Legal issues: Korea, Republic of

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The introduction of a formalized system of laws in the Republic of Korea was largely a result of Japanese influence, notably accelerated by Japan's colonization of the Republic of Korea in the first half of the 20th century. Since Japan itself had been heavily influenced by German law, the legal system in the Republic of Korea is a "Civil Law" system, with strong influences discernible from principles of Franco-German law in areas such as the Civil Code. However, the Republic of Korea has also borrowed from other jurisdictions, and in many other areas has adopted the structures of Anglo-American law, notably since the end of the Korean War.

Insolvency laws in the Republic of Korea consist of (i) the Bankruptcy Act, (ii) the Composition Act and (iii) the Corporate Reorganization Act, which are discussed below in more detail. The Composition Act has its origins in Austrian Law and the Bankruptcy Act's principles were founded in the German system. Both were introduced to the Republic of Korea via Japan. The Corporate Reorganization Act is largely modeled along the lines of US federal law, such as the "Chapter 11" protections.

Historically, the area loosely described as insolvency law was a largely under-utilized and somewhat overlooked section on the nation's legal bookshelves, particularly from the 1960s to the late 1980s, a period which saw a dramatic surge in industrial output and economic prosperity. The shortcomings of what legal structures did exist became all too apparent with the onset of a serious economic crisis from late-1996. The ensuing market instability coincided with a general collapse in economic confidence, which was then further exacerbated by the upheaval caused by the Asian currency crisis that reached the Republic of Korea by September of 1997, leading to a bailout by the International Monetary Fund.

Since then, a massive revision to insolvency laws has been undertaken, with emphasis being placed, among other things, on three specific areas. First, setting out with some clarity and certainty specific procedures to be undertaken in the event of corporate fiscal ill-health, and distinguishing between procedures for recovery (or attempted recovery) and procedures for dissolution. Second, an improvement of the speed with which such procedures were to be undertaken, the emphasis being on setting increasingly tighter deadlines. Third, a trend towards specialization of the judiciary, who until a few years ago, were largely unschooled in the practicalities of insolvency laws, only to find themselves submerged under heavy caseloads in that area of law, being further hampered by the fact that the legislative implements at their disposal were somewhat lacking in effectiveness and sophistication. The various revisions to the insolvency laws which have occurred have generally all followed the above themes.

1 Describe the nature and the effectiveness of the following processes:

a) Civil unsecured debt collection remedies.

A creditor first obtains a judgment from a court against the debtor in connection with the pertinent unsecured debt. Upon the creditor's petition for enforcement of the judgment, the court orders attachment on the debtor's assets and has the attached assets disposed of, normally through a public auction sale. Sale proceeds, net of expenses, will be distributed to the creditor. The creditor may file a petition for preliminary attachment with a competent court prior to the filing of a formal lawsuit, if necessary.

b) Secured property enforcement remedies.

In this case, the creditor need not obtain a judgment from a court. Depending on the nature of the security rights and terms and conditions of the security agreement, the creditor either directly enforces its security rights or petitions the court to proceed with the enforcement process.

c) Any special debt collection or secured property remedies that are available to banking sector creditors.

There was, previously, a special law which contained certain provisions for simplifying and speeding up the procedures in connection with the debt collection or secured property remedies available to banking sector creditors. This special law was repealed in April 1999.

d) Corporate bankruptcy/liquidation processes that are available to corporate debtors and creditors.

Under the Bankruptcy Act ("the BA"), an insolvent debtor company or its creditors may file an application for bankruptcy proceedings. Upon the adjudication of bankruptcy, the court appoints a trustee who will conduct the liquidation process.

e) Formal corporate rescue processes that are available to corporate debtors and creditors.

Formal corporate rescue is conducted through the mechanism of either corporate reorganization, under the Corporate Reorganization Act ("the CRA"), or a composition proceeding, under the Composition Act ("the CA"). Both processes attempt to rehabilitate insolvent companies, and are carried out under court supervision.

Corporate reorganization

Corporate reorganization proceedings are available only to stock corporations. An application for corporate reorganization can be filed in the following circumstances:

- If a company cannot pay its debts when they are due without a significant impact on the continuity of business.
- If there exists the fear that a company will go into bankruptcy. Companies typically file for corporate reorganization on a voluntary basis.

However, the CRA also permits a company's creditors holding claims amounting to at least 10 percent of the company's paid-in capital, or shareholders owning at least 10 percent of the company's total issued and outstanding shares to apply for corporate reorganization of the company.

Existing management and controlling shareholders of the debtor company are excluded from the management of the company. The court appoints a receiver to manage the debtor company under the supervision of the court. Further, a creditors' council, consisting of major creditors of the company, is formed unless the debtor company is a small or medium-sized company. The creditors' council will adjust the interests among the creditors and convey to the court opinions of the creditors relating to the reorganization proceedings. The company's debts are restructured or rescheduled in accordance with the reorganization plan. Further, the debtor company will be managed by the receiver under the supervision of the court in accordance with the reorganization plan.

Composition

An application for composition can be filed in the following circumstances:

- If a company cannot pay its debts when they are due without a significant impact on the continuity of the business.
- If there exists the fear that a company is in danger of bankruptcy.

Unlike corporate reorganization, only debtor companies are entitled to apply for composition. Composition proceedings are available to all forms of companies.

At the time of the filing, the draft composition plan must be reported to the court. If the composition plan is adopted by the creditors' meeting and approved by the court, the debt restructuring of the company will be made in accordance with the composition plan. The debtor company will be managed by the company's own management or the controlling shareholder.

Bankruptcy stemming from corporate reorganization or composition

Under the CRA, reorganization proceedings will be converted to bankruptcy proceedings by the court's adjudication in the following events:

- Where the court refuses to grant the commencement of the reorganization proceedings.
- Where the court discontinues the reorganization proceedings.
- Where the court dismisses the reorganization plan which was adopted by the interested parties' meetings.

Likewise, under the CA, composition proceedings will be converted by the court's adjudication to bankruptcy proceedings in the following events:

- Where the court discontinues the composition proceedings, before the court has authorized a composition plan.
- Where the court dismisses the composition plan which the creditors meeting has approved.
- Where the court cancels the composition proceedings upon application of the creditors, after the court has authorized the composition plan.

f) Informal corporate rescue processes.

So-called "workout" programs are conducted by financial institutions in accordance with a master workout agreement executed among financial institutions. In addition, a debtor company may seek so-called "private composition" – that is, out-of-court debt rescheduling in accordance with one or more private and individual agreements with the creditors.

g) Any other corporate insolvency, or insolvency-related, processes that are available under special legislation.

The Republic of Korea has no special legislation applicable under such circumstances.

2 What is the effect upon debt enforcement and secured property enforcement processes of:

a) An adjudication of corporate bankruptcy/liquidation?

Upon adjudication of bankruptcy by the court, all assets of the debtor are transferred into a bankruptcy estate. Liquidation of the bankruptcy estate is conducted by the trustee, subject to security rights. No unsecured creditor may individually enforce its claims. However, security rights are not affected and secured creditors may individually enforce their security rights.

b) The commencement of a formal corporate rescue process?

Corporate reorganization

The CRA provides for an interim period between the filing of the application and the commencement of the proceedings, whereby the company's assets will be "preserved" for rehabilitation and distribution under the reorganization plan. The court is required to render a decision whether to grant the provisional preservation order within two weeks of the filing date. The court is required to render a decision whether to commence the reorganization proceedings within one month of the filing date. Upon the commencement, both secured and unsecured creditors are prevented from individually enforcing their claims arising prior to the date of commencement by the operation of law. Claims arising after the commencement are not stayed.

Composition

Under the CA the court is required to render a decision whether to commence the composition proceedings within one month of the filing date. The court can issue a preservation order even before the commencement of the composition proceedings, whereby the company's assets will be "preserved" to prevent dissipation, waste, or concealment by the debtor company. Upon the commencement, unsecured creditors are prevented from individually enforcing their claims by the operation of law, except for the claims arising after the commencement. However, security rights are not affected and secured creditors may individually enforce their security rights, unless the secured creditors have agreed otherwise.

c) The initiation of an informal corporate rescue process?

In the case of workouts, participating financial institutions are contractually prevented from individually enforcing their secured or unsecured claims, under the master workout agreement. In the case of private compositions, debt collection and secured property enforcement processes are subject to individual agreements between the debtor and the creditors.

d) The initiation of an insolvency, or insolvency-related, process under any special legislation?
The Republic of Korea has no special legislation applicable under such circumstances.

3 What is the effect on the management of a corporation of:

a) An adjudication of corporate bankruptcy/liquidation?
Upon adjudication of bankruptcy by the court, the debtor company continues to exist only for the purpose of liquidation. Normal business operations are wound up. Existing management and controlling shareholders are excluded from the management of the debtor company and the appointed trustee conducts the liquidation process.

b) The commencement of a formal corporate rescue process?
In the case of corporate reorganization proceedings, existing management and controlling shareholders are excluded from the management of the debtor company. Shares owned by controlling shareholders are in principle extinguished without consideration. Upon a preservation order, the court appoints one or more "interim" receivers to manage the affairs of the company. The interim receiver is replaced by one or more "permanent" receivers at the time of the official commencement of the reorganization proceedings.

In the case of composition proceedings, in general, existing management and controlling shareholders are not excluded from the management of the debtor company. They continue to manage the company. In limited exceptional cases, upon a preservation order, the court appoints one or more interim receivers to manage the affairs of the company.

c) The initiation of an informal corporate rescue process?
In the case of an informal corporate rescue process, in general, existing management and controlling shareholders are not excluded from the management of the debtor company. They continue to manage the company. However, representatives of the creditors generally conduct supervisory roles, particularly in connection with the company's financial affairs. Sometimes, representatives of creditors are dispatched and appointed as the debtor company's officers.

d) The initiation of an insolvency, or insolvency-related, process under any special legislation?
The Republic of Korea has no special legislation applicable under such circumstances.

4 Who is responsible for "case management" control and administration of:

a) A corporate bankruptcy/liquidation?
Please refer to Section 3a above.

b) A formal rescue?
Please refer to Section 3b above.

c) An informal rescue?
Please refer to Section 3c above.

d) A case of corporate insolvency under any special legislation?
The Republic of Korea has no special legislation applicable under such circumstances.

5 Who has the responsibility for the preparation of the plan of rescue under:

a) A formal rescue?
Corporate reorganization
In the case of corporate reorganization proceedings, the court-appointed receiver is responsible for the preparation of the draft reorganization plan.

Under the CRA, the reorganization plan should be adopted within two months from the date of the first interested parties' meeting; provided that if the court deems necessary, it may, upon application from the person who submitted the draft reorga-

nization plan, or *ex officio*, extend such deadline up to an additional one month. The reorganization plan should be adopted within one year from the date of commencement of reorganization proceedings; provided that if there are unavoidable reasons, the court may extend the deadline up to an additional six months.

The plan is formally adopted over the course of three or more statutory meetings of "interested parties." The final meeting is convened to vote on a resolution approving the draft reorganization plan that was deliberated at the previous meeting. In order for the resolution to pass, it must be affirmed by the following:

- Unsecured creditors holding reorganization claims totaling not less than two thirds of the total amount of such claims having voting rights.
- Secured creditors holding reorganization claims totaling not less than three fourths of the total amount of such claims having voting rights (if the draft plan is to rehabilitate the debtor company), or all of the total amount of such claims having voting rights (if the draft plan is to liquidate the debtor company).

Shareholders may also vote in the draft reorganization plan in proportion to their shareholdings. In this connection, the draft reorganization plan must be affirmed by a majority of shareholders, regardless of whether a certain super-majority voting requirement would be required under the Commercial Code. However, if the total liabilities exceed the total assets of the debtor company at the time of commencement of the corporate reorganization proceedings, then the shareholders are not entitled to vote.

Once the interested parties have approved a draft reorganization plan, the court will determine whether or not to authorize the plan. In making its determination, the court will analyze whether the draft reorganization plan meets all of the legal requirements under the CRA and whether it is fair to the interested parties.

Composition

In the case of composition proceedings, the company is required to prepare the draft composition plan in advance and submit the draft plan at the time of filing the petition for composition proceedings with the court. Generally, the draft plan is later modified by consultation with the creditors.

The creditors' meeting is convened to vote on a resolution approving the draft composition plan. In order for the resolution to pass, it must be affirmed by the majority of attending creditors and not less than three fourths of the total amount of such claims having voting rights. If the creditors' meeting fails to approve the draft composition plan, it will be automatically converted to bankruptcy proceedings.

Once a draft composition plan has been approved by the creditors' meeting, the court will determine whether or not to authorize the plan. The court authorization procedure will take approximately one week after resolution of the creditors' meeting. If the court issues a final decision approving the plan, it will become effective immediately.

b) An informal rescue?

In general, the management of the debtor company and the representatives of creditors consult with each other and jointly prepare the draft plan. Relatively speaking, creditors have the opportunity to exert more influence on the preparation of the plan.

c) A case of corporate insolvency under any special legislation?

The Republic of Korea has no special legislation applicable under such circumstances.

6 How are the different classes of creditors treated in relation to:

a) A corporate bankruptcy/liquidation?

The BA classifies creditors into three basic categories:

- Creditors with bankruptcy (unsecured) claims.
- Creditors with separate security right (secured) claims.
- Creditors with claims for the bankruptcy estate.

Bankruptcy (unsecured) claims are defined as claims arising prior to the commencement of bankruptcy proceedings. Secured claims are defined as claims with security such as a lien, right of pledge, mortgage, or lease on a deposit basis on the debtor company's property. Claims for bankruptcy estate are similar to the claims for common benefits in reorganization proceedings. (See below.)

Whenever the court recognizes that there are proceeds appropriate for distribution, it must distribute the proceeds to creditors in accordance with the priority of claims as listed in the distribution list (which was fixed by the procedure of filing and examination of the claims). Thus, distribution may happen more than once.

b) A formal rescue?

Corporate reorganization

The CRA classifies creditors into three basic categories:

- Creditors with general (unsecured) reorganization claims.
- Creditors with secured reorganization claims.
- Creditors with claims for the common benefit.

The claims held by the unsecured and secured creditors may be repaid only pursuant to the terms and conditions provided in the reorganization plan. In contrast, claims held by creditors with claims for the common benefit may be paid or repaid outside the scope of the corporate reorganization plan. This category of creditors primarily includes those creditors whose claims either arose after the commencement of the corporate reorganization proceedings or those creditors whose claims were approved by the court during the preservation period. These claims also include, *inter alia*, employee salaries, severance payments, certain legal expenses, taxes and costs of managing the company incurred by the receiver during the preservation period.

Any reorganization creditor, whether unsecured or secured, which seeks repayment of its claim must file a report of its claim and proof thereof with the court within the fixed time period set by the court. Failure to report claims against the debtor company within the specified period will generally discharge the company from the obligations thereof.

Composition

The CA classifies creditors into three basic categories:

- Creditors with composition (unsecured) claims.
- Creditors with separate security right (secured) claims.
- Creditors with claims for general priority.

Composition (unsecured) claims are defined as claims arising prior to the commencement of composition proceedings. Secured claims are defined as claims with security such as lien, right of pledge, mortgage or lease on a deposit basis on the debtor company's property. Claims with general priority are defined as employees' salary, taxes, and claims approved by the court during the period from the preservation order to the commencement of the composition proceedings. Claims for general priority will be outside of the composition plan.

The reporting of claims is required to establish voting rights at the creditors' meeting. Failure to report the claims within the prescribed period would not discharge the debtor company from the obligations thereof.

c) An informal rescue?

In the case of an informal rescue process, creditors are generally classified into two categories:

- Secured creditors.
- Unsecured creditors.

In principle, secured creditors are treated more favorably than unsecured creditors in preparing the debt rescheduling plan.

d) A case of corporate insolvency under any special legislation?
The Republic of Korea has no special legislation applicable under such circumstances.

7 What is the position of both unsecured and secured creditors who vote against, do not agree with, or do not consent to, a plan of rescue in relation to:

a) A formal rescue?
If a reorganization plan is duly adopted by the interested parties' meetings and approved by the court, such plan has binding force against all secured and unsecured creditors, including dissenting creditors.

If a composition plan is duly adopted by the creditors' meeting and approved by the court, such plan has binding force against all unsecured creditors (whether or not dissenting) as well as participating and consenting secured creditors. Non-participating or dissenting secured creditors are not bound by the composition plan.

b) An informal rescue?
If a workout plan is duly adopted by the representatives of creditors in accordance with the master workout agreement, such plan has binding force against all creditors that are parties to the master workout agreement, whether or not dissenting. Non-participating creditors are not bound by the workout plan. In case of a private composition, a debt rescheduling plan has binding force against only those creditors that have individually agreed to the plan.

c) A case of corporate insolvency under special legislation?
The Republic of Korea has no special legislation applicable under such circumstances.

8 In relation to the need for an insolvent corporation to have urgent working capital funding, what difficulties are encountered in the provision of such funding in relation to:

a) A formal rescue?
The financial credibility of the debtor company that becomes subject to formal or informal corporate rescue process is necessarily decreased. Further, if the court issues a preservation order, such actions as disposing of property and obtaining new loans are only allowed with the approval of the court.

b) An informal rescue?
Please refer to Section 8a above.

c) A case of corporate insolvency under any special legislation?
The Republic of Korea has no special legislation applicable under such circumstances.

9 Briefly describe the relevant provisions relating to the setting aside of antecedent and fraudulent transactions in relation to:

a) A corporate bankruptcy/liquidation?
The Civil Code contains a general provision invalidating fraudulent conveyance transactions (dispositions of property for no or unfairly low consideration). The BA, CRA and CA similarly contain largely parallel provisions.

The scope of "fraudulent conveyance transactions", subject to invalidation under the BA and CRA, is enlarged compared to that under the Civil Code. For example, debt repayment to one or more specific unsecured creditors or disposal of property for that purpose, in and of itself, does not qualify as "fraudulent conveyance transactions" to be invalidated under the Civil Code. However, such activities in violation of the principle of equal distribution among the unsecured creditors which have been taken within a certain period of time prior to the bankruptcy adjudication or after the filing of the bankruptcy or corporate reorganization petition may be invalidated under the BA and CRA.

Under the CA, fraudulence conveyance transactions taken after the filing of the composition petition may be invalidated in the same manner as the BA and CRA. Fraudulent conveyance transactions taken prior to the filing of the composition petition are subject to general provisions under the Civil Code.

b) A formal rescue?
Please refer to Section 9a above.

c) A case of corporate insolvency under any special legislation?
The Republic of Korea has no special legislation applicable under such circumstances.

10 Are there any provisions of law that might operate to invalidate a secured property transaction in relation to:

a) A corporate bankruptcy/liquidation?
Subject to restrictions on security right enforcement explained above, secured creditors are allowed to assign, transfer or otherwise dispose of their security interests to third parties while the debtor company undergoes bankruptcy, corporate reorganization or composition proceedings.

Creation of new security rights over assets by the debtor company is restricted by the preservation order or the statutory provision of invalidating fraudulence conveyance transactions as aforesaid.

b) A formal rescue?
Please refer to Section10a above.

c) A case of corporate insolvency under any special legislation?
The Republic of Korea has no special legislation applicable under such circumstances.

11 Describe the difficulties that are encountered in endeavoring to administer cases of corporate bankruptcy/liquidation and formal corporate rescue that involve property and business interests located in more than one jurisdiction.

The BA, CRA and CA do not apply to the debtor company's assets located overseas. Consequently, where the debtor company has property and business interests located overseas, the effective and fair administering of cases of corporate bankruptcy/liquidation and formal corporate rescue is sometimes very difficult.

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Financial issues: Korea, Republic of

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In the Republic of Korea there is an unusual divide between the insolvency legislation and the arrangements for corporate restructuring.

The insolvency legislation is embodied in statute – specifically the Bankruptcy Act of 1962 (amended 1998), the Company Re-organization Act and the Composition Act. However, early in the financial crisis of 1997 to 1998 it was recognized that the insolvency legislation could not deal effectively and in a socially acceptable manner with the massive number and scale of distressed corporates.

In 1998 the then-new government of President Kim Dae-Jung facilitated the Agreement for the Promotion of Corporate Workout ("the Agreement"), between all significant Korean financial institutions not then subject to formal insolvency proceedings and the Corporate Restructuring Creditors Committee ("CRCC"). The CRCC is a subsidiary body of the Financial Supervisory Commission ("FSC"), a government body ultimately reporting to the President's office through the Financial Supervisory Service ("FSS").

The Agreement sets out a contractual arrangement for major Korean corporates to apply for "workout" and for their debts to Korean financial institution creditors to be stayed and for a due diligence process to be carried out. If prescribed conditions are satisfied regarding the viability of the company and of the proposed workout agreement, a Memorandum of Agreement ("MoA") is entered into by the company and the Korean Creditor Financial Institutions ("KCFIs"). The MoA would normally provide for a range of restructuring measures including asset reduction, repayment holidays, interest holidays and/or reduced interest rates and commitments to restructure businesses and operations.

The Agreement is essentially a contractually binding arrangement based upon the so-called "London Approach" and Chapter 7 of the US Bankruptcy Code.

The Agreement is a contractual arrangement and is not binding on any creditors who have not signed – including foreign creditor financial institutions ("FCFIs"). Usually, the KCFIs have bought out the claims of the FCFIs, either at 100 percent or, if they are material, at a discount. The Daewoo companies are an example in that a protracted and difficult negotiation has led to terms being agreed between the steering committee for the FCFIs and the relevant Korean entities for debt due to the FCFIs to be purchases at prices reflecting the circumstances of the relevant companies.

Notwithstanding that the Agreement does not bind FCFIs of companies entering workout, its operation is relevant to FCFIs in relation to the following:

- ▲ How the debtor company's future will be determined.
- ▲ The treatment of debt due to FCFIs.
- ▲ FCFIs purchasing debt of companies in workout pursuant to the Agreement originally due to KCFIs.
- ▲ The provision of additional funding to companies in workout.

1 Is the restructuring/ insolvency legislation generally:

Understood?
Being followed, and/or available opportunities being taken up?
Being enforced by relevant authorities?

The KCFIs, and especially the major banks that act as lead creditor banks or on steering committees for most workouts, generally understand the operation of the Agreement.

The fundamental structural difficulty affecting the implementation of restructuring in Republic of Korea, whether within the Agreement, under the insolvency legislation or informally, is the difficulty of exerting pressure upon, and, where necessary, changing or strengthening the management of corporates.

Most corporates and chaebol in Republic of Korea are family controlled through a web of interlocking shareholdings and directorships. Although many of the larger companies are listed, the founding families retain either a majority or a large minority of shares.

Further, the historic practice of the commercial banks, prior to the crisis of 1997 to 1998, was to act as conduits of funds to corporates operating, or selected by the government of the day to operate, in selected industries identified as being in the national interest. In general terms, corporates were not expected to repay bank finance other than by means of fresh bank lending. This led to very high debt/equity ratios.

Although bank lending was often secured, with property being the preferred collateral, banks very infrequently relied upon the collateral taken. Further, the property market in Republic of Korea did not operate as a market in the usual sense. Valuations were based on the expectations of the property owner and turnover in the commercial property market was low.

In short, bank finance was generally regarded in practice as long term funding and not ultimately repayable – i.e. more as equity than traditional bank finance. Banks generally did not act in the traditional function of a bank, providing lending to be repaid from future cash flows.

Further, corporate governance, accounting and auditing practices were weak, with very few external (non-executive) directors. Groups of companies were not required to produce consolidated accounts, leaving significant weaknesses in the accounting standards and audit fees fixed by reference to asset size (the first disclosed consolidated financial statements (for Financial Year 1999) were published for the 30 largest chaebol groupings from August 2000). The result has been that corporates have not had the discipline of reporting to stakeholders (whether banks, external shareholders or others) in a coherent, comprehensive, comprehensible, timely and prudent manner. They therefore lacked both the systems and controls, and the culture and will, to do so. Such reporting as existed focused upon size of turnover and of assets, not profitability or cash flow.

For the same reasons, the banks lacked the skills and systems to effectively assess lending opportunities and to monitor and control lending after it had been made.

A more subtle but more pervasive issue is that the banks have lacked the will, the organizational culture and the political connections to take a strong line with management of corporates – particularly the major corporates and chaebol. A policy statement made by the Chairman of the FSC in July 2000 reads in part:

> Management transparency and responsible management of banks will be guaranteed through the prohibition of outside interference, special favors and undue pressure, while the board of directors at banks in which the government is the majority shareholder will assume responsibility for all major managerial decisions.

(Quoted from the FSC Chairman and special member of the Tripartite Commission, Yong Keun Lee, in a report entitled Policy for the Development and Reform in the Financial Industry presented to the meeting of the Tripartite Commission held on 12 July 2000.)

It is unusual for KCFIs to force a major corporate into Court Receivership or bankruptcy unless there is evidence of fraud or the business is very obviously not viable. More often, the corporate will apply for a workout under the Agreement. The KCFIs have in the past almost always approved workout agreements, usually with the same management team in place but sometimes without (e.g. Dongah, various Daewoo companies).

In the early days of the Asian crisis, when the Agreement was made, this was probably the correct balance. The overriding priority was the preservation of economic and social stability. However, once that had been achieved, the priority changed to the more traditional function of insolvency and restructuring laws. This is to give viable corporates encountering temporary difficulties the time and opportunity to make the necessary financial, management and business changes to restore profitability, to ensure that the necessary changes are implemented quickly and effectively, and to identify and weed out corporates that are not or cannot be made viable.

For major corporates in the Republic of Korea, management teams will not usually be changed and/or the corporate not usually forced into formal insolvency unless either (i) major malpractice or misfeasance is alleged or proved; or (ii) an MoA has been approved but breached by the corporate, with the result that a major refinancing is required (e.g. Jindo).

This has meant that corporates in workouts have not been obliged to make the changes necessary to restore viability and many that should have been quietly dismantled have been allowed to continue.

Progress is being made on many of these issues and the government has been energetic and generally effective in encouraging and bringing about reforms. The government has sought to do this in several ways, including the following:

- The introduction of legislation and regulations reforming corporate governance, accounting and reporting practices. A Code of Best Practice of Corporate Governance has been issued and from 2000 all listed companies are required to issues a statement declaring their compliance with the Code. It may be expected that the government will take punitive action if it should be found that a company has issued a false or misleading statement.
- Encouraging banks to identify and properly provide for loans to under-performing corporates, by changing the method by which banks are required to establish reserves.
- Encouraging banks to objectively assess proposed workouts, through the CRCC.
- Changing the political climate to reduce the political influence wielded by chaebol management – the dismantling of Daewoo and the removal of its management has been a key example.

Further progress is required. The problems are deep rooted and will not be solved overnight.

In summary the insolvency and restructuring legislation and provisions are generally understood. Cultural and political systems and skills issues combine to delay identification and action to resolve developing problems of under-performance, with the result that available opportunities are not identified, and/or not taken up as early as is desirable. When the need for a restructuring becomes clear, the banks (strongly encouraged by the government) do enforce the insolvency legislation and the Agreement. Unless the government ensures that the banks do focus on ensuring that the legislation and the Agreement are properly enforced as intended, too often the banks lack the necessary skills, resources and political confidence to ensure that restructuring is effective.

It is noteworthy that in Republic of Korea, almost all reforms are initiated and driven forward by the government. This is particularly true in the corporate and financial sectors of the economy. Not only is the government the principal source of authority and direction in what remains a very disciplined society, but also the political and economic power of the chaebol has often proved greater than that of the financial sector. It has not helped that the chaebol and their controlling families – although forbidden from controlling banks – have major stakes in financial institutions: the old saying “if you owe the bank $1,000, you have a problem; if you owe the Bank $1 million, the Bank has a problem” remains true. The principal difference is scale – the total liabilities of the failed Daewoo chaebol are now estimated to be in the region of US$65 billion.

2 Broadly speaking, in practice, does the restructuring/insolvency legislation tend to lead to:

Early recognition and action on financial difficulties experienced by a corporation? Restructuring alternatives as opposed to liquidation, and if not, why not?

These issues have been touched upon in Section 1 above. Although the commercial atmosphere is slowly changing, in general terms the following is true:

- The financial difficulties experienced by corporates are not generally recognized and acted upon early enough.
- Restructuring alternatives are generally chosen when, in some instances, liquidation would be preferable.
- Restructuring alternatives are often not implemented effectively, allowing businesses to continue to under perform.

As discussed above, the problems are not generally with the insolvency and restructuring legislation, although this is not perfect and some reforms would be beneficial. The problems mostly lie in the social, political and historical context in which businesses operate.

In the typical western economic model, financial difficulties are generally identified as follows:

- By non-executive directors, monitoring in detail performance of the company and its executive directors.
- By shareholders, through the medium of periodic reports and accounts prepared to rigorous standards and subject to independent audit.
- By banks and other finance providers, through the medium of periodic reports and accounts, through monitoring of exposures and through information provided by the company in accordance with banking/finance agreements.

Non-executive directors

There are at present relatively few non-executive directors of corporates in the Republic of Korea. Although there is a statutory requirement for companies listed on the KOSDAQ stock exchange to have a majority of non-executive directors, the legislation came into force as recently as 1 January 2000. Most corporates are still in the process of identifying and appointing non-executive directors and the boardroom culture has yet to adapt to the concept of non-executive directors having an independent role.

The result is that non-executive directors do not yet provide an effective control to identify and take action to remedy the early signs of financial difficulties. The recent reforms are to be greatly welcomed. If the non-executive directors appointed are appropriately trained and their role as protectors of the interests of "external" stakeholders is accepted, both socially and within board rooms, it is reasonable to expect that in the future financial difficulties will be identified and acted upon significantly earlier than has been the case.

Shareholders

Although large numbers of corporates are listed on KOSDAQ, for most listed corporates only a minority of their shares are publicly held. Most are held within the founding family or by other companies within the chaebol grouping. Complex nets of cross-shareholdings are frequently encountered and have their roots in two principal issues, as follows:

- Until 2000, pure holding companies were illegal.
- Corporations were taxed as single enterprises and group tax arrangements were not recognized, so it was difficult to move profits between linked companies without suffering tax.

The result is that hostile take-overs are virtually unknown and it is very unusual for external shareholders to have sufficient voting power to force management change. The position of external shareholders has been further weakened by the lack of reliable accounting information, not least by reason of the historic weakness of Korean accounting standards.

The net effect was to reduce pressures from shareholders for early problem recognition.

The government has taken steps to address these issues. Holding companies are now permitted and tax reforms are being introduced. As noted above, Korean accounting standards have been changed and are now based on the Generally Accepted Accounting Principles of the United States of America. These changes may be expected to lead to more "normal" holding company/ subsidiary group structures and to external shareholders exercising greater influence.

The banks

Discussed in Section 1 above are the weaknesses of the major banks, in particular, (i) lack of appropriate skills, (ii) lack of political connections and will to force management to provide meaningful information and properly restructure businesses, and (iii) regulations concerning provisioning against loans favoring the agreement of workouts, even when these will not lead to greater recoveries.

Also described above are some of the changes encouraged or implemented by the government, which have already brought about some improvement. With greater experience of using the legislation and confidence in the role of banks in the economy generally, further improvements may reasonably be expected.

Overall, the management of corporates is generally in a very strong position in relation to banks and external shareholders. Management usually has a vested interest in the maintenance of the status quo – both to preserve the source of their income and to avoid the loss of face consequent upon the implicit or explicit recognition of past mistakes which is a necessary first step in a restructuring.

This has led to management being able to secure the approval of KCFIs to workouts on generally favorable terms. Further, following approval of workouts, management have rarely taken the radical and hard decisions necessary to reshape the businesses carried on by the corporate and restore profitability. Almost invariably, corporates have failed to meet the projections upon which workouts are based and have succeeded in gaining the acceptance of the KCFIs to a further round of debt-for equity

swaps, interest holidays and interest rate holidays and, most damaging, the provision of further loans to meet working capital needs. Finally, for reasons set out in Section 1 above, the banks have been slow to put pressure on borrowing corporations.

All of the above have tended to work against early recognition of problems.

Current developments

There are signs that the government's continuing pressure, designed to strengthen external shareholders and the KCFIs (and the commercial banks in particular) and to weaken the chaebol, is bearing fruit. A few workout plans have been rejected and management of some corporates have been changed. However, the balance remains skewed towards the survival of existing businesses under existing management and against the recognition of the following:

- It is often necessary to change the management of businesses that are under performing.
- Addressing the underlying under performance of a business will often require a fundamental change to the way in which the business is carried on.
- Some businesses fail and in normal times it is in the wider economic interest for such businesses to be liquidated.

3 What are the main practical difficulties being encountered in:

The preparation of restructuring plans?

The implementation of restructuring plans?

The principal practical issues are summarized below.

Difficulties in the preparation of restructuring plans	Difficulties in the implementation of restructuring plans
Extreme time pressures imposed by the Agreement (stay of three months, extendable to four).	Poor quality of many of the plans including the lack of credible trading projections.
Entire plan must be developed and agreed within the stay period.	Plans are often limited and unrealistic as a result of their hasty development and are difficult or impossible to implement.
Lack of coherent and credible financial information, including properly developed and validated business plans and forecasts.	Lack of coherent and credible information upon the activities and performance of the corporates in restructuring.
Retention of shareholder management in many companies.	Lack of a pool of management talent to introduce into a corporate undergoing restructuring – include "crisis" and "turnaround" management specialists – and arbitrary selection of new management by KCFIs.
The lack of experience of both KCFIs and professional advisors in dealing with restructuring.	Lack of experience of KCFIs in monitoring corporates, and in the management of their stakes in corporates undergoing restructuring.
The "blame culture" and sacred cows – existing management are often very reluctant to acknowledge the causes of under-performance.	The "blame culture" and sacred cows – it is often necessary to make quick and hard decisions, which existing management often find very hard to do.
"Rampant moral hazard" – failure of owners/management to properly disclose assets, liabilities and trading prospects in the course of the development of the workout plan.	"Rampant moral hazard" – shareholders/managers (i) using cash injections from KCFIs for private purposes, (ii) failing to deliver up assets and cash injections promised under the MoA, (iii) neglecting their management responsibilities, and (iv) starting new businesses and funding such businesses from the workout without the consent of the KCFIs (FSS report, 23 August 2000).

KCFIs have not, prior to the Asian crisis in mid-1998, had to deal with the restructuring of corporate entities. The Korean economy enjoyed strong and uninterrupted growth for many years – enabling even poorly managed companies to survive. Also, as noted in Section 1 above, the role of the KCFIs and of the major banks in particular was to provide long term funding to corporates as directed by the government, not to monitor and manage for profit in the usual way a loan portfolio.

The result is that the KCFIs and their staff were not equipped to handle the restructuring of major corporates that became necessary in the sharp recession of late-1997 to early-1998. As part of the World Bank program of aid and support to the economy of the Republic of Korea, all major banks were required to establish workout teams. Foreign advisers were introduced to support and assist the workout teams from September 1998. This has provided the basis for a core of expertise in restructuring.

Similarly some incumbent management teams have good knowledge, skills and attributes, and many are very competent at dealing with the technical aspects of their roles. However, the qualities required of management in a workout are very different from the qualities required during the normal operation of a business.

One of the most critical difficulties in the practical operation of the Agreement has been that the stay on debt repayments and time permitted for negotiation and approval of the MoA is limited to a maximum of four months. The MoA agreed at the end of the process is expected to be complete and capable of performance in every respect.

If the corporates were in possession of credible business plans, budgets and financial forecasts at the commencement of the stay period, and their accounting information was credible, this might be achievable. However, most corporates requiring restructuring do not possess such things, for the reasons discussed above (indeed, the lack of such information has usually been a root cause of difficulties encountered).

It is probably not surprising therefore that most MoAs have been found to be significantly flawed and in need of extensive revision after the first year of the workout.

Perhaps the greatest single difficulty in the implementation of workout plans has been that the retention of shareholder management is a continuing problem in many businesses. In a workout, it is usually necessary to do the following:

- Make and quickly implement tough decisions, to cut costs, terminate unprofitable activities and release cash.
- Recognize that the underlying reason for the under performance of the business is that at some point a wrong strategic direction has been chosen.

A thoroughgoing strategic review is required. Businesses leaving workout are very often radically different in shape and strategic direction from the businesses that entered workout.

It is naturally painful and difficult for management to recognize that it's previous decisions were faulty, and/or that it's strategic vision is lacking, and/or that the knowledge, skills and attributes of the management team are inadequate for the task at hand.

As noted in the table above, moral hazard is an issue. The FSS has said that non-compliant companies and managers will be brought to the attention of the National Tax Service, for tax investigations to be conducted. While this is a welcome step forward, it addresses the symptom but does not resolve the underlying ailment.

One of the issues restricting the extent of management change in workouts is a lack of a pool of available talent.

The FSS report also identified neglect of supervisory responsibilities by KCFIs as a contributory factor. The KCFIs' lack of experience of workouts and restructuring and the political concerns of their management are the principal reasons for such neglect.

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4 To what extent are companies that are going through any formal or informal restructuring merely adjusting their debt/equity structure, rather than genuinely restructuring their business operations?

In general terms, workouts have not led to genuine and far-reaching restructuring of the business operations of the corporate entity. A relatively crude but useful measure is the extent to which companies in workout have met the terms of the MoA setting out the terms of the restructuring, including the required asset reductions and the expected performance of business units.

In September 1999, it was reported that 78 out of 82 chaebol and major corporates that had entered into workout agreements with KCFIs were in significant default of the terms of the MoA. Some of the deficits were very large indeed. Most would require another round of refinancing and debt restructuring. A fresh round of workouts were negotiated in the latter part of 1999 and the early months of 2000. In the latter part of 2000, a number of high profile workouts failed and companies placed in Court Receivership.

Workout plans vary considerably. They will usually include the following components, in varying proportions according to the circumstances of the company and the negotiating strengths of the various parties:

- Debt restructuring, including interest forgiveness/rate reductions, medium and long-term loans, additional working capital finance from lenders and debts for equity swaps, but not debt forgiveness.
- Asset reductions including the sale of properties and of operating divisions or subsidiaries.
- Improvements in the operating performance of businesses to be retained in the company.

PricewaterhouseCoopers' experience is as follows:

- The debt restructuring is usually implemented quickly.
- There are commonly extended delays to the asset reduction programs.
- Operating performance may improve, but improvements are usually slower and lower than envisaged in the workout plan.

Debt restructuring is controlled by the KCFIs, which are efficient in pushing through the required measures.

Asset reduction takes place more slowly and it has been usual to see realizations falling behind schedule. One of the principal issues has been price expectation. The hasty preparation of the MoA and the limited market information available has often precluded, or limited, challenges made to the management's assumptions or assertions regarding the value of properties or business entities. In other jurisdictions, management often seize the opportunity offered when a restructuring is being negotiated to write down assets as far as possible. This enables them to claim in due course, when the asset is sold, that they have either met, or, better, exceeded expectations.

In Republic of Korea, however, this is rarely seen. Incumbent management is usually retained, creating barriers to an acknowledgement that assets are worth significantly less than what was paid. Management will often insist that an unrealistic value is placed on assets for the purpose of the MoA. The asset is then marketed at that price and, unsurprisingly, frequently fails to sell.

Operating performance of the retained businesses is also frequently lower than forecast in the business plans upon which the MoA is based. This is partly a function of the quality of the workout agreements. Most corporates entering workout do not have properly prepared business plans and financial projections, or the skills to prepare such documents. When workouts were being negotiated, business plans and financial forecasts were necessarily prepared, but sometimes hurriedly and/or by inexperienced personnel. The net result was that many of the workout agreements were unrealistic and the performance targets set unlikely to be achieved.

Another significant factor has been the reluctance of incumbent management to make significant changes to the businesses carried on or the corporate structure – the "sacred cows" problem.

The net result is that most corporates in workout have not genuinely restructured their operations.

However, many of the corporates in workout are heavily loss making. The government has given clear signals that it will require the KCFIs to take a stronger line with corporates in workout that fail to meet their MoA targets. The strong growth of the Korean economy in 2000 and the reduction in unemployment has given the government leeway to require KCFIs to impose stricter terms and to enforce existing terms more rigorously, although growth is slowing in early 2001. Initial signs were good with three seriously under-performing companies – Dongah Construction, Daewoo Motor and Woobang Construction – being forced out of workout and into Court Receivership. There are other, smaller examples but it remains to be seen whether the KCFIs will deal effectively with the many corporates that fail to meet the terms of their workout agreements.

A useful illustration is Dongah Construction. Its workout was the first to be approved, in mid-1998. By early 2000, the deficit in the workout was in excess of US$1 billion – attributable in part to delays in selling the Korea Express business, but mostly to trading losses and realized or expected shortfalls in the asset reduction program. Although the president of Dongah was replaced as part of the workout package, many of the previous management team remained. It would appear that the management changes had not been sufficiently deep or far-reaching. A revised MoA was agreed in early 2000 and further management changes imposed, but these were evidently too little too late and Dongah was placed in Court Receivership in October 2000.

There are signs that the balance is shifting away from workout being (in practice) largely focused on debt/equity adjustments and towards a focussed business restructuring process, but it remains to be seen how far and how quickly the balance will shift.

5 What are the main areas from which funding is generally being utilized by companies which undertake either formal or informal restructuring?

Existing finance providers – principally the Korean banks – are the usual sources of finance for companies undergoing restructuring.

In practice, there are often few choices available. The financial information and business performance of companies undergoing restructuring are often such that only lenders or investors willing to accept a higher level of risk would wish to become involved. The KCFIs, therefore, often find that they have few options other than to either see the company proceed into formal insolvency, with the prospect of very heavy losses, or to provide DIP financing in a workout.

Under the Agreement, if a workout is approved by a majority of the KCFIs then all KCFIs with unsecured claims may be required to make fresh loans to the company to be used as working capital as specified in the MoA, *pro rata* to their respective unsecured claims and without regard for whether they have voted for, or against approval of the proposed workout.

After a restructuring has been approved, it is sometimes possible for a company to raise finance outside the KCFIs. Dongah Construction is an example, as it issued interest-bearing bonds to international investors.

However, even less-risk averse investors require some evidence of a satisfactory performance. Many companies in workout find it very difficult to provide that evidence, and in consequence, it is unusual for new investors to provide additional finance.

In many workouts, the claims of FCFIs are bought out. As a result, the burden of providing DIP financing falls almost entirely on KCFIs.

Debt owed by companies subject to insolvency proceedings, such as Court Receivership, is frequently sold by the KCFIs to the Korea Asset Management Company, a government funded body. The debt is repackaged by the Korea Asset Management Company and sold by tender to international investors.

The amount of debt sold may be sufficient to give one, or a group of international investors effective control over the company (e.g. Hanbo Steel). It has yet to be seen whether international investors can resolve the cultural and management problems; but while they grapple with the problems, many will need to provide additional finance.

It has been suggested that debts due by companies in workout will also be sold, as part of the process of cleaning up the non-performing loans books of KCFIs.

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