually have the ability to legally veto a reorganization plan during formal and informal bargaining proceedings.<sup>28</sup> Their threats to veto an efficient reorganization plan, and to send the firms into liquidation unless they are guaranteed

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28. For instance, a reorganization plan needs the consent of the majority of shareholders in order to be approved by the court in formal proceedings in Korea. In informal workouts too, a workout plan needs to get a majority approval at the general shareholders' meeting in addition to an approval of at least two-thirds of the creditors. Situations in the other countries are not much different.

substantial shares of the firms, could be credible threats under existing insolvency mechanisms. Thus, it is crucial for these countries to strike the right balance between protection of shareholder rights and protection of creditor rights of large firms. More fundamentally, countries that give distorted incentives to dominant families should try to overhaul their financial systems.

Corporate governance of firms that are in insolvency proceedings is another issue that has far reaching implications in most Asian countries. The country reports in OECD (1999, Sydney)<sup>29</sup> generally show that debt-equity swaps have been used in formal insolvency proceedings.<sup>30</sup> However, it appears that debt-equity swaps generally do not involve significant changes in the corporate governance of debtor firms, even when they are used in formal reorganization cases<sup>31</sup>.

Thus, insolvency proceedings and market conditions do not provide strong incentives to dominant shareholders to behave in ways that are compatible with economic efficiency. First, old dominant shareholders are frequently given favorable treatment and are allowed to run the firms even in situations where it is clear that they are the source of the problem rather than a solution. Second, creditors sometimes do not act aggressively to install new management in the firms in which they hold large equity as a result of debt-equity swaps.<sup>32</sup>

Third, even if creditors are somehow in a position to sell controlling interests of the debtor firms, it is not easy to find investors

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29. See Nam and Oh (1999), Authors were leading participants in completing this OECD report.

30. For instance, Wisitsora-at (1999) reports that debt-equity swaps are frequently included in reorganization plans in Thailand.

31. Although reliable and complete set of data on the scope and conditions of debt equity swaps is not available, existing literature including ADB reports and interviews of the experts in the region that we conducted seem to support this conclusion.

32. This is probably because creditors are inefficient as lenders due to their own poor governance structures.

who are willing to purchase them, due to concentrated ownership and control of firms as well as underdeveloped financial markets.

### **3) The Government**

In most East Asian countries, the government intervened in the financial market in pursuit of its industrial policies. Korea presents the most extreme form of such industrial policies. Though not in a manner as extreme as in Korea, the other East Asian countries have also depended on industrial policies. Indonesia and Malaysia attempted to build target industries through credit interventions by state-owned banks in the early 1980s, with disappointing results. Even after Malaysia gave up this kind of industrial policy, the government committed itself to a high growth policy based on high investment, which eventually led, albeit indirectly, to the promotion of big projects. Such a policy ultimately resulted in lower rates of return and an increase in non-performing loans. Bailouts that had been widely conducted in Indonesia, Malaysia, and to some extent in Thailand during the past financial crises, appear to be related to investments directed by the same kind of industrial policies.

At least to the extent that industrial policy concerns interfered with the allocation of financial resources, the governments of these Asian countries contributed to the determination of insolvency proceedings that were in force. *Ex-ante* intervention in the allocation of financial resources and *ex-post* intervention in the bankruptcy proceedings by the governments in the region, which more often than not included large scale bailouts, constituted a mechanism that gave distorted incentives to various economic agents in these countries. It is too early to tell whether these countries have given up the old system and begun to adopt alternative systems that are fundamentally different from the old system, and which depend more on market forces and contract-based

institutional arrangements.

## **VIII-2. Comparative Analysis of the Insolvency Proceedings of the Six Countries**

### **1) Overview**

Insolvency proceedings of the six countries had not changed much for a long period before 1998. The insolvency proceedings of the four countries that have been directly affected by the economic crisis appear to have suffered from inefficiency when compared with Singapore and Malaysia. Before 1998, the time from petition filing to approval of reorganization usually took 18 months in Korea, and over 700 days in the Philippines. The situation in Indonesia was no better, although there are no exact figures available. The judicial system in Indonesia has been effective in neither enforcing debt collection nor bankruptcy proceedings. There have been reports that decisions made by the Indonesian judicial system have been inconsistent and unpredictable.

The crisis-hit countries including Indonesia, Korea, and Thailand amended or overhauled their insolvency laws after the crisis. As a result, the degree of sophistication and transparency in the legal structure associated with their insolvency mechanisms has increased significantly. In 1998, Korea amended three insolvency laws, namely the Corporate Reorganization Act, the Composition Act, and the Bankruptcy Act for the first time in any meaningful sense since their enactment in 1962. In Thailand, the Bankruptcy Act, which was legislated in 1940, was amended in 1998 and 1999 so that it now includes 97 articles. Indonesia was no exception with regard to amendments, as its bankruptcy act of 1905 was substantially overhauled in 1998 to contain 289 articles.

In Malaysia, four formal insolvency mechanisms have been in place on the basis of the Companies Act of 1965, the Judicature

Act of 1964, and the Bankruptcy Act of 1967. Corporate workout programs, which are handled outside of the court, also have a legal base in the Pengurusan Danaharta Nasional Berhad Act legislated in 1998.

Singapore has a well developed, perhaps the best, legal infrastructure for insolvency mechanisms among the countries in our study. The Companies Act and the Bankruptcy Act (amended in 1995) constitute the legal base for dealing with corporate and personal bankruptcy cases, respectively. These two laws are equipped with sophisticated statutory rules regarding insolvency proceedings. In the Philippines, the Insolvency Law and Presidential Decree (PD) No. 902-A are the major pillars of the legal structure regarding insolvency proceedings. The suspension of payments in the course of corporate restructuring has its legal base in PD No. 902-A, which was rather quickly formulated under martial law in 1982. PD No. 902-A contains only a few provisions, and as a result, statutory rules regarding bankruptcy proceedings are quite vague with much room for discretion, although precedents have provided some guidelines. In order to supplement the PD No. 902-A, " Rules of Procedure on Corporate Recovery, " which has legal jurisdiction over the decision for suspension of payments, was drafted by the SEC and put up for public review in 1999.

## ***2) Unitary versus Plural System***

<Table VIII-1> summarizes the legal structure surrounding insolvency proceedings in East Asian countries. As can be seen from the table, Indonesia and Thailand have a single law governing insolvency matters. In Indonesia and Thailand, one law regulates all proceedings, but the petitioner must choose between the liquidation or reorganization modality of the insolvency proceedings.

Other countries have separate laws governing insolvency proceedings for each modality of the corporate resolution. For

**<Table VIII-1> Legal Structure of the Insolvency Proceedings in EA Countries**

Country	Procedure	Governance Law
Thailand	- Reorganization - Liquidation	- Bankruptcy Act
Indonesia	- Suspension of Payment (Reorganization) - Liquidation (Liquidation/Rehabilitation)	- Bankruptcy Act
Singapore	- Scheme of Arrangement - Appointment of a Receiver - Liquidation - Judicial Management	- Sec. 210 of the Companies Act - Common Law - Part X of the Act - Part VIII A of the Act
Malaysia	- Liquidation of Corporate Entities - Scheme of Arrangement - Private & Court Approved Receiver	- Part X of the Companies Act - Sec. 176 of the Companies Act - Terms of a debenture
Korea	- Corporate Reorganization - Composition - Liquidation	- Corporate Reorganization Act - Composition Act - Bankruptcy Act
Philippines	- Suspension of Payment - Voluntary & Involuntary Insolvency	- PD 902-A - Insolvency Law

instance, Korea has three separate statutes for three different insolvency proceedings. Singapore is similar to the U.S. in that the Companies Act includes three independent chapters and sections that respectively govern three different insolvency proceedings. The appointment of receiver, however, has its legal base in common law.

The fact that some countries have multiple laws governing insolvency proceedings is closely related to the historical evolution of their legal structures. In most cases, insolvency laws were enacted before industrialization, and hence, focused largely on personal bankruptcy of consumers or the self-employed. As a result, at the time of enactment, insolvency laws were more concerned with liquidation. In tandem with the rapid industrialization of these countries, however, there has been a growing demand for distinct treatment of corporate and personal insolvency. Consequently, new legislation and amendments address

the issue of reorganization of troubled firms. Such chronological development in legal demand has resulted in a system of multiple laws associated with insolvency proceedings.

### **3) Expediency**

Expediency is crucial to successful resolution of corporate failures. The value of an insolvent firm is likely to decay over time as the resolutions are delayed regardless of the modality of resolution. This is particularly so in cases of reorganization. Crisis-stricken countries tried to reduce the time period need in handling insolvency cases in revising their insolvency proceedings.

In Indonesia, the amended Bankruptcy Act stipulates that the provisional arrangement plan shall be finalized within two months from petition filing, and that the plan shall be implemented within 270 days of plan finalization. In Korea, it now takes the court 6 to 8 months to complete a reorganization case, from the date of filing to the final approval, compared to 18 months prior to revisions. According to the newly amended insolvency law of Thailand, the court is required to issue the commencement order within 3 weeks from the petition, approve the reorganization plan within 5 months from commencement, and conclude implementation of the plan within 5 years from approval. In summary, the expediency of the insolvency proceedings seems to have improved, at least in terms of required steps and procedure duration in those three countries whose insolvency laws were amended after the crisis.

Insolvency proceedings of Malaysia and Singapore, which have not been amended since 1998, appear to be fairly efficient in terms of expediency. In Malaysia, the average time period from commencement of arrangement to implementation of the arrangement plan is 8-12 months.<sup>33</sup> Delays could arise from the

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33. Rabindras. Nathan, Report on Malaysia (ADB, 1999), p.58.



fact that in many instances, regulatory body approvals are required. No figures were available for Singapore.

At the individual law level, the number of steps in insolvency proceedings can be an important indicator of the expediency of the insolvency mechanism. In Thailand, standstill is automatically applied upon petition filing. This option can save time with regard to deliberation on the desirability of a protection order. However, most countries are conservative in adopting such an option given the fact that it can restrict creditors' rights.

Another issue related to expediency is whether the commencement of a formal procedure requires a formal court order. In Indonesia, once the bankruptcy petition has been appropriately filed at the Commercial Court and all legal requirements are fulfilled, bankruptcy proceedings should begin within 20 days from the petition date. In other countries, the court issues the commencement order only after a careful review of legal requirements for the order, and this review process can take several weeks to several years, as previously mentioned.

Since the crisis, some East Asian countries have substantially improved expediency of the insolvency proceedings by introducing time limits for the interim steps of formal procedures. <Table VIII-2> below summarizes the measures that have been recently introduced to improve expediency in Indonesia, Korea, and Thailand.

In Indonesia, the newly legislated Bankruptcy Law introduced a time limit for each critical step in order to expedite the proceedings. In order to ensure the court's adherence to the pre-specified time limit, an automatic approval system was also adopted in which failure to make any decision within the prescribed time limit automatically forwards the case to the next step.

In the 1998 amendment of its insolvency laws, Korea also introduced provisions for time limits for critical steps of the proceedings, but the provisions are usually interpreted as a reference

**<Table VIII-2> Measures to Improve Expediency: Indonesia, Korea and Thailand**

Country	Measure to Improve Expediency
Indonesia	<p>From filing to provisional measures: Less than 30 days from the date of submission of bankruptcy petition, as the petition itself must be decided within 30 days from registration with the Commercial Court.</p> <p>From filing to order of opening: Within nine days of the date of registration of the bankruptcy petition with the Commercial Court, the Court must appoint a Panel of Judges and decide on a first hearing date, which may not be later than 20 days after the registration date. However, with the approval of the Commercial Court, the first hearing may be delayed for up to five more days.</p> <p>From order for opening to confirmation of the plan: Approximately 36 days, for the confirmation of provisional composition.</p> <p>From confirmation of the plan to closing of proceedings: Approximately 225 days for completion of permanent composition plan. Or, 270 days as of the date of the provisional composition as stipulated by the court.</p>
Korea	<p>A provisional protection order shall be made within 14 days after the application date.</p> <p>In reorganization procedures for small-and medium-sized enterprises, decision on procedure commencement is required within 3 months from the application date.</p> <p>The reorganization plan shall be submitted within 4 months after the last day for filing of claims and approved within 1 year after procedure commencement.</p> <p>In composition procedures, the court shall decide commencement of the procedure within 3 months from the application date.</p>
Thailand	<p>From filing to order of opening: 3 weeks</p> <p>From order of opening to confirmation of the plan: 5 months</p>

for the judge, not as mandates. The Thai Bankruptcy Act, amended in 1998 and 1999 respectively, similarly provides time limits.

#### **4) Quantum Requirement**

The quantum requirement constitutes a core element of the bargaining game induced by insolvency proceedings and affects the ultimate performance of insolvency proceedings in a number of ways. In all countries except for the Philippines, insolvency

proceedings for reorganization incorporate the quantum requirement, as summarized in <Table VIII-3>. The general trend has been to ease the quantum requirement in order to enable stakeholders to arrive at a resolution more easily. In the Philippines, the SEC handles most insolvency cases under PD No. 902-A, and is allowed to exercise discretion with regard to the design of a reorganization plan with no requirement for creditor consent.

### **5) Expertise of the Court**

Any insolvency proceeding requires extremely complex information processing and professional judgement about the

**<Table VIII-3> Quantum Requirements for Reorganization Plan**

	Secured Creditors	Unsecured Creditors	Shareholders
Indonesia - Composition Plan	Not required (standstill not applied to secured creditors)	1/2 in number & 2/3 in value	3/4 in case of asset grant as collection
Korea - Corporate Reorganization	3/4 (4/5 in extraordinary situation)	2/3	1/2 (if shareholders have voting rights)
Korea - Composition	Not required (plan not applied to secured creditors)	3/4	Not required
Malaysia - Scheme of Arrangement	1/2 in number & 3/4 in value		Not required
Singapore - Scheme of Arrangement	3/4 in number & in value		Not required
Singapore - Judicial Management	1/2 in number & in value		Not required
Thailand - Reorganization	(Cases filed before April 22, 1999) 1/2 in number & 3/4 in value (Other cases) 1/2 in value of total debts and 1/2 in number & 3/4 in value from one affected group		Not required
Philippines	Not required		Not required

value of firms and the likelihood of rehabilitation, among other key considerations. In addition, insolvency proceedings are typically managed under strong pressure generated by the acute conflict of interests among involved parties. In light of this, the expertise of the court is an indispensable ingredient for the successful and fair resolution of corporate failures. Enhancement of expertise and expansion of knowledge cannot, however, be achieved overnight. The process requires a great deal of practical experience. In this sense, lack of expertise is one of the most serious challenges faced by most East Asian countries with respect to insolvency proceedings.

The issue of expertise in insolvency proceedings is not confined to the question of human capital of the court or other authorities. Rather, it can be extended to the realm of the institutional setup, that is, access to accurate information by key decision-makers, and the role of creditors in insolvency proceedings. Some countries have moved in the direction of establishing specialized judicial organizations that deal with insolvency cases more exclusively in order to improve the capability of their insolvency system.

In the Philippines, the venue for all proceedings under the Insolvency Law (enacted in 1909) has been vested exclusively in the regular courts. The economic turmoil in the Philippines that began to brew in 1979 created the need for establishment of an agency that would be able to handle insolvency cases with a high level of efficiency and expediency. Eventually, the SEC was given quasi-judicial powers to handle insolvency cases. Since then, regular courts have hardly been utilized for insolvency proceedings, as corporations prefer to seek debt relief from the SEC. However, the SEC has been criticized for its way of handling debt relief cases. The criticisms that have been raised range from allegations of corruption to long delays in procedure, and further, to the SEC being lenient towards debtors at the expense of the creditors.

In Thailand, the new Bankruptcy Court commenced opera-

tions in June 1999, with 12 appointed judges.<sup>34</sup> In Indonesia, four additional Commercial Courts were established one year after the establishment of the first Commercial Court in Jakarta in August 1998 under the domain of the Central Jakarta District Court. Commercial courts have exclusive jurisdiction over insolvency cases.

Although Korea had gone through long debates on the establishment of bankruptcy courts prior to the 1998 amendment of insolvency laws, it did not adopt a specialized court for insolvency cases. Instead, it chose to create specialized units within some district courts. The first such unit, the bankruptcy department, was established within the Seoul District Court in 1998. In addition, a commission, called the management commission, was created to provide the bankruptcy department of the Seoul District Court with advice on economic and financial matters related to bankruptcy cases.

### ***6) Role of Creditors and Managers of Debtor Firms***

Financial expertise is a critical element in inducing efficient outcomes in insolvency proceedings, given the complexity involved in the reckoning of composite information, such as financial and managerial data, and the valuation of assets and liabilities. There is little question that the participation of creditors and other experts in insolvency proceedings will expand court access to necessary information and knowledge, particularly with respect to financial assessment and restructuring decisions. In general, however, it is hard to expect such skill and finesse from ruling authorities of East Asian countries in their insolvency proceedings.

The participation of creditors in insolvency proceedings seems reasonable in that they have a host of financial information

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34. Second Comparative Report (ADB, 1999), p.57.

about the firm in question as well as technical expertise in the financial dealings of asset sales. The participation of incumbent managers of troubled firms, however, presents both merits and costs. The incumbent managers are perhaps best informed about the business prospects and the financial status of a firm, thus, utilizing their knowledge and information would enhance the efficiency of insolvency proceedings. At the same time, however, they may have distorted incentives with respect to the rehabilitation of firms due, for example, to a conflict of interests, moral hazard, and/or rent-seeking motivation, and hence could incur additional costs to creditors. The balance between these merits and costs needs to be carefully maintained.

East Asian countries demonstrate differences in terms of the role of incumbent managers in insolvency proceedings. In Indonesia and the Philippines, the bankruptcy laws give the incumbent managers a leading role in the rehabilitation process. The Bankruptcy Act of Thailand balances the interests of debtors and creditors. The law stipulates that in cases where more than one person is proposed as the planner, the person proposed by the debtor should be the planner. The creditors, however, can change the planner with a two-thirds majority vote.

In Singapore and Korea, the participation of incumbent managers in insolvency proceedings is allowed or denied depending on the modality of restructuring. Both Korea and Singapore allow the debtor firm an exclusive right to draw up and execute plans in composition and in the scheme of arrangement, respectively. These two proceedings are designed for debtor firms that are relatively small, which are generally solvent, and which have relatively small number of creditors.

But in reorganization proceedings, both Korea and Singapore allow the court to appoint a judicial manager. In Singapore, the court appoints an approved company auditor as a judicial manager so that his or her knowledge and information about the firm in question can be utilized in the rehabilitation process.

Discharged debtors or persons who are deemed to be responsible for illegal acts in relation to the management of firms are excluded from the list of possible candidates for judicial manager.<sup>35</sup> In Korea, too, incumbent managers are generally excluded from the corporate reorganization proceedings. The court usually appoints an independent, professional manager that it can trust as a receiver and lets him draw up and execute rehabilitation plans.

### ***7) Civil and Criminal Penalties for Managers of Insolvent Firms***

Pressing criminal and civil charges against managers of insolvent firms for their fraudulent actions or expropriations has important implications for the efficiency and credibility of the insolvency mechanism, as it reduces the scope for moral hazard in an ex-ante sense and establishes justice in an ex-post sense. Specifically, it could enable creditors and shareholders to recover, at least partially, losses incurred by a manager's expropriation. In addition, it could induce managerial efforts to maintain sound financial structures and to refrain from asset-stripping activities.

In Indonesia, company directors are subject to civil liability if they are responsible for corporate failures and losses. They also could be pressed with criminal charges. However, both civil and criminal penalties do not seem to work as effective incentive mechanisms due to the slow pace of judicial proceedings. It takes quite a long time for judicial proceedings in Indonesian courts to reach a final decision in both civil and criminal cases. Because of this difficulty in pursuing claims through the Indonesian judicial system, civil claims on losses are generally settled through negotiations and compromises. Should such negotiations fail, individual creditors may either pursue legal actions through the Indonesian courts or decide to write off these claims.

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35. Sarjit Singh Gill, Report on Singapore (ADB, 1999), p.55.

In Korea, insolvency in itself is not a crime; accordingly, managers of insolvent firms are not considered criminals. Neither the Corporate Reorganization Act nor the Criminal Code orders any criminal investigation upon commencement of the corporate reorganization process. Criminal charges against a corporate director are not common in Korea even in a situation of bankruptcy. But the prosecutor may begin an indictment process against managers if evidence emerges of embezzlement or breach of trust in the midst of conflicts between creditors and management of debtor companies.

Companies may press civil charges against their own directors if they act against their duty or laws and cause damages to the company, regardless of whether the companies are bankrupt or not. Derivative suits may be used by the shareholder(s) with 3 percent of issued shares (or more than 0.01 percent for listed companies) if the company does not exercise its claims. In addition, the Corporate Reorganization Act stipulates a summary procedure, named 'assessment', against directors who are liable for damages of a failed company. If the damages are deemed caused by the directors, the court orders the directors to compensate pecuniary damages without resorting to a costly and time-consuming regular recovery suit.

However, it should also be noted that civil and criminal charges against directors have been quite rare in Korea. This has been particularly so in the case of large companies, including listed companies. Recent economic crisis has changed the situation to some extent. In the first-ever derivative suit against managers of a listed company in Korea, the court recently ordered the former CEO and directors of Korea First Bank, which failed during the crisis, to pay US\$33 million to the bank as compensation for the damages that they caused to the bank.

Insolvency laws in Malaysia have provisions for restitution in relation to the self-dealing of directors, fraud, and the misappropriation of corporate property. Criminal laws also allow sanc-



tions against theft, expropriation of property, breach of trust, fraudulent deed, and disposition of property. Therefore, as a matter of policy and practice, fraudulent deeds are to be punished at both the civil and criminal levels, rather than settled and hushed up. However, the success rate in the application of these laws is rather disappointing, mainly due to inadequate manpower and expertise.<sup>36</sup> The special administrator is conferred with powers of investigation under the *Pengurusan Danahata Nasional Berhas* Act of 1998. If fraud, misfeasance, or other misconduct is discovered in the course of the investigation, the administrator is obliged to report such findings to the relevant regulatory authority.

In the Philippines, it is possible, in principle, to press civil and criminal charges against directors and managers of failed firms. In fact, there has been a prevailing perception in the Philippines that corporate failures, particularly in the case of large failures, are mostly associated with corruption and fraud by the managers and owners of firms. As a result, civil and criminal charges have been pressed quite often. However, criminal investigations cannot be executed in many cases due to the flight by suspected managers to foreign territory.

Singapore has a strong legal base with respect to civil charges against liable persons or parties. In addition to criminal charges, the court can declare any person who is guilty of fraudulent trading to be personally responsible without limitation for the debts of the insolvent company, under the *Companies Act*. The enforcement of criminal charges is also effective. The prosecuting authorities regularly prosecute such fraud and the courts are prepared to impose deterrent sentences to uphold ethical standards of business.<sup>37</sup> Thailand also allows both criminal and civil charges against fraudulent deeds.

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36. Rabindra S. Nathan, *ibid.*, p.44.

37. Sarjit Singh Gill, *ibid.*, p.68.

## IX. Progress Made and Challenges Ahead

The East Asian countries that have been adversely affected by the recent economic crisis share a common characteristic in that they have not established market-based institutional infrastructures. In particular, their failure to establish proper governance mechanisms in large firms and financial institutions and well-functioning bankruptcy proceedings could be singled out as the main culprit. The four countries that have been hit by the economic crisis all shared these deficiencies. On the other hand, Singapore and Malaysia had arms' length-based infrastructures that were more in line with protection of investors and creditors.

Korea has relied upon a unique system of financing the operation of large firms during her fast path to industrialization that could be termed the *chaebol* system. Such a system entailed distorted governance of large firms as well as financial institutions. The recent economic crisis seems to be closely related to Korea's heavy reliance upon the *chaebol* system, which is compatible with neither investor incentives nor market-based institutional infrastructures concerning bankrupt firms.

It is fair to say that bankruptcy proceedings in Korea have improved significantly due to reform measures introduced since the onset of the crisis. Reorganization procedures have become more efficient in several regards. The court is now required to hand down a final decision on the eventual fate of a bankrupt firm for which a reorganization petition has been filed within 6 months of the date of filing. The number of years within which a reorganization plan must be executed is now limited to 10

years, compared to 20 years in the old system. The court also relies on the economic test that uses the relative magnitude of the going-concern value and the liquidation value of a bankrupt firm in determining whether to allow commencement of the reorganization procedure. In the past, the court had used obscure criteria that partly relied upon public objectives, and that resulted in inefficient prolongation of the lives of the bankrupt firms for which liquidation was clearly a better alternative.

In addition to the changes in the laws that brought about more efficient outcomes, the attitude of the court itself has changed substantially. The court has been taking a much sterner and selective approach in supervising the reorganization processes. For instance, it is taking a much tougher stance toward the reorganization plans that appear to be based upon unrealistically optimistic forecasts about the future profitability of the bankrupt firms, even though the plans are endorsed by a majority of creditors. The court also usually reduces the shares held by the dominant shareholders of bankrupt firms that filed for reorganization in order not to give preferential treatment to dominant shareholders when the firm is to be reorganized.

The court also is more active than before in identifying and liquidating the firms that had been granted reorganization and are under court receivership, but are not viable as a going concern. Thus, the court is seen to have increased the probability that only the bankrupt firms that are worthwhile to reorganize are chosen for the reorganization process.

Still, there appears to be large room for improvement. The court-supervised proceedings fail to put in place an efficient, new management team in the bankrupt firms. Court-appointed trustees are not given adequate incentives to try to maximize the economic value of firms. More fundamentally, the firms in the reorganization process lack a proper corporate governance structure that could lead to efficient management. In fact, the nature of the firms to be reorganized is sometimes unclear.

When a firm is allowed to exist only as a means to service its debt, there is little chance that the firm can realize its commercial potential. This is particularly true when a firm has gone bankrupt once already, and is now in the process of court receivership. Thus, while recent reform of the reorganization law enabled the court to wrestle the power of shareholders' rights from the previous dominant shareholders and to prevent them from continuing to control firms and divert money, it failed to substitute the old governance structures with stable and reliable alternatives.

Another potential problem with the current system concerns the distribution of firm value to be reorganized to various stakeholders. The court has often applied a division rule in reorganization cases that violates the absolute priority rule in dividing firm value between the creditors with varying priority, and the old shareholders. *Ex post*, such a division rule leads to inequitable distribution of firm value. *Ex ante*, it could induce inefficient allocation of financial resources in the market for loans. It also could give weak incentives to shareholders to monitor performance of firms and managers before bankruptcy becomes apparent.

The court's recent decision not to grant composition to large debtor firms received applause from many economists and lawyers. But the question remains as to why we need a separate proceeding for composition law. The attitude of the court that almost automatically forces reduction in the shares of the dominant shareholders of a bankrupt firm is correct in light of the fact that the debt of virtually all firms that file for reorganization outweighs asset value. However, there seems to be a need for a separate proceeding for those firms that fall into liquidity problems, yet are solvent and have higher going-concern values than liquidation values, and which will not automatically entail unnecessary punishment of dominant shareholders.

A more general question is whether Korea needs a unified

bankruptcy proceeding instead of the three separate proceedings currently in place. A few practicing lawyers have advocated unifying the bankruptcy proceedings. However, they have not been able to point out why the current system of separate proceedings may lead to inefficient or inequitable outcomes. In fact, no one has ever produced for possible review a concrete scheme as to how to integrate the three separate proceedings into a single proceeding. We, too, have little to say about the potential problems with the current insolvency system due to the lack of a unitary proceeding, as this project has not analyzed the current system from the perspective of single versus plural proceedings. We do believe that there is a need to analyze potential weaknesses of the separate proceedings currently in place, and to consider ways to integrate them into a unitary proceeding that could potentially lead to more efficient outcomes.

Finally, we would like to stress that the single most important factor behind the inefficient handling of bankrupt firms in Korea is the weak corporate governance of financial institutions rather than the flaws in the proceedings *per se*. As we explained earlier, creditor institutions in Korea, banks and non-bank financial institutions alike, did not play the creditors' role properly, not only in loan decisions but also in insolvency proceedings. At the lending stage, they made loans to many risky, unprofitable projects pursued by *chaebol* firms and directed by dominant shareholders seeking expansion of resources under their control, thus resulting in a plethora of bankruptcy cases.

Distortion in the corporate governance of financial institutions also led them to behave sub-optimally when large debtor firms went bankrupt. Instead of trying to retrieve as much of their loans as possible, creditor institutions usually tried to minimize the amounts of loss that they acknowledge officially. They frequently agreed on a reorganization plan that was very difficult, if not impossible, to achieve in order to minimize the loss that they would have to write off officially. Bankrupt firms for

which such reorganization plans are imposed usually end up dissipating more resources before falling in financial trouble again. Thus, it would be difficult to expect a significant improvement in the performance of the insolvency proceedings in Korea unless corporate governance of lending institutions becomes more in line with profit incentive. Privatizing banks and strengthening prudential supervision are imperative in this regard.

We do not have much to say on how the workout programs fared as we have not been able to collect reliable data on workouts. However, scattered evidence suggests that workouts suffer from deficiencies similar to court-supervised proceedings. Workouts could be advantageous compared to court-supervised proceedings as interested parties could save time and costs required by court-supervised proceedings. On the other hand, the very fact that workouts are pursued outside of the court, which gives them an advantage in terms of cost and flexibility, can also be detrimental because workouts stand on fragile legal ground.

Workouts are based upon private agreements by large creditors, and do not involve mandatory legal procedures that bind all creditors as well as shareholders such as those required by court-supervised reorganization. Consequently, workouts allow greater room, compared with court-supervised proceedings, for holdouts by some stakeholders. Creditors with relatively small loans may find it in their interest to hold out in order to extract concessions from large creditors. In fact, there are instances in which small creditors retrieved their loans while large creditors, usually banks, injected new money. In addition, shareholders of a firm with debts that far exceed its assets as well as going-concern values have little to lose by vetoing a workout plan that includes a fair debt-equity swap.

Despite these problems, workouts are deemed by many to have been successful in preventing massive bankruptcies of

large firms and collapse of the financial system during the crisis period. Most of the workout programs that started in 1998 are officially completed. The Korean government is currently in the process of enacting a law that allows CRV's (Corporate Restructuring Venture) to play a major role in handling non-performing loans of large, bankrupt debtor firms held by lending institutions. The thrust of the CRV law lies in giving CRV's proper profit incentives while at the same time reducing cost arising from the free-rider problem of diverse creditors. CRV's could be interpreted as an attempt to solve the governance problem of bankrupt firms, as CRV's could take control of bankrupt firms and become dominant shareholders through debt-equity swaps.

It is not clear at this point whether CRV's could actually lead to desired outcomes. For CRV's to be an efficient alternative, they must solve the complex coordination problem that plagues creditors under the current regime. But it is not clear how CRV's would be able to do so. Giving proper incentives to management of CRV's poses another challenge. If the government can find a suitable corporate governance structure for CRV's, it could presumably be able to find a suitable governance structure for KAMCO or the nationalized banks under its control. Tax breaks would undoubtedly increase the chance that CRV's could give creditors an incentive to participate. However, tax breaks alone will not make CRV's a panacea.

Arguments surrounding CRV's again remind us that giving proper profit incentives to lending institutions is key to solving the problem of insolvency of large firms in Korea. Establishing a well-functioning financial market requires a fundamental change in the Korean economic system, as it is not compatible with the chaebol system that has dominated the Korean economy over the past four decades. An arm's length relationship between firms and lending institutions implies that distortion in corporate governance of firms and lending institutions that has

been tolerated to support the rapid industrialization of the last four decades must discontinue.

Further, Koreans must find alternative modes of financing and governance for big and risky projects that they need to pursue in order to sustain economic growth. Without a fundamental change in corporate governance of firms and financial institutions, efforts focused on reform in bankruptcy proceedings alone will have only a limited effect.



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