The Second Forum for Asian Insolvency Reform (FAIR)

Bangkok, Thailand 16 – 17 December 2002

In partnership with

The Government of Japan

and

The World Bank

Hosted by the

The Ministry of Justice of the Kingdom of Thailand

Insolvency Law Reform of Korea: A Continuing Learning Process:
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1. Legislative History of Insolvency Law

1.1. 40 Years Experience in Insolvency Law and Practice

This year 2002 marks the 40th anniversary of the enactment of insolvency laws; Corporation Reorganization Act, Composition Act, and Bankruptcy Act. Insolvency laws, however, were not born with a yearlong expectation and labor pains. Though there was no urgent need in the market or in society, these laws were selected under the New Enactment Project in 1962. Without any in-depth research, corresponding Japanese statutes were translated into Korean. Even after the enactment, no serious study occurred to understand the provisions of the insolvency laws. As a result, legal rules in the insolvency laws were not internalized by lawyers.

Until the late 1990's, insolvency procedures were not applied frequently as the following table shows.

Year	Bankrupt Firms	Bankruptcy	Composition	Corporate Reorganization
1983	*	*	**2**	65
1984	*	*	2	52
1985	*	11	0	40
1986	*	26	0	26
1987	*	20	0	30
1988	*	21	2	26
1989	*	37	0	27
1990	4,107	27	0	15
1991	6,159	16	0	64
1992	16,769	14	0	89
1993	9,502	26	0	41
1994	11,255	18	0	42
1995	13,992	12	13	79
1996	11,589	18	9	52
1997	17,168	38	322	132
1998	22,828	467	728	148
1999	6,718	733	140	37
2000	6,693	461	78	32
2001	5,277	842	51	31

1.2. Attitudes Toward the Debtor

Traditional Korean law had a provision for penal punishment against insolvent debtors until 1910. Upon the sudden adoption of the western legal system in the early 1900's, insolvent debtors were not treated as criminals anymore. When the Bankruptcy Act was enacted in 1962, the notion of discharge was first introduced.

Public sentiment, however, could not follow the change of legal principles. Until the 1950's, Korea was a rural society. Even after Korea entered into an industrial society in the 1960's, Korea did not suffer from serious economic depression. For these reasons, Koreans had no experience dealing with innocent insolvent debtors. It was as late as 1999 when the court rendered the decision of discharge for the first time.

As the government did not strictly prosecute corporate related crimes, the public developed a negative orientation and mistrust towards the management of failed firms, especially those of large companies when they did something wrong, such as embezzlement. There was a Korean saying in the 1970's that "the Owner/CEOs are not bankrupt even though their companies go bankrupt." Moreover, during the period of rapid economic development, unjust profit-making increased negative judgments against management.

In the midst of economic turmoil after the crisis in 1997, Koreans came to recognize that the bankrupt could be innocent. Some bankrupts have raised their voices for a fresh start. Liberal lawyers have proposed pro-debtor provisions in the law. Moral hazard, however, is one of the most frequently cited pieces of jargon these days.

1.3. The Infrastructure of Insolvency Law and Practice

Entering into an industrial society based on free competitive market principles in the 1960's, Korea had a relatively immature market of assets, capital, and companies. A reliable accounting system was not well established either. These weak infrastructures have hindered corporate restructuring both in as well as out of court.

The judicial system has been much more reliable. Within the public sector, judges have demonstrated most excellence and least corruption. The public has paid relatively high respect to the court.

One particular feature in the civil process is the open structure of the compulsory execution of claims. When a creditor files a compulsory execution against a debtor's property, other creditors can join the distribution of proceeds according to their own priority. Thus, other creditors do not have to apply for the bankruptcy procedure to collect their claims collectively as in many other jurisdictions.

2. The Economic Background of Insolvency Law

2.1. Government Intervention into Corporate Exit Mechanisms

Korean industrialization started with a Five-Year Economic Development Plan. Government selected the industry that the nation needed in the light of the industrial policy, provided resources through loans to the selected industry, and chose the firms that ran the selected industry under the Plan. Every large firm had direct or indirect support from the government.

When some of those firms went insolvent, it was not only a matter of business failure. The government had to face political responsibility and the partial failure of industrial policy. It intervened into corporate failures and played a central role as far as large firms were concerned through such instruments as:

- Arrangement for Ailing Firms in 1969
- August 3 Presidential Emergency Economic Decree to freeze every outstanding debt
- Industrial Rationalization Measure from mid 1970s through 1980s
- Cooperative Loan Scheme in 1997
- Deferred Nonpayment Declaration Accord (Anti-*budo* Accord) in 1997
- Workout Accord in 1998
- Corporate Restructuring Promotion Act in 2001

Such interventions by the government created a myth of “too big to fail.” Whenever large firms were shaken, the government worried about the impact of their failure on the whole economy. Rescue loans were frequently mentioned when a big firm or an industry in general suffered from financial difficulties. As a result, the public got the notion that a big company could not fail. This myth taught negative lessons to the market. The moral hazard of creditor banks as well as debtor firms was inevitable.

2.2. Government-led Banking

There are two aspects to the government relationship with banks--the largest shareholders and the regulator. The government thought of the banks not as a profit-making industry but as a tool providing resources according to government plans. It did not want banks to compete with each other, but rather for banks to be subservient to economic and political purposes.

The government nominated CEOs of banks even after the 2nd privatization when the government was no longer the largest shareholder. CEOs were more concerned with government policy and political intentions than the profits of banks. Banks had not played their normal functions in the money market as risk assessors and resource distributors.

3. Economic Crisis and Reform Projects

3.1. The Transparency Issue in the 1998 Amendment

A study by the Ministry of Economy (not by the Ministry of Justice) to improve the insolvency law started before the economic crisis of 1997. The strongest complaint concerned the criteria for the commencement of corporate reorganization which were not clear. At that time the court applied a public interest test for commencing the procedure. The public interest test, at least to some, was a rubber band.

Economists developed an economic test, which means to compare liquidation value with going-concern value. They rather preferred mechanical decision-making without courts' discretion. The 1998 amendment, completed three months after the crisis, fully adopted the economic test. If the liquidation value exceeded the going concern value, the court should stop the reorganization procedure and adjudicate the firm bankrupt even though the majority of creditors wanted to stay within reorganization procedures.

3.2. The Issue of Expediency in the 1999 Amendment

During the 1997 crisis, the government promised international financial institutions that it would slim down insolvency laws. The major issue became one of expediency. Although the actual time span in the reorganization procedure of Korea was not bad in comparison with other countries, there were still many who believed that the Korean procedures were very slow.

To expedite the reorganization procedure, the 1999 Amendment provided that the commencement decision should be made within one month from the application. For that purpose, the commencement criteria shrunk to nominal requirements.

3.3. The Workout Issue in the 2001 Amendments

Even though the Ministry of Economy initiated insolvency law reform, it still had doubts about entrusting large ailing firms to the hands of courts. On the edge of a domino effect, the government forced financial institutions to establish an accord for out-of-court workout process in June 1998.

The legal nature of the Workout Accord raised two onerous issues for the government. As the Workout Accord was a contract among domestic financial institutions, most foreign creditors tended to hold out. The judicial corporate reorganization procedure could be a threat to holdouts and also offered an inevitable alternative to the workout. In case of the corporate reorganization procedure, however, the Workout Plan could not be enforced. Moreover, new money injected in the course of the workout could not be repaid with high priority.

To solve these problems, the Ministry of Finance and Economy (MOFE) tried to amend the Corporate Reorganization Act so that the workout plan could be turned into a corporate reorganization plan upon the application for the procedure and so that new money

would earn high priority retrospectively. MOFE, however, faced strong criticism. Lawyers could not tolerate the application of contracts to third parties and things already done.

The final result after those struggles was to facilitate the ability of the creditors to submit the workout plan as a reorganization plan in the corporate reorganization procedure. The law now provides that the agreement among some creditors made in advance of corporate reorganization is to remain effective among the parties.

3.4. The Consolidation Issue in 2002 Reform

Continuous demand from domestic and international circles has continued for a consolidation of the three insolvency laws into one single insolvency law. Although insolvency practice has been much improved since 1998, negative estimations have prevailed not only because observers were not aware of recent changes but also because they did not know the genuine reasons for inefficiencies. Anyway, the government promised to international organizations that it would fundamentally reform the insolvency laws.

Different views have been expressed about the reform. Most economic policy makers, politicians and journalists blame out-of-date and inadequate insolvency laws for the problems they observe. They seem to believe that insolvency law reform is all that is needed for successful restructuring. Lawyers, however, in general do not agree with the criticisms. They find the real cause of inefficiency in the disinterest and poor judgment of creditors. They are angry about frequent amendments—four times in five years.

There can be three options for consolidation: (1) multiple statutes and multiple procedures; (2) a single statute with multiple procedures; and (3) a single statute with a single procedure. In theory, a “chemical” merger has been advanced as the best solution. But there is a strong demand for a rehabilitation procedure. Nobody has put the case for commencing on a single track before knowing whether the final procedure will be rehabilitation or liquidation. Drafters were not ready to persuade the legislators to enact a single-track system. A multiple track under the one statute is now the solution.

The draft is at the final polishing stage in the Ministry of Justice, which is in charge of insolvency law drafting. The new draft is scheduled to be proposed this year to the Congress.

4. The New Draft of the Consolidated Insolvency Law

4.1. Basic structure

The legislative goal of the new draft, though not yet officially endorsed, is to produce an insolvency law that is easy-to-use, hard-to-cheat and restructuring-friendly. It makes one single rehabilitation procedure out of the current separate corporate reorganization procedure and composition procedure. Bankruptcy procedure is by and large left intact as in the current Bankruptcy Act. Special consideration has been given to consumer bankruptcy

and cross-border insolvency.

Composed of 658 Articles, the new draft has five chapters:

1. General provisions
2. Rehabilitation procedure
3. Bankruptcy procedure
4. Individual rehabilitation procedure
5. Cross-border insolvency procedure

Each procedure has its own door, so applicants choose the procedure they want. Transfer is possible from one procedure to another.

4.2. Rehabilitation Procedure

For successful restructuring, drafters believe that early application for the procedure is central. To induce early entry into rehabilitation procedure, the new draft makes some important changes. Though it maintains the trustee system instead of adopting a debtor-in-possession (DIP) system, it enlarges the possibility for incumbent management to maintain control over the firm. It also lessens the economic test, which compares liquidation value with going-concern value. Under the current law, the court renders its dismissal decision in the middle of a reorganization procedure whenever the court finds that liquidation value is greater than going-concern value. Moreover, upon the decision of dismissal, the court should judge the applicant bankrupt in some situations. Under the new draft, this economic test, however, is applied strictly only when the court approves the reorganization plan. And the court provides mandatory bankruptcy adjudication only when the rehabilitation case is dismissed after the approval of the plan.

After heated discussion, the automatic stay has not been adopted. There are technical problems, including the drafting of exceptions and the scope of the stay, and conflicts with bounced check regulation. The new draft also reflects negative public sentiments that debtors can be legitimately protected from non-payment by their simple application. Another hindering factor is the absence of comparative examples in civil law countries.

The rehabilitation procedure is open to any legal entity—corporations, natural persons, and unincorporated organizations.

4.3. Individual Rehabilitation Procedure

Many nations must cope with consumer bankruptcy problems, to which Korea is no exception. Two typical factors make the situation worse than in other countries. One concerns personal guarantees for the debts. It has been a long tradition in Korea to endorse private loans for friends and family without any compensation. The other concerns credit cards. As credit card companies have given too much credit too easily, many young consumers go bankrupt increasingly.

Applicants for the individual rehabilitation procedure should have regular incomes. After examining the financial situation, the court can directly approve a rescheduled payment plan without the consent of creditors. The payment plan, which can be as long as 5 years, should provide creditors more than what they would get in liquidation. Upon the successful implement of the plan, the debtor is discharged completely.

There is, however, strong criticism against this scheme. On grounds of “moral hazard”, opponents offer a long list of criticisms: social punishment for extravagance, balancing concerns for the person who repays his or her debts with hard working persons, and the issue of constitutionality over the lack of creditors consent, not to mention the prospect of a possible credit crunch. Deliberation at the Congress might make some changes on these matters. It would be an appropriate opportunity for the nation to think over the issues of bankrupt and especially the fresh start with a view to working towards a new consensus.

4.4. Cross-border Insolvency Procedure

The new draft bases its cross-border insolvency procedure on the UNCITRAL Model Law. It discards the current principle of territoriality. In in-bound foreign insolvency cases, the foreign insolvency representative can apply for the recognition of foreign insolvency procedures to the Insolvency Division of Seoul District Court (it has the exclusive venue on the cross-border insolvency cases). The new draft, however, does not make legal effects automatically rendered upon recognition as in Article 20 of the Model Law.

At the same time or after the application for the recognition, foreign representatives also can apply for a temporary protection order or to support recognized foreign insolvency procedures, which include stay of any legal actions against debtors’ property, receivership over the debtors’ property, realization and distribution.

In out-bound cross-boarder cases, the new draft empowers the court-appointed trustee to act on behalf of the debtor in foreign courts. For coordination between courts and trustees (or representatives), it provides direct communication with foreign courts and/or foreign trustees. If necessary, the court can allow the trustee to make an accord with foreign trustees. The court will consider what a creditor has received in foreign insolvency procedures when it decides the amount of distribution.

5. The Long Learning Curve

We ardently learn when we have an urgent need. We can learn effectively when we experience the problems in actual situations. We learn most easily when a issue is just a step away and not far off. These principles of learning are to be applied when a nation learns and develops insolvency law and practice.

Though Korea had insolvency laws for the first time in 1962, they were not ours. They were not the products of our agony and struggle. They were just strange written letters. Few

lawyers paid attention to the insolvency laws because there were few cases applied.

The Korea Development Bank was an exceptional entity which was relatively well acquainted with the laws because it had business in corporate reorganization procedures as a big lender. Only a handful of practicing lawyers handled insolvency cases and judges, on average, saw only one insolvency case during their tenure until 1980s. Entering into 1990s, the Supreme Court increasingly paid attention to insolvency cases as the importance of the cases were realized in public.

Legislative history shows that insolvency law most often grows during economic depression since that is the time when learners see an urgent need and suffer from actual problems. Without inside struggle, nothing can be internalized. What is most necessary is not just a “good answer” or a “right answer.” Teacher can give such answers, but students know only what they find for themselves. What matters is how faithfully students try to solve problems.

As there have not been enough political debates and consensus-making on policy issues, we still have many unresolved and conflicting demands, such as rehabilitation first versus liquidation first, or creditor-centered procedures versus a more active role of courts in insolvency procedures, and trustees versus debtors-in-possession. During the process of drafting, debates on these issues were done on a small scale. When the new draft was announced, it was a hot issue covered by the press.

Insolvency law is no longer a set of strange written letters. It is now a living legal rule discussed not only by lawyers but also by journalists, politicians and even normal citizens. The new draft would be the first insolvency bill deliberated by the Congress under such public scrutiny. Consensus building, which is essential to make policy choice, seems to be possible in this stage. At the next stage, we may concentrate on the pure legal issues more than policy issues.

Though the contents of the new draft might still be a little way from good answers or right answers, it is the product of “our” agony and struggle. Our journey of learning insolvency law does not end and will not end forever. The new draft is the project report submitted by drafters to the people and international society in the midst of our journey of learning