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Debt Resolution, Cross-Border M&As, Governance and Control in Korea's Post-Crisis Corporate Restructuring

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Executive Summary

The outbreak of financial crisis in Korea in 1997 exposed the structural weaknesses in the country's economy. Heated debates have failed to generate definitive answers on just what caused the financial crisis. Considering the importance of restructuring the corporate sector, this paper analyzes how the resolution of corporate debts was accomplished and examines the role of foreign capital in Korea's post-crisis corporate restructuring. Special attention is given to the measures devised to recover non-performing loans for the liquidation of corporate debts; to the foreign capital inflows through cross-border M&As or in privatization processes; and to the changes in control through corporate governance reforms. This study concludes that the resolution of corporate debt has been satisfactory and successful and that foreign capital contributed significantly to effective corporate restructuring and debt resolution in the post-crisis restructuring of Korea.

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Debt Resolution, Cross-Border M&As, Governance and Control in Korea's Post-Crisis Corporate Restructuring

Chan-Hyun Sohn*

I. Introduction

The outbreak of financial crisis in Korea in 1997 revealed the structural weaknesses in the country's economy. Naturally, policy makers and experts of diverse fields from economics and finance to social policy have sought remedies, not only to find a way out of the crisis but also to prevent another one from occurring and, to provide a sound base on which to build a healthier economy.

Heated debates on just what caused the financial crisis have not yet led to universally agreed answers. However this paper suggests, with support from the Korean experience, that the corporate sector

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was, although not solely, at the heart of the crisis.

Realizing the importance of restructuring the corporate sector, this paper aims to analyze how the resolution of corporate debts was accomplished and to determine the role of foreign capital in Korea's post-crisis corporate restructuring. Special attention is given to the measures devised to recover non-performing loans for the liquidation of corporate debts; to the foreign capital inflows through cross-border M&As or in privatization processes; and to the changes in control by corporate governance reform.

The paper consists of six parts. Following this section, section II traces the evolution of the financial crisis in Korea and analyses the restructuring initiative. Section III considers various corporate debt resolution intermediaries with a particular focus on the Korea Asset Management Corporation, a specialized debt resolution agency. Section IV studies the role of foreign capital in corporate restructuring, especially through cross-border M&As and in privatization. Then, section V examines changes on the corporate scene, in particular regarding the corporate governance and control system, and discusses how they have led to better corporate performance. This paper is concluded in section VI.

II. Financial Crisis and Corporate Sector Reform

1. Underlying Weaknesses of the Corporate Sector

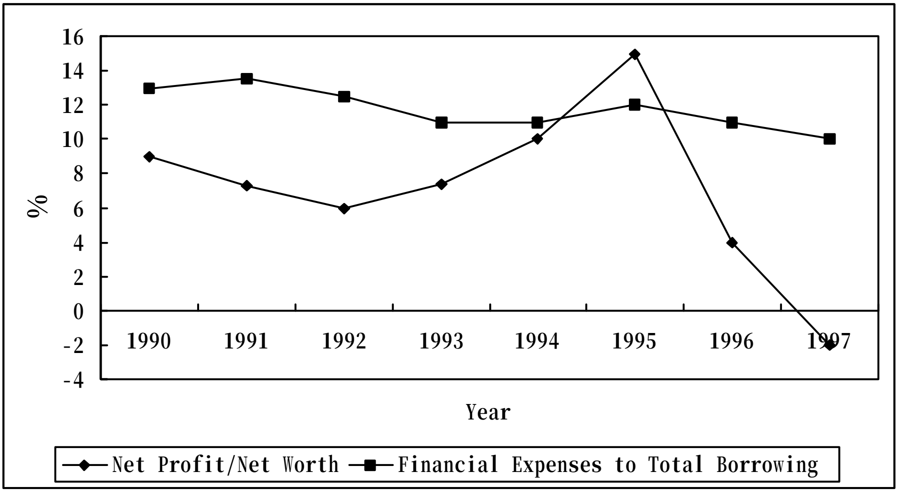
On the surface, the financial crisis that struck many Asian regions seemed to have stemmed from liquidity problems, that is, low foreign reserves and excessive short-term foreign debts. Indeed, Korea's short-term foreign debts amounted to more than six times the value of its foreign reserves. However, at the core of Korea's crisis stood the inefficiency of the corporate sector, a problem which expanded during the country's high growth period.

The inefficiency finally surfaced in the form of a series of large-scale bankruptcies. The number of bankruptcies, including those of the *chaebols*, the large conglomerates, jumped by about 50% near the outburst of the crisis from 11,589 in 1996 to 17,168 in 1997. This succession of bankruptcies increased the level of uncertainty in the Korean economy and shook investors' confidence. Banking and financial crises were immediate.

Three facts of Korean corporations are to blame. First, excessive and inefficient investment and highly leveraged and diversified businesses were financed by debts. Figure 1 shows that in the 1990s the profitability of Korean manufacturing firms was substantially below the opportunity cost of capital, thereby leaving them with a cash flow shortage and structurally vulnerable to external shocks.

As global economic conditions changed and competition got fiercer in both domestic and world markets in the late 1980s, debt-financed growth became ever riskier.[1] What was most critical, though, was the short-term liquidity and cash flow problem that plagued the corporate sector in general.[2]

Figure 1. Profitability and Financial Expenses of Korean Manufacturing Firms



Source: Bank of Korea, *Financial Statement Analysis*, various issues; reproduced from Lim (2001).

1) The warning signs of bankruptcy and high systematic risk started showing in mid-1996. They included over-capacity in investment sector and cash flow shocks.

2) Korea's short-term external debt reached its peak, US$65.6 billion, on September 1997, showing the ratio of short-term debt to total external debt 54.8%. In addition, in 1997, manufacturing firms borrowed 76% of their investment from outside; thus only one quarter was financed by internal sources. (Sohn and Yang 1998)

Second, the collusive relationship between the government and business groups led to inefficient allocation of capital in the financial system. Through its strong control of the financial sector, the government implicitly guaranteed loans to selected companies, in particular *chaebols*, without prudential regulations. This often resulted in the situation where some companies could not repay debts. The inability of the corporate sector to debt-service is the equivalent of the non-performing loans (NPLs) to the financial institutions. Thus the demise of the corporate and financial sectors were intertwined: the increasing number of bankruptcies in the corporate sector burdened the financial sector with NPLs. The size of NPLs sharply increased after the financial crisis. Table 1 shows this trend.

Table 1. Trends of NPLs

(unit: trillion won)

	1997	1998	1999	2000	2001
Total NPLs	97.5	146.7	128.9	157.9	133.1

Source: PFOC and MOFE (2002); Lim (2002).

Third, the traditional and inefficient corporate governance persisted. The owners, who were often the controlling shareholders and usually non-professional managers, were deeply involved in corporate governance. The headquarters of *chaebols* controlled affiliates with a relatively small share of their equity through a centralized hierarchy system known as the "control pyramid system."[3] In fact, the

3) The control pyramid system refers to the system in which a certain shareholder has control over the management of the main businesses and becomes the dominant shareholder of other business lines by con-

average number of affiliates of the top 30 *chaebols* increased from 16 in 1983 to 27 in 1997, while the mean percentage of shareholdings decreased from 15.8% to 8.5% during the same period. This type of corporate governance contributed to poor performance and low firm value reflecting the inefficiency in the corporate sector.

The above factors lay at the heart of the corporate sector inefficiency. Therefore it was imperative that the main focus of overcoming the financial crisis be the corporate sector, especially on corporate debt management and restructuring. The crucial element for the viability and soundness of the sector is cash flow. Various reform measures, as will be shown in later chapters, did succeed in lowering the debt-equity ratio and improving the interest coverage ratio of the corporate sector. But measures to improve the cash flows of the cash-strapped corporate sector, in particular by attracting foreign capital inflows, were urgently needed.

2. General Framework of Corporate Sector Reforms

The corporate sector reforms can largely be divided into two pillar measures—corporate debt restructuring and corporate governance reforms.

Corporate debt restructuring involves rectifying the first two problems specified in the previous section, namely corporate financial restructuring and debt resolution, while corporate governance reforms deal with the third problem. Here the focus will be on approaches to corporate restructuring involving the five major principles: (1) sig-

trolling the assets of other business with its small amount of assets (KERI 2000).

nificantly improving the capital structure; (2) identifying core businesses and strengthening cooperative relationships with small and medium-sized companies; (3) improving transparency of corporate management; (4) dismantling cross-debt guarantees; and (5) enhancing accountability of both controlling shareholders and their management accountability.[4)]

At the outset of the financial crisis, few institutional systems and market mechanisms existed to deal with large-scale insolvency. In need of a systematic mechanism, ways to improve the existing court-based procedures as well as to introduce an out-of-court settlement procedure were sought. Non-viable companies were liquidated or rehabilitated through these two main mechanisms during this period.

The court-based restructuring system is composed of three elements: bankruptcy, composition, and reorganization. Bankruptcy is a procedure in which a debtor's assets are liquidated by a court-appointed liquidator. Composition is a settlement procedure between the debtor and creditors, in which a debtor handles its own estate. It is available to enterprises that owe less than ₩250 billion, for it offers very few guarantees to the creditors. In the re-organization procedure, the court directs the creditors to handle the debtor, and the latter's estate is administered by an external administrator under the influence of the creditor. Creditors and debtors can start any of the

4) Because of changed conditions and new problems, three tasks were further added on August 15, 1999: (1) improving the managerial governance of the non-bank financial institution; (2) eliminating cross-financing and illegal intra-group transaction; and (3) preventing irregular inheritances and donations.

procedures, if there is evidence of cash flow insolvency

Although there actually was a court-based insolvency system before the financial crisis, it barely functioned and was very inefficient.[5] Reforming the court-based rehabilitation system involved revising the bankruptcy law in February 1998: the court could accept and hear cases even when the file was not complete; consolidation of related cases under the same court was made possible; deadlines for the approval and submission of reorganization plans were shortened to between 12 and 18 months; and it became possible to switch from the composition or reorganization options to bankruptcy proceedings. In addition, harsher punishments were meted out to the former managers who were responsible for the company's insolvency. These penalties, intended to make the culpable managers take full responsibility for their mismanagement, included compulsive retirement of shares and deprivation of managerial rights in the reorganization procedure.

Out-of-court workout procedures involve dividing the companies into three groups according to their restructuring capacity, and applying different restructuring approaches. The first group is the top five *chaebols*—Hyundai, Samsung, LG, Daewoo and SK—which were believed to have the capacity to absorb the resulting losses. They were allowed to pursue 'self-directed restructuring.' An additional program called Big Deals was incorporated by the *December 1998 Agreement*[6]

5) Out of more than 17,000 insolvency cases reported by the Bank of Korea in 1997, only 492 cases were filed before the court. Only 41 judges, some of whom were not specialists in commercial law, were assigned to deal with bankruptcy cases, and the proceedings took up to several years (KERI 2001).

6) The agreement also emphasized the reduction of debt-to-equity ratios

to reorganize diversified business lines,[7] and reduce over-capacity and the high debt-to-equity ratios of *chaebols*. In fact it was a restructuring option available only to these top *chaebols*. Next was the '6 to 64' *chaebols* group, which consisted of the 64 largest conglomerates excluding the top five. They were believed unable to restructure successfully on their own, and voluntary out-of-court workout programs were carried out. Daewoo, one of the top five *chaebols*, failed to self-restructure and received workout programs. A voluntary workout is an out-of-court settlement process between the creditors and debtors, based on the principle of 'debt burden sharing' with financial institutions.[8] The third group is that of the small- and medium-sized companies. Their financial structures were too weak to bear the costs of restructuring, so support came from their creditor fi-

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Other points included the exit of non-viable firms, independent management of *chaebol* affiliates, the elimination of intra-group debt guarantees and the transparency of corporate management.

7) The Korean conglomerates, under the government's protection, diversified their affiliates and business areas. The average number of affiliates for the 30 largest conglomerates continued to increase, growing from 19.7 in 1992 to 27.3 in 1997; meanwhile, the average number of business areas also increased from 16 to 20 during the same period (OECD 1998).

8) At the end of 2000, 104 firms including Daewoo Group affiliates were nominated for the workout process. Of the 104 companies nominated, 36 firms have graduated and 34 remained in the program. Among the remaining 34 firms, 8 dropped out, 11 were ejected, and 15 merged with other companies. 10 of the 34 remaining companies were affiliates of the Daewoo Group, while 15 were affiliates of the medium *chaebols* and 9 were small and medium-sized firms.

nancial institutions and the central bank during the restructuring process.[9]

As the pace of reform and growth slowed, and the financial sector was being threatened by high credit risks in mid-2000, the second round of reforms were launched to address the problems and restore confidence in the Korean economy. Corporate restructuring from 2001 was made on the basis of a series of systems established in the former stage. Government intervention was reduced to establish a more market-based restructuring system. *Corporate Restructuring Promotion Law* (effective until 2005) and its *Enforcement Ordinance* were established to efficiently dispose of and reduce the NPLs of financial institutions.

9) Small and medium-sized firms were divided into three groups: priority support group, conditional support group, and others. For the firms in the first two categories, accounting for almost 95% of all small and medium firms, banks were ordered to roll over loans maturing by December 1998. Second, various budgetary support programs were put in. Loan guarantees of ₩33 trillion to small firms and additional budgetary support of ₩2.2 trillion were granted. ₩1.6 trillion was raised through the "Corporate Restructuring Fund" to assist small companies. The central bank relaxed its rules on credit ceiling to encourage banks to support small firms. Third, tax incentives were given: income tax or corporate tax was reduced by half for newly established small and medium firms during their first five years of start-up and tax benefits associated with facility investments were increased.

III. Corporate Debt Resolution

Corporate debts were resolved through a special resolution agency. The Korea Asset Management Corporation (KAMCO) was the first of its kind in Korea, and other institutions including the Corporate Restructuring Fund, Corporate Restructuring Company, Corporate Restructuring Vehicle, and Corporate Restructuring Real Estate Investment Trusts were established to assist in the resolution of corporate debts.

1. Korea Asset Management Corporation

KAMCO, originally a subsidiary of the Korea Development Bank, was specially reorganized into a resolution agency when the financial crisis broke out.[10)]

The main role of KAMCO, as the only 'bad bank,' was to help corporate restructuring by clearing the non-performing loans (NPLs) of financial institutions and normalizing their functions. It bought non-performing assets from banks and other financial institutions with the government's debt-guarantees and public funds.[11)] NPLs were re-sold through three channels: (1) sale in the form of loans; (2) sale in the form of real estate; and (3) sale after management of

10) KAMCO was set up under the *Act on Efficient Management of NPLs of Financial Institutions and Establishment of KAMCO.*

11) The *Non-Performing Asset Management Fund*, a form of public funds, collected a total of ₩20.6 trillion and had ₩12.1 trillion as available capital in 1998 (KERI 2001).

NPLs. More specifically, sale in the form of loans was done by asset-backed securities (ABS), outright sale, and equity partnerships; sale in the form of real estate was carried out by auction and KAMCO public sales; and sale after management of NPLs by sale of real assets such as factories.

To issue ABS, KAMCO established a paper company called Special Purpose Vehicle (SPV) and transferred NPLs, which the paper company subsequently cleared by issuing ABS with the transferred loans as collateral. ABS worth ₩4.1 trillion were issued by June 2002 while NPLs worth ₩27.7 trillion were disposed of during the same period. KAMCO introduced equity partnerships with the private and foreign sectors expecting higher recoveries by enhancing the stability and specialization rather than conventional sales methods.[12] Between 1999 and 2001, six equity partnerships were established, with a total asset book value of ₩3.5 trillion. The aim of the first 3 partnerships was the co-management of NPLs while that of the second 3 was more comprehensive asset management.

As can be seen from Table 2, KAMCO purchases of NPLs have been constantly increasing. The total purchase of NPLs at the end of 2001 accounted for 76.0% of total NPLs worth ₩133.1 trillion. The share of remaining NPLs to the total has significantly decreased, sug-

12) The advantage of the equity partnerships is that they can maximize the returns by introducing an incentive system for general partners (the investors) while minimizing the holding period of the assets. Another advantage is that KAMCO does not have to bear the full burden of collection expenses. On the other hand, there are some weaknesses in equity partnerships. For example, KAMCO has to bear the risk of trusting foreign investors who may make poor business decisions.

Table 2. Trends of NPLs and KAMCO Purchases

(unit: trillion won, %)

	1997	1998	1999	2000	2001
Total NPLs (A)	97.5	146.7	128.9	157.9	133.1
KAMCO Purchases (B)	11.1	44.0	62.2	95.2	101.2
Actual Value	7.1	19.4	23.9	36.8	38.7
Remaining NPLs (A-B)	86.4	102.7	66.7	62.7	32.0
Remaining NPLs/Total Credit (%)	13.3	17.7	11.3	10.2	4.9
Share of Remaining NPLs to Total (A-B)/A	88.6	70.0	51.7	39.7	24.0

Note: All figures are at the end of year.

Source: PFOC and MOFE (2001, 2002); KAMCO (2002) Unpublished Internal Report; Lim (2002).

gesting the active role of KAMCO in purchasing and clearing the NPLs.

Although the total amount of NPLs increased sharply from 1999 to 2000 due to the new addition of Daewoo's NPLs and the introduction of a new asset classification standard, namely forward-looking criteria,[13] their share as a proportion of total loans de-

13) Prior to the crisis, only loans in arrears of 6 months or more had been classified as NPLs. In estimating the "true" magnitude of NPLs at the end of March 1998, however, Korea followed internationally acceptable standards and included loans in arrears of 3 months or more. In December 1999, financial institutions adopted a forward-looking approach in asset classification, taking into account the future performance of borrowers in addition to their track record in debt service. The forward-looking criteria (FLC) pushed creditors to make a more realistic assessment of loan risks based on borrowers' managerial competence,

creased from 11.3% to 10.2% during the same period. Particularly the share dropped sharply to only 4.9% in 2001. Another clear indicator of KAMCO's significant role in clearing NPLs is shown by the decreasing share of remaining NPLs, which fell from 88.6% in 1997 to 24.0% of total NPLs in 2001. By 2001 NPL resolution was almost completed.

As in Table 3, as of June 2002, total NPLs of face value ₩105.4 trillion have been purchased at the price of ₩39.4 trillion. Public funds were used to purchase the NPLs. Of these, NPLs worth ₩24.4 trillion have been cleared, recovering ₩27.7 trillion, showing a very high recovery ratio of 113%. In addition, NPLs worth ₩59.8 trillion, which is 56.7% of total NPLs purchased as of June 2002, were disposed. So far, ₩27.7 trillion, about 70.3% of the ₩39.4 trillion that has been invested, has been recovered. Such a high recovery ratio can be attributed to appropriate uses of various NPL disposal methods with different characteristics. For a large-scale disposal of NPLs through international bids and the issuance of ABS in 1999, diverse methods such as sale to asset management companies and corporate restructuring corporations were introduced and the outcome has significantly improved since 2000.

By taking over the NPLs of financial institutions, KAMCO has successfully resolved debts and thereby improved asset mobility and asset soundness. The average BIS capital adequacy ratio of ordinary banks improved significantly from 7.0% in 1997 to 10.8% in March 2002, and the share of NPLs of banks decreased from 16.9% in1998 to 2.8% of the total amount of loans by 2001 (FSC 2002). Foreign invest-

financial conditions, and future cash flow (Lim 2002).

ment and foreign reserves increased,[14] and the growth of small and medium-sized venture enterprises was induced.

Another major role of KAMCO, apart from resolution of debts, was to provide assistance for the recovery of transferred insolvent companies. These are companies that may have been fundamentally competitive but became insolvent due to a temporary lack of financial resources. The assistance included withholding auction of the company; withholding execution of security rights; adjustment of re-

Table 3. Status of NPLs Resolution

(unit: trillion won)

Amount of NPLs	105.4 (100.0%)
Purchasing Value	39.4
Resolved NPLs	59.8 (56.7%)
Purchasing Value	24.4
Recovered Value	27.7
International Bid	3.2
Issuance of ABS	4.1
Sale to AMC, CRC	1.9
Sale of Individual Loan	0.6
Court Auction	3.1
Repurchases and Cancellation	9.7
Voluntary Repayment	5.1
Remaining NPLs	45.6 (43.3%)
Purchasing Value	15.0

Note: Numbers are at the end of June 2002.

Source: PFOC and MOFE (2002); KAMCO (2002) Unpublished Internal Report.

14) Foreign exchange reserve, which recorded $3.4 billion in December 1997, increased up to $112.4 billion in June 2002.

demption period and interest rates; financial assistance to debt-equity swaps and investment of NPLs; and provision of new loans and debt-guarantees.

KAMCO also contributed to attracting foreign capital through various channels including international bids, issuance of ABS, and sale to corporate restructuring and asset management companies.

Overall, the real contribution of KAMCO to more successful corporate restructuring was that by attracting capital from both domestic and foreign investors, it introduced a market mechanism in which non-performing assets could be liquidated.

2. Other Debt-Restructuring Intermediaries

There are other debt-restructuring intermediaries that assist KAMCO's operations. They include Corporate Restructuring Fund; Corporate Restructuring Company (CRC) and Vulture Fund; Corporate Restructuring Vehicle; and Corporate Restructuring Real Estate Investment Trusts.

CRCs and Vulture Funds were established under the *Industrial Development Law* in February 1999 for the facilitation of market-induced corporate restructuring. CRCs are joint-stock corporations based on commercial law, whose main function was to carry out corporate restructuring through takeovers, management restructuring, and sales of insolvent corporations.[15] They also invested in and pur-

15) Insolvent corporations are taken over through the acquisition of stocks or through merger and divestiture. Then their management is restructured through a group of managers or a board of directors from the CRC. Finally, investment funds are paid back within five years

chased the assets of restructuring companies, mediated M&As, and handled business for composition, reorganization, and bankruptcies. In addition, CRCs, as asset owners, issue ABS via SPVs and manage assets. An important contribution of CRCs, apart from asset management, was that they transmitted a more advanced asset management know-how. They also played a central role in corporate restructuring, being the basis of other debt restructuring intermediaries.

For investment funds they used Vulture Funds as well as their own capital. The functions of Vulture Funds, such as management of assets or management of restructuring of insolvent companies, were fulfilled by the CRCs.

Other debt-restructuring intermediaries work through CRCs. The Corporate Restructuring Fund is a paper company, a form of mutual fund created under the *Securities and Investment Trust Law*. It was established to give support to troubled small and medium-sized businesses and some leading companies. The Corporate Restructuring Vehicle was set up as a device for market induced restructuring. It is also a paper company, a type of mutual fund for a limited period of time. It generated profits through asset operations and distributed them to shareholders. Its functions included facilitating disposal of assets by creditor banks; facilitating effective management and governance; and stimulating capital market development. Corporate Restructuring Real Estate Investment Trusts were introduced through the enactment of the *Real Estate Investment Trust Law* in April 2001. During the financial crisis, real estate was collateral for many distressed corporations. Real Estate Investment Trusts, by speedily con-

through sales of stock and assets

verting real estate into capital, helped to improve the liquidity and cash flow of the companies and thus promoted corporate restructuring activities. They were also expected to provide minority investors with more investment opportunities and develop the real estate market.

Most of all, for the better operation of these debt-restructuring intermediaries, foreign capital inflows and the foreign know-how of debt restructuring were important.

IV. Roles of Foreign Capital

Foreign capital was important as the only source of liquidity to improve the cash flow of the cash-strapped, highly leveraged and indebted corporate sector of Korea. Ultimately it promoted and funded market-oriented corporate restructuring, and also brought other non-financial and non-tangible benefits such as foreign participation in management or financial market discipline.

Bold reforms were carried out to attract foreign direct investment (FDI). It was first allowed into Korean enterprises, although to a limited degree,[16] in April 1998. Because of continuous efforts, foreign investments in Korea have increased sharply since 1998.[17] It was largely due to the government's initiatives to deregulate the financial market and open it more to foreigners, but the devaluation of assets at the outburst of the crisis was also a contributive factor. Foreign corporations, on the other hand, pursued globalization and increasing market share through investing in Korea.

This section focuses on the two major forms of foreign investment —cross-border M&As and investment in privatization of state-owned enterprises—and examines their roles in the process of corporate restructuring.

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16) FDI was still prohibited in 31 business lines.

17) The foreign investments until 1999 were focused on the financial and corporate sectors, but extended to the real estate market in 2000.

1. Cross-Border M&As

Cross-border mergers and acquisitions increased significantly especially after the financial crisis, in response to deregulation of laws restricting hostile M&As, but also to lower asset prices and depreciation of the won. In addition there were abundant acquisition opportunities as many of the distressed firms were selling off parts of their business lines in the process of restructuring. In many cases, rescue funds flowed in from existing foreign partners to ease liquidity constraints. Common forms of M&As have included buying out joint venture partners, existing investors expanding through acquisition, and the creation of new establishments in collaboration with Korean partners to acquire existing business units (Yun 2002).

Several key industries have been opened up, including construction, leasing, securities, and futures brokerage, with a liberalization rate of 98.9% by May 1998.[18] In May 1998, the rule limiting foreign ownership to not more than 10% without the approval of the board of directors was eased to allow 33% foreign ownership. The ceiling on total foreign shareholdings in individual companies was completely abolished in May 1999. In addition, all forms of M&As, including hostile takeovers, were fully liberalized by the same time - before the financial crisis, even friendly M&As were limited to cases where the total assets of the companies involved did not exceed ₩2 trillion. Further, two stock market rules—the rule requiring statutory tender offers in the case of purchase of 25% or more, and the rule requiring disclosure of incremental acquisitions of stakes larger than 5%

18) This effort raised M&As by foreign companies sevenfold, which accounted for a fifth of all such deals in Korea in 1998 (OECD 1999).

—were abolished.

Because of these deregulation efforts in cross-border M&As, foreign purchase of shares and assets of Korean companies increased. In 1998, sales of newly issued and outstanding corporate stocks and corporate assets bought by the foreign investors reached $1.84 billion and $2.93 billion. Together they accounted for 60.9% of total foreign investment in that year. In case of acquisition of outstanding stocks, the foreign companies acquired the shares of troubled domestic joint venture partner companies and subsequently became the sole owner. In case of acquisition of newly issued stocks, the investments took the form of joint ventures through additional infusion of capital into existing businesses, and establishment of new companies through asset acquisition. These forms of investment are close to M&As (Rhee 1999).

As Table 4 suggests, a large bulk of foreign direct investment was

Table 4. Pattern of Inward FDI in 1998

(Unit: US$ million, %)

Classification	Acquisition of Newly Issued Stocks			M&A			Long-term Loan	Total
	New	Added	Sub-total	AOS	AA	Sub-total		
Invested amount (%)	1,020 (13.0)	2,049 (26.1)	3,069 (39.2)	820 (10.5)	2,930 (37.4)	3,750 (47.8)	1,019 (13.0)	7,838 (100.0)
Investment size per case	46.4	42.7	43.8	27.3	154.2	76.5	113.2	61.2

Note: Only investments exceeding $10 million are counted; AOS (Acquisition of outstanding stocks); AA (Acquisition of Asset).

Source: Cited from Rhee (1999); data from MOCIE.

made through M&As rather than greenfield investments. More specifically, a large part of corporate restructuring was carried out through foreigners' acquisition of outstanding stocks and assets. In 1998 for example M&As accounted for 47.8% of all FDI inflows and in particular acquisition of assets accounted for 37.4%.

Official statistics, however, considerably underestimate the extent of cross-border M&As because the acquisition of assets and business units are counted as acquisition of new shares. Even taking this into account, it is easily observable from Table 5 that the level of M&As has increased dramatically from $192.0 million in 1995 to $3.65 billion in 2001. Particularly noteworthy is the sudden jump of inward M&As from $836 million in1997 to $3.97 billion and $10.06 billion in 1998

Table 5. Trends of FDI and Cross-Border M&A

(Unit: US$ million, %)

	1995	1996	1997	1998	1999	2000	2001
FDI inflow (A)	1,776	2,325	2,844	5,412	9,333	9,283	3,198
M&A sales (B)	192	564	836	3,973	10,062	6,448	3,648
Ratio (B/A)	10.8	24.3	29.4	73.4	100.0*	69.5	100.0*
FDI outflow (C)	3,552	4,670	4,449	4,740	4,198	4,999	2,600
M&A purchase (D)	1,392	1,659	2,379	187	1,097	1,712	175
Ratio (D/C)	39.2	35.5	53.5	3.9	26.1	34.2	6.7

Note: FDI includes cross-border M&As and greenfield investments. Thus, theoretically the ratio (B/A) cannot exceed 100%, but calculations from the data yield figuresgreater than 100%. This is because the figure for FDI has been measured on an arrival basis while cross-border M&As have been measured on a notification basis. All calculated figures exceeding 100% are thus adjusted to 100%.

Source: UNCTAD (2002), *World Investment Report.*

and 1999 respectively. FDI inflows also increased from $1.78 billion in 1995 to $9.28 billion in 2000. The low figures in 2001 can be accounted for by the global economic recession.

This massive scale of foreign purchases of the shares and assets of Korean companies eventually enlarged the scope and scale of their businesses. For example, the total sales of the four foreign companies —Nokia TMC, Motorola Korea, Hangook Hewlett-Packard and Hangook BASF—ranked within the top 200 companies in the domestic market.[19] In particular, the growth rate of total sales of Motorola Korea recorded 270% in 1999.

As a result of increased cross-border M&As, foreign companies expanded their market shares in Korea. In the petrochemicals, paper, pharmacy, and food industries, foreigners have accounted for over 50% of the markets since 1997. In the acetic acid, rolled aluminum, disposable diaper, feminine pads and polyurethane material markets they have accounted for over 70%.

Apart from bringing foreign capital, cross-border M&As have been important in introducing global management practices, such as good capital structure, profit orientation, efficient management process and merit based personnel system, to Korea (Rhee 1999). The market competition is also affected—domestic companies now face fiercer competition in both domestic and global markets.

2. Privatization

A second new channel for FDI is privatization. On July 3 1998, the

19) Each ranked 82nd, 118th, 147th and 167th respectively (Yoo 2000).

first privatization plans for public enterprises were announced. The plan included 32 public enterprises—11 public investment and financing institutions and their 21 subsidiaries—out of 108.[20] There were two stages of privatization - immediate and phased privatization. As a general rule more market-oriented public enterprises were privatized, and when early privatization was not immediately feasible, privatization followed structural reforms of the enterprises with yearly checkup programs. The former case included five public enterprises and the latter case included six others. The number of public enterprises subject to privatization accounted for only 30% of a total 108 public enterprises, but in terms of the number of employees and sales revenues, they accounted for 70% (Cho 2001).

Foreign investors could acquire shares of Korean companies without being restricted by foreign investment ceilings except in five designated companies—POSCO (Pohang Iron and Steel Corporation), Korea Electric Power Corporation, Korea Telecom, Korea Gas Corporation and Korea Tobacco and Ginseng Corporation—although the specified ceilings varied for different state-owned enterprises (Yun and Park 1999). However, in the process of privatization, the government gradually reduced the level of regulation: POSCO's 30% ceiling on acquisition of shares by foreigners and 3% ceiling for a single foreign investor were lifted in 2001; the restrictions on acquisition of Korean Tobacco and Ginseng Corporation by a single person was eliminated in 2000.

International offers in the process of privatization have mainly taken the form of depository receipts (DRs) issuance. The issuance of

20) Public enterprises include 13 public investment institutions and their 30 subsidiaries and 13 public financing institutions and their 52 subsidiaries.

DRs was an attractive way of privatizing Korean public enterprises because it allowed relatively easier access to the international capital markets and share ownership could be dispersed with little threat of an M&A, since purchases were made mainly by institutional investors.

Looking at the outcomes so far, foreign investors and capital indeed have been deeply involved in the process of privatization. A remarkable example is POSCO, which successfully offered its shares in the form of DRs: it sold the government's shareholdings (3.14%) and the shareholdings of the Korea Development Bank (2.73%) through the issuance of DRs at the NYSE in New York and LSE in London; further shareholdings of Korea Development Bank in the amounts of 8% and 4.6% were sold in 1999 and 2000 respectively.

Korea Electric Power Corporation issued foreign DRs twice—14.5% of total shares in 1999 and 17.8% in 2001—and issued foreign exchangeable bonds and bonds with warrants—11.8% of total shares—in December 2001. Korea Tobacco and Ginseng Corporation issued 10% of its shares owned by the Industrial Bank of Korea as foreign exchangeable bonds in 2000, and in 2001, 19.8% owned by the government and Industrial Bank of Korea was transformed into foreign DRs and exchangeable bonds. The government currently plans to sell its shareholdings of government-run banks which account for 33% of total shares in the domestic (19%) and foreign (14%) markets. Korea Electric Power Corporation sold the government's share of 5% on the NYSE through DRs and in 2000 the facilities of the Korea District Heating Corporation were sold to LG-Caltex.

Korea Electric Power Corporation was privatized in the form of DR issues and trade sale of generation plants. Its foreign share as of

June 1999 was 25.8%. POSCO was privatized in the form of DRs and sale of Korea Development Bank shares. Foreign share of the company was 51.0% in 1999. Finally Korea Telecom was privatized in the form of DRs and strategic tie-ins with foreign telecommunication firms. Foreign share of the company was 19.4% in 1999. However, without strategic cooperation with foreign telecommunication companies, there are still some difficulties in promoting privatization.

As discussed so far, in addition to KAMCO's sale of NPLs to foreigners through indirect methods such as international auctions, issuance of ABS, and sale to CRCs, cross-border M&As and privatization contributed greatly to increasing foreign capital inflows. As such, the role of foreign capital has been significant and important in helping corporate restructuring.

V. Corporate Governance and Changes in Control

Many have suggested that the problem of huge debt burden on Korean enterprises was due to the inherent problem of *chaebol*-type governance and ownership structure. Approaches to deal with this problem can thus fundamentally change and improve the corporate sector of Korea. This section examines the various reforms that attempted to bring changes to corporate governance and control, and assesses the outcomes.

1. Towards a New Governance

Corporate governance structure is the system that commands and controls a corporation.[21] Recognizing that the numerous problems in corporate governance structure played a major role in bringing the Korean economy to the financial crisis, various measures of reform have been sought.

The reforms focused on four major areas: (1) improving transparency of corporate management; (2) strengthening financial market discipline; (3) strengthening internal governance; and (4) prohibiting

21) Cadbury Committee Report (1992) gives this definition. Normally, corporate governance structure means a systematic relationship between an owner and the management. In a broad sense, it means there is a systematic process to maintain and manage a clear or implied contract among the persons concerned of the corporation, such as shareholders, creditors, employees and so on.

inappropriate intra-group relationships. Improving transparency included introducing consolidated financial statements; and appointing outside auditors. Strengthening financial market discipline included strengthening deregulation of bank loans; and liberalization of M&As. Strengthening internal governance included introducing the outsider director system; protecting the rights of minority shareholders and institutional investors; and strengthening the responsibility of major shareholders. Finally prohibition of inappropriate intra-group transactions included the following: harsher punishments for unfair internal transactions; revival of some regulations; and abolition of debt guarantees. The main contents of the corporate governance reforms are summarized in Table 6.

Several cases of changing corporate governance can be observed after the reforms. In particular the changes in corporate laws and regulations have been quite dramatic (Park 2000). Improvements in transparency were apparent in 1996 as the shareholders of Oriental Brewery Company requested to inspect the company's books—the first such case in Korean corporate history. Such actions posed a serious threat to the management of the company. The case of Samsung Electronics shows how the voice of minority shareholders could be heard after the reforms. Shareholders of the company had been questioning a huge suspicious loss and inefficiencies in some investment projects. In 1998 they finally filed a shareholder derivative action suit against the directors of the company on various accounts including illegal inside transactions among affiliates. The management was also fined by the district court for not disclosing the contents of the minutes of the board of directors' meeting, which was requested by the shareholders. In turn, in 1998, SK Telecom was forced to elect two

Table 6. Corporate Governance Reform Measures

Classification	Main Contents
(1) Improving Transparency	1. Introduction of consolidated financial statements 2. Obligation of establishing election committee for the assignment of outsider auditors for listed companies and affiliates of the chaebols
(2) Strengthening Financial Market Discipline	1. Regulation in banks loans - Debt-equity ratio 200% became a de facto limit in provision of loans - Prohibition of new loans with guarantee by affiliated firms - Establishing a system for constant assessment of corporate credit risk, including introduction of forward looking criteria (FLC) 2. Liberalization of M&A market - Permitting hostile takeovers - Abolition of regulations on foreigners' shareholding
(3) Strengthening Internal Governance	1. Outsider director system - 1/4 of the board of directors should be outside directors 2. Responsibility of major shareholders - Registration of the controlling shareholder as the representative director of leading affiliates. - The removal of the 'Chairman's Office' 3. Right of minority shareholders - Loosening conditions for derivative suits, inspecting accounting books, and request for the dismissal of directors and auditors by shareholders - Introduction of a cumulative voting system when appointing directors 4. Right of institutional investors - Allowing voting rights for shares in funds managed by investment trust companies and bank trust accounts.
(4) Prohibiting Inappropriate Intra-Group Relations	1. Strengthening punishment on 'unfair' internal transactions 2. Revival of regulation on the amount of investing in related firms to 25% of net assets of a business group 3. Abolition of cross debt guarantee

Source: Tabulated from Sohn (2002) and Chang & Shin (2002).

outside directors and an independent auditor chosen by the shareholders. The outside directors actually cancelled two deals between firms in the group. In 1997 the Fair Trade Commission ordered the company to recover the subsidy provided to its affiliate, SK Logistics.

2. Changes in Control

The crucial characteristic of the *chaebols* is the concentration of ownership. The founding families of a *chaebol* group normally own a large share of the firms. The common practice in the management of *chaebols* is that the owners, who are often non-professional managers, have greater voting power than other shareholders and thus can exercise exclusive control of the firm. Moreover, it has been suggested that in these *chaebols* controlling shareholders exercise control in excess of their holdings through a hierarchical chain of ownership (Chang 2002). This is an example of the non-separation of ownership and management of *chaebols*.

Agency theories suggest two different predictions. One is, according to the convergence-of-interest hypothesis, that non-separation of ownership and management is beneficial to the performance of the firms because there is less conflict of interest between the two groups. The other prediction, based on the entrenchment hypothesis, is that the firm value decreases as managerial ownership increases, because managers—be they professional or the owners—hold a substantial share of the firm which would provide them with voting power that guarantees their employment with a handsome salary.[22] The two very different hypotheses, however, converge to an agreed conventional wisdom that the ownership structure affects firm performance or value.

Many previous studies have focussed on issues of concentrated ownership or non-separation of ownership and management. This paper, however, pays attention to another characteristic of *chaebols*—the single-nationality of ownership. Here the highlight is shed on what managerial aspects can be improved by making ownership multi-national.

The massive inflow of foreign capital after the financial crisis through cross-border M&As, privatization and the sale of KAMCO's assets brought big changes in corporate control and ownership. Foreign investment can have significant effects on corporate management, especially with respect to sharing control and power.[23] The experience of three companies, Hansol PCS, the Korean First Bank and Samsung Heavy Industry illustrate the point very well.

Hansol PCS, a mobile phone operator and a subsidiary of Hansol, a major *chaebol*, received investment from Bell Canada International and AIG, an American investment fund. The 38% of total outstanding shares of Hansol PCS was divided between the two investors. They consequently adopted "super majority voting rights," which gave minority shareholders enhanced power and gained about 33~49% of voting rights by electing four representatives to the board.

The Korea First Bank also came under foreign ownership. It was the largest bank in Korea in terms of assets and profits, but when it went insolvent in 1998 its non-performing loans were \$3.2 billion. Soon Newbridge Capital acquired 50.99% of shares and a foreign

22) Theories are well summarized in Cho and Chae (2002).

23) Case studied by Yun (forthcoming).

manager was elected the president and chief executive officer of the bank. The most important change in the Korea First Bank from the entry of foreign capital and management was the general reorganization of the bank involving the organizational structure redesigned after the western style division system, an employee reward mechanism, and new business strategy.

Volvo's acquisition of Samsung Heavy Industry significantly contributed to the management of the Korean firm. The so-called "flat management" introduced by Volvo reduced direct and indirect transaction costs by eliminating steps in the decision-making process.

VI. Assessment and Conclusion

The Korean economy has almost recovered to its pre-crisis level, judging from its macroeconomic performances. The GDP growth rate recovered to the pre-crisis level of 5.5% in 2001 from −6.7% in 1998. Foreign exchange reserves, owing to a trade surplus that has continued for the last four years, recorded to over $112.4 billion in June 2002 from $3.4 billion in December 1997. The foreign exchange rate appreciated to about 1,200 won to US$1.00 in June 2002 from 1,840 won in January 1998. In addition, the interest rate decreased to 5.4% from over 19.0%. Moreover, the unemployment rate dropped to 2.7%, from 6.8%. Owing to its rapid economic recovery, Korea was able to repay its IMF loans in August 2001; two years and eight months earlier than originally scheduled.

The sharp recovery of the post-crisis Korean economy can be best assessed and reflected in the various sovereign ratings of the global credit rating agencies. In March 2002, Moody's raised Korea's sover-

Table 7. Trends in Korea's Sovereign Rating

Company	Pre-crisis	During the crisis	Post-crisis
Fitch IBCA	AA-	B- (-12)	A- (+10)
S&P	AA-	B+ (-10)	A (+7)
Moody's	A1	Ba1 (-6)	A3 (+4)

Note: The numbers in the parenthesis denote the changed stages from the pre-crisis period for the 2nd column and from during the crisis period for the 3rd column.

Source: Ministry of Finance and Economy (2002b).

eign rating to A3, as seen in Table 7. This is a rise from Korea's rating of Ba1 in the crisis period, the lowest level it has ever received, and only two levels below the country's pre-crisis rating. Both S&P and Fitch IBCA also raised the sovereign rating to A- (2 levels below) and A (3 levels below) respectively.

In facilitating Korea's rapid economic recovery, structural reform, especially corporate restructuring, made a great contribution. In the *Article IV* consultation with Korea in February 2002, the IMF expressed its positive opinion in the "sustained implementation of its structural reform," saying that the Korean government's policy improved market discipline, along with macroeconomic fundamentals, and therefore the resilience of its economy.[24)] In the five years since the financial crisis, the financial situation of Korean corporations has greatly improved.[25)]

Table 8 lists various financial indicators that clearly show improvements. Both the debt-equity ratio and interest coverage ratio have shown improvements since the financial crisis. But these figures can be misleading guides of the viability and soundness of firms. The fall in debt-equity ratio might have been induced by the revaluation of equity, rather than by an actual reduction in debts. Also, the im-

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24) Ministry of Finance and Economy (2002).

25) On the other hand, it cannot be ignored that favorable external conditions—an information technology boom in the U.S. and a low interest rate in the world market between 1999 and 2000—also had positive impacts on the restoration of the Korean economy. Especially, the low interest rate in the world market gave the Korean government the leeway to steadily carry out economic restoration in spite of its low interest rate policy, evading the problem of capital outflow.

provement in interest coverage ratio may be due to the cut in interest rates after the financial crisis, particularly after 1999, rather than improved profitability.

Table 8. Financial Indicators

	1995	1996	1997	1998	1999	2000	2001
Debt-Equity Ratio	286.8	317.1	396.3	303.0	214.7	210.6	182.2
Ordinary Income to Sales	3.6	1.0	-0.3	-1.9	1.7	1.3	0.4
Operating Income to Sales	8.3	6.5	8.3	6.1	6.6	7.4	5.5
Return on Equity	11.02	11.03	2.02	-4.21	0.04	-5.8	0.02
Return on Assets	2.83	0.5	-0.93	-3.59	0.01	-1.9	0.01
Interest Coverage Ratio	149.6	112.1	129.1	68.3	96.1	157.2	132.6

Source: Bank of Korea, Financial Statement Analysis. various issues.

However, as discussed earlier, it is clear that the sharp increase in foreign capital in the form of FDI inflows, particularly in cross-border M&As, significantly contributed to successful corporate restructuring. Cash flows also improved through other channels: KAMCO's operations including international bidding, issuance of ABS, and sales to CRCs and AMCs[26]; cross-border M&As; and foreign inward privatization.

Also, it appears that various restructuring intermediaries, in particular KAMCO, have successfully resolved corporate debts. NPLs have continuously been purchased and cleared, and the share of remaining

26) International bidding, issuance of ABS and sales to AMCs and CRCs account for about one third of KAMCO's total operations.

NPLs to total has significantly decreased. In particular, the remaining NPLs to total credit was lowered below 5% in 2001. As of June 2002, KAMCO has recovered ₩27.7 trillion, or 113.5% of the purchasing value of NPLs, making profits of ₩3.3 trillion. Also as of June 2002, the remaining NPLs accounted for 43.3% of total NPLs. However, if Daewoo's NPLs are excluded, KAMCO's operations have been very successful, clearing almost three quarters of total NPLs.[27] Korea's performance in resolving corporate debts can be compared with other crisis-struck countries. While Korea has cleared three quarters of its total NPLs, Indonesia has cleared 9% and Malaysia 85%.[28]

The financial crisis and the consequent reform measures suggest some lessons. First, the importance of short-term cash flows and liquidity of the firms must be recognized. The objective of the firms and restructuring of the corporate sector should not focus only on conventional targets such as growth, productivity and profitability, but also on the efficient management of cash flows. Second, although the resolution of corporate debts has been successful, there should be continuous legal and institutional efforts to resolve the remaining NPLs. Third, the benefits and importance of foreign capital are now recognized. Thus both financial and corporate sectors must continue to attract more foreign capital, not only to reinforce the on-going corporate restructuring, but also to improve the viability and soundness of the corporate sector. Fourth, the changed corporate governance and ownership structure must successfully be linked to better corpo-

27) Daewoo's NPLs have remained uncleared following political difficulties.

28) The official figure for Korea is 40%, but as mentioned, the exclusion of Daewoo's NPLs leads to three quarters. Malaysia has recorded the highest rate among the crisis-ridden countries (Mako 2001a).

rate performance.

This paper has analyzed various corporate sector reforms encompassing corporate debt restructuring and corporate governance reforms and found two major factors behind this rapid rehabilitation of the Korean economy. They are the successful resolution of corporate debts and large inflows of foreign capital through such channels as cross-border M&As and privatization, which have improved, among other things, the cash flows of the corporate sector. Thus the conclusion of this paper is straightforward: First, the resolution of corporate debt has been satisfactory and successful. Second, foreign capital contributed significantly to effective corporate restructuring and debt resolution. However to reach a more concrete and solid conclusion, we need more detailed and in-depth research in identifying the precise channels through which corporate debts are resolved. As yet, comprehensive statistics and research on the role of foreign capital in corporate restructuring is still lacking; this current study may mark a starting point for a long journey.

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