

# KOREAN GOVERNMENT'S PROPOSED BILL FOR THE UNIFIED INSOLVENCY ACT

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## 1. Background

Since the Korea's financial crisis in the late 1997, Korea's three insolvency related laws, the **Corporate Reorganization Act** ("CRA"), the **Composition Act** ("CA") and the **Bankruptcy Act** ("BA"), have been amended in order to enhance the expertise and lessen the workload of the courts and make the insolvency proceedings more efficient and expeditious.<sup>1</sup> However, there have been criticisms and arguments that such amendments were insufficient to make fundamental improvements on Korea's insolvency-related legal system and that these three insolvency-related laws should be unified into a single act to govern all insolvency proceedings.

Responding to such criticisms and arguments, the Ministry of Justice of Korea ("MOJ") established the Committee on Insolvency Law Reform ("CILR") in May 2001. After a series of internal discussions, the CILR finalized and the MOJ announced the Initial Draft of the Unified Insolvency Act ("IDUIA") on November 6, 2002, in an attempt to unify the three insolvency-related laws as well as reform insolvency-related legal system. After gathering comments and opinions on the IDUIA from various groups and individuals, including courts, other government ministries and agencies, enterprises, financial institutions, consumer associations, etc., the MOJ slightly revised the structure and several provisions of the IDUIA and finalized the bill for the *Act on Rehabilitation and Bankruptcy of Debtors*, also known as the Unified Insolvency Act, and submitted the proposed bill to the National Assembly of Korea on February 21, 2003 (the "Bill").

## 2. Major Characteristics of the Bill

### a. Unification of the Insolvency Laws and Abolition of Composition

<sup>1</sup> The CRA, the CA and the BA were amended effectively as of February 1998 and April 2000. Further, the CRA was amended in April 2001.

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The Bill consolidates the CRA, the CA and the BA in order to establish more systematic procedures for rehabilitation and liquidation of insolvent companies. Among others, it abolishes the Composition proceedings. Under the current insolvency laws, Bankruptcy is regarded as a process of **liquidation** of insolvent corporations, which takes place under the court supervision. In the Bankruptcy proceedings, the assets of an insolvent company (debtor-company) are disposed of, and its debts are repaid equitably to the creditors, in accordance with procedures and standards set forth in the BA. In contrast, the procedures for the Composition and the Reorganization are both designed to permit insolvent corporations to **rehabilitate** themselves from financial difficulties, where such companies may otherwise have been forced into the Bankruptcy proceedings.

The Composition and the Reorganization share a common characteristic in that both seek to rehabilitate insolvent companies and are carried out under the court's supervision. However, they also present some differences between each other. For instance, the **Composition** can be described as a passive corporate rehabilitation program, the main purpose of which is to protect insolvent companies from liquidation. Also, in the Composition, there is little legal protection for the insolvent companies and the rights of creditors may be virtually rescheduled by the concession of creditors only. For example, the rights of secured creditors and creditors with priority are generally not adversely affected by the Composition proceedings. In addition, the court's intervention in the Composition proceedings occurs much less compared to the Reorganization, except in the early stages of the Composition. Also, the existing management of insolvent company under the Composition is normally not replaced under the Composition procedures.

In contrast, the **Reorganization** is a more proactive procedure designed to rehabilitate an insolvent company in financial difficulties although it may not be in such a severe state of imminent liquidation. The insolvent companies may seek rehabilitation under the court supervision with the legal protection provided in the CRA. For instance, the rights of creditors are adjusted pursuant to the provisions of the CRA, and the creditors are entitled to recover their claims only in accordance with a reorganization plan that has been approved by the court. The CRA applies only to a joint stock company (*Chusik Hoesa*). Further, in principle, the court will replace the existing management of insolvent company under the Reorganization with one or more receiver(s).

There have been some criticisms that the Composition proceedings have not effectively worked as a corporate rehabilitation scheme. By consolidating such three laws, the Bill abolishes the Composition proceedings and establishes the Rehabilitation proceedings, with some improvements and modifications to the existing Reorganization

proceedings, as the only corporate rehabilitation procedure. In sum, the Bill provides two corporate insolvency procedures, the Bankruptcy and the Rehabilitation.

**b. Introducing Personal Rehabilitation System**

Such being the case, the Bill introduces the **Personal Rehabilitation** system under which individual debtors, who are expected to receive regular income either by employment or self-employment, may restructure their debts without the bankruptcy process. Only the individual debtors, not the creditors thereof, may file an application for the Personal Rehabilitation proceedings.

**c. New Rules on Cross-border Insolvency Procedures**

The current insolvency laws of Korea are based on territorialism. If any insolvency procedures are commenced in Korea, only the debtor's assets located in Korea may be subject to such insolvency proceedings, and the debtor's assets located outside Korea will rarely be subject to the jurisdiction of the Korean insolvency laws. Similarly, any foreign court's judgment from the insolvency proceedings in a foreign country will not have effects on the assets located in Korea. Also, the authority of insolvency administrators appointed in the foreign insolvency procedure depends on whether, under Korean insolvency laws, such administrator has the authority to administer the assets located in Korea on behalf of the corporate debtor of the foreign insolvency proceeding. Thus, the authority of the insolvency administrator depends on the laws of Korea, not of the insolvency administrator's country. Therefore, even if the laws of the insolvency administrator allows the administrator to administer the assets in Korea, such administrator is not deemed to have an authority to act in Korea on behalf of the corporate debtor unless he/she obtains an approval from the competent Korean court. Moreover, the foreign creditors have the same rights as Korean creditors and the foreign creditors are treated equally as the Korean creditors in insolvency proceedings only if there is reciprocity between the laws of Korea and the insolvency laws of such foreign creditors. That is, the insolvency laws of such foreign creditors should also provide the equal treatment and protection to Korean creditors in their own insolvency proceedings.

In order to introduce an insolvency system effectively to the global business environment, the CILR had an opportunity to review the UNCITRAL model law on cross-border insolvency and to explore the way to have the Korean laws conform to the international developments based on a universalistic approach. The Bill provides the procedures for recognizing the foreign insolvency procedures. Also, the representative of a

certain foreign insolvency proceeding may seek assistance from Korean court and the debtor company, the receiver or the bankruptcy administrator may seek assistance from foreign court.

First, the collegiate court of Seoul District Court has the exclusive jurisdiction over the cases for the recognition of foreign insolvency proceedings and the court's assistance. However, the court's assistance may be provided by the court having general jurisdiction on debtor company's registered office or principal place of business in order to promote efficiency of the proceedings. The representative of a foreign insolvency proceeding may file an application for the recognition with the competent Korean court. The Korean court shall make a decision on the recognition within one (1) month of the date of such filing of application unless it would be manifestly not in conformity with the good morals and public order of Korea. In this case, the Korean court may render a preservation order prohibiting creditors from enforcing their rights to protect creditors' interests and to keep the assets of the debtor company. Such preservation order may include the suspension on the legal proceedings for the exercising enforcement rights against the debtor's assets, prohibition of repaying debts, disposing of property, providing security interest or otherwise disposing of any assets of the debtor, and other measures the court deemed necessary to preserve the assets of the debtor company and to protect creditors' rights and interest. Upon the decision for the recognition of foreign insolvency procedure, the representative of the foreign insolvency proceeding may participate in, or file a petition for the commencement of, the insolvency procedure in Korea.

Furthermore, under the Bill, after the recognition of foreign insolvency procedure, the Korean court may render a decision for the assistance, such as the measures similar to the preservation order above, including a stay of enforcement rights, in order to protect the rights and interests of creditors and to preserve the assets of the debtor company. In addition, the Korean court may appoint a foreign insolvency administrator who has the authority to manage the debtor company's assets in Korea.

Moreover, the Bill sets forth the provisions for the concurrent proceedings (joint trial) where there are applications for recognition of two or more foreign insolvency procedures. Finally, the Bill provides that the Korean court shall cooperate and exchange information with foreign courts or the representatives of foreign insolvency proceeding in order for the enforcement of cross-border insolvency procedures to be proceeded in a fair and smooth manner.

### **3. Other Notable Changes in the Bill**

#### **a. General Provisions**

Standard for the Commencement of Rehabilitation and the Conversion to Bankruptcy

Under the existing CRA, the court shall refuse to render a decision for the commencement of the Reorganization proceedings or discontinue the Reorganization proceedings where it is evident that the liquidation value of the debtor company exceeds the going concern value of the debtor company. Also, where the court discontinues the Reorganization proceedings or dismisses the Reorganization plan, the Reorganization proceedings will be automatically converted to bankruptcy proceedings by the court's adjudication. In such a case, the bankruptcy proceedings may commence contrary to the wills of creditors and/or debtors. Moreover, in a situation where it is not apparent whether the going concern value exceeds the liquidation value of the company, the debtor company might hesitate to file an application for the Reorganization proceedings. Hence, it has been pointed out that such mandatory conversion provisions may unfairly deprive a debtor company of utilizing the reorganization proceedings.

The Bill lifts the provision that requires the court to refuse to commence the Rehabilitation proceedings if the liquidation value evidently exceeds the going concern value of the debtor company and allows the court to have a discretion whether to discontinue the Rehabilitation proceedings even if the liquidation value exceeds the going concern value of the debtor company. Furthermore, the Bill allows the court to have the discretion to adjudicate on bankruptcy even if the court refuses to grant a petition for the commencement of the Rehabilitation proceedings, discontinues the Rehabilitation proceedings or dismisses the Rehabilitation plan.

#### **(1) Interested Parties' Rights of Access to Information**

In order to facilitate M&A of the insolvent companies, the Bill provides that the interested parties shall have the right of access to the documents and records, together with copies thereof. Also, upon request of the interested parties or on the court's own motion, the court shall be able to make inquiries into the debtor's assets so that debtors who are capable of paying the debts will not be relieved from their obligations through the loopholes of the bankruptcy procedures.

## **b. Rehabilitation Proceedings**

### Changing the Principle on the Appointment of Receivers/Replacement of Management

Under the current CRA, one or more outside receiver(s) are appointed to replace the existing management of a debtor company. Therefore, under the CRA, the existing management of the debtor company tends to hesitate to file the application for Reorganization proceedings. Also, in the case where the court fails to appoint competent receivers, the normalization of the debtor might be delayed.

The Bill proposes that, in principle, existing management shall be appointed as a receiver of the debtor company under the Rehabilitation so that the management know-how of the existing management may be utilized. However, the court may appoint outside receivers and replace the existing management where there is a cause for excluding existing management. For example, if the existing management has been responsible for the important matters which led the debtor company to insolvency, or the creditors council requests for the appointment of outside receivers with justifiable reasons, the court shall not appoint the existing management as receivers.

### **(2) Introduction of Comprehensive Temporary Stay**

Under the current CRA, during the period between the filing application for the Reorganization proceedings and the court's decision for the commencement thereof, the debtor company is only allowed to file an application for a temporary stay on specific creditors' enforcement rights on a case-by-case basis.

The Bill introduces the concept of comprehensive temporary stay. Under this scheme, the court may render a decision for comprehensive temporary stay, which will prohibit creditors, both secured creditors and unsecured creditors, from exercising their claims or enforcing their rights against the assets of the debtor company. The court order for such comprehensive temporary stay may be rendered if the court considers it probable that the purpose of the Rehabilitation would not be adequately fulfilled by the ordinary temporary stay.

### **(3) Expansion of the Scope of Voidable Transactions**

The Bill expands the scope of voidable transactions in the Rehabilitation

proceedings. Under the current CRA, the receivers shall have the right to take a legal action to avoid or nullify transactions deemed prejudicial to the creditors, except when the beneficiaries of such transactions did not have knowledge of such prejudice. Additionally, the Bill provides that if a transaction so deemed prejudicial to the creditors was made among the “specially related persons”, which is to be defined in the relevant Rules promulgated by the Korean Supreme Court, it shall be presumed that the parties consummated the transaction with knowledge of such prejudice and such transaction will be voidable.

#### **(4) Guaranty of Liquidation Value for Creditors**

Currently, the CRA has no provisions that creditors shall be entitled to repayment of the minimum liquidation value of the debtor company. As a result, certain creditors may be repaid in the amount which is even less than the liquidation value of their claims.

The Bill requires the Rehabilitation plan to include the provisions that: (i) secured creditors shall be entitled to the repayment in the amount not less than the liquidation value of the assets secured for the relevant claims; and (ii) unsecured creditors shall be entitled to the repayment in the amount not less than liquidation value of the business of the debtor company.

#### **Facilitating M&A of the debtor company**

Under the existing CRA, M&A through business transfer (asset sale type) is not permitted unless such business transfer is expressly contemplated in the Reorganization plan. The Bill paves the way to transfer all or part of the business of the debtor company before the court’s authorization of the Rehabilitation plan. In this regard, upon court’s approval, an M&A transaction via asset transfer may be sought and consummated after the court renders a decision for the commencement of the Rehabilitation proceedings even prior to the court’s authorization of the Rehabilitation plan.

#### **4. Prospects**

The MOJ hopes that the National Assembly of Korea review the Bill as soon as possible and pass the Bill by the end of June 2003 at the latest. If so, the *Act on Rehabilitation and Bankruptcy of Debtors* will become effective as of July 2003. Regretfully, however, we are of the view that it is not likely that the National Assembly of Korea will review the Bill sooner or later due to the various other crucial issues it has to

handle. More importantly, there are still some criticisms and remaining issues on this proposed Unified Insolvency Act from various points of view. Also, although it may not be substantial, it is possible that some further amendments to the provisions of the Bill may be made during the course of the review by the National Assembly of Korea. Accordingly, the Bill probably would be passed during the second half of 2003 and it might take several months from now for the *Act on Rehabilitation and Bankruptcy of Debtors* to become effective.