Organisation for Economic Co-operation and Development

Organisation de Coopération et de Développement Économiques

in co-operation with

the Korea Development Institute

and with the co-sponsorship of the Government of Japan and the World Bank

Conference on

"CORPORATE GOVERNANCE IN ASIA: A COMPARATIVE PERSPECTIVE"

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Corporate Restructuring in Korea and Thailand

Seoul, 3-5 March 1999

DISCUSSION OUTLINE

This discussion covers corporate restructuring incentives, processes, and initial results for Thailand and Korea. It draws particular attention to links between court-supervised and voluntary corporate restructuring; issues raised by voluntary debt restructuring; the need for debt/equity swaps; and potential mechanisms to exit or manage converted equity.

Thailand

Thailand's approach to corporate restructuring has emphasized positive incentives to encourage corporate restructuring. These include the following:

- *Provision of an option for court-supervised reorganization.* Until mid-1998, Thailand's 1940 Bankruptcy Act had provided only for court-supervised liquidation.
- *Temporary tax relief for debt restructuring.* For a two-year period – from 1 January 1998 until 31 December 1999 – losses from debt restructuring could be deducted by financial institution creditors and gains to the debtor would not represent taxable income.
- *Financial sector regulation and re-capitalization.* In early 1998, Bank of Thailand (BOT) regulations gave financial institutions until year-end 2000 to recognize all losses from corporate debt restructuring. Moreover, a restructured loan classified as non-performing could be re-classified as performing once the debtor successfully services the restructured loan for 3 successive months. Subsequently, in its August 14th financial sector reform program, the Government committed Baht300 billion for re-capitalization of the financial sector and linked the provision of public funds for Tier 2 re-capitalization to successful corporate restructuring and increased business lending.
- *Liberalization of rules on foreign investment and property ownership.*
- *Adoption of the "Bangkok rules" for voluntary corporate restructuring.*

Negative incentives – i.e., punishment for failure to service debt or cooperate with voluntary workout efforts – remain weak. Court-supervised liquidations are not being pursued. Foreclosure procedures are uncertain and can take 5+ years to conclude. While replacement of management's proposed planner as part of a court-supervised reorganization might encourage voluntary out-of-court cooperation, two-thirds of creditors would need to agree on replacing the insolvency planner proposed by management. Weak negative incentives have given rise to "strategic defaulters" – those who have the liquidity to service debts but refuse to do so. Their refusal may reflect debtor desires to enhance their bargaining position, hopes of driving the creditor out of business, or concern about their competitive position and future access to working capital.

Process responses in Thailand have focused on monitoring, facilitation, and efforts at arbitration. The Bank of Thailand is upgrading its capacity to monitor NPLs, monitor progress in high-priority cases, and respond proactively (e.g., by instructing major creditors to convene debtor/creditors meetings) to insufficient progress. Associations representing creditors and debtors have formed a Corporate Debt Restructuring Advisory Committee (CDRAC) under BOT auspices to liaise with debtors and creditors in order to encourage progress and to identify legal, regulatory, or procedural

impediments to progress on corporate restructuring.[1] Recognizing that agreement among major creditors is a prerequisite for voluntary corporate restructuring, financial institution creditors and their trade associations are exploring avenues for arbitrating or otherwise resolving differences among themselves in particular workout cases. Foreign banks, which have substantial exposure to Thai corporates, may differ from Thai institutions in their willingness to take losses. Nevertheless, there is some agreement among financial institutions that 75 percent is a reasonable threshold for creditor agreement on a voluntary workout and that cases where there is 50-75 percent agreement could be submitted to a three-person arbitration panel – at least on a case-by-case basis.[2]

By year-end 1998, non-performing loans at 13 Thai banks had reached Baht2.4 trillion – or 54 percent of outstanding loans.[3] A large number of smaller loans to businesses and individuals account for about half of these NPLs, as indicated in Table 1.

Table 1. YE98 NPLs at Thai Banks

Loan Size	Number of Cases	Percent of NPLs
Over Baht 500 million	300	25%
Baht 100-500 million	1300	25%
Under Baht 100 million	Almost 500,000 (including 40,000 firms)	50%

Source: BOT

Recent developments suggest that Thailand is beginning to make progress on corporate restructuring. On February 2nd, creditors approved the first court-supervised reorganization – for Alphatec, which will be taken over by AIG and Investor (Sweden). By late February, voluntary restructurings had been announced for UCOM ($570 million in debt) and negotiations were complete (or nearly so) for TPI ($3 billion in debt) and Sri Thai ($120 million in debt). Box 1 summarizes key terms of the UCOM deal. According to the BOT, negotiations have been completed on 53 of 200 high-priority cases. It is also noteworthy that Thailand attracted $7.6 billion in foreign direct investment in 1998, including $5.5 billion for industry and $2.1 billion as part of bank recapitalizations. This substantially exceeds the 1997 total of $3.6 billion. While the progress on larger cases is encouraging, the composition of NPLs indicates a greater need for Thai banks to address SME indebtedness.

[1] CDRAC is chaired by the BOT Governor and includes representatives from the Board of Trade, Federation of Thai Industries, Thai Bankers' Association, Association of Finance Companies, and Foreign Bankers' Association.

[2] Arbitration procedures are still under consideration. A financial institution creditor could agree, for instance, to allow an arbitration option for all cases or for specified cases.

[3] *Bangkok Post*, 26 February 1999.

Box 1. Voluntary Restructuring of UCOM

Twenty-eight major creditors have agreed with UCOM management to restructure $570 million in debt. $120 million in convertible bonds will be converted into equity. As a result, these creditors will hold 43 percent of UCOM's shares while current controlling shareholders will be diluted from 40 percent to 22 percent. The remaining $450 million in debt is to be paid off by year-end 2003. The agreement contains additional convenants limiting the liabilities/equity ratios of affiliated companies (including the local participant in the Iridium consortium); require operating cash flows to equal or exceed interest expense after 31 December 2001; and limit dividend payouts until this restructuring has been fully implemented.

Source: Bangkok Post

Korea

Reform bills passed by the National Assembly in February 1998 included many positive incentives to promote corporate restructuring. E.g.,:

- *Tax Exemption and Reduction Control Act* – provides tax breaks for company restructuring, including exemption of SMEs from capital gains on the sale of real estate used to repay debt to financial institutions and for real estate transfers through M&A transactions.
- *Bank Act* – increases the limit on bank ownership of a corporation's equity from 10 to 15 percent, or higher with Financial Supervisory Commission (FSC) approval.
- *Corporation Tax Act* – advances non-deductability of interest on "excessive" debt from 2002 to 2000.
- *Foreign Direct Investment and Foreign Capital Inducement Act* – permits takeovers of non-strategic companies by foreign investors without government approval and raises from 10 percent to 33 percent the shares that a foreign investor can acquire without board approval (subsequently further liberalized).
- *Antitrust and Fair Trade Act* – prohibits any new cross guarantees and eliminates existing cross guarantees by March 2000.

In addition, the FSC has maintained relatively relaxed rules on accounting for restructured debt. These have made it easier for Korean banks to negotiate substantial rate reductions and conversions of debt into equity or low-yield convertible bonds.

Negative incentives punishing failure to service debt or cooperate with voluntary restructuring include a credible threat of bankruptcy/foreclosure and Fair Trade Commission (FTC) investigations of intra-chaebol transactions. In February 1998, the National Assembly passed three measures to reform Korea's insolvency regime:

- *Bankruptcy Act* – concentrates authority over insolvency cases in district courts.
- *Composition Act* – introduces an administrator for asset preservation, requires debtors to report on implementation, and requires creditors to evaluate debtor implementation.
- *Reorganization Act* – establishes expedited deadlines, promotes specialization within the courts, and strengthens creditors by recognizing creditors' committees.

Even prior to these reforms, the deterrent effect of bankruptcy/foreclosure was established as a result of 13 chaebol insolvencies which occurred in 1997. Including such large cases as Kia and Halla, these 13 cases cumulatively involved about W47 trillion in assets and W28 trillion in debt. In at least ten of the cases listed in Table 2, the chaebol was placed under court receivership which typically involves replacing management with a court-appointed adminstrator. Such examples involving loss of control and ownership can provide a powerful example and incentive for other companies to cooperate with voluntary workout efforts.

Table 2. Insolvent Chaebol

(in Won billions)

Chaebol	Assets	Debt	Status
Hanbo	4,470	4,091	Court receivership; sale underway
Sammi	2,515	875	Court receivership
Jinro	3,898	1,917	Composition
Daenong	1,759	1,172	Court receivership
Hanshin Construction	1,326	502	Court receivership
Kia	14,186	6,624	Sold to Hyundai
Ssangbangwool	1,420	595	Court receivership
Taeil Media	1,102	588	Composition
Haitai	3,397	3,046	Court receivership; sale underway
New Core	2,803	1,215	Applied for court receivership
Soosan Heavy	1,267	639	Court receivership
Halla	6,627	6,453	Court receivership
Chunggu	1,897	728	Court receivership
Total	**46,667**	**28,445**	

Source: Goldman Sachs, YS Jung

In addition, the FTC has conducted two rounds of investigating transactions among the affiliates of Top 5 chaebol: 80 affiliates in the first round and 40 in the second. The FTC imposed penalties of W72 billion in the first round and W21 billion in the second. In the first round, the FTC found over W4 trillion in improper transactions. According to the FTC, these included unfair support to affiliates through the purchase of commercial paper and subordinated debt at below-market rates (i.e., above-market prices) and payment of above-market prices for rent and real estate.

The Government has used or supported a number of processes to promote corporate restructuring. While Lead Banks are responsible for leading voluntary workout efforts, the FSC indirectly drives corporate restructuring through its powers to regulate and supervise Korean financial institutions. At FSC's encouragement, 210 financial institutions entered into a Corporate Restructuring Agreement in July 1998, which requires the following:

- Conclusion of voluntary workout agreements within 3-6 months after an initial standstill;
- Selection by CRA signatories of a 7-person Corporate Restructuring Coordination Committee to arbitrate inter-creditor disagreements;
- Establishment of a 75 percent threshold for creditor approval of any voluntary workout;
- Submission of proposed workouts that lack 75 percent approval to the CRCC for arbitration; and

- Significant penalties for violation of the CRA, including failure to honor CRCC arbitration decisions.

Additional examples of indirect promotion by the Government of corporate restructuring include FSC requirements for each chaebol seeking a new loan or a loan roll-over to develop and implement capital structure improvement program (CSIP), for banks to identify and exit from non-viable chaebol affiliates,[4] and for financial institutions to limit their holdings of chaebol debentures and commercial paper. Government proposals for the sale or merger of Top 5 affiliates in sectors suffering from over-capacity (i.e., the "Big Deals") represent an attempt at more directly influencing corporate restructuring.[5]

Table 3 summarizes identifiable large corporate restructuring as of YE98. Over $61 billion in chaebol restructuring transactions were completed or – in the case of insolvent chaebol still under court supervision – underway as of YE98. This total excludes labor reductions and other cost savings that would subsequently appear on income statements. Of the $61 billion, about one-third represents the debt of insolvent chaebol,

Table 3. Summary of Selected Chaebol Restructuring

(in $ billions)

Chaebol #	**Share of YE97 Assets**	**Debt in Court-Supervised Insolvencies** (1997)	***Voluntary Restructuring***			**Total**
			Business & Asset Sales *(9 mos. 1998)*	Equity & Bond Issues *(6-9 mos. 1998)*	Troubled Debt Restructuring *(Oct-Dec 1998)*	
Top 5	57%	0.0	2.6	12.8	0.0	15.4
6-64	43%	20.3	5.0	3.2	17.5	46.0
Total	**100%**	**20.3**	**7.6**	**16.0**	**17.5**	**61.4**

Source: Goldman Sachs and author's estimates

which has been resolved (e.g., the sale of Kia to Hyundai) or is proceeding under court supervision, while the remaining two-thirds has occurred as a result of voluntary restructuring. Although the 6-64

[4] In June 1998, banks identified 55 chaebol affiliates as non-viable and designated for exit.

[5] These sectors are: oil refining, petrochemicals, aircraft, rolling stock, marine engines, power generation facilities, semiconductors, automobiles, and electronics.

chaebol held only 43 perecent of YE97 assets, the 6-64 chaebol account for three-quarters of corporate restructuring transactions. All 13 chaebol insolvencies, representing W28.4 trillion ($20.3) in debt, have occurred among the 6-64 chaebol. The 6-64 chaebol accounted for 66 percent of business/asset sales for the first 9 months of 1998 and all of the troubled debt restructuring agreed under CRA procedures. Thus it appears that the Top 5 have managed to float over Korea's corporate distress. Indeed, the Top 5's ability to absorb 80 percent of the proceeds from bond and equity offerings during the first – respectively – 6 and 9 months of 1998 suggest that the Top 5 will emerge from the crisis in a stronger position vis-à-vis the 6-64 chaebol.

Troubled debt restructuring under CRA provisions represents about 45 percent of voluntary restructuring in 1998. Almost all of the CRA workouts have been concluded since October. Approximately W24.5 trillion ($17.5 billion) in the debt of 31 affiliates from 12 chaebol plus 19 other companies was restructured in these deals. Table 4 summarizes the application of alternative debt restructuring methods in these deals to the different types of pre-workout debt.

Table 4. Troubled Debt Restructuring Through YE98

Method	**Portion of Total Debt Restructured**	**Application**
Rate Reduction	69%	Secured debt
Debt/Equity Conversion	5%	Unsecured debt
Conversion to Convertible Bonds	7%	Unsecured debt
Interest Exemption	15%	Cross guaranteed debt
Forgiveness of Principal	2%	Cross guaranteed debt
Term Extension	2%	Various
	100%	

Source: Author's estimates

As indicated above, just over two-thirds of CRA debt restructuring involves rate reductions – typically from about 16.5 percent to prime – along with deferrals on principal repayment and deferral/capitalization of interest payments. Another 12 percent represents conversion of debt into

equity or into low-yielding convertible bonds (CBs). Only 2% of the troubled debt has been forgiven. Thus, it appears that debt forgiveness has been the last resort while conversion of debt into equity or CBs has been the next-to-last resort.

Debt/equity swaps are expected to significantly dilute controlling shareholders. At one chaebol, the equity interest of controlling shareholders may be cut from 30 percent to 2-3 percent. At another, the equity interest of controlling shareholders in two remaining affiliates could be reduced from 50-58 percent to 25 percent.[6]

In many or all of these debt/equity swaps, it appears that all new financial institution shareholders would have to agree before any could sell converted equity. It is argued that this is necessary to protect the controlling equity interests acquired by banks and to preserve a share block for potential sale to a strategic investor. But this practice also serves to obscure the value of non-tradeable converted equity and insulate management from potentially activist investors. Banks seem inclined to not interfere so long as current managements meet quarterly business targets.

A final issue has to do with accounting for restructured debt. Lenient provisioning regulations have encouraged banks to undertake initial debt restructuring. Especially now that initial debt restructuring deals have been completed, it would be appropriate to tighten regulations on accounting for restructured debt.

Inevitability of Debt/Equity Swaps

While operational restructuring (e.g., business and asset sales) and equity-raising efforts have been significant, the corporate debt overhang and the saturation of asset and equity markets have made debt/equity swaps inevitable. It is simply not feasible to reduce leverage to sustainable levels in a timely manner through business/asset sales and new equity issues alone. Table 5 summarizes one set of projections on the challenges Top 30 chaebol would face in climbing down from mid-1998 leverage to a liabilities/equity ratio of 200 percent by YE99.

Table 5. Projected Change in Top 30 Leverage

(amounts in Won trillion)

[6] Actual dilution will depend on market prices for these shares at the time of conversion.

	Assets	**Liabilities**	**Equity**	**Leverage**
At 6.30.98	***435***	***360***	***75***	***478%***
Incremental effects:				
Asset/business sales	(26)	(26)		
New equity issues		(10)	10	
FX effects	(6)	(6)		
Big Deals and exits	(34)	(34)		
Remaining at 12.31.99	***369***	***284***	***85***	***334%***

Source: Goldman Sachs

Assuming the projections in Table 5 represent the maximum amounts that can be raised from asset sales and new equity issues, substantial debt/equity conversions and/or debt forgiveness would be required to reach liabilities/equity ratios of 200 percent.

Mechanisms to Exit or Manage Converted Equity

Whether or not debt/equity swaps are inevitable, Korean financial institutions are in fact becoming major corporate shareholders. Debt/equity swaps feature prominently in the 12 chaebol restructurings negotiated under CRA auspices as of YE98.

Financial institutions in the region are stressed enough without having also to manage the follow-on operational restructuring of corporations in which they hold shares and to exercise effective corporate governance. This suggests a need for mechanisms by which financial institution shareholders in

distressed corporates can exit from or more effectively manage converted equity. Exit/management options include the following:

- Pre-conversion sale of distressed debt;
- Sale of converted equity;
- "Warehousing" of converted equity in a vehicle (e.g., trust or partnership) managed by professionals appropriately compensated on an incentive basis; or
- Retention by Standing Ex-Creditors Committee of advisors to maximize the value of converted shares and to oversee corporate management.

The apparent inevitability of debt/equity swaps and the fact that swaps are underway heightens the urgency of developing effective exit/management mechanisms.

It is also important to develop norms and regulations for financial institution accounting for converted equity and for related-party transactions (e.g., lending) between financial institutions and corporations in which these financial institutions hold shares.

General Conclusions

1. Realignments of ownership structures are occurring as a result of insolvencies, business sales, foreign investment, new equity issues, debt/equity swaps, and spin-offs.

2. The volume of corporate distress necessitates heavy reliance on voluntary workouts. Reliance solely on court-supervised insolvencies would otherwise overwhelm existing institutional capacity (e.g., courts, administrators, insolvency professionals).

3. Positive incentives (e.g., tax breaks, liberalization of foreign investment) are not enough to induce an adequate volume of voluntary corporate restructuring on a timely basis.

4. A credible threat of court-supervised insolvency (including ready replacement of management) and foreclosure encourages debtors to cooperate with voluntary restructuring.

5. Direct government pressure on debtors (e.g., investigations of related-party transactions for violating the rights of public shareholders) and indirect pressure by supervisors via financial institutions (e.g., Capital Structure Improvement Plans and mandated exits) can encourage voluntary restructuring.

6. Substantial debt/equity swaps are inevitable given the magnitude of corporate indebtedness and the saturation of asset and equity markets. Such next-to-last resort transactions can buy time to do more fundamental operational restructuring and more "up market" corporate finance transactions.

7. Ongoing debt/equity swaps are creating an immediate need for exit/management mechanisms for the financial institutions that are becoming holders of converted equity. In addition, debt/equity swaps raise accounting and other prudential regulatory issues for financial institutions. These issues should be addressed in a timely manner so as to support ongoing corporate restructuring, enhanced corporate governance and competitiveness, and avoidance of future corporate crises.