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Abstract

Considering Korea's current economic environment, foreigners are likely to have greater interest in Korean bankruptcy procedures than before. However, little English-written material covering the subject currently exits. To fill this gap, this paper briefly describes reorganization procedures and introduces some of the related discussions that have taken place recently. Korean reorganization consists of two distinct processes: composition and corporate reorganization. Some of the most important issues raised with respect to these procedures are; 1) treatment of existing managers and shareholders, 2) the appropriate roles of composition and corporate reorganization (and whether they should be unified), and 3) interim financing.

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I. Introduction

Following the outbreak of the foreign currency crisis in December 1997, the resolution of domestic debt has emerged as the primary task for restoring economic stability in Korea. Problems regarding exit barriers, the reorganization of firms, and bankruptcy procedures have all been amplified due to the extent of corporate failure. In this rapidly changing environment, how bankruptcy procedures are conducted in Korea may be of interest to potential foreign investors and scholars at large. However, little material on the subject written in English currently exists. To fill this gap, this paper briefly describes reorganization procedures and introduces some of the related discussions that have taken place recently. Bankruptcy laws are complex and far reaching. Therefore, this study does not claim to encompass all of the aspects of Korean bankruptcy procedures and the related debate, nor does it offer any solutions to the problems. Instead, it is hoped that this paper will serve as an introduction to readers unfamiliar with Korean bankruptcy procedures.

Section II of this paper discusses the extent of corporate failure in Korea, after which Section III provides a background to bankruptcy law and procedures in Korea. Section IV takes the reader through the recent debate, focusing on three major issues: treatment of existing managers and shareholders, the appropriate roles of the two separate procedures for corporate reorganization, and interim financing. Section V presents a new bankruptcy procedure proposed in the recent theoretical literature and considers whether it would be appropriate for the Korean situation. This is followed by conclusions in Section VI.

II. Corporate Failure and the Financial Crisis

A simple glimpse at current statistics demonstrates clearly the widespread insolvency problem in Korea. According to statistics released by the Bank of Korea, 17,168 firms failed in 1997. This was a 52.53% increase over 1994. Furthermore, the composition of the failures has changed. Of the 11,255 firms that defaulted in 1994, 40% were corporations (as opposed to private firms), only five of which were large firms. In 1997, the ratio of incorporated firms increased to 47.9%, 58 of which were large ones. From January through April of this year, an average of 3,000 firms failed each month. This, in turn, has exerted great pressure on financial institutions, some of which have been closed down themselves. Corporate debt of the top 28 chaebols reached 247 trillion won, with the average debt-equity ratio reaching 449% per firm at the end of 1997.[1] The most recent figure for non-performing loans of banks provided by the Financial Supervisory Commission is 87.26 trillion won ($63 billion) as of the end of March 1998. This accounts for 16.89% of total bank loans,[2] or 20.72% of Korean GDP in 1997.[3] These figures reflect

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1) *Korea Economic Daily*, 30 March 1998. Corporate debt is approximately $177.57 billion, based on the exchange rate as of 3 June, 1998 ($1 = 1391 won).

2) See Table 2 for more detailed statistics; non-performing loans (*yo-ju-eoi*) accords to IMF standards, including debt on which interest has not been paid for three months.

3) Korean GDP in 1997 was 420.986 trillion won. The proportion of bad loans in Korea is huge compared to that of the US during its

the seriousness of what is in fact a financial crisis.

Table 1. Number of Bankruptcies: 1994-1998

No. of Firms	1994	1995	1996	1997			1998			
				Year Total	Nov.	Dec.	Jan.	Feb	March	April
Total	11,255	13,992	11,589	17,168	1,469	3,197	3,323	3,377	2,749	2,462
Incorporated Firms (%)	4,503 (40)	6,031 (43.1)	5,157 (44.5)	8,226 (47.9)	714 (48.6)	1,559 (48.8)	1,600 (48.1)	1,499 (44.4)	1,192 (43.4%)	1,079 (43.8)
Large Firms	5	5	7	58	9	6	9	6	1	3

Source: Bank of Korea

Table 2. Non-Performing Loans (ending March 1988)

(unit: trillion won)

	Total Loans	Non-Performing Loans (% of total)
Banks	516.6062	87.2645 (16.89)
Other Fin. Institutions	256.9355	24.7611 (9.64)
Total	773.5779	112.0256 (14.48)

Source: Financial Supervisory Commission

Given the level of corporate debt, it is evident that resolving the financial crisis is directly related to industrial and corporate restructuring, success of which, in turn, hinges upon orderly exit of ailing firms. In a world of perfect capital markets, financially

Savings & Loans crisis; bad loans of FDIC member financial institutions almost reached 4% of total loans and 2.5% of US GDP in 1987 (FDIC statistics quoted by Bae (1997)).

distressed firms are simply liquidated (via cash auction) and the debtors paid off; if the firm has sufficient value as a going concern, those who perceive this can raise the required cash to buy out the firm. Perfect competition would ensure that the assets of the failed firm are efficiently utilized. However, in the real world, capital markets are often underdeveloped and usually imperfect. Thus, an economically efficient outcome is not always obtained through outright liquidation. For example, there may not be a market for the insolvent firm's assets, or these assets maybe undervalued and the firm which is fundamentally sound but is only temporarily illiquid is not saved. While liquidation of truly distressed firms releases resources for other more productive activities, saving firms which are insolvent but fundamentally sound would increase social welfare.

One way to save such a firm is for debtors and creditors to renegotiate the terms of debt. However, private workouts (ie, out-of-court settlements between creditors and debtors who have defaulted) are often difficult to achieve due to collective action problems on the part of creditors and the high cost of renegotiating the debt structure every time a debtor defaults. Even in the US, where financial markets are well developed and contractual mechanisms operate relatively efficiently, private workouts often fail. Summarizing figures from several studies of private workouts using different samples, Schwartz (1993) reports that creditors accept offers in fewer than half the cases on average. Gilson's (1997) empirical study also suggests that private workouts may not be as successful as legal bankruptcy procedures, and often lead to second bankruptcy or debt restructuring. Gilson attributes this mainly to high transaction cost of a private settlement. For example, a debtor firm cannot unilaterally force a financial settlement on all creditors as can be done under legal bankruptcy procedures. This gives individual creditors an incentive to hold out for more favorable terms. Further, various regulations discourage institutional lenders from writing down principal or exchanging debt for equity, and income from debt forgiveness is taxed. At the same time, private workouts often force debtors to sell assets at fire-sale prices. In contrast, Chapter 11 facilitates asset sales through its ability to reduce buyer uncertainty (eg, through mandated disclosure and the right of discovery) while encouraging multiple bids.[4]

Due to problems related to private workouts, most countries have standard, legal mechanisms under which financially distressed firms are protected from their creditors and given the chance to reorganize.[5] The most well known of such procedures, and the most frequently studied, is Chapter 11 under the US Bankruptcy Code. European bankruptcy laws have been traditionally more favorable to creditors, though recent trends show an attempt to move towards the "rescue culture."[6] However, dissatisfaction with the efficacy of such procedures continues to prevail worldwide. The Korean bankruptcy procedure is no exception, and this paper sets out some of the related current issues.

4) Nevertheless, as Weiss and Wruck (1997) note in a case study of Eastern Airlines, firm value can be substantially devastated by asset stripping due to overly optimistic managers and misguided judges in a court sponsored reorganization.

5) Hart (1995, Chapter 5)

6) OECD (1994)

III. Bankruptcy Procedure in Korea

1. Background

There are basically three bankruptcy procedures in Korea: composition (under the Commercial Code), liquidation (under the Commercial Code), and corporate reorganization (under the Corporate Reorganization Act). The Corporate Reorganization Act, established in 1962, was basically adopted from Japanese corporate reorganization law, which in turn, is based on the old Chapter 10 of the US Bankruptcy Code. The Corporate Reorganization Act was amended in 1981 and 1984, though with little change to its structure. The Korean composition law had not been revised since its enactment in 1962 until recently. Under pressure of the recent surge in bankruptcies and requests by international lending institutions to modernize Korean bankruptcy procedures, all bankruptcy related laws were amended in February 1998. Since liquidation so far has not been an outcome of larger firm default and most of the issues raised concern reorganization of distressed firms, this paper discusses only composition and corporate reorganization.

Out-of-court voluntary liquidation was the ordinary solution for small firms in distress until recent years. Utilization of bankruptcy court procedures were rare until the 1980s due to the lack of large, incorporated firms at the time. The utilization of court procedures in cases of default increased rapidly after 1990 when the court ruled that auctioning off secured debt owed to financial institutions of a firm under corporate reorganization was unconstitutional. Meanwhile, composition, originally designed for small firms, was rarely used until very recently due to little understanding on the part of potential users.

For the past ten years, the average number of Korean corporate reorganization cases per year was 44, far less than the one million cases in the US and 3,300 in Japan. The number of Korean reorganization cases have increased recently, however, peaking at 94 corporate reorganization cases and 186 composition cases by the end of November 1997.[7] The recovery rate for corporate reorganization has been 25% over the last three years, which is quite low compared to 91% in Japan, but comparable to levels seen in the US. Table 4 shows major firms that have either gone into composition or corporate reorganization as of May 1998.

Table 3. Number of Applications for Corporate Reorganization

	1993	1994	1995	1996	1997
Application for Corporate Reorganization	41	42	79	52	94(Nov)
Application for Composition	0	0	13	9	186

Source: Koo (1998)

7) Koo (1998)

Table 4. Major Firms under Bankruptcy Procedure (as of May 1998)

Firm	Date of Default	Bankruptcy Procedure by Type
Hanbo	Jan 97	corporate reorganization
Sammi	March 97	"
Jinro	July 97	composition
Midopa	March 98	corporate reorganization
Kia	July 97	"
New Core	Nov. 97	corporate reorganization
Halla	Dec 97	composition for most of the affiliated firms
Cheongu	Dec. 97	corporate reorganization

Source: *Maeil Business Daily*, May 15, 1998.

Until the mid-1980s, the government's heavy intervention in the industrial sector prevented more effective utilization of court bankruptcy procedures. Entry and exit of large firms were an intrinsic part of government industrial policy, and the government controlled these processes mainly through the Industrial Development Act, the Tax Exemption Act, and through its heavy influence over the financial sector. This policy relegated court bankruptcy procedures to a supporting role of government decisions.

The government's control loosened in the 1990s as the Industrial Development Act gradually faded from the economic landscape. Yet, when large firms fail, which may send potentially significant repercussions throughout the economy, the government tended to take the matter in its own hands on an ad hoc basis. In doing so, the government showed little regard for consistency of policy, thorough economic analysis, or adherence to legal procedures. The Anti-Bankruptcy Accord of 1997 is a case in point. The Accord protected a select number of very large firms from creditors, the basis for which was never economically apparent nor legally justified. The Accord, unsuccessful in reviving companies, was discontinued and replaced largely by bank co-financing.[8] Table 5 shows that co-financing given to a select number of major firms amounted to more than two trillion won since last October. Just as was the case with the Anti-Bankruptcy Accord, co-financing has demonstrated little success in reviving the health of beneficiaries.[9]

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8) Refers to syndicated loans orchestrated by major creditor banks to financially distressed firms.

9) One incentive to continue supply of funds to prevent default of firms which in all accounts should have gone into corporate reorganization or liquidation, has been the weak financial standing of the banks themselves. Since the outbreak of the foreign currency crisis and the onset of financial reform, the BIS ratio has been used as the main criteria according to which licenses of financial institutions with weak capitalization can be revoked. Non-performing loans require increasing bad debt reserves, which lowers the net worth to total capital ratio, which in turn leads to the bank's demise itself. It is clear therefore, that without restructuring of the banks themselves, debt workouts would not be very meaningful.

Table 5. Co-Financing for Major Business Groups

(unit: billion won)

Firm	Major Creditor Bank	Amount	Conditions
Haitai	Cho-heung	194.7	13.5%, with collateral
New Core	Jae-il	54.5	14.8%, no collateral
Jinro	Seoul	106.0	16.8%, with collateral
Shin-ho	Jae-il	80.0	24-27%, no collateral
Han-hwa	Han-il	742.0	14.5-36.5%, partial collateral
Han-il	Han-il	50.0	20.5%, with collateral
Dong Ah Construction	Seoul	360.0	23-26%, with collateral
Go-hap	Han-il	300.0	14.5%, partial collateral
Shin-won	Export-Import	200.0	15.5%, with collateral
Woo-bang	Seoul	110.0	up to each bank, w/ collateral
Hwa-sung	-	80.0	-
Total		2,277.2	

Source: *Maeil Business Daily,* May 15, 1998.

Thus, failure of the Korean economy to deal with corporate failure had stemmed largely from factors peripheral to bankruptcy procedures themselves. For the most part, the shortcomings of legal bankruptcy laws have only become evident with their more frequent use during the 1990s. This movement towards a more legalistic approach to resolving corporate default, as opposed to heavy reliance on the government, underscores the importance of recent reformed bankruptcy related laws and the ongoing debate. What follows are brief descriptions of the procedures for composition and corporate reorganization. For a comparative summary of the two procedures, see Appendix I.

2. Composition

Composition under the Commercial Code was originally established for small and medium firms with simple capital structures. It is designed to be shorter, and therefore less costly than corporate reorganization. However, there has been no explicit upper limit to firm size, attracting many large corporations to apply for composition in 1997. This has led the legislators to make requirements for application and withdrawal for composition more strict under the 1998 amendment. For example, application cannot be withdrawn once an order of stay is declared and the court guidelines to judges recommend that composition not be allowed for firms with total bank loans of more than 250 billion won.[10)]

This procedure requires pre-agreement with creditors before the court can officially consider application and order a stay on firm's assets. A court-provided stay under composition applies only to junior claims; secured loans, trade credits, government claims and taxes are free to be collected. Therefore, without a pre-agreement with creditors, composition would be meaningless.

Similar to pre-packaged bankruptcies in the US[11)], a restructure

10) *Korea Economic Daily*, May 11, 1998.

11) Often called pre-packs, its main difference from a traditional Chapter 11 is that a bankruptcy petition and reorganization plan must be filed concurrently. That is, terms of restructuring are agreed to outside the court but reorganization occurs under court supervision, with the agreement binding on all claim holders. Pre-packs are therefore a hybrid form of reorganization. They offer an inexpensive solution to the free rider/holdout

plan (terms and conditions to which creditors have agreed) must be filed concurrently with filing for composition. A very important provision which makes composition popular, is that existing management stays in control. As mentioned, the procedure is a short one, usually lasting only for two to three months from application to approval. The court can cancel the process if the interim between application and approval of the conditions exceeds nine months. Once composition is approved, the involvement of the court ends. That is, the implementation of the restructure plan is not legally binding and the firm is free from court supervision once approval is won. Further, composition has no procedure for investigating reported debt and any disputed claims must be contested by separate litigation. Therefore, the mechanisms for enforcement is quite weak under composition. This contrasts with pre-packs in the US, where the agreement with the creditors takes place privately but confirmation and implementation of the plan is enforced by the court under Chapter 11.

In many cases, composition has failed to revive distressed firms. The weak legal enforcement is one of the major causes of this failure. Another reason is that usually, terms of new agreement are unfavourable to debtor firms, exerting a high level of burden on their ability to pay back. For example, the interest rates are often higher than in corporate reorganization. Such an arrangement may be inevitable, given that creditors need

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problem in out-of-court settlements while providing the advantages of Chapter 11 at a lower cost (Tashjian et al 1996). For a more negative view of pre-packs serving to protect manager's interests, see *The Economist*, February 15, 1992.

inducements to agree to composition rather than to press for liquidation or corporate reorganization. But the unfavourable terms for a small debtor firm also result from its weak bargaining position vis-a-vis its creditors, which are often large banks. Therefore, though designed for small firms, composition on the whole has been quite an ineffective procedure for reorganizing small firms.

3. Corporate Reorganization

Corporate reorganization is designed for large incorporated firms whose bankruptcy may have significant repercussions throughout the economy. Small firms, with assets worth less than 20 billion won and capitalization under two billion won, were prevented from applying for reorganization on the premise that the procedure is too expensive and lengthy. However, recognizing the little chance of reorganization for small firms, the 1998 amendment has included a special provision under which small firms in certain cases can opt for the corporate reorganization procedure.

Managers, shareholders, or creditors can file for reorganization. An application for a stay is filed at the same time. The court then takes between one and two weeks to consider providing a stay while a receiver investigates debt claims. The stay is applicable to all classes of debt, and in this sense, the firm is better protected from creditors than under composition.

Formerly, management was forced to resign and shareholders relinquish all their shares without compensation. A court appointed receiver would manage the firm until it emerged from the court procedure. The harshness with which shareholders and managers were treated has made distressed firms to seek protection under composition, even in cases where debt structure was complex and level of debt high, making them inappropriate for such a short and simple process as the composition. Therefore, to increase the incentives for large firms to apply for corporate reorganization rather than composition, and to do so early in the period of troubles rather than when recovery becomes impossible, some changes were made by the 1998 amendment. Under the new rules, existing management (if judged by the court to be suitable) is allowed to remain in joint control with a court appointed trustee. Further, major shareholders are not required to relinquish their shares except when:

1) they are involved in seriously mismanaging the firm or found guilty of illegal activities. In this case, they will be required to give up more than 2/3 of their holdings, and in addition, will not be allowed to buy any new shares in the reorganized company.

2) the amount of debt is greater than asset value. In this case, shareholders must give up 50% of their shares without compensation.

At the same time, the role of creditors has been strengthened. Under the amended procedure, a committee of creditors is formed to coordinate conflicting interests among themselves and to advise the court of their views concerning the reorganization process. Creditors are entitled to any important information regarding the process from the court and the trustee. Furthermore, creditors can call an end to the process when the firm under corporate reorganization appears irrecoverable; only the court could make this decision before the amendment.

The 1998 amendment also attempted to make bankruptcy procedures more efficient and speedy. The court is now to decide whether to provide a stay on a firm's assets within two weeks of the application for corporate reorganization. Once all debts of the firm are registered and clarified, the trustee must submit plans for reorganization within the ensuing four months. The court can end the reorganization process if the process is not resolved within one year of initiating the reorganization process (under extraordinary circumstances the deadline for resolution is extended to one and a half years). Further, the recommended maximum payback period has been reduced from 20 to 10 years.

In addition, to handle information flows more efficiently, all three bankruptcy procedures are now to be administered by the regional courts, whereas before the 1998 amendment, liquidation and composition had been handled by local courts and corporate reorganization by regional courts.

4. Relationship between corporate reorganization, composition and liquidation

Korean bankruptcy law favors reorganization over liquidation. Among corporate reorganization and composition, the former is favoured to the latter. This is apparent from the priority the court gives to corporate reorganization. Once a corporate reorganization is approved, application for composition or bankruptcy cannot be filed. Further, application for corporate reorganization overrides composition, even if the latter has been already applied for or is in process. Kia is a good example of this: the management had applied for composition, but creditors forced it into corporate reorganization. At the same time, only when corporate reorganization is denied or the process is stopped can an application for composition be filed. When application for liquidation and composition are filed at the same time, composition takes priority, and once composition is approved, application for liquidation cannot be filed. However, once the firm is denied composition, it has to file for liquidation and cannot go into corporate reorganization.

IV. The Korean Debate

1. Treatment of Managers and Shareholders

Much debate has focused on how existing management and shareholders of bankrupt firms should be treated under reorganization. The relatively severe treatment of management and shareholders under the old law precipitated large firms applying for composition rather than for corporate reorganization. This outcome was inefficient as composition lacked adequate facilities for dealing with large, complex cases and was widely seen as providing excess protection to incompetent managers. To encourage application for corporate reorganization, the amended corporate reorganization procedure treats managers and shareholders less severely, as we have already seen in the last section.

However, some scholars argue for harsh treatment of managers and shareholders. For example, Yoo et al (1997) argue that soft treatment of major shareholders (and managers acting on their behalf[12]) has led them to undertake too many risky projects,

12) Most strategic decisions (eg major investment) are made by the founder-owner in Korea, especially among the chaebols. Managers have little power over these decisions, though they may be consulted. Further, through cross shareholdings, owners and their families have compounded their influence across affiliated firms over and above what their original shareholdings entitle them to. This way of "conglomeration" arose because of the commercial law preventing holding companies. At the same time, minority

resulting in the high rate of corporate failures. That is, the disciplining role (or the bonding role) of debt is lost. Therefore, they suggest that major shareholders should be made to relinquish all of their shares.[13)] Such a harsh treatment would signal that firms should not undertake too many risks which would expose them to financial distress, and force managers not to act against the interests of the creditors.

It is possible that when treatment of shareholders and managers are *too* harsh, they may engage in risky but inefficient behaviour (eg, gambling with the firm's assets) when bankruptcy is imminent; for when things go well, shareholders and managers benefit but when things go bad, it is the creditors that lose. Yoo et al (1997) acknowledges this possibility but asserts that in the Korean situation, losses stemming from reckless behaviour of managers facing imminent bankruptcy are less than losses associated with sending out the wrong signals. This assertion, however, is rather difficult to accept, given that in Korea, managers and major shareholders show extreme personal

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shareholders traditionally have had little role monitoring either the major shareholders or the managers. Concentration of shares and influence of owners would not be bad in itself, as long as there is a mechanism which holds them accountable to their actions.

13) Another reason Yoo et al (1997) recommend that major shareholders give up their shares, is that this makes it easier for others with better financial and managerial resources to acquire the firm for a quick turn around. However, they overlook the fact that sometimes there is little demand for these highly leveraged firms. Further, existing owners and managers who know the firm best, maybe able to restructure the firm better than anybody else.

attachment to remaining in control of the distressed firms. The harsh treatment of shareholders and managers under reorganization procedure will only cause management to take desperate measures to avoid bankruptcy at any cost, and losses to social welfare arising from this maybe larger than Yoo et al (1997) may assume.

It is clear from the above discussion that a good bankruptcy procedure must penalize managers and shareholders to some extent, but not too harshly. Of course, determining the optimal level of harshness is a difficult matter. One method suggested by Ko (1998) is to base the ratio of shares that existing shareholders are allowed to keep on the degree of financial distress of the firm in question. Ko proposes that the base rate of the amount of shares that major shareholders in a bankrupt company should be allowed to keep be set at 50%. Ko then proposes varying this figure by how much the financial leverage of the firm (the debt to equity ratio or the equity to total assets ratio) differs from the industry average. For example:

> Amount of share kept by existing major shareholders = 50% $\pm$ [(equity to total assets ratio) - (industry average of equity to total assets ratio)]^2

In this way, shareholders in failed firms which have a very heavy debt burden will be left with very little, whereas shareholders in those firms failing despite a fundamentally sound capital structure will lose less.

With respect to minority shareholders, Ko suggests using the following formula:

> Amount of shares minority shareholders must forfeit = (amount major shareholders forfeited) x (percentage of minority shares/ percentage of major shares).

That is, minority shareholders give up the same amount as major shareholders (reflecting the financial situation of the company) on a pro rata basis. Division by the percentage of major shares ensures that minority shareholders have the same ratio of forfeited shares as major shareholders. In this way, minority shareholders are made to take some responsibility in monitoring the firm, but also benefit from successful restructuring of the firm. Furthermore, minor shareholders should suffer no more or no less relative losses than major shareholders. Above all, while taking into account peculiarities of particular cases, this method is still carried out in an objective and quantitative way, thereby leaving little to the discretion of the court.

What is not clear, however, is whether the above calculations should be based on indexes reflecting the degree of debt burden which would give managers incentive to always maintain a healthy capital structure, or rather, on indicators based on expected future flows of income, reflecting the payback capability of the firm.

2. Eligibility for Corporate Reorganization

Another area of contention focuses on which firms should be allowed to apply for corporate reorganization. Before this year's amendment, the impact of the firm's insolvency on public interest (e.g. employment, subcontractors, and the economy in general) was a major consideration when deciding whether a firm could enter into corporate reorganization. In particular, this was a main criteria for initiating corporate reorganization under the industry rationalization programs during the 1970s and 1980s. The greatest criticism of this policy was that too much was left to the discretion of the courts, which were heavily swayed by political pressure. The end result was that the judicial system sometimes allowed large firms to undergo corporate reorganization even though they showed little sign of viability. In reaction, many argued that the prerequisite for corporate reorganization should be changed from "possibility of recovery" to "firms with economic value" (i.e., the value of the firm is greater under reorganization than under liquidation) and be based solely on economic analysis, ignoring considerations for public interest, which would be biased favorably towards large chaebols. This argument has been reflected in the amended law.

Meanwhile, some individuals in the legal community assert that bankruptcy procedures should not serve as a tool of reform (i.e., to punish certain chaebols or promote M&As of specific firms by third parties), as has been the case so far. Rather, the development of good bankruptcy procedures must in principle be based on the relationship between debtors and creditors. Further, they argue that allowing firms to go into liquidation would be much more effective in maintaining the bonding role of debt than treating managers and shareholders harshly under reorganization. Moreover, it is argued that public interest should not be completely ignored, and that there should be some degree of flexibility according to the peculiarities of different cases. A related issue centers on what to do with small and medium firms. Unlike in the US, where most of the applicants of Chapter 11 are small firms (though a great number of them are eventually turned over to Chapter 7), in Korea, there had been little recourse for small firms to reorganize under court protection from creditors. Corporate reorganization was reserved mainly for large firms. The mechanism designed for small firms - composition - was ineffective due to its weak legal enforcement mechanism. To resolve this problem, the amended law adopts special provisions under which small firms can apply for corporate reorganization.

It is not very clear why bankruptcy procedures should be so strictly bound by firm size. Reorganization of firms with simple debt structures would not take as long and would cost less than for large firms under corporate reorganization. At the same time, creditors for each group of firms would be protected by law to the same degree regardless of debtor size. Bankruptcy procedures would be much more simple if all the three procedures were unified under a single law and court, without restricting procedures on the basis of firm size or qualifications other than the firm's economic condition. The creation of a single bankruptcy law and the establishment of a specialized bankruptcy court, left unresolved in the last amendment due to the complexity of the matter, remains one of the most debated issues related to bankruptcy procedures.

3. Order of Claim Priority and Interim Financing

The question of the status (with respect to priority in the order of claims) of new loans to firms under bankruptcy procedures came under spotlight while working out Rothschild's bridge loan of one billion dollars to the Halla Group.[14] According to media reports, Rothschild took no mortgages or guarantees but instead requested first priority in the order of claims, which is the position Rothschild would receive as the debtor in possession (DIP) financing under US Chapter 11.[15]

The problem lies in the fact that most of Halla's affiliated firms are under composition rather than under corporate reorganization. Under Korean corporate reorganization procedures, it is very clear that new loans have first priority. New loans are regarded as claims by the government, which have first priority, followed by employee payroll and then secured loans. Afterwards, other taxes and employ benefits, and insurance must be paid before ordinary loans (e.g. promissory notes and unsecured loans) can be paid.[16]

Under composition, the status of new loans is a bit unclear.

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14) The Halla Group consists of 14 affiliated firms, its most important sectors being heavy industries, automotive components and construction. Most of the affiliate firms are now either under composition or corporate reorganization. Default of Halla Heavy Industries triggered the group's debacle, bringing down other affiliated firms that had provided cross loan guarantees.

15) *Korea Economic Daily,* March 25, 1998.

16) One concern about this order of priority is the heavy emphasis on the welfare of the government and employees, rather than creditors.

According to the February amendment, new loans under composition do not automatically receive first priority status, but they can be put before other claims if the court sees fit. However, as explained above, the court's role is officially over when it declares its acceptance of a composition agreement. Hence, the question begs, "What happens to new loans once the court is no longer in control?" The answer is not clear. According to the Korea Development Bank (1998), new loans, just like secured loans, are not subject to a stay; they can be collected anytime in accordance with private agreements concerning debt restructuring. Though interim financing is an important factor affecting successful reorganization, composition lacks the procedural capability to attract new loans.

In the case of Rothschild, collateralization practice in Korea seems to be even more difficult to deal with than sorting out the order of claims. DIP loans in the US are often provided with liens on most liquid assets such as cash, accounts and notes receivables, and inventory; this is rarely done in Korea. Accounts receivable cannot be used as collateral without the active cooperation of the account debtors and without standardized legal procedures permitting utilization of such assets as collateral, every time a new account receivable is created, the same process of negotiating with account debtors must take place again. Furthermore, under composition, trade creditors are not subject to stays and usually have first claims to notes receivables. Another area of concern for Rothschild is the uncertainty of the new lender's status if proceedings concerning the Halla Group is turned into a liquidation procedure.[17]

17) Ross Jr (1998)

V. A New Bankruptcy Procedure: Preliminary Considerations

In this section, a new bankruptcy procedure suggested in theoretical literature is considered, though how it might be applied specifically in Korea is beyond the scope of this paper. The bankruptcy procedure described here was first developed in Aghion, Hart and Moore (1992), as a procedure which could be adopted in the transition economies of Eastern Europe. The procedure is further developed in Hart et al (1997). In principle, they suggest a debt-equity swap, allocating new equity among creditors in a way that does not violate priority of claims, and using auctions to determine the value of the firm (i.e., the restructuring plan) simultaneously.

Some aspects of the above process may be suitable for the Korean situation: it is designed to work even when capital markets do not function well; it is mechanical and simple so that little is left to the discretion of the receiver; it is designed to work when the value of the firm is not known; and it resolves the two questions of what to do with the firm and how shareholders should be treated (both of which have been subject to extensive debate in Korea) simultaneously. Given that much of any lack of active foreign interest in ailing Korean firms is due to high leverage ratios, the most compelling feature of this process is that it temporarily eliminates debt. In addition, because managers have to win the final vote in order to keep their jobs, the procedure maintains the bonding role of debt. Of course, this procedure need not be adopted by the state; the process is based on a debt-equity swap mechanism originally developed by Bebchuk (1988) for private workouts, and can always be adopted in out-of-court settlements.

The new bankruptcy procedure described here mainly follows Hart et al (1997). The order of procedure is presented first to show the essence of what this process attempts to achieve. Then, details on each step are explained.

1. Principal Steps

There are three principal steps.

Step 1. Bankruptcy is filed, the court places an automatic stay and appoints a receiver, whose tasks are to a) draw up a list of the claims against the firm and determine priority; b) solicit reorganization offers in cash and/or non-cash securities for the whole firm or its parts; c) run the every day operations of the firm or supervise the current management. This process may take about three months, at the end of which the list of claimants and offers for the firm are made public.

Step 2. Two auctions take place, an inside auction followed by one outside, which may take about a month. First, the receiver issues 100 shares, each share representing a 1% stake in the firm and conferring the right to a vote in determining the future of the firm. Through an inside and an outside auction, all debt will be transformed into shares, thereby aligning the various economic interests of the principal actors of the firm.[18)]

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18) Aligning the interests of the principal actors is important because each group will try to influence the decision on what to do with the company in a way that will maximize their private interests

Initially, all 100 shares are issued to the most senior creditors, each creditor getting an amount proportional to her debt exposure. These shares then, can be recalled for an amount which pays off the debt. Each junior creditor is given the right to acquire shares at a unit price equal to 1% of the claims that have higher priority. The shares they acquire can also be recalled for an amount which pays off their debt. In this way, the order of claim priority is maintained.[19] Furthermore, this provides claimants the opportunity to buy preferential shares prior to any

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rather than maximizing the value of the firm. Further, since restructured companies do not have an objective value, it is hard to know what fraction of the post bankruptcy proceeds each group of claimants, including shareholders, are entitled to receive. As a result there can be a great deal of haggling (Hart 1995).

19) Adherence to absolute priority is important because if a debt priority structure that was agreed to contractually can always be violated within bankruptcy, then people may be unwilling to lend to the company in the first place, since their claims will be unprotected (Hart 1995). However, some argue that greater efficiency can be achieved by removing the rigidity deriving from the imposition of absolute priority: "... if the most senior creditor, who has all the decision power according to absolute priority rule, is guaranteed his claim in any event, his incentives to monitor disappear, leaving the remaining creditors with not enough proceeds to induce them to monitor efficiently the firm..." (Cornelli & Felli 1997, p. 477). That the possibility for a violation of the absolute priority rule could improve the creditor's incentive to monitor is telling for the Korean situation, where monitoring by the major lending banks had virtually been nil.

public auction. The closed auction also plays an important role in determining the value of the firm because when capital markets are imperfect, public auctions often fail to produce optimal results. For example, outsiders might have the cash to outbid the firm's claimants, and yet, can get away with bidding less than the true value of the firm.

Outside firms are invited to submit bids to buy shares from those claimants who acquired shares in the inside auction; a claimant is obliged to relinquish the share if and only if his claim can be paid in full from the revenue raised from outside bids. The public auction provides an early opportunity for at least some creditors to sell their shares for cash, since in principle, they ought to be paid back in cash, rather than in shares. Public auctions can also generate surplus revenues which can be used to compensate any liquidity-constrained claimants who are unable to exercise their options to acquire shares in the inside auction.

Step 3. New holders of shares meet to vote and select the best reorganization offer solicited in Step 1, and the firm emerges from bankruptcy. The offers may be complex, coming from different management teams and comprising different mixtures of cash and non-cash securities, and difficult to evaluate; but the interests of the electorate is homogeneous - their common aim being maximization of firm value. Thus, there would not be as much haggling as one would expect under conventional bankruptcy procedure or private workouts.

2. The Two Auctions

1) Inside Auction

a) There are n classes of creditors who are owed debts D_1, D_2,...D_n, with the subscripts denoting seniority of claims. The shareholders are last in the order, and form the $(n+1)^{th}$ class.

b) The receiver initially issues all 100 shares to the most senior class of creditors, Class 1. At this point, the existing shareholders have to relinquish all their shares, but receive the option to buy new shares before the firm goes into public auction. The newly issued shares can be recalled - when there is a demand from the next immediate creditor class - at a unit price of $D_1/100$. This price ensures that all the debt of Class 1 is paid off when all the shares are bought by other creditors or shareholders. This is the "call price" for Class 1, or the "option price" for the next creditor class.

c) A creditor in the next senior class who is owed d_2 is given the right to buy up to her pro-rata number of shares, $100(d_2/D_2)$ at a price p2 = $D_1/100$. But shares they acquire can be recalled at a price of $(D_1+D_2)/100$, upon demand from the next immediate senior creditor class. And so on, with a creditor in class j who is owed d_j, given the option to buy up to $100(d_j/D_j)$ shares at a unit price, $p_j = (D_1 + D_2 + ...+ D_{j-1})/100$.

d) Shareholders who hold z% of the firm's equity are given the option to buy up to z non-callable new shares at a unit price of $p_{n+1} = (D_1 + D_2 + ...+ D_n)/100$. If they exercise all of their options, then there are just enough proceeds to pay all the firm's debt and the auction ends: i.e., the cash the junior claimants get from the shareholders is used to buy shares from senior creditors so that the cash moves up the hierarchy and the shares moves down the hierarchy. If shareholders cannot raise enough money to buy all the shares, or if they do not have enough confidence in the future of the firm, some debts will not be paid off, and the process then turns to the public auction.

2) Public Auction

a) The receiver invites outside investors to bid for the new shares, and draws up a demand curve. At the start of the auction, claimants who succeeded in acquiring new shares in the inside auction own all 100 new shares; they supply new shares at their call prices (class j claimant sells at the reserve price of $p_j = (D_1 + D_2 + ...+ D_{j-1})/100$).

b) The receiver calculates the equilibrium price, and those claimants who are either unable or decide against selling their shares maintain their right to participate in reorganizing the firm and become residual claimants.

3. Examples

Assume there are three classes of creditors and each class is owed \$100 (i.e., n=3, and $D_1 = D_2 = D_3 =$ \$100); the best reorganization offer for the firm is perceived by everyone to be worth \$250 - i.e., a new share is perceived to be worth \$2.5. The option prices per share, $p_2 =$ \$1, $p_3 =$ \$2, and $p_4 =$ \$3 are paid by Class 2 claimants, Class 3 claimants and shareholders respectively, according to the rules explained above.

1) Example with no liquidity constraint

First, let us consider the case where no participants are liquidity constrained. Initially, a shareholder would not choose to exercise her options because she has to pay p_4 = \$3, which is more than \$2.5, the expected value of the reorganized firm. But Class 3 creditors will exercise all their options because they only have to pay \$2 for a share which is expected to be worth \$2.5. The funds generated thus amount to \$200, just enough to pay all Class 1 and Class 2 debt, and the auction ends. A Class 3 creditor, who was owed \$1, receives one share worth \$2.5, having paid out \$2. This is equivalent to a 50% recovery of what is owed to her in the form of equity rather than cash. However, since Class 3 creditors become residual claimants, they may be able to recover their loans if the firm's value increases. A further benefit of such a system is that it would ensure that the creditors (or, the future shareholders) would have incentive to vote for a restructuring plan that maximizes firm value. In this particular case, shareholders receive nothing.

2) Example with liquidity constraint

Now, suppose some of the Class 3 creditors are liquidity constrained and a public auction is held. Suppose only 40 of the Class 3 creditors can raise money to buy the shares at their option price \$2. This will provide \$80 to Class 2 creditors who could then buy 80 shares with this money because their option price is \$1. At the same time, they would want to raise \$20 to buy the remaining 20 shares from Class 1 creditors, since perceived value of the new share is \$2.5, which is greater than their option price of \$1. This will result in Class 2 creditors purchasing all 100 shares from Class 1 creditors, who will therefore be fully paid off.

At this point, when Class 2 creditors hold 60 shares and Class 3 creditors hold 40 shares, a public auction takes place. Suppose outside bidders bid the true value of the firm ($2.5 per share). Class 3 creditors will not sell since their reserve price is $3 but Class 2 creditors will sell because their reserve price (or call price) is $2. This means that the supply schedule is horizontal at $2 for quantities less than 60 shares; horizontal at $3 for quantities between 60 and 100; and becomes vertical at 100. We have assumed that bidders bid the true value of the firm, which means that the demand schedule is perfectly elastic at $2.5. Therefore, the equilibrium price per share will be $2.5, while equilibrium quantity sold will be 60 shares (see Figure 1 below). This generates $150, of which $100 is used to pay off what is owed to Class 2 creditors, and $20 to compensate Class 2 creditors for what they raised to buy out Class 1 creditors; the surplus of $30 is used to compensate the 60 Class 3 creditors who did not have the money to exercise their option to buy new shares, though it does not fully cover the debt amount claimed. The 40 Class 3 creditors who could exercise their options, end up wih 40 shares which are worth $100 at market value. Since they paid out $80 initially, their net gain is $20. This is equivalent to them recovering half of what is owed to them, in the form of equity. This result is same as the result in the example where nobody was liguidity constrained.

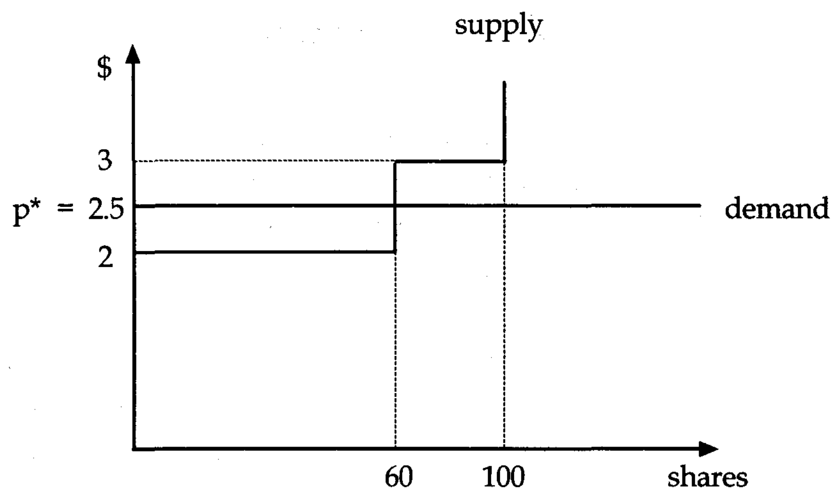

Figure 1

Note that the amount paid off depends on the perceived value of the firm (the strength of outside demand) and whether shareholders or junior claimants can raise enough money to finance the auction. In the case where the outside market for the firm is thin, creditors can get stuck with new shares, which could potentially have little value. Furthermore, inside auctions cannot operate if shareholders or junior claimants lack available funds but cannot raise it from the capital market. This problem, however, may not be as serious as the first problem since the auction is decentralized, and each creditor needs to raise money on a pro rata basis, not the whole amount that can buy up all of the shares. Not everyone in their respective group needs to exercise their options. In this sense, this procedure may work best when there is a large number of creditors each holding small debt claims. Furthermore, shareholders effectively have the opportunity to receive shares only if the expected value of the firm is very optimistic.

VI. Conclusion

After the February amendment of bankruptcy related laws, debate on the procedural aspects of bankruptcy has stalled somewhat. The more immediate task of differentiating financially distressed firms and viable firms has been assigned to major creditor banks. While the result of this process and the way in which banks plan to use bankruptcy procedures are still unclear, once this process is complete, many major firms are likely to file for bankruptcy within a short span of time. No doubt, this would precipitate another round of discussion with respect to bankruptcy related procedures and laws. A reorganization procedure from the theoretical literature has been suggested in a very preliminary form as an example of how new bankruptcies could be handled. However, the main purpose of this paper has been to introduce a perspective on the nature of recent debate related to bankruptcy procedures in Korea rather than propose a solution.

Cross border issues related to bankruptcy, which have not been studied very much in the past require greater investigation. As cross border activities increase, these issues will certainly become more important. Rothschild's loan to the Halla group is a good example of how different bankruptcy laws of different countries may affect reorganization efforts and the business decisions of firms. Furthermore, for better evaluation of current policies and regulations, there is a need for more detailed empirical studies on the costs of bankruptcy and the effects of corporate reorganization on competitor firms at the industry level. Case studies of major firms that recently filed for bankruptcy, or have concluded debt restructuring agreements privately, would be a good starting point as a follow-up to this paper.

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Appendix: Comparative Summary of Reorganization Procedures After February 1998 Reform

	Composition	Corporate Reorganization
Criteria for Filing and Opening	• Debtor can file for composition not only when bankruptcy actually occurs, but when bankruptcy seems probable. Therefore, when composition is rejected or the process is stopped, the debtor does not go into liquidation automatically but only upon actual default. • To prevent abuse of the procedure, application cannot be withdrawn after a stay is declared. • Composition will not be allowed when: -debtor assets, size of debt and number of creditors are too large (eg. when debt surpasses 250 billion won). -bankruptcy resulted from misappropriation of corporate funds by managers.	• Corporate reorganization will not be allowed when firm value is greater under liquidation than in operation under reorganization. • Creditors can now force the process to stop; only the court had this right before this amendment.

	Composition	Corporate Reorganization
Treatment of Shareholders and Managment	• Original shareholders and managers remain in control.	• Shareholders have to give up a certain ratio of their shares when debt of the firm is greater than the value of its total assets. • Major shareholders will be required to give up all of their shares only when they have been involved in mismanagement of the firm. • Owners of the firm can appoint original managers familar with the firm as receivers to facilitate quick recovery.
Role and Rights of Creditors	• Creditors can stop the composition procedure when they have reasons to believe that debtors are not abiding by the agreement. • Creditors can form a committee to participate in the composition process and monitor the debtor firm after composition is declared.	• A committee of major creditors will be formed to coordinate creditor interests and submit creditor opinions to the court with respect to the procedure. The committee shall be entitled to all important information about the process. • When creditors or shareholders have filed for corporate reorganization, they are entitled to information on the firm's managerial and financial status.

	Composition	Corporate Reorganization
Efficiency	• Specified dates for each stages in the procedure: receiver must submit investigation report and opinion within 2 months of filing, opening decision must be made within 3 months, and the proceeding will be forced to close if no decision has been made within 9 months.	• The court must make a decision on stay within 2 weeks of filing. After all debts have been reported, the reciever must submit a restructuring plan within 4 months. • The court can stop the process if the restructuring plan is not approved within one year, or if there are unavoidable reasons, within one and a half years. • Maximum time period within which all debts need to be paid back has been shortened to 10 years (from 20 years before the amendment).
Responsibil-ities and Specialization of the Court	• Receivers will have the right to request reports from the debtor with respect to activities affecting its assets and can require changes.	• A comminttee under the jurisdiction of the court will be established (1 chairman, 3-15 members) to assist the reciever.
Interim Financing	• Debtor can seek permission from the court to obtain new loans to meet necessary expenses in between filing and opening of composition.	• New loans are treated as government claims; i.e., have first priority - no changes made.

국문요약

1997년 이후 대기업들의 도산, 그리고 IMF 구제금융 이후 흑자도산의 급증 등으로 인해 효율적인 企業退出制度가 그 어느 때보다 시급하게 요구되고 있다. 破産法改正은 IMF와 IBRD의 지원자금에 대한 이행조건 중 하나였으므로 국내에서 진행중인 논의에 대한 외국인들의 관심도 높을 것으로 생각된다. 그러나 현재 경제학적인 관점에서 국내 파산법을 연구한 문헌은 그리 많지 않으며 이에 대한 영문 자료는 거의 全無한 실정이다. 본 글의 목적은 특정한 개선방안을 제시하기보다는 우리나라의 破産法 制度와 현재 論議中인 事案들을 영문으로 소개하는 것이다.

파산법은 그 성격상 매우 광범위하고 포괄적인 분야이나 본 글에서는 주로 그동안 가장 논란이 많았던 和議法과 會社整理法의 개시규정에 대한 논의, 구경영권과 소유자의 처리 문제, 그리고 아직 많은 논의가 이루어지지는 않았지만 企業回生에 있어 매우 중요한 신채권의 우선변제권 문제 등에 중점을 두었다.

또 한편으로는 경제학적인 관점에서 본 不實企業 整理方案을 제시하고 우리나라 상황에 도입될 수 있는 가능성을 타진하여 보았다.

파산법의 가장 중요한 문제점은 어떻게 하면 기업가치를 극대화하면서도 채권자와 채무자 사이에, 그리고 채권자들간의 衡平性을 유지하는가 하는 것이다. Hart et al (1997)이 제시하는 負債-株式 轉換方法은 위의 문제를 효율적으로 극복할 수 있는 방안이며 높은 부채비율로 인하여 경제성은 있으면서도 外國人을 포함한 제3자 인수가 어려운 기업들에게 적절한 퇴출경로가 될 수 있을 것이다.

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