

ASIAN DEVELOPMENT BANK

**REGIONAL TECHNICAL ASSISTANCE
TA NO: 5795-REG
INSOLVENCY LAW REFORM**

**SUPPLEMENTARY REPORT ON
KOREA**

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A. Insolvency Processes

1. Please supply number and details of cases of:

- (a) corporations whose financial affairs have been or are being handled under the relevant process, framework or agreement governing informal corporate debt restructuring [the numbers should be from the date that the process, framework or agreement was established to facilitate informal restructuring; details of the corporations should relate to size, industry type , debt level];**

The number of bankrupt companies in the year 1998 was 23,000 and most of these companies can be judged to have gone through renovation procedures by negotiating with financial institutions (creditors). However, there is not a system for informal corporate debt restructuring in Korea, and it is known that companies went through various different forms of agreements respectively with creditors to survive.

- (b) corporations which have been placed in formal liquidation under the relevant insolvency law [numbers and details should be from January 1999].**

The statistics for 1999 has not been compiled yet and is difficult to find. For your information, the straight bankruptcy case filed with the courts in 1997 was 38 in total. It grew to 467 in 1998 and it is predicted that 1999 will see a similar number of cases to 1998. The filed composition cases for 1998 were 700.

- (c) corporations whose financial affairs have been or are being handled under the relevant insolvency law governing reorganisation [numbers and details as in (b)].**

The information for 1999 is unavailable. The number of reorganization cases filed with the courts in 1997 was something like 100, but in 1998 about 160 cases were filed. It is predicted that 1999 will be similar to 1998.

2. Provide details and copies of any published comments, opinions or statements describing how the above processes are working and the level of success or otherwise.

While, owing to the amendments of the insolvency laws in February 1998, the courts has been able to speed up the processes of insolvency cases, most of the bankrupted or defaulted companies tend not to make formal insolvency proceedings, but to rely on informal negotiations with creditors.

B. Insolvency Reforms

1. Provide details of any reforms that have occurred in relation to insolvency law and practice and related areas (such as corporate governance, secured transactions and so forth) since January 1999.

The Bankruptcy Act, Composition Act and Corporate Reorganization Act were modified in February of 1998. These Acts form the backbone of Korea's insolvency law. There are no other modifications post-1999.

2. Provide details of any proposed reforms as above.

The Ministry of Justice announced the draft for reforms in the insolvency laws in 9th February 1999.

The main changes

1) Raising the speed of the procedure:

Reduction in the period deciding commencement, Easing of the conditions for approval on the corporate reorganization plan, Harmonious execution between different procedures

2) Raising the efficiency of the procedure:

Changes in the conditions for small bankruptcy, Establishment of the Committee of Inquiry, Dismissal of Bureaucrats and the Appointment of Experts in Management

3) Raising the fairness of the procedure:

Maintenance of the system of right of revocation (i.e. against preferential treatment), Increase of the candidates for assessment, Changes in the ambit of foundation bonds.

C. Corporations

1. Identify and detail the areas in which it is considered that relevant accounting practice or regulation is weak and could be strengthened [for example, accounting and financial information; projections of income/expenditure; valuation of assets; debtor and creditor control]

Korean GAAP does not address the accounting treatment for restructured loans or in-substance foreclosure; accordingly, such loans are usually treated in a manner similar to other loans.

On the other hand, under U.S. GAAP, for example, troubled debt restructuring are to be accounted for based upon expected future cash flows in accordance with SFAS No. 114, as amended. In addition loans that meet the criteria as "in-substance foreclosures" are reported as other real estate owned, or as loans (if SFAS No. 114 has been adopted). Such assets are to be carried at the lower of the loan balance or the fair value of the collateral, regardless of classification. The amounts of interest that would have been earned under the original terms and the actual interest earned on such loans are to be disclosed.

2. Identify and detail areas of weakness in corporate governance by reference to such factors as director's duties and their performance; financial management and responsibility; the interests of shareholders and creditors. If possible, provide specific examples of cases in which examples of such weaknesses have been found to exist.

The following problems are stated in relation to Korean companies and its governing structure.

1) The management of directors cannot be watched over nor supervised.

- 2) Weak auditing, divided accounting, and fraudulent notification are increasing the damage to companies.
- 3) The power of supervision of minority shareholders is weak.

The following are stated as solutions for above problems.

- 1) Financial institutions and listed companies with its capital more than 500 billion Won should have the number of outside directors to be 50 % of total directors.
- 2) There must be a supervisory committee within the board of directors, and two thirds of this supervisory committee should be comprised of outside directors.
- 3) Introduction of class action system.
- 4) Introduction of representative action, and a system, which allows any shareholder who possessed shares for longer than a week to be able to use such system.

The following worries are mentioned relating to the above solutions.

- 1) There are only a small number of people who can carry out the job as outside directors competently.
- 2) Friction is expected between the board of directors and the supervisory committee and may result in the reduction of managerial efficiency.
- 3) The number of people required for the commencement of group actions must be raised.
- 4) Unnecessary actions by minor shareholders are expected and this will delay the decision procedure. Companies will try to resolve representative action without conceding and this will result in special losses.

3. **Identify and detail areas of concern regarding political, government or commercial links with corporations, by reference to such factors as “cronyism”, “patronage” and corruption.**
4. **Identify and detail areas of concern regarding the size and power of corporations, corporate groups or conglomerates.**

In Korea, there is a distinct form of companies called chaebol or conglomerates. They are by products of Korea’s rapid economic development and they have been the cause of various social and economical problems. The problems of chaebols are as follows:

- 1) Due to the failure of the market, the internalizing of the market has caused damage to the efficiency of the society in general and caused distortion in the distribution of resources.
- 2) Economical discomfort due to the concentration level of danger
- 3) The expansion of group of companies resulting in the bureaucratic tendencies and authoritarian and inefficiency.
- 4) The uneconomical aspect of size in terms of maintaining the organization.
- 5) The loss of competitiveness of individual industries through lack of expertise
- 6) Lack of device for restraint or control due to concentration on possession.

5. **Is it practical and might it be of benefit to introduce legal guidelines on director duties and responsibilities and to provide sanctions or penalties for breach or non-observance of such duties? If so, outline the areas to be covered and the nature of any sanctions.**

The directive on the obligations and responsibility of directors are practical and might be of benefit. Directors will take those directives as the guideline for their behavior, and therefore, will make it easier for directors, the more detailed the directive is, to determine the

kind of behavior expected of them. However, a directive that is too detailed or rigid may restrict or induce directors to commit illegal acts.

Area-Responsibility over the director's company and shareholders especially the distinction between management decisions and illegal acts.

6 Would directors of corporations benefit from education and training on such areas such as financial management and responsibility, negotiation of a financial restructure, informal work out techniques? If so, detail the areas and the type of program.

With regards to financial management and responsibility internal programs exists in general and external educational programs such as seminars hosted by universities and research institutions do also exist. However, the substance of such educational programs is not conceived as deep enough and the time involved is determined as insufficient for educating directors.

It is said that special programs on the negotiation of a financial restructuring and informal work out techniques are unavailable.

D. Banks/Finance Providers

1. Identify and detail the areas in which it is considered that the lending practices of domestic banks are weak and might be improved or strengthened.

For so long, Korean lending practices are heavily dependent upon secured lending. Domestic banks are weak in analysing credit of borrowers based on financial data. Recently Korean government strongly encourages domestic banks to set up lending practices based on credit analysis of each borrower without simply relying on security value. In line with this government policy, such weakness of Korean domestic banks would be improved in the future.

2. Identify and detail areas of concern regarding the involvement of banks with corporations (for example, through equity holding, long term relationship, government association).

Each corporation in Korea normally has one Korean bank as primarily transacting bank. Accordingly such primarily transacting bank of a corporation normally exposes large amount of lending to the corporation.

3. Would officers/employees of banks/finance institutions benefit from education and training on such areas as lending practices, formal insolvency practices, informal work out techniques and practices? If so, detail the areas and the type of program.

Officers and employees of financial institutions from time to time obtain training provided by the Financial Training board which has been established by co-donation of all financial institutions of Korea.

E. Property Law

1. **To what extent might the law relating to ownership, mortgages and the creation of other security interests in land and other property be improved/reformed to enable secured transactions to be transacted more efficiently?**

For example, collective mortgage that whole company's value including business right, credits, etc. can be mortgaged might be introduced.

2. **Are there particular commercial or other practices (as distinct from formal laws) associated with the laws relating to property and secured transactions which impede or restrict the latter?**

Creditors, especially banking institution, frequently combine *keun*-mortgage and superficies, but creditors don't intend to use lands, they just want to strengthen mortgage value.

Yangdodambo is a unique mortgage system in Korea, which creditor gets title of property before payment but debtor can use and take profit from the property.

F. Secured Transactions

1. **What are the major impediments to the enforcement of security rights over property?**

non-registered tenant's right, excessive mortgage in *keun*-mortgage,

2. **How might these impediments be best overcome?**

This might be overcome by developing disclosure system which would more accurately publicate the amount of secured loan covered by relevant security.

3. **Is there a fair balance between the enforcement of secured property rights and the restraint on those rights under relevant insolvency law? If not, in which areas is there an imbalance and outline what improvements might be made**

There is a fair balance between the enforcement of secured property rights and its restraint under Korean insolvency law.

G. Insolvency Law

1. **What are the major substantive defects in the corporate insolvency law viewed from the respective positions of:**
 - (a) banks/financial providers
 - (b) secured creditors
 - (c) unsecured creditors
 - (d) employees
 - (e) corporations
 - (f) directors
 - (g) shareholders?

If a corporation is to go to insolvency, extra shareholders' meeting is needed. But shareholders are not interested in insolvency resolution in such a situation. So if there is no

prospect for recovery, it is necessary to exclude the provision for shareholders' meeting or to mitigate the provisions for related system such as court's decision for dissolution.

In liquidation for insolvency, creditors' right must have priority to shareholder's right, so shareholder's right to demand the company to purchase shares must be eliminated.

Liability of major shareholder or business administrator should be legal liability. M&A in the insolvency process should be activated.

2. What are the major practical defects in the application of the insolvency law viewed from the respective positions of:

- (a) corporations**
- (b) creditors?**

Debt researching conditions are too strict to keep.

Process is too slow for recovery, especially preservative measure.

It is necessary to prevent corporations from using insolvency laws to cover faltering up or shrink liabilities, for example, not to apply more strict process if rejected in one process.

It is unclearly communicated in the court's inquiry process for commencement decision whether creditors waived security rights or not.

H. Judicial System

1. Has there been any discernable improvement or change in the operation of the judicial system in relation to the conduct of:

- (a) debt collection/recovery processes;**
- (b) enforcement processes in respect of secured property rights;**
- (c) recovery or enforcement processes in respect of leased property;**
- (d) formal corporate insolvency processes?**

If possible, provide some detail of cases in which any such change or improvement has been made apparent.

1998. 2. 24. Revision

In company Reorganization Act, Managing committee in court and creditors' council were introduced, economic value substituted possibility of recovery as a condition of commencement and public value condition was excluded, and process was improved to rapid progress.

Tax creditor's rights were weakened.

Court can cancel preliminary attachment or provisional disposition on company's asset for recovery.

In Composition Act, jurisdiction was integrated and many conditions were improved.

Court can order the company to provide securities at application for making sure to perform composition conditions.

Company should report to court semi-annually in composition for supervising purpose and if company breaches the conditions, the court can cancel composition or creditors may ask the court to cancel composition.

Even in the composition process, company can pay debt upon restriction for operating and recovery.

Company must get approval of court for change of composition conditions.

Court can reject composition application if trouble is due to intentional faltering management or applicant is too large company (as process inefficiency from complicated relations and managers who may use composition for keeping managing right).

2. What reforms, if any, have been made to improve the operation of the judicial system in relation to the above 4 areas?

Korean government recently drafted new insolvency laws and passed them on to the National Assembly for its review during its regular annual session starting in September this year.

3. Are there any identifiable proposals for reforms in these areas?

Proposal for Unified Insolvency Law (newspaper)

In Seoul District Court, composition part will be strengthened.

Asset Liquefaction Act

Transfer of credit with *keun*-mortgage will be allowed. (notice of legislation)

Act on the Structural Improvement of the Banking Institutions

Deposit Insurance Corporation will be allowed to engage actively in the bankruptcy process of banking institutions.

Company Reorganization Act and Composition Act

Loosen conditions and commencement will be decided within 1 month.

Bankruptcy Act

Employee's wage will be included in bankruptcy foundation.

Prior process will have effect even if composition process goes into bankruptcy process.

International insolvency problem such as jurisdiction and effect will be improved.

4. What are the main problems or difficulties regarding the operation and application of the corporate insolvency law through the court system?

Insufficiency of expert judge.

5. What practical improvements might be made to overcome these problems/difficulties?

To specialize court.

I. Informal Work Out Techniques

1. Provide detailed examples of some cases of successful informal work outs and also cases of genuine attempts at informal work outs which have not been successful.

In the aftermath of the recent financial crisis of 1998, under the auspices of the Korean Financial Supervisory Commission, creditor banks in Korea initiated work out process on Korea corporations whom they have transactions with. This is because they would prefer to reschedule the debt and participate in planning a way to saving the Korean corporations rather than to observe the faltering Korean corporations going through the insolvency proceeding such as liquidation or corporate reorganization.

The following techniques are used for the work out operation:

- debt to equity swap for outstanding loans,
- re-scheduling of short-term loans into long-term loans,
- extension of loan principal repayment,
- reduction (exemption) of interest,
- debt reduction,
- support in the form of new capital injection,
- elimination of cross guarantees,
- capital reductions,
- selection of/concentration on core businesses, and
- foreign capital inducement.

An example of a successful case is Jindo Co. Ltd. The owner of the company, who was also the management, agreed to reduce his stake in the company. Furthermore, there was agreement with the creditor banks on a debt to equity swap on its loan. This is considered to be one of the model examples of restructuring.

In addition, in the case of Hanchang Co. Ltd., the large shareholder completed successful restructuring itself by eliminating the cross guarantees among affiliated entities and then concentrating on its core businesses after the sale of its non-core assets to third parties. This is also seen as a successful case of restructuring.

However, a substantial number of companies under work out are demanding for an alteration of the work out system. They especially sought change because where one decides on a workout they must endure the handicap of paying high interest rates to creditor banks and also bear the consequence of its credit rating being at a lower level.

2. In practice, are such technique/s operating efficiently and successfully?

Where the opinions of creditor banks and work out Korean companies differ, efficient work out is seen as not being done or capable. Some companies cause financial damages on investors by requesting for work out operation immediately after an increase in capital.

3. What are the major problems in the application of these technique/s?

There is a fundamental problem because companies under work out wish the input of new capital whereas the creditor banks put emphasis on short-term retrieval of loans. There are cases where the creditor banks demands the resignation of the present management who has been the majority shareholder, although which was rejected by the work out from time to time.

4. **Is it considered that training and education in the operation of these technique/s would be valuable and, if so, in what areas and to whom should the training be directed?**

The people responsible at the creditor banks must develop various and flexible work out techniques of some being the ability to assess long term risk and negotiation ability.

J. Insolvency Administration System

1. **Comment on the extent of development, expertise and efficiency regarding both public and private sector administration of formal cases of:**
- (a) **corporate liquidation; and**
 - (b) **corporate reorganisation**

There is a lack of specialists in the field of insolvency. There will be a loss of efficiency and flexibility since the people who manage insolvent companies are a small number of judges responsible for the insolvency cases as well as other burdensome cases.

2. **Is it considered that education and training in these areas would be valuable and, if so, in what areas?**

There must be an increase in the number of lawyers and relevant government officials. There is also a need to utilize experts by expanding the pool of bankruptcy trustees and receivers.

3. **Is it considered desirable to introduce more formal structures of both public and private sector administration of insolvency cases?**

It is necessary to maintain the relevant legislation and the court's relevant organization but there seems no necessity for the installation of a separate apparatus.

K. Information & Statistics

1. **Is it desirable to establish systems to gather information concerning:**
- **Incidence and results of formal insolvency cases under the insolvency law**
 - **Incidence and results of informal work out cases**
 - **Statistics of value of assets and liabilities**
 - **Causes of financial failure, main area/s of business?**

If so, how best might such system/s be established?

There seems to be no need for this.

L. General Insolvency Information and Developments

1. **Provide details of any other relevant information or developments since January 1999 in regard to such issues as the effect of insolvency law policies on areas such as employment, fiscal/revenue debts, detection and recovery of corporate fraud, domestic and foreign investment and etc.**

In order to actually guarantee the detection and recovery of corporate fraud, legislation conferring for creditors the right to request for such recovery is being introduced.. Legislation allowing reimbursement of wage claims without having to go through the insolvency procedures, therefore raising equality, is also being introduced.

- 2. Is there any evidence of a change in attitudes (such as social/commercial stigma, aversion to strict legal processes, fear of loss of control) toward the use of:**
- (a) formal insolvency processes; and**
 - (b) informal insolvency processes**

in respect of corporations in financial difficulty or insolvent corporations? If possible, provide details of any specific cases which might reflect evidence of change.

With examples of companies going into court receivership after the threat of bankruptcy and weathering through the storm safely such as Kia Motors, the impression of court receivership of many owners are more positive than in the past.