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2011 Modularization of Korea's Development Experience:

Crisis and Corporate Insolvency

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MINISTRY OF STRATEGY AND FINANCE

KDI Korea Development Institute

2011 Modularization of Korea's Development Experience:

Crisis and Corporate Insolvency

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Crisis and Corporate Insolvency

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Preface

The study of Korea's economic and social transformation offers a unique opportunity to better understand the factors that drive development. Within one generation, Korea had transformed itself from a poor agrarian society to a modern industrial nation, a feat never seen before. What makes Korea's experience so unique is that its rapid economic development was relatively broad-based, meaning that the fruits of Korea's rapid growth were shared by many. The challenge of course is unlocking the secrets behind Korea's rapid and broad-based development, which can offer invaluable insights and lessons and knowledge that can be shared with the rest of the international community.

Recognizing this, the Korean Ministry of Strategy and Finance (MOSF) and the Korea Development Institute (KDI) launched the Knowledge Sharing Program (KSP) in 2004 to share Korea's development experience and to assist its developing country partners. The body of work presented in this volume is part of a greater initiative launched in 2007 to systemically research and document Korea's development experience and to deliver standardized content as case studies. The goal of this undertaking is to offer a deeper and wider understanding of Korea's development experience with the hope that Korea's past can offer lessons for developing countries in search of sustainable and broad-based development. This is a continuation of a multi-year undertaking to study and document Korea's development experience, and it builds on the 20 case studies completed in 2010. Here, we present 40 new studies that explore various development-oriented themes such as industrialization, energy, human capital development, government administration, Information and Communication Technology (ICT), agricultural development, land development and environment.

In presenting these new studies, I would like to take this opportunity to express my gratitude to all those involved in this great undertaking. It was through their hard work and commitment that made this possible. Foremost, I would like to thank the Ministry of Strategy and Finance for their encouragement and full support of this project. I especially would like to thank the KSP Executive Committee, composed of related ministries/departments, and the various Korean research institutes, for their involvement and the invaluable role they played in bringing this project together. I would also like to thank all the former public officials and senior practitioners for lending their time and keen insights and expertise in preparation of the case studies.

Indeed, the successful completion of the case studies was made possible by the dedication of the researchers from the public sector and academia involved in conducting the studies, which I believe will go a long way in advancing knowledge on not only Korea's own development but also development in general. Lastly, I would like to express my gratitude to Professor Joon-Kyung Kim for his stewardship of this enterprise, and to his team including Professor Jin Park at the KDI School of Public Policy and Management, for their hard work and dedication in successfully managing and completing this project.

As always, the views and opinions expressed by the authors in the body of work presented here do not necessary represent those of KDI School of Public Policy and Management.

May 2012

Oh-Seok Hyun

President

KDI School of Public Policy and Management

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Summary

The 1997 financial crisis is a landmark for change in the methods of corporate restructuring in Korea. During the high-powered growth era prior to the event, the government had been in the center of both resource allocations and distress resolutions. With an advantage in information over the private sector, government authorities had engaged in the operational details of corporate businesses for the purpose of expediting economic development in a short period of time. This strategy had been very successful, yielding over 7 percent real annual growth for nearly 40 years with few serious catastrophes.

The 1997 crisis ended this prosperous era, exposing various systemic problems within the economy. With the high ratios of debt to equity, Korean corporations were expected to yield high profitability on their equity. However, the corporate sector had become less and less profitable since the early 1990s. The return on capital, on average, had been lower than its opportunity cost for almost ten years before the crisis. In the meantime, Korean financial institutions were not able to properly control and absorb borrowers' risks. More problematic was the lack of understanding about the seriousness of both corporate and financial distress inside the policy-making entities, especially for the financial supervisory authorities. Under these circumstances, it became a key issue to reform both troubled financial institutions and corporations and create a different structure than the past. The relevant stakeholders started to move into the limelight, while the government remained behind the scenes. Market principles thus became more important than government discretion.

Financially distressed companies that are incapable of servicing debts for a significant amount of time are subject to corporate restructuring. Depending on the causes and depth of their delinquency, the creditors choose various combinations of restructuring strategies, including debt rescheduling, change in core businesses, employment adjustment and management and/or ownership reshuffling. It is desirable that consensus from all relevant stakeholders is the basis for these decisions, but practically, in most cases, there exist leading groups who take the initiative in restructuring.

Corporate restructuring can be classified into four methods in terms of the leadership: 1) court, 2) main bank, 3) a council of creditors, and 4) government. Undoubtedly it is the creditor who should assume leadership in and be responsible for restructuring a debtor company. If there exists a single creditor, in most cases a bank, the restructuring procedures against delinquent companies tends to be relatively simple. When both the debtor and creditor agree with a plan for debt relief, they enter into private restructuring. Otherwise, either one of the two parties will file with the court for corporate reorganization. In this case, the leader of corporate restructuring becomes the court instead of the direct stakeholders. This is known as court-led restructuring.

Multi-creditor cases require time, endurance, and costs from the stakeholders before they reach an agreement on the plan. Because of these difficulties, creditors usually form a council to serve as a decision making body, and designate a leader who takes the initiative on works related to detailed restructuring on their behalf. In such a case, one of the major banks often plays a role in leading every step of corporate restructuring. Depending on the extent to which the bank initiates or simply moderates the restructuring process, the former may be called bank-led restructuring and the latter market- or creditor council- led restructuring.

When restructuring large companies that may adversely affect an entire economy, however, resolution becomes complicated due to the potential aftermath. The complex debt structure of these companies, especially in terms of the number of creditors, adds one more dimension of difficulties in arranging a harmonious restructuring plan. This scenario has taken place from time to time in Korea during the development era for the last forty years. The government-led development strategy of focusing enormous investments on large business groups has, by and large, turned out to be satisfactory, but there were occasional business failures of sizeable enterprises. Since the funds channeled to these large companies were attributable to and arranged by the government, the government was itself one of the biggest stakeholders and de facto served as an ultimate creditor, if not an official one, who should and could orchestrate the resolution for the distressed firms. For these reasons, the government became heavily involved in corporate problems ranging from debt rescheduling to the very fate of the debtor companies. This type, for obvious reasons, is called government-led restructuring.

Court-led restructuring is based on the laws governing insolvency, so that it is not necessary to ask for its justification. However, for the other three types of private restructuring methods, divergent opinions about their causes and justification have been raised by not only economists, lawyers, and practitioners but also by relevant stakeholders. Particular concerns have been raised about giving priority to economic efficiency over legal justice. For example, government-led restructuring may be understood as an inevitable measure in consideration of the current economic environment and desire for efficient resource allocation, but can later be interpreted as excessive interference in favor of the beneficiary firms and concealment of government policy failures. It is also often blamed

for violating market discipline. Furthermore, the legal background for government-led restructuring, such as the Industrial Development Act corresponding to the industrial rationalization policy in the 1980s, was judged to encroach upon the property rights of the owners of the restructured companies. Hence, the application of the law sometimes appears constitutionally questionable.

Such argument was also applied towards the bank-led corporate restructuring. Up until the financial crisis, in addition to aiding the administrative efficiency of the government, the main bank system served the mutual benefits of the debtors and creditors. The main bank was a major loan provider as well as the sole credit examiner. It reviewed and monitored debtor companies and reported to other financial institutions on their business prospects, financial health, credit rating, and funding needs. Then it arranged the terms of loan covenants against the debtors among the participating financial institutions.

Owing to this informational advantage over the debtors, it is quite natural for the main bank to take the initiative on restructuring in cases of financial distress. However, in spite of these gains in efficiency, bank-led restructuring is vulnerable to claims of infringement on small stakeholders' rights by restricting their votes, especially since the legal grounds for these restrictions do not exist-a serious problem.

The same issue has been raised as a fundamental weakness of the Korean Corporate Workouts, which are formally known as market-led restructuring, where the government remained behind the scene and main banks played dominant roles. Based on the voluntary agreement over the Corporate Workouts, seventy-five percent approval of a plan can gain supremacy over the dissents, which, nevertheless, does not secure legal grounds for action.

Notwithstanding the disputes over legal justification of restructuring methods, practically, the choice among the above three private restructuring methods depends on economic factors. First, at the stage of economic underdevelopment, government-led corporate restructuring is preferred, for it is the most efficient and accountable method. All the relevant information is concentrated in the government, putting the body in a superior position, on which the authority to execute necessary measures is bestowed. As an economy develops, however, the government may not have such an information advantage over private sectors nor expertise to yield successful results. Thus, market-led restructuring, or bank-led restructuring at least, becomes more consistent and persuasive at this stage from the standpoint of both justness and effectiveness.

Second, the methods of restructuring are chosen in a different manner corresponding to the overall supply and demand of funds. When capital accumulation is shallow vis-à-vis available investment opportunities, funds are in excess demand, generating credit rationing by the government or financial institutions. Under such environments, government-led or bank-led restructuring perform well because they are engaged in lending at the outset. In contrast, as financial markets become developed in terms of depth and breadth of liquidity, the number of creditors increases, to the point that a single dominating creditor cannot take the sole initiative of corporate restructuring against failing companies. In this case, market-

led restructuring is the only remaining option and thus success depends upon prerequisites of the related infrastructures, such as a fair and transparent accounting system, sound corporate governance, professional intermediaries, etc.

Third, the extent of capital market development also affects the choice of restructuring methods. When capital markets are underdeveloped, the ways to resolve distressed companies tend to take the form of confidential arrangements and public loss sharing. The typical example is the industrial rationalization in the 1980s. These practices against the market principles were feasible due to deficiencies in and inaccessibility of relevant and valuable information about the companies. The lack of accountability for business and policy failures enabled the government to choose confidential methods. Once capital markets are fully developed, government-led restructuring may bring about many side effects and criticisms, and thus the government should stay out, unless the corporate distress is so severe as to ignite a systemic crisis. In this case, depending on the origins of the corporate failures, either bank-led or market-led restructuring will be chosen, but the applied tools for the turnaround of the ailing companies should be market-friendly.

After the 1997 financial crisis, Korea has taken various approaches to resolve corporate sector distresses outside the jurisdiction of the court. One of the attempts was a Big Deal, where government played the role of a deal arranger of M&A in the industries afflicted with severe excess capacity problems. Facing enormous political pressure to meet the public expectation of the earliest possible delivery of visible outcome, government was forced to turn to the old trick of intervening in what were supposed to be private deals. Another attempt was the Corporate Workouts as a Korean counterpart of the London Approach, aiming at rescuing both distressed companies and financial institutions, in the cases when the delinquency of the former was a threat to the latter. The initial targets were relatively large companies such as the 6-64th largest conglomerates in asset size. Later the Workouts were applied to the second largest chaebol company in Korea, Daewoo Group, and afterwards small and medium-sized enterprises (SMEs). Although, the creditor financial institutions acknowledged the need for corporate restructuring, the financial institutions had difficulty in implementing actual measures since the voluntary agreements among financial institutions were not binding. To remedy the situation, the Corporate Restructuring Promotion Act (CRPA) was enacted as a legally founded measure, despite the existence of controversies over the CRPA.

The lessons learnt from Korean experiences in corporate sector restructuring are as follows. First, there is no one-size-fit-all solution. A successful system in a country is not often applied to other countries due to fundamental differences in environments, causes of corporate distress, or institutional complications. Second, despite its effectiveness out-of-court settlement should be accompanied with a strengthened in-court settlement system. Participating financial institutions in the out-of court settlement do not reach the first-best solution due to their incentive problems as explained in the Prisoner's Dilemma game. However, no insolvency regime will be credible and sustainable without imposing losses on

those who caused the distress in the first place. In this respect, market discipline should be imposed in any type of corporate workout to the extent that it provides an effective control on reckless risk-taking behaviors, but this ideal tends hardly to be implemented. The very existence of an effective in-court settlement system working as the last resort can render all stakeholders to bind themselves to voluntary out-of-court insolvency mechanisms. Third, the out-of-court settlement system which is based on voluntary participation of relevant stakeholders cannot produce fruitful performance unless it is secured by legal supports. Even if the corporate workouts have some limitations in the nature of the system and validity of administrative processes, they have worked as an effective substitute for inefficient in-court restructuring mechanisms. But such good performance cannot always be taken for granted. Rather, the out-of-court insolvency process needs to be strengthened legally in order to have practical solutions. Financial regulations on bank assets, securities trading, as well as other financial activities, should correspond to the out-of-court settlement system.

Chapter 1

Introduction

Introduction

Ease in closing firms is as important as ease in starting-up in determining the environment for business and these processes hinge critically upon a well-functioning insolvency system. And yet, the importance of an insolvency system is often neglected in normal times, when there tend to be fewer dramatic cases of firm failure.

Korea is no exception to this idea. Before the financial crisis in 1997, the concept of corporate insolvency was very primitive, something not far different from a debt collection system for creditors.[1] Creditors in fact had little legal means to deal with firms in distress other than simply wait for firms' declaration of default and collect whatever value remained in the defunct firms.

Obviously, failed managers also paid a high price for insolvency. They had not only to give up their ownership of firms but also often to face criminal charges. This sounded fair but tended to lead managers not to reveal their difficulties until the very last moment. Such secrecy surrounding running firms certainly became an inhibiting factor against the development of a sound corporate credit market. Under this circumstance, it was no wonder that the only available corporate lenders were either commercial banks which were under the strong influence of government or those who had both privileged access of information and promise of secured collateral.

The fact that commercial banks were the major creditors to many firms widened the government's choices when dealing with firms in financial distress. When things went far enough wrong to undermine the very survival of a given industry, government often intervened in the name of saving the industry. But government intervention in such cases amounted only to a bailout, thus instigating the myth of "too-big-to-fail."

1 In fact, Korea Asset Management Corporation (KAMCO), which turned out to be the most effective facilitator of the Korean corporate debt market after the crisis, was called as "Sung-Up Kong-Sa," which means literally, the corporation for completing business. And its role used to be confined to collecting debts on creditor banks' behalf.

The 1997 financial crisis brought a much-needed momentum for changes in Korea's insolvency system. The existing system turned out to be simply too simple and too out-of-date to deal with corporate insolvency cases which were rising both in number and size. If the insolvency system had remained as a primitive debt-collection mechanism of the pre-crisis era, many Korean firms that claim formidable competiveness in the world market these days might not have been given a chance of rehabilitation at all. This would have been a great loss to the economy as a whole, let alone those who have vested interests in the firms in distress.

Corporate insolvency reform took three forms. The first was to overhaul insolvency laws, which dictate principles and procedures of the court-receivership program. The laws were revised to reduce the moral hazard on the part of incumbent managers while dealing with the potential hold-out problem of non-secured creditors. These were all intended to facilitate the corporate restructuring process, so that distressed firms can have an earlier chance of rehabilitating themselves.

The second direction of the reform was to introduce the out-of-court-settlement procedure of corporate restructuring. The corporate work-out scheme was the most renowned example. The scheme bench-marked the London Approach, which is basically a voluntary agreement among financial creditors with the tacit awareness about the role of Bank of England as a facilitator in actual restructuring cases.

Accordingly, it was beyond the jurisdiction of court and it was not subject to insolvency laws. Nonetheless, the work-out scheme was very closely related with changes in insolvency laws, as creditors could always turn to in-court-settlement procedure dictated by insolvency laws whenever they found the work-out scheme unworkable. The Korean work-out scheme was designed to allow a more pro-active role of financial supervisory authorities than the London Approach. Indeed, Korea even legalized the workout scheme by enacting a special temporary law.

The third direction was the continuation of the traditional way, although it was much refined both in the method and the depth of intervention. The mostly-cited example was the "Big Deal," where government played the role of a deal arranger of M&A in the industries afflicted with severe excess capacity problems. Facing enormous political pressure of meeting the public expectation of the earliest possible delivery of visible outcome, government was forced to turn to the old trick of intervening in what were supposed to be private deals.

To be fair, however, government made every effort not to repeat the old way of government intervention. It was very cautious not to displace the private sector's role, refraining from acting like a deal designer but trying to remain as a deal arranger. And yet, the final outcome was only half-satisfactory at best.

Among these three dimensions, the second was the most referable, not only because most of the corporate restructuring cases during the 1997 crisis fell into this category,[2] but because it was the area where Korea actually demonstrated a great deal of creativity as it was overcoming the crisis. Accordingly, the bulk of this paper will be allocated to introduce various out-of-court settlement schemes. But due coverage will also be given to the first and third dimensions, as these three reform efforts were inter-linked to each other. The paper will begin with the concept of the corporate insolvency mechanism, followed by discussion of the nature of the corporate insolvency system before the crisis.

2 Even Daewoo group, the second largest big business group (Chaebol) before the crisis, was restructured under the work-out scheme.

Chapter 2

Issues and Economics in Corporate Insolvency Mechanism

1. Issues regarding Corporate Insolvency Mechanism

2. Economics behind Insolvency Mechanism

Issues and Economics in Corporate Insolvency Mechanism

1. Issues regarding Corporate Insolvency Mechanism

Firms become insolvent when they fail to pay their debts. When they do, their creditors are faced with two options: either let the firms dissolve (liquidation) and collect the salvage value of the firms or give the ailing firms a chance of turn-around by providing debt relief (rehabilitation). In the case of the former, the issue is rather simple, because interested stakeholders tend to be creditors only. As the net worth of a firm becomes negative, shareholders have no legal claim on the salvage value of the firm. So, the only remaining issue would be how to distribute the remaining salvaged assets among creditors, particularly between secured creditors and non-secured creditors. But by the time of liquidation, there is likely to be not much of value left for distribution.

In the latter case, the issue becomes much more complicated, as there tend to be many more interested parties involved and thus much higher likelihood of conflict of interest. There may be the tension between creditors and shareholders, especially governing shareholders (manager). Ailing firms may have better prospects of turning-around if incumbent managers are allowed to remain in charge because they know the firms best. This, in turn, may bring better outcomes to creditors as a whole, as it would be likely to leave much more pie to share among them. And yet, creditors have to recognize the potential danger of moral hazard on the part of debtors (At the end of day, incumbent managers are those who are most responsible to the insolvency of ailing firms. How could they be trusted again?).

Interests of creditors are not identical, either. Secured creditors whose lending is backed by collateral are generally major creditors. Their interest tends to be better served when insolvent firms retain a ‘going-concern’ status. They also tend to be more patient than non-secured creditors, as they are entitled to higher priority in receiving loan payments as long as a failing firm remains afloat. On the other hand, non-secured creditors tend to be very

impatient. They are likely to try to collect on their loan as soon as it is due. But when they do so in large numbers, ailing firms may not have any second chance of turning-around, even if secured creditors wish that to occur.

Potential conflicts between secured creditors and non-secured creditors may surface even more sharply when creditors negotiate over the terms of rehabilitation plans among themselves. Even if non-secured creditors agree that giving a chance of rehabilitation to insolvent firms would enhance the value for creditors to be retrieved collectively from the firms, they may still find that a holding-out strategy would yield better terms for their interest, as they know that secured creditors would have more to lose from negotiation delays.

Given the complicated nature of conflict of interest among various interested parties, it would be very hard to see any compromise emerge in a timely manner, when those parties are left alone to settle their potential disputes over the rehabilitation plans. This is why a reliable insolvency mechanism is needed in the first place. The value of insolvent firms generally decreases rapidly in reality. So if a chance for rehabilitation is deemed suitable, it would be better on the grounds of efficiency to be given at the earliest possible date, certainly well before a firm's value as a going-concern falls to less than liquidation value. This would be very difficult to realize unless there is some degree of intervention by a third party, empowered by a proper insolvency mechanism.

At the same time, however, the pursuit of efficiency may run counter to fairness, as it may harm the very opportunity for some of interested parties, especially minor creditors, to act to safeguard their interest. Therefore, striking a proper balance between efficiency and fairness is a challenge in designing a proper insolvency mechanism. There is no 'one-size-fits-all' solution to this. But there are a number of checkpoints that deserve thoughtful consideration.

1.1 Debtor-in-Possession

Incumbent managers are supposed to best informed about the business prospects and the financial status of a firm; thus utilizing their knowledge and information would greatly enhance the efficiency of insolvency proceedings. At the same time, however, they may have distorted incentives with respect to the rehabilitation of firms due, for example, to a conflict of interests, moral hazard, and/or rent-seeking motivation, and hence could incur additional costs to creditors. The balance between these merits and costs needs to be carefully maintained.

1.2 Automatic Stay

Automatic stay is an automatic injunction that halts actions by creditors, with certain exceptions, to collect debts from a debtor. It begins right upon the moment that the bankruptcy

petition is filed, protecting the debtor against certain actions from the creditor, including: (1) beginning or continuing judicial proceedings against the debtor, (2) actions to obtain debtor's property, and (3) set-off indebtedness owed to the debtor before commencement of the bankruptcy proceeding. For the sake of efficiency, it is quite a powerful arrangement as it saves time of seeking another procedure to obtain the court's approval of an order protecting the assets of the debtor, particularly in a very critical time of deciding whether the proceeding is worth starting.[3]

1.3 Absolute Priority

Absolute priority refers to the seniority of the claims on bankrupt firms. When the absolute rule applies, the next senior right-holder cannot claim its right until the more senior ones retrieve all of their claims. Since it states clearly the order of claims, in which secured creditors are given the most senior status with non-secured creditors being the next and with shareholders being the least, the rule speeds up the whole process. But it is not likely to generate cooperation from those whose claims have lower seniority than secured credit, certainly not shareholders. Due to this reason, the absolute priority rule is rarely adopted during the process of rehabilitation. Rather, it tends to be applied during the liquidation of assets of a business entity that has chosen to file bankruptcy. As the assets are converted into cash, the bankruptcy court evaluates the creditor, and then determines the amount of payment each of the creditors will receive, once all assets have been liquidated.

1.4 Cram-down and Its Quantum Requirement

While the absolute rule tends to be adopted in the liquidation process, the cram-down rule is often adopted in the rehabilitation process. The cram-down option aims toat induceing a more efficient and expedient collective bargaining by discouraging marginal creditors from playing strategic holdout. That is, under the rule, courts are authorized to approve a reorganization plann, if a certain conditions are met, even if even if the subset of creditors fails to reach an agreement on the proposed plan. The stipulated conditions, which are intended to protect the rights of dissenting interested parties, are as follows: 1) the collateral for the secured creditors is to be preserved, or 2) the proceeds from the sale of assets or collateral are to be fairly distributed to the secured creditors, unsecured creditors and share-holders respectively, or 3) fair values of claims determined by the court are to be paid to claim holders.

In reality, however, courts rarely attempt to exercise this option, even if they are so empowered. Instead, courts strongly encourage reorganization plans adopted under the

3 While the US bankruptcy procedure includes an automatic stay, the Korean approach has been more cautious. While automatic stay has been incorporated in the informal insolvency mechanism such as the public work-out scheme, it is still not allowed in the formal insolvency mechanism, both the Composition Act. [[not clear]]

quantum requirement, of which mode and content vary across countries as shown <Table 2-1>. Nevertheless, the fact that courts can always turn to the cram-down option is likely to facilitate an agreement among interested parties. The general trend has been to ease the quantum requirement in order to improve the expediency of the insolvency proceedings.

Table 2-1 | Quantum Requirements for a Reorganization Plan[4]

	Secured Creditors	Unsecured Creditors	Shareholders
Indonesia (Composition Plan)	Not required (the standstill is not applied to secured creditors)	1/2 in number and 2/3 in value	3/4 in case of asset grant as collection
Korea * (Corporate Reorganization)	3/4 (4/5 in an extra-ordinary situation)	2/3	1/2 (if shareholders have voting rights)
Malaysia (Scheme of arrangement)	1/2 in number & 3/4 in value		Not required
Singapore (Scheme of arrangement)	3/4 in number & in value		Not required
Thailand (Reorganization)	1/2 in value of total debts and 1/2 in number & 3/4 in value from one affected group		Not required
Philippines	Not required		Not required

Note: The cram-down option is additionally rendered by courts

Source: edited from Nam and et al.

1.5 Procedural Simplicity and Time Limit

Procedural simplicity is also one of the key factors in securing expediency in the insolvency system and is greatly affected by the number of laws involved. The system of multiple laws seems to be less favorable in terms of the expediency of insolvency proceedings. One remedy is to let the legal system allow easy transfer of the cases from one procedure to another. Specifically, upon the dismissal of the petition by the court, the new insolvency proceedings need to incorporate the progress made in the previous proceedings, including, for example, the results of due diligence and other considerations made by the court.

But a more efficient way is to unify the multiple laws governing insolvency cases into a single law. Under the unified legal structure, the court can determine the choice of the

4 It can generally be said that the easier the quantum requirement is, the speedier the rehabilitation process will be. But in the case of Korea, the mere existence of the cram-down rule acts like a facilitator despite its seemingly stringent requirement.

modality of the resolution after careful reviews on the likelihood of rehabilitation. As the court's decision tree is internalized under the unified system, the insolvency proceedings can be shortened by preventing unnecessary duplication of common procedures, such as due diligence and the filing of claims.[5]

In their pursuit of expediency, countries may consider putting time limits on each of the important steps in insolvency proceedings. In fact, this seems to be the trend in the countries whose insolvency laws were amended after the crisis. For example, in Indonesia, the amended Bankruptcy Act stipulates that the provisional arrangement plan shall be finalized within two months of the filing of the petition, and that the plan shall be implemented within 270 days of the finalization of the plan. According to the newly amended insolvency law of Thailand, the court is required to issue the commencement order within 3 weeks of the petition, approve the reorganization plan within 5 months of the commencement, and conclude the implementation of the plan within 5 years of the approval.

1.6 Prepackaged Bankruptcy

While procedural simplicity refers to is about the transferability of cases between different insolvency regimes, prepackaged bankruptcy is about transferability from an informal insolvency scheme to an in-court-settlement scheme. Under this rule, an insolvent firms and its creditors agree on a reorganization plan, even before its case is filed, and then courts will regard it as the steps taken under the formal insolvency proceedings. As such, a prepackaged bankruptcy can certainly expedite the formal process once it is opened. It also stimulates informal bargaining among interested parties even before case is formally filed with the courts. But it may be criticized for to undermining rights of minority creditors too seriously.

2. Economics behind Insolvency Mechanism

Why is an formal insolvency mechanism needed in the first place? An immediate answer to this question would be because it enables all interested parties to work for a more beneficial resolution collectively rather than leaving them to settle individually. The insolvency regime differentiates itself from a simple debt collection mechanism. It aims to bring greater value to all interested parties than the liquidation value.

In order to illustrate this point, let us assume a non-cooperative game where there are two creditors; one is secured and the other is not, as in the [Figure 2-1].[6] It is also reasonable to assume that the secured creditor provides larger lending (A) than the non-secured (B)

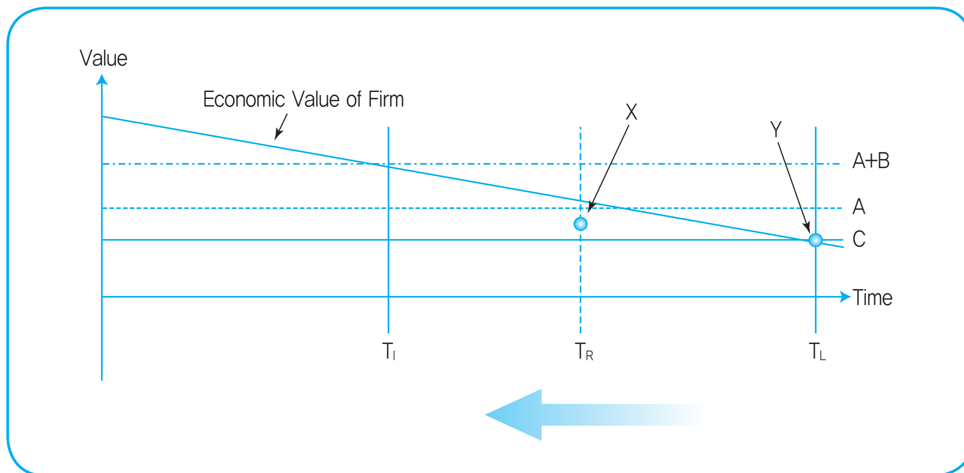
5 Indeed, the recent trends in East-Asian countries are in favor of the unified structure, as can be seen in Indonesia and Thailand. Korea also moved in this direction by enacting a so-called Unified Insolvency Law in 2006.

6 The simplicity as such can be justified because harmonious resolution of differing interests among creditors is normally the most critical point in the reorganization procedure.

and that the economic value of the ailing firm decays over time. We also assume that the liquidation value is lower than the A. This means that at the time of liquidation, even the secured creditor cannot recover its claim in full even under the absolute priority rule, which is not terribly unrealistic at all. The model also captures the common sense that the firm becomes insolvent (negative net worth), when the firm's economic value is lower than its debt (A + B) (T_I in the Figure 2-1) and that it has to liquidate when its economic value is lower than the liquidation value (T_L in the Figure 2-1).

Let us explore the motivations of the two players. The secured creditor knows that it can recover as much as the liquidation value at the time of T_L. It also knows that its credit value could be enhanced only if a rehabilitation plan were to be agreed upon with the non-secured creditor. On the other hand, the non-secured creditor knows that it would get nothing when the firm liquidates but it has a chance to recover its claim in full if it chooses to withdraw its lending before the other player does.[7] This means that the non-secured creditor has every incentive to withdraw from the insolvent firm. But its doing so only accelerates the firm's bankruptcy and thus liquidation.

Figure 2-1 | Non-Cooperative Game Between a Secured Creditor and Non-Secured Creditor



Under this circumstance, dominant strategies for both players would be the ones that only lead to the firm's liquidation. A properly designed insolvency mechanism can break such a prisoner's-dilemma-like situation. It can provide an environment whereby both creditors negotiate for a mutually beneficial outcome. Here, the firm's litigation is the

7 The withdrawal strategy would be a very unrealistic option for secured creditors, since they normally enjoy additional longer-term strategic value beyond a simple credit value by maintaining relations with client firms.

default option for both creditors. But they know they could have a better outcome if they negotiate sincerely and speedily. They concern themselves less about the other player's betrayal under the protection provided by the insolvency system.

[Figure 2-1] shows a cooperative outcome at T_R but it could be anywhere between T_I and T_L, depending upon the design of formal insolvency regime.[8] If a society puts more emphasis on efficiency rather than fairness in designing the insolvency regime, the resolution point would be closer to T_I. The checkpoints discussed in the previous chapter would be critical elements to consider in designing an insolvency system.[9]

In any case, the players agree on the burden-sharing between them to rehabilitate insolvent firms at T_R, as is illustrated as the point X in the [Figure 2-1]. At X, no creditors can recover their credit in full. But both have a better outcome than the point X at T_L in the diagram. And this would not be realized unless a proper formal insolvency mechanism is in place.

Another reason why a formal insolvency mechanism is needed is because it makes an out-of-court settlement mechanism work. One of the weaknesses of an informal insolvency mechanism such as a work-out scheme is lack of enforceability. But if it is to operate in parallel with the formal mechanism, its weakness can be largely addressed. Furthermore, its strength, which is flexibility that leads to earlier resolution, is likely to be realized.

How does this work? In order to answer this question, we modify [Figure 2-1] as in [Figure 2-2]. Here, let us suppose that a formal insolvency mechanism is already in place, which would lead both players to settle disputes at T_R. Now let us also suppose a situation whereby two players negotiate over a rehabilitation plan out of court. Since both players know that they can always turn to a negotiated outcome under the auspices of the court (point X), the possibility that they reach agreement even before the time T_R., for instance T_V., as illustrated in [Figure 2-2].

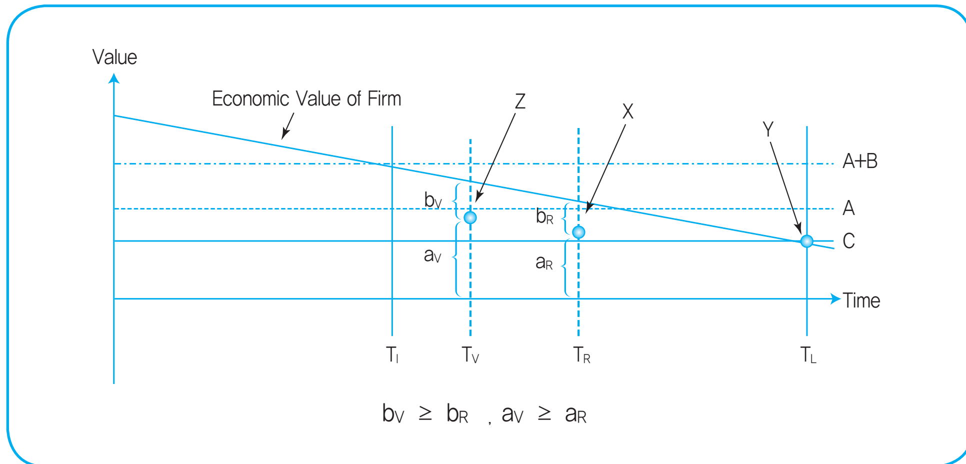
The agreed outcome (point Z) at T_V., would have to bring greater benefits to both players than the one (point X) at T_R.,, because there would be no point of early resolution otherwise. ($a_V \geq a_R$ and $b_V \geq b_R$) Put differently, the secured creditor can use the presence of the formal insolvency mechanism as a credible threat in negotiating with the non-secured creditor. If the formal insolvency mechanism includes the prepackaged bankruptcy procedure, the threat posed by the secured creditor would be even more credible.[10]

8 It would be very unlikely to see the resolution point before TI , because the debtor company would not be willing to declare insolvency. Non-secure creditors would not agree to early resolution. Instead, they may withdraw from the ailing firm whenever they have a chance to recover their credit in full.

9 For example, allowing debtor-in-possession and an easier quantum requirement could facilitate insolvency proceedings but may undermine interests of lower-seniority-claim-holders. Social consensus is needed in finding a right balance between efficiency and fairness in designing an insolvency system

10 This point seems to be well proven in the case of SK Global, where domestic financial creditors had a buy-out negotiation with foreign creditors. (refer to Chapter IV)

Figure 2-2 | In-Court Settlements versus Out-of-Court Settlements



One important point worth making here is that it does not really matter whether the formal mechanism is actually used or not. The very presence of the mechanism can create an environment whereby various informal arrangements may work effectively.

Chapter 3

The Insolvency Mechanism before the Crisis in Korea

1. Formal Insolvency Procedure

2. Informal Corporate Insolvency Procedure

The Insolvency Mechanism before the Crisis in Korea

1. Formal Insolvency Procedure

Korea has three statutes on insolvency: the Bankruptcy Act, the Composition Act, and the Corporate Reorganization Act. The Bankruptcy Act deals with the liquidation cases. Both the Composition Act and the Corporate Reorganization Act deal with rehabilitation cases, but differ mostly in two aspects. One is the treatment of incumbent managers. In the case of the composition process, incumbent mangers are allowed to play a central role. They are the only party eligible to file cases with the court and they are also mainly responsible for preparing a rehabilitation plan.

Table 3-1 | Comparison of the Three Processes

	Bankruptcy	Composition	Corporation Reorganization
Eligible for Proceeding	Individual, Corporate and other legal persons	Individual, Corporate and other legal persons (certain large-size joint stock companies may not be eligible)	Joint stock company
Applicant	Debtor, creditor	Debtor	Debtor, qualified creditor(s), qualified shareholder(s)
Business Operation and Disposal of Assets	Receivers (no interim receiver is recognized)	Debtor (under the supervision of interim administrator and administrator)	Interim trustee, Trustee

	Bankruptcy	Composition	Corporation Reorganization
Qualification of Trustee/ Administrator	Individual	Individual	Individual or financial institution
Foreclosure of Mortgage and Other Security Interest	Foreclosure is not Stayed	Foreclosure may not be stayed	Foreclosure is stayed once the proceedings id connected
Execution of Judgment	Stayed	Stayed	Stayed
Compulsory Redemption of Shares without Compensation	Not applicable	Redemption of shares is not required	Redemption of all or part of outstanding shares without compensation if mandatory in certain cases
Filing of Proof of Claims	Mandatory	Not mandatory (if not filed, the creditor loses only voting rights)	Mandatory
Suspension of Litigation	Suspended	Not suspended (diversity of opinion in practice)	Suspended
Submission of Plan	Not applicable	Composition condition should be submitted at the time of petition for commencement proceedings (but the plan may be changed)	Plan is submitted after the commencement of the proceeding
Repayment Period	Not applicable	No restriction (usually, 4-8	Up to 10 years from the approval of the plan
Court's Involvement	Until the completion of distribution	Until the approval of the condition	

In the case of the reorganization process, however, incumbent managers are generally not allowed to participate. They are not the only party who can take the case to court and, more importantly, they are barred from preparing a rehabilitation plan.[11] Another difference between the Composition Act and the Reorganization Act is that the former mainly targets small and medium-sized firms,[12] while the latter is for joint stock companies, which are typically larger firms (Refer to <Table 3-1> for more details).

Despite the existence of the laws, which date back to 1962, however, they were rarely used before the crisis broke out in 1977.[13] There were several reasons for this. The Civil Procedure Act has usually been employed for debt collection on an individual basis. In most cases, the demand for collective measures for debt collection was weak because most assets of a debtor were already subject to mortgage or security. Secured creditors divided their portion according to the order of priority. Almost nothing was left for unsecured creditors.

Besides, the Korea Asset Management Corporation (KAMCO), which used to act as a debt collector on behalf of commercial banks, was given the most preferred status in terms of seniority on claims on liquidated assets. This means that any in-court insolvency could not open without prior consent of KAMCO. This clause was judged to be unconstitutional by the Supreme Court only in 1990.

A more important reason, however, would be that there was little need of court-supervised settlement because of government intervention. Government, which used to have control over financial institutions in a practical sense, took every possible measure to enforce or induce restructuring, as will be discussed later.

The 1997 crisis changed the landscape completely. Insolvency cases began to surge even before the crisis broke out. While insolvency laws have been referred to more frequently, their hidden loopholes have also emerged in plain view. Perhaps the most notable one arose due to stark difference between the composition process and the organization in terms of treatment of incumbent managers.

Incumbent managers of ailing firms saw the loophole in the Composition Act which did not inhibit the large firms from filing and thus they increasingly chose the composition process. Debtors tended to exploit the loophole for seeking legal protection from creditors in order to earn time. In fact, filings under the Composition Act surged in the midst of the outbreak of the 1997 crisis as shown in <Table 3-2>. Even would-be bankrupt firms, including Kia Motors which was the third largest automobile manufacturer in Korea and

11 This sounds too harsh for incumbent managers but has some history. In 1996, the CEO of 'Non-No', a large apparel company, fled abroad after issuing many bounced checks, even before the court-supervised reorganization process began. Being the biggest insolvency case thus far, it elicited very strong public outcry which led to a stringent revision of the law .

12 This needs some clarification. The Corporate Reorganization Act did not state eligible firms in terms of size. This actually turned out be a big loophole in the system.

13 A judge who was assigned to the court specialized in insolvency cases after the crisis was quoted to say that there used to be only one insolvency case for any judge in his/her lifetime before the crisis.

the biggest insolvency case thus far, filed under the Composition Act which was intended to target small- and medium-sized firms.

Another loophole featured very subjective criteria related to commencement of the proceedings. The Corporate Reorganization Act used to provide three conditions in determining whether the case is worth of opening the proceedings as such: 1) whether or not high social cost is expected if the petition is not accepted, 2) whether or not the debtor is experiencing financial stress, and 3) if there is possibility of rehabilitation. These are all very difficult to prove in quantitative terms and thus easy to be misused by debtors who seek a legal shelter from creditors.

Table 3-2 | The Number of Cases under the Three Insolvency Proceedings

Year	Bankruptcy	Composition	Reorganization
1983	U/A	U/A	47
1984	U/A	2	52
1985	12	2	40
1986	11	-	26
1987	26	-	30
1988	20	-	26
1989	37	2	27
1990	27	-	15
1991	16	-	64
1992	14	-	89
1993	26	-	45
1994	18	-	68
1995	12	13	79
1996	18	9	81
1997	38	322	151
1998	467	728	65
1999	733	140	37

Source: Court Administration Agency (1999) Bank of Korea

Besides, there used to be little time limitation, if any, on the various steps of insolvency proceedings. There also used to be no barrier between the composition process and the reorganization. Accordingly, a debtor could choose to hop from one process to another rather freely, protracting the insolvency procedure to his own advantage. These all created

an opportunity for moral hazard on the part of incumbent managers of the debtor firm, undermining the interests of creditors as a whole, which led to the law revision in 1998 in a very desperate effort to fix the formal insolvency system.

2. Informal Corporate Insolvency Procedure

An informal corporate insolvency mechanism was virtually non-existent in Korea before the crisis. Rather, government tended to be a mastermind of major restructuring packages for ailing firms, given the fact that the corporate sector in Korea relied heavily on borrowing from commercial banks which used to be under the government's control.

Since the early 1960s, policy loans were extensively utilized as an important instrument for industrial policies. The Korean government directly owned all major banks in 1961, and directed policy loans to priority sectors such as exports and heavy and chemical industries (HCIs). Policy loans were indeed substantial during the HCI drive in the 1970s: they constituted about 63 percent of the total loans extended by deposit money banks. Most banks were privatized in the early 1980s, but remained under the substantial influence of government at least before the crisis, albeit indirectly.

The provision of policy loans combined with interest rate control contributed to investment resource mobilization and rapid industrialization. At the same time, however, such a policy resulted in heavy corporate leverage, particularly for chaebols, groups of business under a family's control, as well as the underdevelopment of the banking industry in terms of risk management and credit evaluation. The debt-ridden chaebols became vulnerable to business fluctuations, and corporate failures posed systemic risks at the time of recession. Given the tight linkage between the banking and corporate sectors, corporate failures had an immediate impact on the soundness and viability of banks.

For fear of systemic risk as such, government often prepared restructuring packages, which turned out to be nothing more than bailouts. Notable examples were the emergency measure of August 3rd, industrial restructuring of major HCIs in the early 1980s, and industrial rationalization measures in depressed industries such as shipping and overseas construction during the mid-1980s. In each measure, ailing firms were given a financial relief from creditor banks, which were in turn provided with financial support from the Bank of Korea (central bank) in order to prevent systemic risks.

The government-led bailouts exacerbated the already weak market discipline and caused serious moral hazard problems. Excessive corporate leverage based on implicit risk-sharing by the government created the so-called "too-big-to-fail" hypothesis, which worked as an important exit barrier and often overshadowed the voices calling for financial market liberalization.

Banks themselves perceived little need for corporate monitoring either. Given the implicit state guarantees on bank lending, banks had little incentive to monitor client firms'

investment decisions. Strict prudential regulation and supervision were rarely applied to banks given the fact that the government and banks were in the same boat in the sense that both acted as a risk-sharing partner of business firms. Indeed, in the course of bailouts, the management of rescued financial institutions and corporations was not replaced, further undermining incentives for prudent behavior. Such recurrent corporate bailouts resulted in a vicious cycle of reckless lending and investment and pervasive moral hazard problems, which led the corporate sector in Korea to near bankruptcy during the 1997 crisis.

Chapter 4

Three Pillars of Corporate Insolvency Reform in Korea

1. Reforms on Corporate Insolvency Laws: the First Pillar
2. Introduction of Out-of-Court Settlement: the Second Pillar
3. Big Deal: the Third Pillar

Three Pillars of Corporate Insolvency Reform in Korea

1. Reforms on Corporate Insolvency Laws: the First Pillar

Reforms of the formal corporate insolvency mechanism were taken in two steps. The first step was to fix the loopholes in the formal insolvency mechanism that came to the surface right after the outbreak of the crisis.[14] One was to bar large firms with complicated capital structures from filing under the Composition Act.

Another important change made was the introduction of economic criteria at the commencement stage of the insolvency proceedings. That is, the rehabilitation proceedings can open only when the case has higher going-concern value than liquidation value.[15] If the liquidation value is proven to be greater, the court not only disapproves the petition of rehabilitation but also initiates the liquidation proceedings.

Changes were also made to speed up the process. Various time limits were placed on the critical steps of insolvency procedures. For example, a provisional protection order shall be made within 14 days after the application date. In reorganization procedures for small- and medium-sized enterprises, decision on the commencement of the procedure is require to be made within 3 months from the application date.

The reorganization plan shall be submitted within 4 months after the last day for filing of claims and approved within 1 year after the commencement of the procedure.

In composition procedures, the court shall decide the commencement of the procedure within 3 months from the application date.

14 Insolvency laws were revised in February 1998 and once again in December 1999.

15 The Act does not prescribe any specific method for calculating those values. The Supreme Court Rule on Corporate Reorganization, however, suggests one possible method: for liquidation value, to sum up the discounted price of individual assets on a balance sheet, and for going concern value, to evaluate the present value of future cash flow in addition to the value of not-for-business assets.

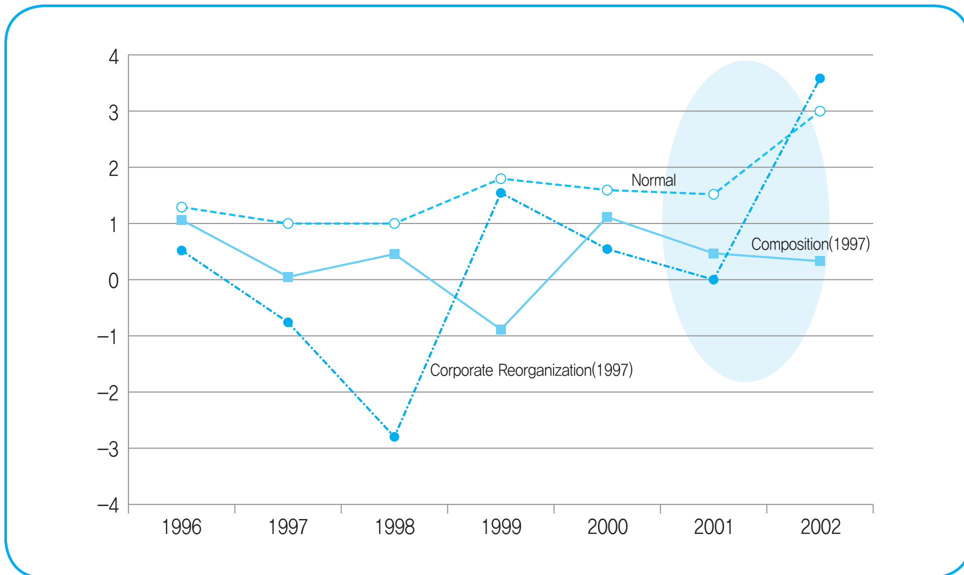
These changes alone contributed to a much speedier resolution. <Table 4-1> shows the duration of reorganization cases from their commencement until their conclusion. It captures the trend that those cases filed after the law was revised in 1998 tend to resolve faster than the cases filed prior to the law revision.

Table 4-1 | Duration from the Order of Commencement to the Conclusion

	Number of Cases	In 3 years	In 5 years	In 7 years	In 10 years	In 15 years	In 20 years
1993	4	0	1	1	2	0	0
1994	9	0	0	1	4	4	0
1995	5	1	0	0	0	3	1
1996	8	0	0	1	1	5	1
1997	5	3	0	0	1	1	0
1998	2	1	0	0	0	1	0
Total	33	5	1	3	8	14	2

Moral hazard of debtors was greatly curtailed as well, according to Kim, who compared performance of firms that entered into the insolvency proceedings before the law revision (1997 insolvency cohort) and ones that entered after the law revision (1998 insolvency cohort). Kim demonstrated that those firms which filed under the Composition Act performed much worse in both profitability and leverage than those which underwent restructuring under the Corporate Reorganization Act, before the law revision (Figure 4-1 and a-7). But after the law revision, both the corporate organization cases and the composition cases tended to return to normalcy after 4~5 years of rehabilitation process, although the organization case, being bigger than the composition case, was more leveraged at the commencement stage. This it may be interpreted that the law revision contributed to a better level-plain framework of rehabilitation between the two formal insolvency mechanisms.

Figure 4-1 | IPCR of 1997 Insolvency Cohort



IPCR: Interest payment coverage ratio (operating profit/interest payment)

Normal: Performance of solvent firms (as a reference point)

Source: Kim (2003)

Figure 4-2 | Total Borrowings to Total Assets for 1997 Insolvency Cohort

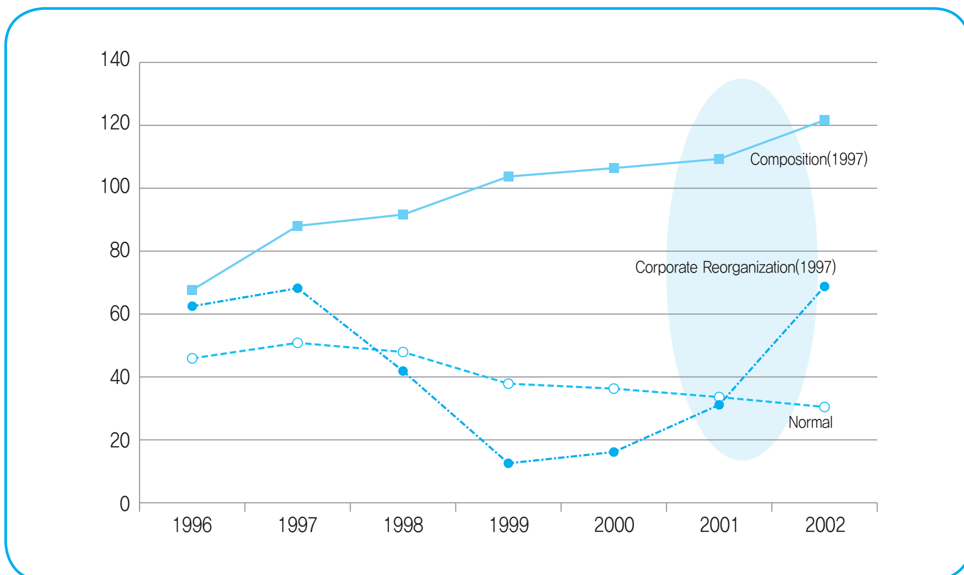


Figure 4-3 | IPCR of 1998 Insolvency Cohort

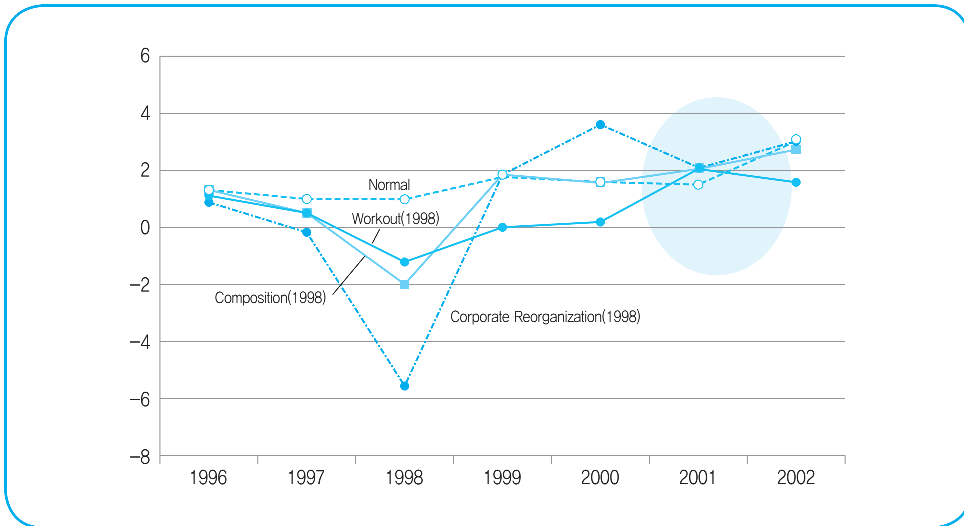
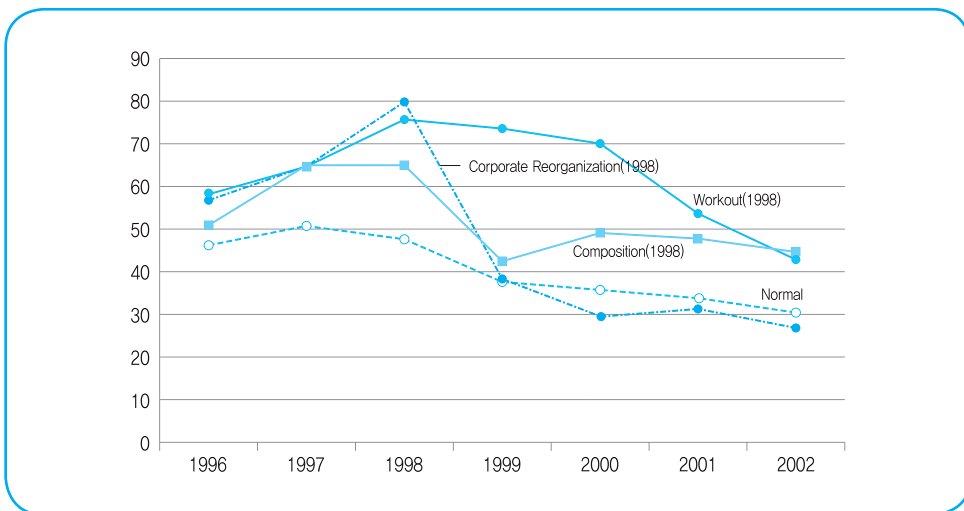


Figure 4-4 | Total Borrowings to Total Assets for 1998 Insolvency Cohort



The second step in the reform of the formal insolvency regime took much more time. After some three years of debate, the National Assembly finally passed the new Act on Rehabilitation and Bankruptcy of Debtors (so-called Unified Insolvency Law) which entered into force on April 1, 2006. The new legislation regulating corporate and individual insolvency proceedings (including both liquidation and rehabilitation) unified and replaced

four separate insolvency laws: the Corporate Reorganization Act, the Composition Act, the Bankruptcy Act and the Individual Debtor Rehabilitation Act.[16]

The new law moved the balance between efficiency and fairness in the insolvency system toward efficiency by adopting most of the principles that were discussed in Chapter II. Major changes made in the new law are as follow:

Procedural simplicity: Under the new law, corporate rehabilitation and liquidation became a single unified process. Liquidation proceedings can open during the rehabilitation proceedings when the going-concern value of a firm is judged to be smaller than its liquidation value. The corporate rehabilitation proceeding under the new act is based on the corporate reorganization proceeding prescribed by the Corporate Reorganization Act. The composition proceeding was abolished under the new law.

Debtor-in-possession: The new act adopted a mechanism rather similar to the debtor-in-possession system under US bankruptcy law. Under the new law, the court appoints a receiver (who will administer the rehabilitation proceeding under the supervision of the court) from the existing management of the debtor company with some exceptions.[17] This new mechanism contrasts with the prevalent practice under the Corporate Reorganization Act that existing management be replaced by a third-party receiver.

Automatic Stay: Although the new act did not provide for an automatic stay mechanism, it introduced a comprehensive stay order system. It allows the court to grant a comprehensive stay order by which all future enforcement actions by secured and unsecured rehabilitation creditors can be comprehensively barred during the period between the filing of a rehabilitation petition and the formal commencement of the rehabilitation proceeding. Under the Corporate Reorganization Act a debtor had to file a separate petition for an injunction against each creditor.

Prepackaged bankruptcy: Although the new law does not allow prepackaged bankruptcy, it introduced various arrangements to render its intended effect. For example, the new provisions permit a debtor company to sell or transfer all or part of its business even before the court's confirmation of a rehabilitation plan, with the approval of the court and pursuant to the other relevant procedural requirements prescribed by applicable laws and regulations (e.g. shareholder approval and the granting of appraisal rights to dissenting shareholders). Furthermore, in the case of a debtor company whose liabilities exceed its assets, the two procedural requirements (i.e., shareholder approval and the granting of appraisal rights) may be dispensed with for a business transfer preceding the confirmation of a rehabilitation plan, provided that the court approves the business transfer.

At the same time, the new law also made due consideration to safeguard the fairness principle in the corporate insolvency mechanism. A notable example is the adoption of the principle of "the best interests of the creditors" in order to protect the interests of dissenting

16 In addition, the Corporate Reorganization Promotion Act was repealed at the end of 2005. This act regulated the out-of-court restructuring process commonly referred to as the "workout" process.

17 The exceptions include when the company's financial distress is attributable to the existing management's mismanagement or misappropriation of assets and when the creditors' council has reasonable grounds to request an outside receiver.

creditors. Thus, in order for a corporate rehabilitation plan to be confirmed by the court, the plan should entitle each creditor to receive at least what it would receive if the debtor were liquidated, unless the creditor consents otherwise.

The new law also permits some leniency to the minority creditors with regard to the filing of claims. Under the Corporate Reorganization Act creditors were required to file their claims by a specified deadline; failure by a creditor to make a timely filing resulted in the final and conclusive denial of its claim. To mitigate this harshness, the new act, in addition to the claim filing system, now requires the receiver of a corporate rehabilitation proceeding to prepare and submit a list of creditors. The listed creditors are deemed to have filed claims (irrespective of whether they actually did).

2. Introduction of Out-of-Court Settlement: the Second Pillar[18]

The out-of-court settlement mechanism refers to a negotiation between the debtors and their creditors outside the formal bankruptcy process. Its aim is to provide a chance for rehabilitation to ailing firms before they enter into bankruptcy. Accordingly, it precludes the liquidation process, from the outset. It resembles the rehabilitation process of the formal insolvency mechanism in many aspects but it also differs in a number of ways due to the very fact that it has to operate without the empowered enforceability of the in-court-settlement system. Its main difference from the formal rehabilitation proceeding derives from the differing coverage of claims. While all claims on debtor companies, whether financial or non-financial, are affected once the formal mechanism opens, the informal mechanism generally intends to cover claims by financial institutions.

The informal mechanism designed to cover only financial creditors has some pros and cons as compared with the formal one. The most notable advantage would be ease in securing efficiency. Since the informal scheme is intended to facilitate negotiation between like-minded creditors, it can be designed to incorporate all of the key elements to ensure the efficiency of the rehabilitation process, without too much concern about fairness. In fact, all of the out-of-court settlement mechanisms designed during the crisis in Korea actually allow debtor-in-possession, automatic stay and more stringent time limits and quantum requirement than the formal mechanism requires.

The informal mechanism, however, has its own drawback, indeed its very informality. In order to overcome such an intrinsic shortcoming, the mechanism is designed to operate under the oversight of the country's financial supervisory authorities.[19] It operates upon

18 The purpose of this section is to provide a bird's-eye view of the issue. Accordingly, the coverage is rather sketchy. More detailed treatment will be presented in Chapter V, whereby each type of the out-of-court settlement will be discussed at length.

19 In the case of the London approach, the oversight role is given to the Bank of England. In the corporate workout scheme in Korea, the Financial Supervisory Commission (FSC) was used to play that role, perhaps much more proactively than the Bank of England in the London approach.

gentlemen's agreements but the presence of the supervisory authorities complements their enforceability.

This system tends to work rather efficiently when the structure of creditors is simple in both number and diversity. In the case of resolution for SMEs or even medium-sized groups, of which borrowings mostly come from commercial banks, the system worked quite well as will be discussed in Chapter 5. But when the creditor structure becomes complicated, even-handed negotiation among financial creditors becomes increasingly difficult. The matter becomes even worse when the debt in question becomes sizable. This is because creditors become increasingly reluctant to provide debt restructuring as this would undermine the solvency of their institution.

This was what happened in Korea's workout scheme. Despite its inception in June 1998, the scheme performed rather poorly for the initial 2~3 years mostly due to the concerns of financial institutions over capital inadequacy. According to Kim (2004) who investigated performance of the three rehabilitation schemes, the work-out case performed worse than the reorganization case despite the fact that it generally generated greater operating profits during the period of 1998~2000 [Figure 4-5]. This is mostly due to the reluctance of financial creditors in providing much-needed debt relief [Figure 4-6 and 4-7].

Figure 4-5 | Operating Profits to Total Asset for 1998 Insolvency Cohort

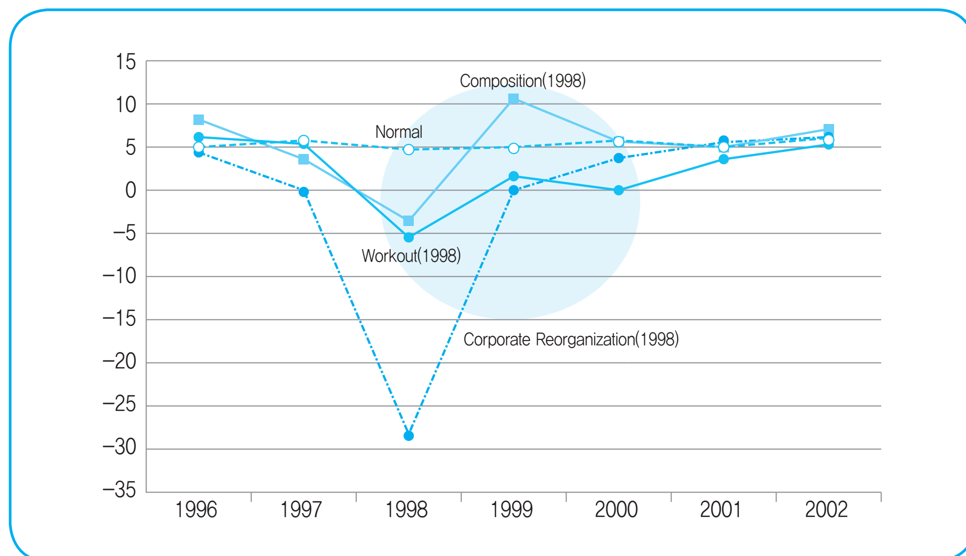


Figure 4-6 | Total Borrowings to Total Asset for 1998 Insolvency Cohort

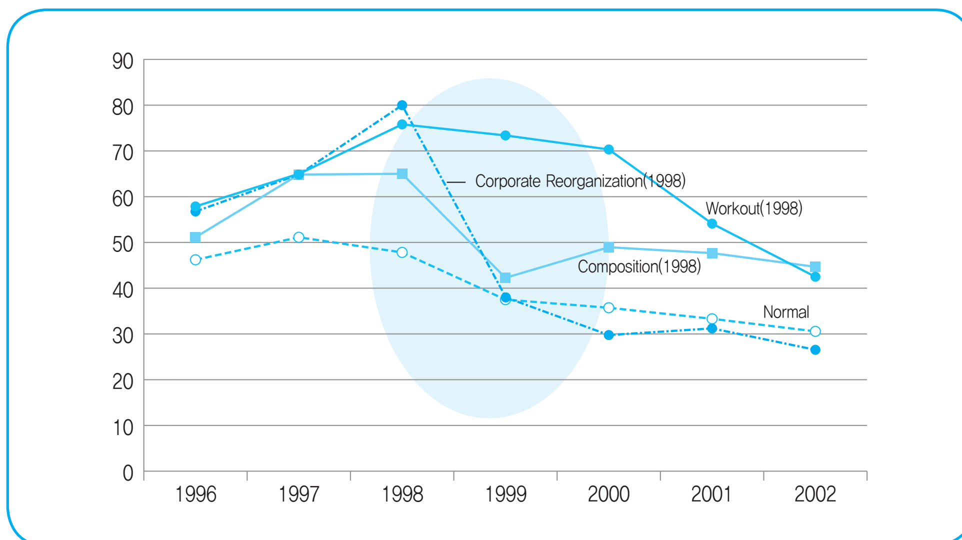
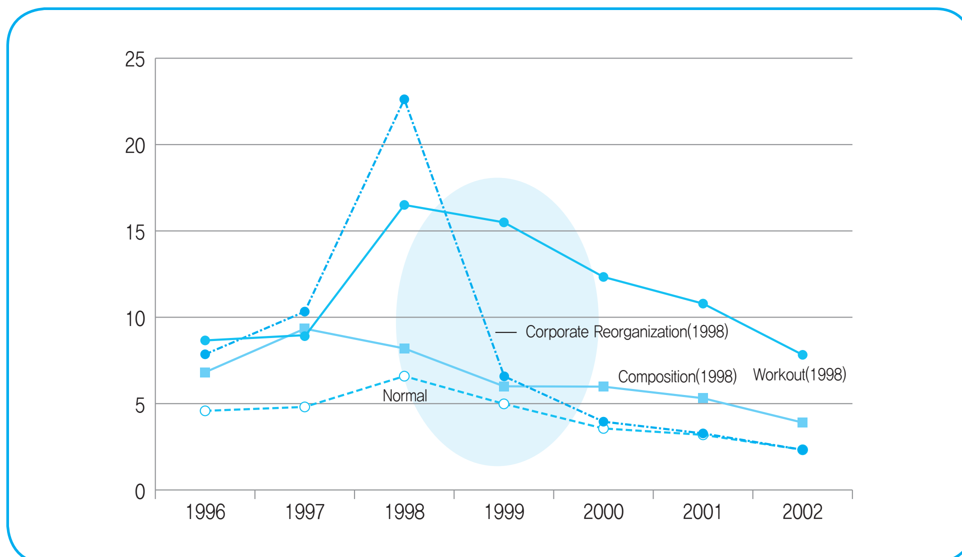


Figure 4-7 | Interest Expenses to Total Asset for 1998 Insolvency Cohort



Korea addressed this problem in a two-fold manner. One was to increase the public funds directed toward financial restructuring in order to provide a safety-net to financial institutions which may be concerned about their own survival, but it also sent a very clear signal to the market as to the seriousness of the authorities with regard to corporate restructuring. As a matter of fact, lack of progress in corporate restructuring led the government to decide to

secure more public funds for the second round of financial restructuring. With the additional money (up to 40 trillion won) approved by the National Assembly at the end of 2000 and recycled money from the previous one (64 trillion won), the government offered capital injection up to the BIS ratio of 12% to those creditor banks which might be hesitant to provide debt restructuring for fear of capital inadequacy.[20] Such effort yielded some concrete results. Performance of work-out firms reached the level of normal firms as demonstrated in [Figure 4-2].

Another channel was to formalize what would have remained an informal mechanism. In 2001, the Korean government enacted the Corporate Restructuring Promotion Act to legalize the workout program. Its effectiveness, despite the criticism that it may be unconstitutional,[21] was proven in the cases with a complicated structure of creditors, especially in cases with foreign creditors.[22]

These two measures, together with the improvement in the formal insolvency mechanism, actually made the Korean experience in the field of out-of-court settlements distinct from more conventional approaches like the London Approach, as will be discussed in the next chapter at length.

The Cases of Daewoo Group and SK Network

Korean experience demonstrates that dealing with foreign creditors is one of the very difficult issues under the work-out scheme as foreign credit is not made subject to the scheme. Since foreign creditors are not granted stays automatically, any new money injected to rehabilitate debtor firms would be used for repaying debts owed to foreign creditors. This possibility would certainly discourage domestic creditors from agreeing upon any rehabilitation plans, no matter how sound and urgent they may be. An alternative would be to let debtor firms file for formal insolvency proceedings. But if the formal insolvency mechanism is biased to the principle of fairness, domestic creditors would have very little to gain from the proceedings.

One solution to address such a "catch-22 situation" is to buy out foreign credit before rehabilitation is finally implemented. Indeed, in the workout cases of Daewoo Group in 1999 and SK Network (formerly SK Global) in 2004, both of which included sizable foreign credit, the cash buy-out option was actually executed. This box tries to compare the two cases to draw some implications.

20 In fact, the government's demand was even more specific in dispensing with their non-performing loans (NPLs). It asked creditor banks to reduce NPL ratios, which stood at about 12% at that time, to the level of 5% in just two years.

21 Due to the possibility of its unconstitutionality, the Corporate Restructuring Promotion Act (CRPA) was passed as a temporary law with the lifetime of 5 years and repealed when the Unified Insolvency Act entered into force in 2006.

22 This point was well demonstrated in the case of SK Global, the first case that the CRPA was referred to. Despite the fact that SK Global has equally diverse foreign creditors as the Daewoo Group, its buy-out negotiation with foreign creditors concluded much more speedily than the Daewoo case.

1. Cash Buy-out Negotiation under the Daewoo Group Workout

Negotiation started right after 12 affiliates of the Daewoo Group applied for the work-out scheme on Aug. 18, 1999. As of June 1999, foreign debt accounted for about 15% (6.9 billion US dollars) of what the Daewoo Group owed. And its creditors were scattered all over the world, 480 creditors with 69 nationalities.

The negotiation was about the terms of buying out unsecured loans (US$ 4.84 billion out of the total foreign debt),[23] under the condition that the Group observe a stand-still. The negotiation was undertaken between the representative of KAMCO, on behalf of domestic creditors, and the Foreign Creditor Steering Committee[24] on behalf of foreign creditors. And it was very difficult as foreign creditors continued "to seek a preference over domestic creditors." The Koreans also used the bankruptcy proceeding option as a threat to foreign creditors. But this threat was not perceived to be credible. Indeed, foreign creditors also threatened legal actions against Daewoo which would have led to the Group's bankruptcy. The negotiation took almost five months, and concluded in Jan. 2000.[25] Foreign creditors agreed to be paid at 39~40% of the overall face value of their outstanding loans in cash, a bit higher rate than the one applied to domestic non-secured bondholders (35%).

2. Cash Buy-out Negotiation under the SK Networks Workout

SK networks' troubles came to light on March 11 2003, when a sizable accounting fraud (US$ 1.4 billion) was publicly announced by Korean public prosecutors. Unlike the Daewoo workout case, it benefited from the legal protection provided by the Corporate Restructuring Promotion Act (CRPA). On the very next day, Hana Bank, the lead creditor bank for SK Networks, convened a general meeting of the Creditors Council by notice to the other CRPA creditors and Financial Supervisory Service (FSS). That same day, the FSS's chairman sent a standstill request to all CRPA creditors as laid out in the law.

But problems arose with regard to dealings with the sizable foreign creditors (US$ 2.9 billion of the total borrowing of US$ 6.1 billion including those of overseas subsidiaries), who were not bound by CRPA. Although CRPA creditors agreed on the terms of the rehabilitation plan for the SK Networks rather speedily during the three-month-long stand-still period, they could not implement the plan up until they settled the dispute with foreign creditors, who wanted preferential treatment. In the end, domestic creditors

23 Makers of secured foreign loans agreed to share collateral with domestic creditors and were thus excluded from the coverage of the cash buy-out negotiation.

24 The committee consisted of nine members including representatives of foreign banks such as Chase Manhattan, Tokyo Mitsubishi and HSBC.

25 But it took another six months before both sides actually signed as the two sides disputed whether due diligence on individual claims was a part of the initial agreement or not. It may look absurd in hindsight but it was due to the choice that the Korean side deliberately made during the first round of the negotiation; i.e., it did not demand due diligence explicitly in order to focus its negotiation leverage, if any, not to allow preferential treatment to foreign creditors. This, again, demonstrates how weak the Korean side was in terms of negotiation leverage against foreign creditors.

approved the rehabilitation plan, the implementation of which was made conditional on reaching a satisfactory agreement with foreign creditors.

But, negotiation with foreign creditors was protracted, as expected. Being frustrated, the Korean side resorted to the pre-packaged bankruptcy option allowed in the CRPA. The Creditors Council authorized Hana Bank to file a pre-packaged corporate reorganization proceeding in mid-July 2003. According to Walker et al. (2005), "the threat of a filing gave foreign creditors a powerful incentive to negotiate."[26]

About a month later, Hana Bank on behalf of CRPA reached agreement with foreign creditors that CROA creditors would purchase foreign claims at 43% of their face value in cash. It would be rather difficult to compare these terms with those of the 2000 Daewoo workout case, but it is believed to be a bit fairer thanks to the presence of the CRPA.[27] Furthermore, the CRPA helped complete SK Networks' restructuring in less than eight months, a "fast international standard and impressive" given the complex creditor structure of SK Networks.

3. Big Deal: the Third Pillar

The third pillar differs from the other two pillars in that the government adopted a more interventionist approach with the hope for even faster resolution. In September 1998, after the meeting with then-President Daejung Kim, the leaders of the country's top chaebol made the public pledge that they would settle managerial control issues by Oct. 1, 1998 on the seven target sectors[28] and complete the deal by the end of the year. <Table 4-1> summarizes the "Big Deal" plan announced on October 7, 1998. Since this deal would require a "grand compromise" among business leaders at the height of the economic crisis, reminiscent of the government-arranged restructuring package on the heavy and chemical industries in early 1980s, it was nicknamed "Big Deal" in the media (hereafter Big Deal).

Although government's intervention in the deal was undeniable, Big Deal was different from the previous government-arranged transactions. The government this time only suggested the guiding principles for the deal such as 1) each business group needs to focus on its core competence and 2) each deal has to be merged with a "managerial control body,"

26 In their contribution to International Financial Law Review (Jan, 2005), Messrs. Walker, Bromley and Han wrote, "For the foreign creditors, too, the threat of a pre-packaged reorganization was daunting. They made loans to SK Networks' overseas subsidiaries and their claims against the parent were in its capacity as guarantor. In previous Korean corporate reorganization proceedings, the courts had often discounted guarantee claims heavily, notwithstanding the fact that they were not legally subordinated to direct claims".("Lessons for Korea's New Restructuring Act")

27 In the words of Messrs. Walker, Bromley and Han, "by ignoring repeated threats by foreign creditors (who witnessed government's intervention in the 1999 and 2000 restructuring of the Daewoo Group companies), the approach facilitated a fair sharing of the burden among majority stakeholders." (ibid)

28 The seven target industries include aerospace, oil refining, petrochemical, power generating equipment, rolling stock, ship engines and semi-conductors. At the final moment, a swap deal between the automobiles and the consumer electronics sector was included.

letting the business leaders to agree on the details of the deals including the industries to be covered.[29] The government even promised to provide tax and fiscal assistance in the process of implementation.

Besides, Big Deal was basically a series of M&As in the industries which were afflicted with severe excess capacity problems. As a matter of fact, M&A is a way to dispose of excess capacity while overcoming the "free lunch" problem,[30] which was proven in the market over the years, especially in depression.[31] Indeed, many of the rehabilitation cases under both court-supervised reorganization and workout schemes returned to normalcy through M&A at the final stage of their rehabilitation.

So, there seemed to be nothing against the market principles in the Big Deal. Rather, the Deal would appear to yield much faster outcomes than would have happened otherwise, since the deal structures were already agreed upon especially in the presence of the President. Business leaders agreed that they would accept the financial penalty in an accelerated manner for their non-observance. [32]

Table 4-2 | Big Deal Plans

Business	Plan of the Deal	Controlling Body
Semiconductor	Samsung Electromics Co. →	Samsung Electronics Co.
	Hyundai Electronics Ind. LG Semiconductor Co. → Merger	Hyundai Electronics Ind. (Decided in March 1999)
Power-Generation Equipment	Hyundai Heavy Industries Co. Korea Heavy Industries & Construction Co. Samsung Heavy Industgries Co. → Merger	Koraa Heavy Industries & Construction Co.
Petro-Chemicals	SK, LG, Dalim, Lotte, Hanwha →	SK, LG, Daelim, Lotte, Hanwha
	Hyundai Petro-chemical Co. Samsung General Chemical Co. → Merger	Sole corporation establishment

29 The government suggested the list of industries for the deal. But only a half of industries in the final list matched the government's list.

30 Firms would be willing to dispose of their excessive capacity only when they could monopolize benefits from the disposal. M&A is certainly one of the options that ensure monopolistic gain for the acquirer.

31 A textbook on M&A says "M&A is a process of creative destruction: plant closing, layoffs and so on." It also states that "during 1894~1904, more than 1,800 firms disappeared into the formation of 93 consolidated firms with a important market share in their respective industries." (Applied Mergers and Acquisition, Robert F. Brunner)

32 The first step of the penalty was that creditor banks would stop lending, which would be followed by their demand for accelerated repayment of existing debt.

Business	Plan of the Deal	Controlling Body
Aircraft Manufacturing	Korea Air Line Co. → Samsung Aerospace Industries Co. Daewoo Heavy Industries Co. Hyundai pace & Aircraft Co. (Merger →)	Korea Air Line Co. Sole corporatio establishment
Railway Vehicles	Hyundai Precision & Ind. Co. Daewoo Heavy Industries Co. Hanjin Heavy Industries Co. (Merger →)	Sole corporation establishment (Share ownership ratio: 4:4:2)
Ship Engines	Hyundai Heavy Industries Co. → Korea Heavy Industries & Construction Co. Samsung Heavy Industries Co. (Merger →)	Hyundai Heavy Industries Co. Korea Heavy Industries & Construction Co.
Oil Refining	SK, LG, Ssangyong → Hyundai Oil Co. Hanwha Energy Co. (Merger →)	SK, LG, Ssangyong Hyundai Oil Co.

Contrary to this expectation, however, the final outcome of the Big Beal was only half satisfactory at best. The business swap deal between Samsung Motors and Daewoo Electronics never materialized.[33] Even seemingly-market-friendly deals like M&A turned ran into problems. The deals that were completed as announced were either fixed before the announcement of the Big Deal (oil refinery) or those in which a public corporation was deeply engaged (aerospace, power generating equipment and ship engines). The most contentious case was the M&A deal on the semiconductor industry. The deal was made finally under the tight mediation of the government but the merged company (Hynix) ran into financial difficulties later.[34]

What went wrong in the seemingly sensible deal? Perhaps, an answer can be found in a distorted incentive of the players in the deal due to wrongly ordered procedures. For an intuitive explanation, let us consider the prisoner's dilemma game (Table 4-3), where players tend to be end up like A, when they are not allowed to cooperate. The way to solve this type of prisoner's dilemma is to allow cooperation among players, which is certainly true in the case when M&A partners discuss the deal in the marketplace. No one would agree on the deal unless the deal provides a win-win situation (situation A). But suppose

33 Samsung Motors filed for the bankruptcy procedure in June 1999, during the process of which it was acquired by Renault. And Daewoo Electronics went to the work-out scheme.

34 It is believed that one of the main causes of Hynix's financial difficulty was the very high price that was paid to the seller, LG Semiconductor.

players now know that the counterpart would be obliged to cooperate, perhaps under heavy pressure from government. Then, each of the players would have incentive not to cooperate, expecting a higher gain. This might lead to the collapse of what would have been a cooperative game, returning to the situation of the prisoner's dilemma.

This may explain the case of the semiconductor industry. In Oct. 1998, both LG Semiconductor and Hyundai Electronics agreed to sell their semiconductor business to the one judged to be superior by an independent consulting company. Two months later, the consulting firm concluded that Hyundai could be a more competent managerial body. LG initially defied this judgment very strongly but soon yielded to accept the deal on the condition that the payment should be only in cash.

But this condition turned out to be another Trojan horse. The deal was originally structured such that the seller would retain an equity stake, though minority, in the merged firm, because that could prevent a deadlock situation in price negotiations.[35] Although the cash-only condition laid out by LG was clearly against the original design of the deal, public opinion at that time was strongly sympathetic to LG. Given intentional ignorance on the part of government, Hyundai had to accept the condition, paying a very high price afterwards.[36]

Table 4-3 | Prisoner's Dilemma Game

		Player 1	
Player 2		Co-op	Non-Co-op
	Co-op	A (5, 5)	B (7, 0)
	Non-Co-op	C (0, 7)	D (1, 1)

What can be learned from the Big Deal? Government intervention, albeit seemingly benign, may distort incentives in the private sector, resulting a completely different outcome than otherwise expected. A more standard way of dealing with large ailing firms has been workouts, in which creditors give up some of the loans that they made to the firms in return for the shares of the firms. Had the government chosen this path, the creditors of the firms that were targets of big deals would have become new owners. The new owners of the firms then could voluntarily decide whether to merge their firms and negotiate the terms of the merger.

35 Without this arrangement, the seller would have no incentive to safeguard the value of the merged firm, which in turn hinges critically upon the amount of the price paid to the seller.

36 Not unexpectedly, LG demanded an astronomical figure of some 8 trillion won despite the market analysis of some 1 trillion won at that time. The finally-negotiated price after the mediation of government was 2.6 trillion won, which was believed to be one of the major causes for Hynix's financial difficulty in the following year.

Chapter 5

Out-of-court Restructuring Schemes in Korea

1. The Corporate Workouts

2. Bank-led Corporate Restructuring Initiatives

3. Corporate Restructuring Promotion Act

4. Restructuring for Small and Medium-sized Enterprises

Out-of-court Restructuring Schemes in Korea

1. The Corporate Workouts[37]

1.1 Background

The massive distress in the corporate sector occurring around the Korean financial crisis in 1997, combined with the danger of financial market collapse due to the subsequent capital inadequacy of most commercial banks, called attention to the wide uses of corporate finance tools under bankruptcy. As the financial crisis was an event that imperiled not only the viability of the individual firms but also that of the entire financial system, most corporate distresses could not be unraveled solely with formal resolution methods, nor with commonplace bankruptcy filings incourt. In addition to the weak capacity and lack of expertise of the court, a host of distressed companies and sizable amounts of delinquent debts that could further exacerbate the already crisis-hit economy rendered the formal bankruptcy procedures insufficient as well as inefficient. Indeed, according to World Bank (1999), more than 80 percent of corporate restructuring is known to follow private agreements among the relevant stakeholders rather than court decisions under crisis situations.

The Korean Corporate Workouts Program was born in 1998 under conditions of systemic crisis, aimed at rescuing both distressed companies and financial institutions, in the cases when the delinquency of the former was a threat to the latter. Most financial institutions troubled with capital inadequacy, including major commercial banks, could not afford to take fair bankruptcy procedures against their non-performing corporations. They needed the time and resources in order to reorganize themselves along with rehabilitating the debtor companies. From the government perspective, it would be too costly to apply market principles and in-court restructuring methods to all the distressed companies, which could lead to liquidations in many cases. The managers and owners of the distressed companies

37 This chapter is reedited based on Kang (2004a).

preferred to be evaluated under the Corporate Workouts procedures, for they had a greater chance to lose management rights under the court decisions. The workers in these companies could also expect to retain their positions during the workout, whereas they would have been dismissed in the course of harsh employment restructuring. Given these incentives, the government initiated the proposal of the Corporate Workouts and all the other related stakeholders reached an agreement.

1.2 Overview of the Korean Corporate Workouts

1.2.1 History

From the beginning of 1997, just before the outbreak of the financial crisis, a few large corporations went into bankruptcy and many sizable business groups became financially distressed due to illiquidity, which ignited massive loan collections by creditor financial institutions, especially merchant banks. As the urgency about a possible systemic crisis increased throughout the entire economy, creditor banks assumed a leadership role in order to rescue the distressed companies under the so-called Insolvency Respite Agreement on April 18, 1997. Though the agreement contributed to the postponement of market failures resulting from the bankruptcy of troubled firms, the effect was only temporary. Until the end of 1997, the agreement was applied to 33 companies, of which 6 filed for the court-led Corporate Reorganization and 25 for Corporate Composition. On top of the existence in the agreement of non-participating creditor financial institutions such as investment trust companies, insurance companies, brokerage houses, and merchant banks, the lack of mediators to bridge the gap between different opinions among the creditors often limited successful performance of the agreements. The management and/or owners of the debtor companies worried about losing management rights were also passive in receiving financial assistance under the agreement. Thus, this kind of regime turned out to be ineffective in creating best practices for corporate restructuring in the crisis situations where every economic agent does not have room to consider others' distress due to concerns over their own viability.

The massive corporate distress generated by near-insolvency at the time of the financial crisis imperiled not only sound firms in the corporate sector but also almost all financial institutions. On top of the already deepened credit crunch in financial markets, the in-court restructuring ordered for all the problematic companies threatened to paralyze the flow of funds within corporate businesses, which could have further exacerbated the overall catastrophic situation, ending in a vicious spiral. Above all, the financial health of most financial institutions was not sufficient to absorb losses from the court-led restructuring. Under these circumstances, the Korean Corporate Workouts Program was initiated by the Financial Institutions Agreement for Promotion of Corporate Restructuring (hereafter the Agreement) signed by the 210 creditor financial institutions on June 25, 1998, as a successor to the former Bankruptcy Respite Agreement.

1.2.2 Characteristics

A workout is a negotiated agreement between debtors and creditors outside the bankruptcy process. In workouts, the debtor has to convince the creditors that they would be financially better off with the new terms of a workout agreement than they would under the terms of a formal bankruptcy. The main benefits of workouts are cost savings and flexibility. These benefits, however, do not come without risks. The main risk is a holdout problem associated with the stakeholders' violation of terms in the agreement. If this problem cannot be circumvented or controlled, workouts are inferior to the formal bankruptcy filing.

The Korean Corporate Workouts Program is similar to ordinary workouts, but is not exactly the same in terms of its objectives and operations. It was initially prepared for restructuring financially unhealthy medium-sized chaebol companies, especially targeting the 6-64th largest conglomerates in asset size. It can be defined as not only a corporate sector restructuring program aimed at resolving corporate distress, but also a subsidiary initiative to support financial sector restructuring.

The Workouts Program in Korea is understood as being semi-formal, instead of informal, in terms of its policy-making structure. Officially, it was the council of creditors that determined the conversion of original debt covenants into new ones. Practically, the Corporate Restructuring Coordination Committee (CRCC), a mediator that creditors established in order to resolve technical problems in the process of negotiation, played critical roles in preparing for every detail in the new contracts. Though consisting of private members, the CRCC had close ties with the Financial Supervisory Commission (FSC), a control tower orchestrating both financial and corporate sector restructuring. The CRCC and FSC collaborated with each other in the architecture of debt reduction such as the amounts of write-offs, maturity extensions, debt-equity swaps, etc., because the size of reduction would be in tandem with the amount of recapitalization of the creditor banks assisted by public funds. Government involvement in the corporate workout processes was inevitable in view of the depth of the corporate and financial sector distress. Under these circumstances where banks were subject to considerable risks of closure, their optimal behavior should be passive in terms of corporate restructuring, as it could yield to their insolvency or illiquidity, at least. [[not clear]]After the council of creditors approved the restructuring plans, then the main creditor bank followed up with execution, implementation, monitoring, and even additional loan arrangements. In summary, the Korean Corporate Workouts Program contained mixed characteristics for restructuring, being government-led in essence, market-led in its form and bank-led in real operations.

1.2.3 The Workout Companies

After the main creditor bank of the Kohap Group took four subsidiaries to the Corporate Workouts Program on July 6, 1998, a total of 104 companies had been under the scrutiny of the affiliated creditor financial institutions by virtue of the Agreement. Out of all the

applicants, the workouts against 8 companies were repealed, either because the creditors had suspicions about their viability or the owners of the companies had worries about losing their management rights. Thus, the creditor financial institutions commenced the Corporate Workouts with a total of 96 ailing firms. In the course of the Workouts, 17 companies were merged into their respective mother companies and 4 companies were partitioned from the Daewoo Corp. and the Daewoo Heavy Industry, Ltd. The total number of the workout companies then became 83.[38] <Table 5-1> summarizes the workout companies.

Table 5-1 | Summary of the Workout Companies

Application	Rejection	Workout Companies			
		Approved	Merger (Δ)	Partition	Total
104	8	96	17	4	83

Table 5-2 | Companies Entering into the Corporate Workouts Program

	1998	1999	2000	Total	Ratio (%)
Daewoo	-	12	4[1)]	16	19.3
Non-Daewoo	55	10	2	67	80.7
6-64 group	26	3	2	31	37.3
Others	29	7	-	36	43.4
Total	55	22	6	83	100.0

Note: 1) Partitioned companies from Daewoo Corp. and Daewoo Heavy industry, Ltd.
Source: Financial supervisory Service (2003).

Out of the 83 workout firms, 55 entered into the Workouts Program in 1998. These are the companies belonging to medium sized chaebols or independent ones. After the second largest chaebol in Korea, the Daewoo Group, declared a moratorium against the debts from the financial institutions in July1999, 12 Daewoo subsidiaries and related companies were put under the program (See Table 5-2). In terms of the number of the companies, Daewoo subsidiaries composed one fifth, but nearly two thirds of the notified debts belonged to Daewoo. Indeed, out of the total of KRW 103.8 billion, Daewoo's liabilities to the financial institutions reached KRW 66.6 billion (See Table 5-3).

38 This paper thus sets the number of the entire sample of the workout companies to be 83 hereafter.

Table 5-3 | Notified Debts of the Workout Companies

(Units: 100 million KRW, %)

	1998	1999	2000	Total	Ratio
Daewoo	-	665,767	-	665,767	64.1
Non-Daewoo	333,817	15,838	22,536	372,191	35.9
Total (ratio)	333,817 (32.2)	681,605 (65.6)	22,536 (2.2)	1,037,958 (100.0)	100.0

Source: Corporate Restructuring Coordinating Committee.

The results of the Corporate Workouts as of the end of 2002 are reported in <Table 5-4>. Out of the entire sample, 40 companies had already graduated from the Workouts Program and 15 companies were in the process of self-restructuring away from the Council of Creditor Financial Institutions. From the creditors' point of view, the 55 companies that are categorized in these two groups, which will be called normalization, seem with high probability to have become revitalized. However, the Workouts Program had been suspended against 16 companies and was still in progress for a remaining 12 companies.

Table 5-4 | Results of the Workout Companies as of the end of 2002

	Total	Normalization			Distress		
		Graduation	Self-restructuring	Subtotal	suspension	In-Progress	Subtotal
Chaebol	47 (100.0)	20 (42.6)	8 (17.0)	28 (59.6)	9 (19.1)	10 (21.3)	19 (40.4)
Others	36 (100.0)	20 (55.6)	7 (19.4)	27 (75.0)	7 (19.4)	2 (5.6)	9 (25)
Total	83 (100.0)	40 (48.2)	15 (18.1)	55 (66.3)	16 (19.3)	12 (14.5)	28 (33.8)

Note: ( ) is ratio in percentage.

1.2.4 Initial Financial Conditions of Workout Firms

Many factors might affect the performance of the Corporate Workouts. Much literature has reported that the initial conditions of the workout companies were one of the most important factors.

<Table 5-5> depicts the initial debt structure and business conditions of the non-financial 73 workout companies, for which the data are available. The banks' credits ratio to the total notified credits is around 30%, which does not vary much over the different industries,

workout results, and relations to Daewoo. The top five creditors' credit ratio is about 70%, with an average total number of creditors of 24.5. The debts are fairly concentrated on the small number of creditors. The number of creditors for Daewoo is also similar to that of others, but we should be cautious in assessing the numbers for Daewoo because the numbers were collected after the commencement of the Corporate Workouts. Before the Daewoo subsidiaries were put under the Program, they had 480 creditors from 69 countries. Aiming at pursuing efficient corporate restructuring, the government got involved in debt negotiation with foreign creditors. As a result, the Korea Asset Management Corporation (KAMCO) purchased the foreign Daewoo debts of the nominal amount of 36.9 billion US dollars at an average of 43 cents per dollar.[39] <Table 5-5> does not capture this simplification process. This table also reports the average ratio of going-concern business value to liquidation value in the last column.

Table 5-5 | Initial Debt Structure and Business Conditions of the Non-financial Workout Companies

	Section	Relative to Total Credits of Financial Institutions(%)					GCBV[1] (LV)[2]
		Banks' Credits	Top Five Creditors' Credits	Guaran-tees	No. of Creditors	No. of Banks	
Industry	Manufacturing [53]	31.2 (14.3)	71.3 (16.4)	34.0 (20.4)	24.4 (16.6)	8.8 (5.1)	1.5 (0.5)
	Construction [10]	25.4 (10.7)	63.6 (16.3)	26.3 (14.0)	28.0 (13.7)	12.3 (5.8)	1.6 (0.4)
	Retail & Wholesales [7]	29.9 (17.1)	67.0 (15.1)	23.4 (17.4)	25.9 (23.2)	9.7 (5.0)	1.5 (0.4)
	Others [3]	51.2 (17.5)	92.0 (13.0)	39.8 (22.0)	9.7 (7.2)	4.3 (3.5)	1.8 (0.1)
Workout Result	Graduation [36]	31.5 (13.9)	74.4 (15.9)	34.3 (22.2)	18.1 (10.7)	7.8 (3.9)	1.6 (0.4)
	Self-Restructuring [12]	41.6 (19.7)	75.1 (15.8)	32.9 (11.7)	21.4 (13.7)	7.8 (4.7)	1.3 (0.8)
	In-Progress [12]	25.0 (10.3)	59.5 (10.7)	24.3 (11.0)	38.3 (13.9)	12.2 (5.9)	1.5 (0.4)
	Suspension [13]	27.0 (12.1)	67.4 (19.9)	32.9 (22.3)	31.2 (24.1)	11.4 (6.9)	1.3 (0.4)

39 See Jeong and Hong (2003) for the detailed story of the KAMCO's acquisition of the foreign debts of the Daewoo subsidiaries.

	Section	Relative to Total Credits of Financial Institutions(%)					GCBV[1] (LV)[2]
		Banks' Credits	Top Five Creditors' Credits	Guaran-tees	No. of Creditors	No. of Banks	
Daewoo	Daewoo [10]	23.2 (10.3)	61.2 (18.3)	13.7 (8.8)	39.4 (23.7)	11.7 (5.8)	1.5 (0.5)
	Non-Daewoo [63]	32.3 (15.0)	72.2 (16.1)	35.1 (19.1)	22.1 (14.2)	8.8 (5.1)	1.5 (0.5)
All [73]		30.9 (14.7)	70.7 (16.6)	31.7 (19.7)	24.5 (16.6)	9.2 (5.2)	1.5 (0.5)

Note: [ ]: number of observations
( ): standard deviation
1) GCBV: Going Concern Business Value
2) LV: Liquidation Value

1.3 Specific Restructuring Methods

Corporate restructuring aims at reorganizing the financial and business structures of the ailing or failing companies through various methods. By and large, we can categorize the reorganization efforts into groups by the following four aspects: debt, business, employment, and governance. In this subsection, we discuss the specific corporate restructuring methods used in the Workouts.

1.3.1 Debt Restructuring

Debt restructuring is a prime ingredient of the Corporate Workouts because the direct causes of corporate distress stem mostly from high external debts relative to debt service capacity. Interest relief and composition are typical methods of debt restructuring. Interest relief includes debt extension of payment terms and/or conditions, lower interest rates on debts, and similar alternatives. Composition means accepting a haircut on the principal of the debts. When the creditors exempt the debtors from paying the principal, the former usually reduces the equities of the latter and converts the debts into either equities or convertible bonds (CBs) in order to recoup the upside potential of recovery.[40]

In the Workouts program, when the creditors reset the interest rates, they calculated the sustainable debt amounts based on the estimates of future free cash flows. The amount of debt exceeding what was affordable was converted into equities or CBs, and then lower interest rates were applied to the remaining debts. <Table 5-6> summarizes the contents of debt restructuring in the Workouts Program. The major instrument utilized was interest

40 In order to facilitate equity conversions, the government revised regulations on the financial institutions. In the case of an equity investment on the workout companies, the ceilings on securities investment of financial institutions, or less than 15% of the voting stock in any other company, are not applied.

rate reduction. As for the debt amounts, interest rates were lowered or periods of interest payments were extended on KRW 66.1 trillion, or 67% out of the total debt restructuring of KRW 98.7 trillion. Debt-to-equity and debt-to-CB conversion for the unsecured claims[41] were widely used in the Corporate Workouts, as well, with totals of KRW 15 trillion and KRW 3.3 trillion, respectively.

<Table 5-7> shows the interest rates on the workout companies over time. From 1998 to 2002, the corporate loan rates had declined monotonically due to economic recovery after the crisis and stabilized inflation. Following this trend, coupled with the improved ability of the financial institutions to absorb losses from the non-performing loans, the interest rates applied to the workout companies also declined until 2001. In 2002, however, despite the low loan rates for corporations, the interest rates for the workout companies rose because the massive debt-to equity conversions, especially for the Daewoo subsidiaries, reduced the credits applied to low interest rates.

Table 5-6 | Debt Restructuring for the Workout Companies

(Unit: KRW 100million)

	Debt relief			Debt-equity conversion			Others[1]	Total
	Interest rate reduction	Normal interest rate	Subtotal	Equity conversion	CB conversion	Subtotal		
Normalization	65,689	30,563	96,252	95,374	14,582	109,956	45,519	251,727
In Progress	134,978	17,624	152,602	51,817	12,966	64,783	17,045	234,430
Suspension	460,701	10,023	470,724	2,466	5,728	8,194	13,901	492,819
Total	661,368	58,210	719,578	149,657	33,276	182,933	76,465	978,976

Table 5-7 | Interest Rates on the Workout Companies

(Unit: %. %p)

	1998	1999	2000	2001	2002	Average
Secured Credits (A)	9.8	8.3	8.2	5.4	6.9	7.7
Unsecured Credits (B)	9.9	5.21)	6.6	5.0	6.5	6.6
Difference (A-B)	- 0.1	3.1	1.6	0.4	0.4	1.1
Average for workout companies	9.9	5.8	7.2	5.1	6.6	6.9
Corporate loan rate	15.2	8.9	8.2	7.5	6.5	9.3

41 The secured creditors tried to avoid equity conversion, worrying about the losses from security evaluations. However, there are cases in which secured creditors participated in the recapitalization. In such cases the stock price exceeded the face value in the exchanges or put-back option was provided.

1.3.2 Business Reorganization

In return for debt restructuring, creditors usually ask debtors to reorganize the business towards raising long-term profitability. Also, the companies that could not survive only with debt restructuring need to employ business restructuring. Some of the examples are sales of assets such as real estate, securities, or businesses, and recapitalization through measures such as external equity participation.

In order to support these self-restructuring efforts, the government revised the various legal straitjackets. For example, corporate partitions were introduced by the revision of the Commercial Act, to allow the comprehensive transfer of businesses. This helped to reduce the costs of business sales and subsequently those of corporate restructuring.[42] In order to facilitate M&A, the investors for the workout companies are exempted from the clauses on tender offers in the Securities and Exchange Act.[43] To invite foreign investments in the distressed companies, the restrictions on foreign investors on the gross amount of investment were removed. Through a number of revisions of the Special Tax Treatment Control Act, tax incentives for corporate restructuring have been provided as well.

<Table 5-8> reports the data on the self-restructuring efforts by the workout companies to regain confidence in business operations. The self-restructuring efforts have been concentrated on the Daewoo. As a matter of fact, various approaches have been experimented by them.[44] More than 70% of the business restructuring in terms of the amounts is attributable to the Daewoo subsidiaries.

Table 5-8 | Business Restructuring Efforts by the Workout Companies

(Unit: KRW 100 million)

	Asset Sales					Sub-sidiary	Capitali-zation	Owner Contri-bution	Others	Total
	Real Estate	Security	Business	Other Assets	Subtotal					
Daewoo	20,135	4,960	23,192	3,856	51,454	4,647	9,897	1,205	2,867	70,081
Non-Daewoo	7819	7,247	6,388	2,659	24,113	2,207	202	0	3,171	29,693
Total	27,954	12,207	29,580	6,515	75,567	6,854	10,099	1,205	6,038	99,774

42 The Daewoo Corp. and Daewoo Heavy Industry adopted spin-off strategies for prospective businesses according to the legal grounds for corporate partition.

43 According to the paragraph (1) of the Article 21 in the Securities and Exchange Act, a person who intends to acquire voting stocks through a purchase outside the securities market or the association brokerage market shall acquire the stocks through a tender offer in a case where the total number of the stocks held by such person and specially connected persons after the purchase is 5/100 or more of the total number of the stocks.

44 As for the cases of restructuring the Daewoo subsidiaries, see Korea Development Bank (2003).

1.3.3 Employment Restructuring

Employment restructuring is usually considered one of the components of self-restructuring, but needs to be discussed separately due to its sensitivity. In the Corporate Workouts under the crisis, unlike the private workouts during normal times, policy makers should pay attention to unemployment as well as creating an efficient system, as collective endeavors, rather than sacrifices of certain groups, could be driving forces to overcome a catastrophic situation. From the micro perspective, harsh employment downsizing may fail to obtain cooperation from the laborers, one of the important stakeholders for the success of corporate restructuring.

<Table 5-9> shows the percentage changes in the number of employees and personnel expenses of the workout companies. Overall, 32.6% of employees were reduced between the beginning and the end of the Workouts. This means over 31,000 laborers had been laid off. The employment restructuring is more severe in the Daewoo subsidiaries in terms of both the decreased numbers of employees and the personnel expenses. It is also interesting to note that the per capita personnel expenses have increased, since the laborers have decreased more rapidly than the total personnel expenses. The workers who are able to keep positions in the workout companies thus seem better off.

Table 5-9 | Employment Restructuring in the Workout Companies

	Percentage Changes in		
	No. of Employees	Amount of Personnel Expenses	Per Capita Personnel Expenses
Daewoo	-39.29%	-21.10%	29.96%
Non-Daewoo	-26.51%	-1.38%	34.20%
Average	-32.55%	-11.21%	31.65%

1.3.4 Governance Restructuring

Weak corporate governance has long been blamed as one of the causes of the financial crisis in Korea. The restructuring of governance in the distressed companies is of particular importance in that it could not only place responsibility for the poor management on the incumbent managers and owners, but also provide momentum for revitalization. Improvement of governance is thus consistent with fairness and efficiency.

As of the end of 2002, the old owners stepped down from the top management in 56 out of the 83 workout companies. The old owners kept management rights in the other 27 cases, of which most graduated from the Corporate Workouts through self-restructuring efforts and improvement in business operations.

1.4 Performance

The five-year experiences of the Korean Corporate Workouts Program have produced various experiments in private, or semi-private at least, corporate restructuring led by the creditors. They are quite unique in the sense that the data on the corporate rehabilitation tools, as well as the discrete results of either success or failure, are available to such an extent that empirical analyses could be feasible. Normally, corporate restructuring entails a series of confidential negotiations and contracts so that only a piecemeal set of information is available, usually contained within case studies. In Korea, however, the restructuring efforts by both the creditors and debtors have been traced and recorded by the government authorities. The characteristics of the Korean Corporate Workouts Program and its funding structure made data collection possible, though it was not made publicly available.

Based on the empirical analyses, we can make the following remarks as evidence on the performances of the Korean Corporate Workouts. First, the initial status variables are the key success factors in the Corporate Workouts. The ratio of the top five creditors' credits to total credits is found as the most significant factor to affect the revitalization of the workout companies in terms of debt service capacity. Also, as the ratio of over-10% creditors to total creditors becomes higher, the distressed companies are more likely to recover in their business operations. Creating the proper debt structure of the workout companies has dominated various restructuring efforts. The importance of the simple debt structure in the Workouts is consistent with the analysis by Gilson, John and Lang (1990) that showed that private workouts did not perform well in the U.S. companies that had a host of creditors due to bond issuance in the markets.[45]

Second, debt-to-equity conversion is the most effective tool among various debt restructuring methods, though it does not seem to be very significant. Other ways to relieve the debt burdens of the workout companies had affected the corporate revitalization in the opposite direction of conventional wisdom. Especially, the debt-to-CB conversion has adversely affected the capability of the distressed companies to redeem debts in a very significant manner. These observations can be understood as the result of the creditor-led corporate restructuring. As mentioned earlier, the Korean Corporate Workouts Program aimed mainly at restructuring the distressed financial institutions. Corporate restructuring was a supplementary instrument with which they tried to boost the recovery of the NPLs from the corporate sector. Thus, the amounts of the debt restructuring were provided in a conservative fashion that enabled them to minimize the losses. The positive correlation of the debt-to-equity swap with corporate revitalization from the creditors' perspective is thought to be the result of sorting by the financial institutions, which have larger private information sets than is available to the public. These institutions had converted debts into equities only for the prospective companies.

45 Asquith, Gertner and Scharfstein (1994) also find consistent the observation that the financially troubled firms issuing bonds publicly are more prone to file for Chapter 11 rather than being privately restructured out of court.

Third, business and employment restructuring turn out to be insignificant in corporate revitalization. As for almost all of the proxy variables for these categories, the null hypothesis that the coefficient is zero cannot be rejected. Per capita personnel expenses, one of the employment restructuring variables, are relatively significant and consistent only in the results of business rehabilitation from the debtors' perspective

Fourth, it is quite delicate to interpret the effect of the governance reshuffling on the performances of the Workouts. Under the criteria reflecting creditors' positions, this variable is quite significant, but contrary to conventional wisdom. The harsher the management and ownership reshuffling is, the worse the recovery of debt service capacity turned out to be. Under the criteria reflecting debtors' positions, however, the results are less significant, but follow a more expected path: the harsher the management and ownership reshuffling is, the better the business operations are.

One of the possible explanations for this phenomenon is that the creditors and managers of the workout companies may collude with each other for the sake of their own incentives. Their incentives are quite clear. The creditors hoped to maximize the recovery, while the managers were eager to retain their positions. If they behave as their incentives dictate, the empirical observations forecast that the debt service capacity would increase while the distressed companies would be less likely to move back into normal business conditions. This is just a conjecture, and further research should verify the true relationship between governance reshuffling and corporate revitalization.

2. Bank-led Corporate Restructuring Initiatives

2.1 Corporate Restructuring before the Financial Crisis

The Korean economy had averaged growth of over 7 percent per year in real terms from the early 1960s to the crisis in 1997. Following the strategy of choice and concentration on the heavy and chemical industries first, and electronics next, the government had led economic growth by nurturing large business groups, or chaebols. The government support for these companies was multi-faceted, including providing special loans and even occasional debt relief. Indeed, both financial assistance during good times and corporate restructuring during bad times were led by the government. The government-led restructuring in Korea proceeded under the rationale of reallocating resources efficiently by removing overlapping and excessive investments. Thus, the industrial rationalization seems to have originatet from theories of central planning, in which government intervention is justifiable when private markets fail at significant levels.

This process of industrial rationalization had been initiated three times. The initial incident in this category was the Corporate Rationalization Measures that occurred between 1969 and 1971. In the 1960s when Korean corporations could not borrow from abroad with their own credit ratings, the government provided them with loans whose funds originated from

foreign aid or government borrowing. In the case of the recipients of these loans becoming distressed due to inefficient management, the government reshuffled the management and collected debts through asset sales on the condition of financial restructuring.

The second case of industrial rationalization was the 8.3 Emergency Executive Order in 1972. The main content of this order was a corporate bailout by the government that included a temporary moratorium on the payments of corporate debts against non-financial institutions as well as debt rescheduling. All corporate loans from the curb market were converted into long-term loans, at a maximum interest rate of 16.6 percent, when the prevailing curb-market rate was over 40 percent per annum. About 30 percent of the short-term bank loans to businesses were converted into long-term loans at a reduced interest rate. This conversion was ultimately backed by the central bank, which underwrote the special debentures issued by the commercial banks.[46] Such a measure was deemed inevitable in the face of unbearable default risk in the corporate sector stemming from high leverage. However, this policy was not free of costs. The government bailout exacerbated the already weak market discipline and caused serious moral hazard problems. Excessive corporate debt-to-equity ratios based on implicit risk sharing by the government created the so-called too-big-to-fail hypothesis. Given the implicit state guarantees on bank lending, banks had little incentive to monitor client firms' investment decisions.[47]

The third industrial rationalization, and largest in scale, was the Resolution of Distressed Firms during 1984 and 1988. In 1984-85 the rationalization targeted marine transportation and overseas construction businesses. In 1986-87 fifty-seven financially troubled firms were reorganized, of which twenty-one firms were liquidated in the end. The rationalization measures were taken unilaterally by the government and often lacked legal grounds or legally adequate procedures.[48] All of the key decisions were made by the government, including those of whether to liquidate or restructure the firm, as well as the terms of restructuring. In fact, there were no legitimate principles or guidelines that governed the rationalization measures, and hence, there was little transparency in the proceedings. At first glance, banks were the biggest losers as they were forced to incur most of the losses. But since the banks operated virtually as government entities and their losses were eventually covered by the public money, it was the taxpayers who ultimately paid the costs. Indeed, the central bank provided special loans on favorable terms to those banks whose financial health was seriously undermined by the massive write-offs of the loans made to the firms targeted by the rationalization measures.

The Big Deals during 1998 and 2000 also contain elements of industrial rationalization, even after the crisis. At the height of the financial crisis, the government announced the plan for mergers by large firms in several industries. The plan, in theory, was based on voluntary agreements by the participating firms and did not officially involve the government. Doubts

46 See Kim (1990), Kim (1994), and Cho and Kim (1995).

47 About the 8.3 Emergency Executive Order, see Nam, Kim, Kang, Joh and Kim (1999).

48 The rationalization policy became based on the Industry Development Act only after 1986.

have been raised, however, that the government could have played a negligible role in setting up the Big Deals. Normally, a government would be interested in deterring mergers and acquisitions that would significantly harm competition. In that case, the Big Deals might have been motivated by industrial policy concerns aimed at making the Korean firms in the target industries competitive in the world market. From the financial perspective the mergers were initiated by the heavy indebtedness of the firms involved. As the dominant shareholder of major banks, the government was interested in minimizing the losses of the banks by arranging mergers so as to make the loans perform again.[49]

2.2 Changes in Corporate Restructuring after the Crisis

The 1997 financial crisis stands as a watershed event for corporate restructuring. Before the crisis, government-led or even government-directed restructuring was the only viable solution to resolve large scale corporate distress, as seen in the previous section. Banks, among the stakeholders, participated in the process of restructuring, but in the very narrow sense that they supported the policies already decided by the government. The financial crisis, however, was not an event in which any single economic agent, including the government, could entirely incur all the costs in the course of corporate restructuring. The total size of losses was simply too huge, and the number of stakeholders was too many. Diverse uncertainties prevailed, so that no one could assume the potential risk stemming from hasty decision making.

Under these circumstances, market forces reflecting on economic democracy stood as the last resort, reinforcing the notion that all participants should be responsible for their past and future behaviors. In such cases, then, the government should underpin the infrastructures that facilitate proper functioning of the markets. Private agents should also develop the software aspects of restructuring under these settings. The next section describes the changes in the policies and banks' internal behaviors toward corporate restructuring following the crisis.

2.2.1 Changes in Policies to Facilitate Corporate Restructuring

The corporate restructuring plans varied in terms of their methodologies to rehabilitate the ailing firms, particularly depending on their status. Restructuring of the financial aspects such as debt write-offs, rescheduling, debt-to-equity conversion, etc., was the first necessary ingredient for rescuing the financially weak companies. The financial regulations, however, required financial institutions to comply with prudential norms, such as ceilings on securities investments to non-financial companies and of amounts of credit against the same person.

These regulations limited the scope of debt restructuring of creditor financial institutions. As a result, the prepared corporate rehabilitation program might not have been effective to

49 About the Big Deals, see Nam, Oh and Kim (2000).

rescue the corresponding companies. The financial policy maker, the Ministry of Finance and Economy (MOFE), and the financial regulatory authority, FSC, thus amended the Banking Act and its Presidential Decree in 1999 so as for banks to contain various debt restructuring measures. According to paragraph (1) of Article 37 in the Banking Act, no financial institution shall hold more than 15/100 of the issued voting stock in any other company. But the amendment of the Act on February 5, 1999 recognized the exception of the paragraph; a financial institution, if a company falls under any category of businesses as determined by the Financial Supervisory Commission or, if it obtains approval from the Financial Supervisory Commission as necessary for promoting corporate restructuring, may hold more than 15/100 of the issued voting stock in the company. The Corporate Restructuring Promotion Act, effective as of September 2001, stipulates the exemption from applying paragraph (1) of Article 37 in the Banking Act, and also similar clauses in other financial laws, for the cases in which creditor financial institutions swap debts for equities or restructure debts following the decision of a council of creditors. These amendments and enactments released the straitjacket of financial institutions to participate in debt relief over the distressed companies.

There were cases in which debt relief was not enough to revive the distressed firms. These firms, being short of liquidity, could not take any action toward a turnaround without additional cash. Thus, fresh loan provision should be necessary for further business and/or employment restructuring. The creditor financial institutions, however, were not only reluctant to supply additional credits but also unable to do so under the regulatory requirements. According to paragraph (1) of Article 35 in the Banking Act, no financial institution shall extend credits exceeding 25/100 of the relevant financial institution's equity capital to the same individual, corporation and person with whom it shares the credit risk. On May 12, 1999 the government inserted the stipulation in the Presidential Decree corresponding to the Banking Act that new loans to the companies under in-court restructuring or the Corporate Workouts Program are exceptions for calculating the credit line for the same borrower.

In order for the ailing companies to become revitalized, financial restructuring is a necessary condition, but not a sufficient one in the cases where they face deep trouble in business prospects. For example, suppose that a company runs two different kinds of businesses like construction and shipbuilding. Both businesses are in distress due to domestic economic downturn and a drop in foreign demand. If the downward shift in the domestic construction business is anticipated to last long (because of overall weakness in the domestic purchasing power after the crisis) whereas the foreign demand for ships will recover soon (because of exchange rate adjustments), the company and its creditors ought to formulate a strategy to save the shipbuilding business and to dispose of the construction part.

Technically, this strategy can be implemented through corporate partition or business transfer and acquisition. The previous methodologies for corporate spin-off were business

transfer and acquisition or real capital investment in which individual assets and liabilities were transferred. However, these involved very costly and time-consuming tasks. Thus, the government amended the Commercial Act on December 28, 1998 to newly establish a corporate partition in which all of the assets and liabilities belonging to the spun-off business are transferred comprehensively. In addition to this legal basis, tax benefits were provided, such as deferral of the profits from a business partition and exemption from the acquisition tax of a newly created company.

Though they took the detailed turnaround actions as planned, banks are not experts in corporate restructuring because their core business remains in furnishing loans based on credit examination. In order to effectively turn hard-hit companies around, banks need to take advantage of the expertise and funds available in the market. One of the ways for these market forces to be involved in corporate restructuring is to activate mergers and acquisitions (M&A). The existence of various legal restrictions and cultural constraints on corporate takeovers in Korea, however, had deterred creditors from selling the debtor companies to investors, especially foreigners. Therefore, the government initiated a number of policy changes to facilitate the M&A.

Table 5-10 | Summary of Policy Changes for Efficient Corporate Restructuring

Section	Policy Changes	Purposes
Promotion for Debt Restructuring	Exception for the application of ceilings on securities investments of financial institutions to non-financial companies	To facilitate debt-to equity swap for distressed companies
	Exception of the application of ceilings on the credit line for the same borrower	To provide additional loans to distressed companies
Promotion for Business restructuring	Introduction of corporate partition	To allow comprehensive transfer of businesses
	Tax benefits like exemption from acquisition tax of a newly created company	To relive the financial burden on business restructuring
Promotion for M&A	Exemption from a tender offer Regarding	To facilitate M&A of distressed companies
	Removing restrictions on foreign investors' acquisition of stocks of domestic companies	To invite foreign investments on distressed companies
	Exemption of foreign investors from the restrictions on gross amount of investment regarding companies under the Corporate Workout or under the collective management of creditors following the Corporate Restructuring Promotion Act	To invite foreign investments on distressed companies

Section	Policy Changes	Purposes
Reducing Costs for Corporate Restructuring	A number of revisions of the Special Tax Treatment Control Act	To provide tax incentives for restructuring
	Deferral of Profits from M&A	To benefit investors from liquidity and cost perspectives

The following are some of the examples of these changes. First, according to paragraph (1) of Article 21 in the Securities and Exchange Act, a person who intends to acquire voting stock through a purchase outside the securities market or the association brokerage market shall acquire the stock through a tender offer in a case where the total number of the shares held by such a person (and other connected persons) after the purchase is 5/100 or more of the total number of the shares. The purposes of this enactment were to ensure fairness in the competition of management rights through improving the transparency of a tender offer process and to protect investors through timely disclosure of information. In most cases where a debt-to-equity swap occurred for the distressed companies, however, creditor financial institutions as a whole became dominant shareholders. If so, an M&A trial through confidential negotiations would not harm investors other than the financial institutions. As a matter of fact, it would benefit most stakeholders by increasing the value of the firm. In this context, the FSC revised the Regulation on the Issuance and Notification of Securities on January 3, 2003, so that, as for the companies under the Corporate Workouts or under the collective management of creditors following the Corporate Restructuring Promotion Act, investors are exempt from a tender offer.

Second, before the financial crisis, a restriction existed on foreigners acquiring stocks of domestic companies. They had to obtain approval from the board of directors. However, in February 1998, the government amended the Foreign Investment and Foreign Capital Introduction Act, thus ruling out this constraint. Also, in January 2001 and January 2002, the government revised the Monopoly Regulation and Fair Trade Act so as to exempt foreign investors from the restrictions on the gross amount of investment regarding the companies under in-court restructuring or under the collective management of creditors following the Corporate Restructuring Promotion Act.

Various policy measures have been provided to relieve the tax burdens of creditors, debtors and investors, for tax incentives can reduce the costs to the creditors and debtors and increase the returns to the investors. These policies imply that the government and ultimately the taxpayers are willing to participate in loss sharing in order to achieve more gains from an expeditious restructuring. On December 13, 1997, just after the crisis, the Corporate Tax Act was revised in favor of enabling the profits from a merger to be deferred over time. Several amendments on the Special Tax Treatment Control Act have supplied tax incentives for business restructuring such as asset sales, stock swaps and spin-offs, as well as financial restructurings like debt-to-equity conversion.

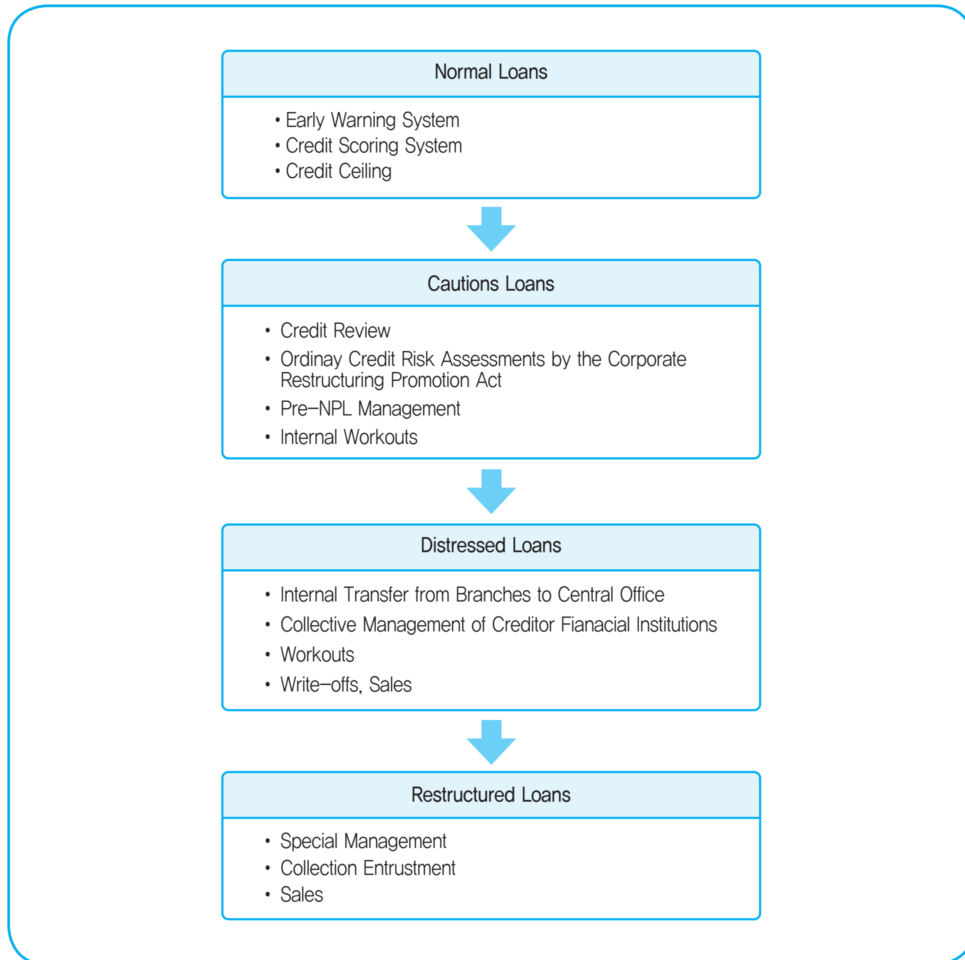
2.2.2 Changes in Banks' Internal Behaviors

Substantial changes have occurred inside Korean commercial banks aimed at efficient management and resolution of financially distressed companies. From the beginning of a loan application, the banks systematically examine borrowers' creditworthiness. After loans are made, banks thoroughly monitor their credit migration utilizing an early warning system. Various ceilings on the same borrower contribute to reducing the occurrence and size of non-performing loans (NPLs). Periodic credit reviews upon the loans reveal the likelihood of insolvency. When it starts to grow, banks classify the loans as cautionary and put them into pre-NPL management. Sometimes they workout the debtor companies following the internal regulations (See Figure 5-1).

Once the banks recognize the symptoms of debtors' distress, they prepare a resolution plan for loan recovery within a month and take necessary measures within two months (See Figure 5-2). For example, distressed assets, or NPLs, are immediately transferred from branches to the department of loan recovery in the central office within ten days after their occurrence. The corporate restructuring specialists in the department calculate various prices of the NPLs by using the official, historical, and auction data as well as pursuing due diligence, if necessary. Based on the quantitative assessments and legal considerations, the committee, consisting of working-level officials, arranges a restructuring plan. The committee for resolving corporate distress, the highest level decision-maker, consisting of managing directors for large-scale loans or the managing director alone for smaller ones, decides whether the plan should be approved or revised.

In the above process, the core expertise that the banks have achieved throughout the periods of overcoming crises is how to value distressed assets. Before the financial crisis Korea was not equipped with transparent accounting standards for sound corporations, let alone for troubled ones. The financial statements of the distressed companies were filled with false reports and artificial embellishments, which stemmed partly from the fraudulent behaviors of the management and/or owners and also from the lack of generally accepted accounting principles within these companies. The Korean Corporate Workouts Program has educated the commercial banks to develop reasonable accounting standards for the distressed companies. Accumulation of relevant data sets, numerous performances of due diligence, repeated negotiations and actual results have provided the stakeholders with near consensus on the reasonable values of distressed companies.

Figure 5-1 | Credit Risk Management by Loan Classification in Bank



More specifically, banks set a number of prices on the NPLs for different purposes. The internal price is the very first one used in the transaction between the central office and the branches where the NPLs originate. The reference data point to set the internal price is a liquidation value from the company's past history. Another reference data point is the acquisition price of the Korea Asset Management Corporation (KAMCO), which works as a lender-of-last-resort to the banks. Next, due diligence yields the price of evaluation that reflects on the going-concern business values of the firms. This price works as a reservation price to the bank that limits the lowest sale price of the assets. When the NPLs are pooled for sale, for example, through an auction in the form of asset-backed securities (ABS), we observe the bid price of the pooled assets. The unit price per each asset is then a wholesale price. The successful bidder may split the pooled assets into pieces and resell them separately. The final price of the individual NPLs becomes a retail price. This entire

price structure was not recognized before the financial crisis due to the non-existence of NPL markets, but today even highly quantitative assessments on the various prices are feasible among most commercial banks.

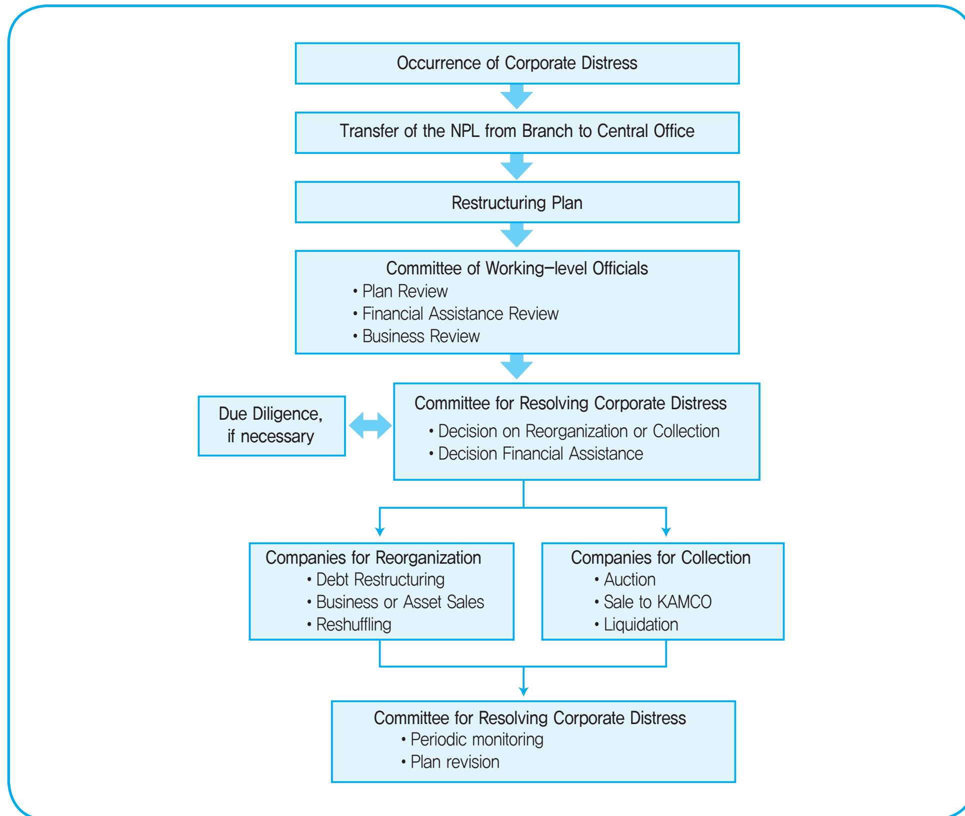
On top of the improvements in the software such as the generally accepted accounting standards and pricing techniques for distressed assets, significant changes have taken place from the perspectives of organization and labor placement in the banks. Before the financial crisis, the department and its staff managing and recovering distressed assets in the banks did not attract attention from the management. Despite the importance of the successful management of NPLs in terms of contributing to bank profits, it was recognized as one of the least popular departments, and so staff would try to get out of the so-called "mess clearing tasks" that offered no reasonable incentives.

Things have changed dramatically, as the resolution of NPLs has become increasingly important. Since the performances of the department have affected the entire profitability of the bank, capable and skilled labor forces in and out of the banks join the department. Though it is still often compared to the cleaning industry, the NPL disposition task requires top-notch financial and legal knowledge, data processing techniques, and strong negotiating skills. As the NPL market develops in Korea, these bank staffs have become experts. Their experiences also have become an invaluable asset to the banks for the efficient disposition of potential distressed assets.

Now that corporate restructuring cannot proceed by the initial creditors, or banks alone, the existence of a strong and integrated network matters not only at the beginning of the corporate turnaround but also at its end. As mentioned above, it is desirable to exploit market expertise and funds whenever possible. In other words, the widespread network with various market participants, for example investment banks, financial and management consulting firms, accountants, lawyers, and real estate specialists, among others, is one of key factors in successful corporate restructuring.

Effective networking with the market, however, is not built up overnight. Through tedious corporate restructuring and asset sale processes after the crisis, Korean commercial banks positioned themselves better to communicate with international market leaders. With the understanding and mutual appreciation of the nature of corporate restructuring and NPL markets, the division of labor is established which can resolve bad assets in the most efficient way. For example, a number of asset management companies purchase the corporate related NPLs from the originators through auctions or individual loan sales and employ industry-specific corporate restructuring specialists to make a plan. Investment banks and/or private equity funds advance either equities or fresh loans for business operations in view of the characteristics of the risks involved. Credit collection agencies come in to play a role in recovering the scrap values of the liquidated firms. All of these infrastructures constitute an ordinary restructuring system under normal times.

Figure 5-2 | Flowchart of Resolving Distressed Companies in Bank



Finally, but not least importantly, it is noticed that the banks change internal regulations and set rules for expeditious responses to corporate distress. Before the financial crisis and even until the year 2000, it was very difficult for the Korean financial institutions to relieve debts without court decisions. For example, according to the agreement on the tasks of the Korea Development Bank (KDB), a fully government-owned bank, with MOFE, KDB was not allowed to exempt delinquent debtors from redeeming the principal of borrowed loans. Since KDB was one of the leaders in industry loans and other commercial banks tended to follow its guidance at that time, virtually no commercial banks issued exemptions from principal redemption. The measures that allow banks to give up loan recovery rights would definitely motivate the debtors to make attempts to revive, but the bank staff related to the delinquent loans would be concerned about accusations leading to their responsibilities. Understandable as it is, this practice is not economically rational and fair in the sense that it would not benefit anyone except for the staff who should be accountable for their misbehavior. MOFE and KDB changed the agreement on the KDB's tasks toward enabling the bank to relieve both principal and interests if necessary. Furthermore, most banks systemize the process and standards for corporate restructuring.

3. Corporate Restructuring Promotion Act

3.1 Enactment of the Corporate Restructuring Promotion Act

The prompt responses to the 1997 financial crisis such as liquidating failing firms and moving forth with corporate restructuring contributed greatly to stabilizing the financial system. However, conducting corporate restructuring on such a large scale during a short span of time had its repercussions and market uncertainties arose. Hence, the authorities decided that it was desirable to have a standing credit risk evaluation system which the creditor financial institutions may utilize in implementing corporate restructuring.

The financial institutions set up and operated corporate credit risk evaluation systems per operating standards the FSS provided. On April, 2001, the creditor financial institutions selected 250 firms subject to credit risk evaluation over the course of six months. Liquidation processes were carried out for 141 firms and restructuring processes for 66 firms.

Despite the efforts to establish a voluntary corporate restructuring system, the corporate restructuring system led by financial institutions pursuant to the Corporate Workout faced some difficulties. The market was still very inexperienced to embrace the voluntary restructuring process. Also, there were incentives for some financial institutions to ride free rather than share losses by participating in the corporate restructuring. The system itself was still very premature.

Although, the creditor financial institutions acknowledged the need for corporate restructuring, the financial institutions had difficulty in implementing actual measures since the voluntary agreements among financial institutions were not binding. The inefficient process of the restructuring led by the financial institutions only caused market uncertainties to worsen.

To remedy the situation, the Corporate Restructuring Promotion Act (CRPA) was enacted on July, 2001, and went into effect on September 15, 2001. Firms with total credit exposure of more than KRW 50 billion were now subject to the CRPA, and firms with the exposure of less than KRW 50 billion were subject to creditor bank's voluntary agreement when undergoing credit risk evaluations and restructuring.

3.2 Controversies over Enactment of the CRPA

3.2.1 Violation of the Right to Private Ownership of Property

One of the controversies was that the CRPA violates the constitutional right of private property ownership. The clause of the CRPA that financial institutions are required to defer collecting on their claims without court intervention against part of creditors' interests was seen as a possible violation of the constitutional right. However, creditor financial institutions may run to collect their claims, thus hindering with the rehabilitation process. Such cases ultimately damage other financial institutions. The property right nonetheless

needs to be protected; hence the requested standstill lasts no longer than seven days from the day the creditors' meeting is called.

Having objecting financial institutions reshuffle claims and grant additional credit lines following the majority votes was also seen as a possible violation. However, the CRPA allows for the financial institutions to request a buyback option enabling them to collect claims based on liquidation value. The agreement on debt rescheduling, however, should be made, taking the priority of rights into consideration.

Denying voting rights to creditor financial institutions that failed to report the amount of credit within the granted deadline was seen as another possible violation. Thus, financial institutions were allowed to report after the deadline. The financial institutions will be granted the voting rights with the reporting of the credit, but the effect will not be retroactive.

When creditor financial institutions request a buyback to collect claims, the exercised price of the claims may exceed the market price. This was seen as another possible violation as the financial institutions buying the claims have to pay more than the market price but the request may delay necessary restructuring process. Hence the claims were to be bought back at the provisional price and adjusted according to fair loss sharing after some time period.

3.2.2 Violation of the Principle of Private Autonomy

Having the firm seek an approval of the Trustee appointed by the creditor financial institutions on crucial business matters was seen as a possible violation of the Principle of Private Autonomy. However, as the creditor financial institutions must burden the loss their supervision over the flow funds was seen as necessary. Also the appointing of the Trustee and the supervision over business operations is based on the agreement between the firm and the creditor institutions. If the firm rejects such measures, the firm may choose a different restructuring process.

3.2.3 Insufficient Legal Remedy

According to the initial proposal of the CRPA, a debtor firm showing signs of distress and being put under joint control of the creditors or restructuring lacked means to object or to convey opinions to what had been agreed at the creditors meeting. Hence an article ensuring the debtor firms the opportunity to convey any opinions was included. The debtor firm was not limited in its right to object to the decision made by the main creditor bank. Also the firm was ensured the right to choose any other restructuring process.

The creditor financial institutions lack the right of access to courts to object to decisions made by the Committee of Creditor Financial Institutions. Hence an article ensuring the right of access to courts for the objecting creditor financial institution was included.

3.2.4 Violation of Equal Rights

The fact that only the domestic creditor financial institutions are subject to the standstill and other measure while commercial creditors and foreign financial institution are exempt was seen as a violation of equal rights. However, since the objecting domestic creditor financial institutions may opt to request a buyback not to participate in the reorganizing claims, fairness of the process is ensured.

3.3 Features of the Corporate Restructuring Promotion Act

3.3.1 Internal Accounting Control System

To improve on corporate accounting transparency, establishment of an internal accounting control system was formalized. Firms are required to institute an internal accounting control procedure and to disclose details concerning the operation of the procedure. The firm representative is responsible for the operation of the internal accounting control procedures and the auditor regularly assesses the progress and reports to the directors. The Securities and Futures Commission (SFC) will notify the financial institutions of the audit report and the measures the Commission undertook.

3.3.2 Standing Evaluation on Corporate Credit Risk

The creditor bank regularly (biannually) evaluates firms at risk of falling into distress. Of the firms with a credit exposure of more than KRW 50 billion, those meeting the criteria FSS has determined are selected for evaluation. Creditor banks transmit the list of selected firms to the main creditor bank. The main creditor bank of the firms is selected to establish plans for evaluation and notify the other creditor banks (within 10 days of firm selection). Creditor banks prepare sub-criteria according to FSS standards and conduct evaluations. The firms are rated accoridnt to a system of four degrees. Credit banks may conduct spot evaluations whenever firms suffer from sudden credit distresses. The four ratings are firms being able to continue normal business operations (A), firms highly at risk of showing signs of distress (B), firms showing signs of distress (C), and firms with no possibility of normalization (D). Firms given a C rating undergo restructuring procedures and those given a D rating undergo liquidation procedures.

3.3.3 Committee of Creditor Financial Institutions

The main creditor bank assesses if normalization will be possible for firms showing signs of distress and decides whether it jointly manages the firm with other creditor financial institutions, puts the firm under bank management or proceeds with liquidation or rehabilitation procedures. To facilitate the joint management, a Committee of Creditor Financial Institutions is formed and operated. The Committee makes key decisions in the

restructuring process such as deferring the exercise of rights to claims and the rescheduling of debts. For mediating matters among creditor financial institutions, the Creditor Financial Institutions Steering Committee is established.

3.3.4 Restructuring Process of Firms Showing Signs of Distress

The Committee of Creditor Financial Institutions ensures that the plans to normalize business operations will be followed by an MOU between the creditors and debtor in distress. The plans to rehabilitate business operations are submitted by the firms, the restructuring plans are to be included in submitted plans. The main creditor bank conducts quarterly inspection of progress and reports the evaluation based on the inspection.

3.4 The Second Corporate Restructuring Promotion Act

The Corporate Restructuring Promotion Act went into effect on September 15, 2001, and was scheduled to expire by the end of 2005. The intent of the sun-set clause was to move the full corporate restructuring process to the market. At the time of the expiration date, however, it was assessed that the creditor financial institutions-led voluntary corporate restructuring had not yet taken root in the market. A motion to extend the term was proposed, but the Act became null when the motion failed to pass.

However, consensus on the necessity for CRPA resumed forming with the cases of corporate restructuring falling through due to creditor financial institutions failing to come to an agreement. With this, a new CRPA was passed by the National Assembly on July, 2007. The new CRPA went into effect on November 4, 2007 and was supposed to expire at the end of 2010. The second CRPA had some modifications to remedy the shortcomings of the first CRPA.

Creditor banks were to determine whether a firm is showing signs of distress, utilizing its own loan management systems in evaluating credit risk and preparing measures accordingly. In the first CRPA, the creditor banks followed FSS standards in evaluating credit risk and preparing measures. The article prohibiting additional granting of credit was removed. The restriction on selling the converted stocks owned by creditor financial institutions was relaxed. The period of exemption from restriction of investment and property management was clarified.

3.5 The Third Corporate Restructuring Promotion Act

After discussions on the legislation of the third CRPA following the expiration of the second CRPA, the third CRPA was put into effect on May 19, 2011, to expire by the end of 2013. While the second CRPA largely maintained the basic outline of the first CRPA with slight modifications, the third CRPA includes some critical changes, including

acknowledgement of greater rights of the debtor firms and better protection for the claims of minority creditor financial institutions.

In the previous CRPAs the firms given C and D ratings were automatically designated as firms showing signs of distress and such ratings were transmitted to the major creditor banks. The Committee of Creditor Financial Institutions then decided how to proceed with the restructuring process. However, in the new CRPA, the firms are notified of the evaluation results and choose to request the restructuring process to the major creditor bank. If the firm does not wish to proceed with the restructuring process, the major creditor bank cannot move forward with the process.

The Trustee is no longer required to be appointed according to the new CRPA. The issue was seen as a possible violation of the Principle of Private Autonomy in the previous CRPAs. The supervision and management over the operations and assets will now be carried out according to the agreement between the debtor firm and the creditor financial institutions.

Legal grounds on which the debtor firm may request termination of the restructuring process are introduced into the new CRPA. Previously, only the Committee of Creditor Financial Institutions had the power to terminate the restructuring process.

The debtor firm is now granted the right to arbitration. If no agreement is reached on the issues of adjustment of claims and plans to grant credit at the Committee of Creditor Financial Institutions, then the debtor firm can now directly request arbitration to the Creditor Financial Institutions Steering Committee. Previously, the debtor firm only could stand by even if no agreement is reached on the issues of adjustment of claims and plans to grant credit.

The rights of the creditor financial institution requesting a buyback of claims are better protected in the third CRPA. When a creditor financial institution requests a buyback, the other creditor financial institutions are required to fulfill the request within six months. Also, a tighter restriction on the exclusion of creditor financial institutions with small claims is now enforced. Only creditor financial institutions with a claim smaller than 5% of the total credit exposure may be excluded. The creditor financial institution may not be excluded against their wishes.

The changes made in the third CRPA are significant. However, the significance is in that the issues have been explicitly acknowledged. Even with the previous CRPAs the working-level practices were largely the in accord with the third CRPA.

3.6 Corporate Restructuring Cases under CRPA

3.6.1 Restructuring of the Construction and Shipbuilding Industry

The world economy suffered a great setback with the onset of the global financial crisis and Korea was no exception. While Korea's economy as a whole was dealt a serious blow, some industries were hit harder than others. The strains on cash flows seriously stifled

the construction and shipbuilding industries. In order to deal preemptively with market doubts and uncertainties, the Governor of the Financial Supervisory Service announced on December 23, 2008 that corporate restructuring would be carried out with a priority in these industries.

According to the standing CRPA, regular Corporate Credit Evaluations would have been carried out from April to June, but the situation was considered to have warranted immediate attention. To prevent domino bankruptcies in the construction and shipbuilding industries, credit evaluations were scheduled to start in January, 2009.

a. Task Force

The standards for credit risk evaluation employed by creditor banks under the CRPA and the operating agreements of creditor banks on corporate credit risk evaluation differed with each bank and were inadequately equipped to deal with the specifics of the construction and shipbuilding industries. Hence, a task force (TF) was formed to draw up a uniform guideline for credit risk evaluation, including industry specific characteristics.

To ensure objective perspectives when preparing the guideline, the TF was composed of 18 members in total. Twelve bank officers in charge of the construction and shipbuilding industry, three certified public accountants and three officers from credit rating agencies were divided into two working level teams for the two industries respectively.

b. Credit Risk Evaluation

(1) First Credit Risk Evaluation

The first credit risk evaluation for the construction and shipbuilding industries was carried out from January 2 to 20 in 2010. The first evaluation for the construction industry was conducted on 92 firms with credit exposure of more than KRW 5 billion within the top 100 construction firms in terms of capacity. The first evaluation for the shipbuilding industry was carried out on 20 firms, 19 small to medium sized shipbuilding firms with credit exposure of more than KRW 5 billion and one additional firm that is based in China but issued Refund Guarantees (RG) and involved in credit transactions in Korea.

After the first evaluation, the main creditor banks gave 14 firms C ratings and 2 firms D ratings. The president of Kookmin Bank announced on January 20, 2009 the list of firms subject to corporate restructuring.

It was emphasized that the Workout on the firms with C ratings was not aimed at weeding out the firms but targeted preemptive and collaborative efforts by the firm and the creditors to overcome operational difficulties. Also, it was announced that the firms receiving D ratings would be subject to either normalization efforts without the support of the creditors or the rehabilitation process according to the “Debtor Rehabilitation and Bankruptcy Act”.

The Corporate Credit Support Task Force (CCSTF) also analyzed the effects of the restructuring within the construction and shipbuilding industries. Together with the Ministry of Land, Transport and Maritime Affairs and the Ministry of Knowledge Economy, the

CCSTF prepared countermeasures to contain any negative effects the restructuring of firms within the two industries might have.

Table 5-11 | Firms Subject to the First Credit Evaluation

	Construction		Shipbuilding	
		Number of firms		Number of firms
Basic criteria	Top 100 construction capacity firms	100	Domestic small and medium sized shipbuilding firms	26
Excluded Firms	Firms with credit exposure of less than KRW 5 billion with main creditor banks and public institutions	8	Firms with credit exposure of less than KRW 5 billion with main creditor banks	7
Additional Firms			China-based firm	1
Total Firms		92		20

(2) Follow-up Action

To mitigate concerns that creditor institutions exercising their rights to claims following the announced results of the first credit risk assessment hinder an efficient restructuring process, it was necessary to take measures to delay collection of claims during the period from the Committee of Creditor Financial Institutions (CCFI) being called and the commencement of the Workout. Hence, the Governor of the Financial Supervisory Service, per procedure set forth by the CRPA, requested that the collection of claims be delayed until the first CCFI is called to commence the Workout process.

There also were cases of deposit payment suspensions, of loans and security deposits set offs on Workout firm accounts. Such cases of financial restrictions hindered the normal operating activities of the firms. The CCSTF utilized the 'SME Financial Consulting Center' as a reporting channel and supervised banks to lift the financial restrictions.

However, some construction firms continued to have difficulties in finding the financial security necessary for unhindered business operations. The CCSTF, Ministry of Strategy and Finance, Ministry of Land, Transport and Maritime Affairs and the Ministry of Knowledge Economy discussed the matter, and took measures to ensure early normalization of the firms. Agencies concerned in the matter were supervised to cooperate, issuing guarantees for the Workout firms so that they may carry on business.

The shipbuilding firms also faced difficulties. The banks and the insurance companies were in disagreement in as how to distribute new funds. The insurance companies held majority voting rights, hence the Workout could not move forward without insurance companies' agreement. The Creditor Financial Institutions Steering Committee (CFISC) intervened to help the two parties reach an agreement.

Also, the Workout firms are normally expected to have sufficient liquidity for the duration of three to four months while the firm normalization plans are finalized. However, the firms subject to Workout were greatly strained in cash flow. Creditor financial institutions were reluctant in granting new funds or issuing guarantees until a concrete plan was finalized. To facilitate with the Workout process, the normalization plans for four firms were finalized within two months and plans for four more firms were finalized within three months.

1. Resolving Difficulties for the Construction Firms

To deal with overseas contracts being cancelled due to delays in the issuance of guarantees , the Export-Import Bank of Korea and the Korea Trade Insurance Corporation cooperated to assure prompt performance.

The Korea Credit Guarantee Fund assisted with issuing guarantees for Workout firms without standing guarantees.

The Korea Housing Guarantee Corporation assisted with issuing guarantees for housing security deposits and reducing the required ratio of collateral value when issuing maintenance bonds for Workout firms.

Facilitate the signing of MOUs by reducing the duration of due diligence and assisting a fast consultation process. [[Who facilitated the signing? This and the next two incomplete sentences need a subject.]]

2. Resolving Difficulties for the Shipbuilding Firms

Assisting the distribution of new funds to the Workout firms to settle disagreements among creditor institutions regarding RGs, facilitating the commencement of the Workout process.

Assisting the Workout process by working closely with the main creditor banks.

(3) Second Credit Risk Evaluation

The second credit risk evaluation was carried out from March 9 to March 27 in 2009. Some voiced concerns that the second evaluation should follow on the heels of the first evaluation, but in favor of securing market trust by looking at the more exact financial status of the firms the second evaluation was carried out after the final financial statements became available.

The second evaluation for the construction industry was carried out on 70 firms with credit exposure of more than KRW 5 billion within the top 101 to 300 ranked construction

firms in terms of capacity. The second evaluation for the shipbuilding industry was carried out on 4 firms with credit exposure of more than KRW 5 billion within the seven firms excluded from the first evaluation. After the second evaluation, the main creditor banks gave 15 firms C ratings and 5 firms D ratings.

As with the firms from the first evaluation, most construction firms suffered from financial woes due to lackluster sales of residential construction and excess guarantees on Project Financing (PFs). The shipbuilding firms subject to restructuring were mostly newly founded firms lacking in technology and experience.

The number of firms subject to restructuring rose from 16 to 20. However, the amount of credit exposure of the firms was relatively smaller and the negative effects to the financial institutions' soundness were anticipated to be limited.

Table 5-12 | Firms Subject to the Second Credit Risk Evaluation

	Construction		Shipbuilding	
		Number of firms		Number of firms
Basic criteria	Top 101 to 300 construction capacity firms	200	Domestic small and medium sized shipbuilding firms excluded in the first evaluation	7
Excluded Firms	Firms with credit exposure of less than KRW 5 billion with main creditor banks	130	Firms with credit exposure of less than KRW 5 billion with main creditor banks	3
Total Firms		70		4

(4) Follow-up Action

As the firms subject to restructuring were announced, they had to face financial restrictions hindering their business operations. Hence, the CCSTF requested before making the announcement that financial institutions implement such restrictions. The CCSTF also requested that the Korea Credit Guarantee Fund, the Korea Housing Guarantee Corporation, the Construction Guarantee and the Seoul Guarantee Insurance to assist with issuing guarantees to ensure unhindered operations.

Following the announcement of the second evaluation, some firms were criticized for allegedly exploiting the standing Debtor-in-Possession system for the purpose of maintaining management rights. To prevent fraudulent usage of the Debtor-in-Possession system, CCSTF requested the creditor financial institutions to actively voice their opinions when inquiries are made upon request for Debtor-in-Possession.

Since the end of 2008, contracts for new ships had virtually ceased. Hence, to bolster the industry as a whole, the restructuring of troubled shipbuilding firms and liquidity support for firms conducting their business well were to be interconnected.

c. Restructuring Process

29 construction firms were subject to restructuring after the two credit risk evaluations in 2009, of which 24 firms were given C ratings and five firms given D ratings. By the end of 2010, six firms of the 24 firms that were given C ratings had graduated the Workout process and 11 firms were steady on schedule according to their respective normalization plans. The Workout processes for seven firms were halted.

Seven shipbuilding firms were subject to restructuring after the two credit risk evaluations in 2009, of which five firms were given C ratings and two firms given D ratings. By the end of 2010, one firm of the seven that were given C ratings had graduated the Workout process and one firm was on schedule according to the normalization plan. The Workout process for three firms was halted.

Table 5-13 | Restructuring of Construction and Shipbuilding Firms (as of Dec, 2010)

		C Rating				D Rating	Total
		Graduation	Workout	Halted	Sub Total		
Construction Firms	First Evaluation	2	7	2	11	1	12
	Second Evaluation	4	4	5	13	4	17
	Total	6	11	7	24	5	29
Shipbuilding Firms	First Evaluation	-	1	2	3	1	4
	Second Evaluation	1	-	1	2	1	3
	Total	1	1	3	5	2	7

3.6.2 Restructuring of the Kumho Asiana Group

a. The Kumho Asiana Group

The Kumho Asiana Group (henceforth the Group) had started as Gwangju Taxi in 1946 and by the end of 2009 had grown into a business group worth nearly KRW 36 trillion. However, two members of the Group, Kumho Industrial (a construction firm) and Kumho Tires, were typically economy-sensitive businesses with a high probability of being

negatively affected by economic downturns. Also, Asiana Airlines was exposed to excessive financial costs from loans in purchasing aircraft and business risks such as terrorism and diseases.

At the start of the 2000s, Asiana Airlines suffered from high foreign exchange rates, with the 9. 11 terrorist attacks in 2001 and the SARS outbreak in 2003 furthering their woes. The Group went through with restructuring, selling off property, aircraft and non-core businesses and increasing paid-in-capital to recuperate from the situation.

After overcoming the crisis and with improved financial structure amidst a booming economy, the Group sought to expand in size through aggressive M&A deals. With the acquisition of Daewoo Engineering and Construction (E&C), the number-one construction firm, in 2006 and Korea Express, the number-one logistics firm, in 2008, the Group was reorganized into four main businesses comprising construction, transport/logistics, chemical/tires and service.

According to 2009 numbers, the three main construction businesses, mainly composed of Daewoo E&C and Kumho Industrial (42.8%), the transport/ logistics business, mainly composed of Asiana Airlines and Korea Express, and chemical/ tires, mainly composed of Kumho Petrochemical and Kumho Tires, accounted for 97.5% of the sales.

b. Trouble Begins

The Group expanded in size with the acquisition of Daewoo E&C and Korea Express. However, the acquisition was mostly funded with external loans, and the ensuing financial costs and the downturn of the global economy caused damage to the Group's business performance.

Excessive loans to fund a large M&A had largely increased the total loans of the Group from KRW 5.8 trillion in the end of 2005 to KRW 16.1 trillion by the end of 2009. The Group had acquired 72.1% of Daewoo E&C shares at KRW 6.4 trillion. The acquisition price was at KRW 26,262 per stock, with a 28.2% premium on the market price of KRW 20,492 per stock. KRW 2.9 trillion was funded with issuing corporate bonds of subsidiaries, bank loans and self raised funds. The additional KRW 3.5 trillion was funded by Financial Investors (FIs). A Put-Back Option (PBO) ensuring a maximum of 9% annual return was awarded to the FIs.

On March 14, 2008, the Group acquired 60.0% of Korea Express shares at KRW 4.1 trillion (KRW 171,000 per stock). KRW 3.4 trillion was funded by issuing Exchangeable Bonds by its subsidiaries, bank loans and self raised funds. The additional KRW 663 billion was funded by Strategic Investors (SIs) and FIs. A PBO ensuring a maximum of 9.7% annual return was awarded to the investors.

c. The Core Businesses Fail to Perform

Up to the end of 2006, Kumho Industrial was performing well enough, posting current net profits. However, following the acquisition of Daewoo E&C (at the end of 2006) the

increased financial costs and the economic downturn in the construction industry had cut into its current net profits. The prolonged economic downturn had caused damage to the financial conditions such that by the December 2008, the Group was only barely floating by extending the maturities on the loans.

Kumho Tires had a fairly stable business foundation as the number-two domestic and number-10 global tire manufacturing firm. However, with the construction of overseas factories in 2006 and funding the Daewoo E&C acquisition had a severe negative effect. Kumho Tires recorded three consecutive years of current net losses since 2007.

Asiana Airlines had enjoyed a stable profit trend with the increase in international ticket shares, but the rise in foreign exchange rates and gas prices in 2008 caused great damage. In 2008, Asiana Airlines recorded operating losses of KRW 52.7 billion which only worsened to KRW 236.7 billion due to the global economic crisis and the effects of the avian flu scares.

Kumho Petrochemical recorded relatively healthy numbers, but underperformance of Kumho Industrial, Kumho Tires and Asiana Airlines caused current net losses of KRW 614.8 billion in 2009 due to losses of KRW 827.3 billion in equity method valuations.

Table 5-14 | Financial and Profit Standing of Kumho Asiana Group Major Subsidiaries

(Unit: KRW billion, %)

	Kumho Industrial		Kumho Tires		Asiana Airlines		Kumho Petrochemical	
	2008	2009	2008	2009	2008	2009	2008	2009
Total Assets	4,349.6	6,415.7	3,104.2	2,409.0	5,990.2	5,815.0	3,714.8	3,199.9
Total Liabilities	3,114.2	7,545.7	2,196.3	2,344.5	5,204.1	5,083.2	2,551.7	2,664.8
Loans	1,910.2	1,968.0	1,333.9	1,577.4	4,044.7	3,894.5	1,971.5	2,2307
Capital	1,235.5	-1,129.9	907.9	64.5	786.1	731.8	1,163.1	535.1
Debt Ratio	252.1	Fully impaired	241.9	3,636.0	662.0	694.6	219.4	498.0
Sales	2,456.4	2,413.3	2,398.6	1,894.7	4,261.5	3,887.2	3,182.5	2,801.7
Operating Profit	161.4	0.6	36.3	-213.6	-52.7	-236.7	281.3	116.2
Current Net Profit	36.5	-2,340.1	-200.4	-776.2	-227.2	-266.3	-19.7	-614.8
Interest Costs	137.3	167.1	76.4	118.5	219.3	220.6	89.1	110.0
Cash Flow for Operation	-63.3	-181.1	103.4	25.2	102.6	-203.3	-34.4	281.7

d. Creditor Financial Institution-led Restructuring

The Group tried a self-restructuring process in an effort to overcome the crisis. However with the failure to sell of Daewoo E&C, the effort was ultimately fruitless. With the subsidiaries on the brink of bankruptcy, the Group and the Korea Development Bank agreed on the normalization plan for the Group and on December 30, 2009 finalized and announced a creditor financial institution-led restructuring plan.

The four major subsidiaries were included in the restructuring plan. Kumho Industrial and Kumho Tires were to go through the Workout process according to CRPA, and Kumho Petrochemical and Asiana Airlines were directed to make rigorous self-rescue efforts to normalize their business.

To ensure a fast and smooth normalization of the Group, the KDB-led Private Equity Fund (PEF) was to acquire Daewoo E&C. The restructuring of Kumho Asiana Group's subsidiaries was to be made through rigorous self-rescue efforts with an aim for a swift turnaround of management, which included sales of subsidiaries and, under the responsibility of major shareholders, the provision of stock and assets for collateral to creditors.

The direct impact of the restructuring of the Group's two subsidiaries, Kumho Industrial and Kumho Tires, was expected to be not too great on the soundness of financial companies and markets. The current size of their net profits was thought to allow them to absorb the level of the additional provisions caused by the two companies of the Group in Workout.

e. The Restructuring

The restructuring process began with Kumho Industrial and Kumho Tires commencing their Workouts on January 6, 2010 and the Creditor Bank Voluntary Agreement took effect for Asiana Airlines and Kumho Petrochemical on January 18, 2010. The creditor financial institutions agreed to finalize the restructuring plans for each subsidiary following the due diligence conducted by an outside agency and to support normalization by delaying exercising rights to claims, providing new funds of KRW 1.6 trillion and additional KRW 2.6 trillion by conversion of investment.

Table 5-15 | New Funds and Conversion of Investment

(Unit: KRW billion, USD million)

	New Funds							Conversion of Investment
	Phase 1		Phase 2		Total			
	KRW	USD	KRW	USD	KRW	USD	Total in KRW	
Kumho Industrial	280	-	360	-	640	-	640	2,252.3
Kumho Tires	100	30	158.2	208	258.2	238	538.9	380
Kumho Petrochemical	60	35	200	60	260	95	371.3	-
Total	440	65	718.2	268	1,158.2	333	1,550.2	2,632.3

Note: The above reflects the plan finalized by May 2010
With the economy of the airline industry improving, the funds to be supported to Asiana Airlines was not needed

Exchange rates: KRW 1,172 /dollar

The four major subsidiaries of the Group simultaneously underwent the restructuring process, leading the amount of conversion of investment and new funds becoming quite sizable compared to other Workout cases. Also, the need to negotiate with the FIs on top of all this presented the restructuring case for the Group many hurdles that needed to be overcome.

In the case of Kumho Industrial, reflecting the expected loss from FIs exercising the PBO on the financial statements resulted in its capital being fully impaired. After tough negotiating with the FI, the FI settled on the exercise price of the PBO and completed providing funds of KRW 2.5 trillion to Kumho Industrial by March 30, 2010.

(1) Kumho Industrial

The first meeting of creditor financial institutions was held on January 6, 2010. Sixty-one of the ninety-five creditor financial institutions attended and agreed to commence the Workout.

With the commencement of the Workout, the creditor financial institutions deferred exercising their rights to claims, but new funds were additionally necessary to carry on business operations. At the second meeting on February 3 it was agreed that new funds of KRW 290 billion would be provided for Kumho Industrial.

As the due diligence revealed that going-concern value of Kumho Industrial was greater than the liquating value, the creditors decided it was better to normalize the firm and finalized a plan at the third meeting on March 26. The MOU between the creditors and Kumho Industrial for proceeding with the normalizing plan was signed on April 13, 2010.

The MOU stated that the creditors will defer exercising their rights to claims until the end of 2014 and provide KRW 2.3 trillion by conversion of investment and additionally

provide new funds of KRW 360 billion. The creditors also agreed to issue performance bonds and refund guarantees of USD 10 million each. The Kumho Industrial agreed to provide KRW 1.6 trillion by rigorous self-rescue efforts.

The creditors completed the conversion of interests of KRW 2.3 trillion on March 30 to resolve the situation of fully impaired capital preventing the delisting of Kumho Industrial.

Reduction of capital was carried out with the majority shareholders being reduced 100 shares to 1 and 4.5 shares to 1 for the minority shareholders.

(2) Kumho Tires

The first meeting of creditor financial institutions was held on January 6, 2010. Twenty-three of the twenty-eight creditor financial institutions attended and agreed to commence the Workout and to defer exercising the rights to claims until April 5, 2010.

On February 9, the creditors agreed to provide operating funds of KRW 100 billion and a usance letter of credit (L/C) with a limit of USD 30 million to the firm to resolve the liquidity problem. However, the new funds were only provided on April 22 when the labor union finally agreed to the Workout.

As the due diligence revealed that going concern value of Kumho Tires was greater than the liquating value, the creditors decided it was better to normalize the firm and finalized a plan at the third meeting on May 4. The MOU between the creditors and Kumho Tires for proceeding with the normalizing plan was signed on May 31, 2010.

The MOU stated that the creditors would defer exercising their rights to claims until the end of 2014 and provide KRW 380 billion by conversion of investment and additionally provide new funds of KRW 160 billion. It also stated that USD 200 million will be provided in L/C and D/A (Document Against Acceptance).

The creditors completed the conversion of interests of KRW 403 billion (additional KRW 21 billion by creditors with Commercial Papers (CP)) on November 29. Reduction of capital was carried out with the majority shareholders being reduced 100 shares to 1 and 3 shares to 1 for the minority shareholders.

Kumho Tires failed to provide the planned self-raised KRW 160 billion. Also as the Daewoo E&C failed to sell, resulting in the downgrading of the overseas operations credit ratings and ultimately leading to difficulties in extending the maturity of loans. The creditors decided that normalizing the overseas operations was necessary in normalizing Kumho Tires and agreed to provide operating funds of KRW 258.2 billion and D/A with a limit of USD 39 million. On November 30, the creditors agreed to support the extension of maturity of the loans by two years.

(3) Asiana Airlines

The parties accepted the Voluntary Agreement on January 18. To prevent liquidity strains, the creditors agreed to extend the maturities for loans until the end of 2010. Also creditors agreed to allow the revolving loans to be available up to the limits on January 1, 2010.

The creditor bank agreed to provide new funds of KRW 120 billion to Asiana Airlines. However, the new funds were not necessary due to the improving performance of the airline industry and the successful issuance of Asset Backed Securities (ABS) in the amount of KRW 30 billion.

As the due diligence revealed that going concern value of Asiana Airlines was greater than the liquating value, the creditors decided it was better to normalize the firm and finalized a plan at the fourth meeting on April 19. The creditors received the agreement to proceed with the normalizing plan from Asiana Airlines on May 31, 2010. Asiana Airlines agreed to continue with the self-rescue efforts.

(4) Kumho Petrochemicals

The Voluntary Agreement was accepted on January 18. To prevent liquidity strains, the creditors agreed to extend the maturities for loans until the end of 2010. Also creditors agreed to allow the revolving loans to be available up to the limits on January 1, 2010.

The creditor banks agreed to provide new funds of KRW 60 billion and L/C of USD 35 million to Kumho Petrochemicals on February 24, 2010.

As the due diligence revealed that going concern value of Kumho Petrochemicals was greater than the liquating value, the creditors decided it was better to normalize the firm and finalized a plan at the third meeting on April 20. The MOU was signed on June 8.

The MOU stated that the creditors will defer exercising their rights to claims until the end of 2011 and provide new funds of KRW 200 billion and L/C of USD 60 million.

(5) Sale of Daewoo E&C

On March 26, 2010, the 18 FIs agreed to sell shares of Daewoo E&C at KRW 18,000 per share to the KDB PEF. Originally, KDB was to acquire 50%+1 shares of Daewoo E&C. However, KDB changed the original plan and acquired 39.6% of shares due to the value of Daewoo E&C stocks being significantly lower than KRW 18,000 per share. On December 28, 2010, KDB went ahead with a paid-capital increase of KRW 1trillion. The funds were to be used to pay off loans and as investment for future operations. On January 6, 2011, KDB PEF acquired an additional 37.1% of Daewoo E&C shares to own 50.75% shares in total.

f. Assessment

The Kumho Asiana Group restructuring was the first case of restructuring a major conglomerate after the restructuring of Daewoo Group in 1999. However, it was a unique case in that the size of funds needed was quite large and many non-agreement creditor parties like FIs were involved in the firm normalization process.

Also the performance of the firms greatly improved only after six months into the restructuring. This can be seen as the effects of the creditor financial institution-led reconstruction process.

4. Restructuring for Small and Medium-sized Enterprises[50]

4.1 Background

In Korea, as of the end of 2002, nearly 3 million SMEs were in business, employing 10.4 million people. Since large companies employ about 1.6 million workers, the SME sector contributes to 86.7% to the national work force. Out of all SMEs, small businesses with fewer than 50 workers amount to 2.86 million firms, from which micro businesses with fewer than 10 employees comprise 2.62 million of the total number of firms. Therefore, Korean SMEs can be characterized as being "too small" on average. In terms of the number of entities, most SMEs are categorized in service industries such as wholesalers and retailers, restaurants, hotel and lodging, education, and transportation.

Despite the low share (11.2%), manufacturing firms show a relatively high share of employment (25.7%) compared to other industries. In particular, medium-sized manufacturing firms employ around 100 workers on average.[51] The average number of employees per SME is only 3.5. This is extremely small, especially when compared to Taiwan and Japan.[52] The declining trend in firm size in terms of the number of employees has been reinforced in the course of recent financial and corporate restructuring efforts following the 1997-98 crisis. The massive restructuring of financial institutions and large corporations led to layoffs, as many of the workers were forced to find jobs in the SME sector or start their own businesses. In order to improve cost efficiency, large corporations also spun off businesses, which were classified as SMEs due to their turnover size and/or number of employees. Consequently, both the number and size of SMEs (in terms of the number of employees) have been growing substantially.

Korean small and medium-sized enterprises (SMEs), however, were at a crossroads during 2004-05. On average, SMEs had been experiencing a secular downturn in their financial health and business profitability. From a business cycle perspective, the current difficulties faced by SMEs were to some extent understandable: weak domestic consumption since early 2003, on top of recent price hikes in raw materials like oil and steel, placed many SMEs in a "nowhere-to-go" situation in terms of both revenue and cost.

More seriously, this sector faced structural challenges: first, the relative underperformance of SMEs in productivity and profitability when compared to large corporations, attributable to a lack of innovation capacity; second, the inefficient factor utilization resulting from the restructuring following the 1997-98 financial crisis; and third, the emergence of fiercely

50 This chapter mostly employs the arguments of Kang (2005).

51 Many economists and policymakers pay close attention to the medium-sized manufacturing firms in relation to taking SME policy measures. This paper also focuses on these firms in relation to corporate restructuring.

52 Japan has slightly more than 4.7 million SMEs that hire about 30 million employees as of 2001, thus the number of employees per firm being 6.4. In Taiwan 1.1 million SMEs are run with 7.4 million employees. The average number of employees is 6.7.

growing competitors, especially Chinese counterparts. In addition, financial assistance offered by the government to SMEs, once considered as a disadvantaged sector in terms of economic development, only provided temporary relief. In the long run, this aid was detrimental, for it has gradually eroded the competitiveness, self-independence, and viability of those firms receiving assistance.

Despite these structural problems deeply rooted in Korean SMEs, the sector had hardly been restructured, even amid the wave of massive corporate reform efforts undertaken after the crisis. To prevent contagion of defaults among SMEs, the government offered various bailout programs such as credit guarantees and insurance, structured financing instruments, etc. Debt restructuring of large corporations also created a favorable financial environment for SMEs; as a result, financial institutions tried to provide more funding than before.

4.2 Causes of SME Distress

Financial distress in the SME sector has been growing over the last decade. This tendency has been intensified by the recent unfavorable macroeconomic environment which includes the decline in consumption demand due to the consumer credit bubble bursting as well as the emergence of China, whose enterprises compete directly with Korean counterparts domestically and overseas. The effects have been immediate. Many SMEs have lost market share, which is the most often cited cause for distress according to surveys. Indeed, declining sales is the primary reason for corporate difficulties. Some other causes include the inability to collect trade receivables or default of counter-parties that are liable to the sellers.

The survey results, however, do not address the fundamental causes, as they only describe those superficial and immediate factors which directly affect the performance of businesses. That is to say, other underlying factors seem to exist that ultimately weaken sales capability and reinforce credit risks. In general, businesses face uncertainties from all directions and, thus, the core competency lies in managing these various risks. As the survey shows, since the causes for the distress reveal the inexperience and inability of SMEs to cope with events that, while unexpected, are still foreseeable, the problems affecting the bottom-line at SMEs stem from a lack of management skills and competencies.

In addition, the absence of financial instruments and institutions that allow SMEs to manage risks worsens the situation. In order to properly manage the risks associated with counter-party defaults, collection of credit receivables, asset price changes and the like, enterprises should be provided with credit insurance, outsourced debt collection services, and financial derivatives markets. The demand for these services is even more desperate among SMEs that lack in-house expertise and resources to manage risks. However, the market offering these financial services and products has not yet been well developed in Korea.

There are two main reasons for this lack of development. First, Korean financial markets have not yet matured enough to accommodate the diverse range of needs for risk

management. This problem would be easily addressed once competition is triggered in the financial markets for exploiting arbitrage opportunities. A more serious problem lies in the second reason: government intervention in SME financing. The efforts taken by the government to remove the financial difficulties of SMEs has distorted the development of market-friendly financial services. For instance, the publicly supported credit guarantee program lowers the cost of financing for SMEs compared to private financial arrangements, with which the market is crowded. Also, managers at SMEs to some extent expect to be given preferential treatment and, therefore, take the assistance for granted. Consequently, the government's over-involvement may have weakened the development of a well-functioning financial market, as well as increased the over-dependency of SMEs on government policy considerations.

More fundamentally, productivity in the SME sector has not improved as much in comparison with that of large companies. The Korea Development Institute (2003), for example, reports substantial evidence that the corporate distress experienced at SMEs is highly likely to stem from structural problems, or stagnant productivity and dwindling profitability. KDI (2003) reports prominent productivity differences in terms of plant size. It is found that larger plants recorded higher productivity during the period from 1985 to 2001, and that the gap between large and small plants has been widening. Analysis on the growth rate of labor productivity also showed a similar pattern: larger plants recorded higher growth rates. However, if the whole sample period is divided into three sections, it is found that smaller plants showed higher growth rates in the first sub-period (1985-89). The trend reversed in the second sub-period (1989-97), until the gap widened greatly in the third sub-period (1998-2001) when the productivity growth rate was led mostly by large firms.[53] Therefore, the currently distressed SMEs account for the declining productivity and thus lower profitability.

4.3 Restructuring Distressed SMEs

4.3.1 Ways to Restructure Distressed SMEs

Corporate restructuring efforts aimed at rehabilitating firms consist of numerous types: debt restructuring,[54] employment downsizing, business reorganization and even management and governance reshuffling. Depending on the origin of difficulties, particular methods or a combination of methods are chosen to tackle the problems. In general, debt restructuring is a necessary component of most of the reform efforts, since signs of corporate distress tend to surface when firms have difficulty in making repayments on debt. Accordingly, debt restructuring comes first in the turnaround process.

53 KDI (2003) also reports the differences of capital productivity and total factor productivity according to the size of plants. The results are analogous to the case of labor productivity.

54 Debt restructuring comprises maturity extension, interest relief, debt write-off, debt-to-equity conversion, etc.

Despite corporate rehabilitation being the main ingredient, restructuring is seldom sufficient in restoring profitability at distressed enterprises, especially when the underlying causes of distress stem from structural and operational aspects. The current Korean SMEs seem to fit this mold. As seen in the previous section, productivity and profitability at SMEs have experienced a secular downturn during the last decade. Changes in the business environment such as the rapid growth of Chinese competitors and structural decline in domestic economic growth potential have not been favorable to the SMEs. Although historic low interest rates have, for the time being, alleviated the financial burdens of SMEs, once interest rates begin to rise their financial health will surely be undermined drastically. The unprecedented low interest rates also imply that restructuring debt passively, like debt relief or maturity extensions alone, would not be effective enough to revitalize the problematic SMEs. An all-out restructuring effort, including more active debt restructuring methods such as debt-to-equity swaps and business reorganization, is required at many marginal enterprises.

4.3.2 Differences of Restructuring SMEs and LEs

The fact that the causes of the distress at SMEs are more fundamental in nature calls for expedited restructuring of main business lines, rather than just cosmetically changing the financial structure of the firms. However, it is well known that painful restructuring is easier said than done: despite the long-term overall gains in economic efficiency, restructuring generally demands sacrifices, at least in the short-term, from relevant stakeholders. It also brings about inevitable wealth redistribution. Thus, a compatible incentive scheme in which every stakeholder would at least not be worse off by participating in the workouts is of practical importance. In this regard, we need to diagnose the deeply buried complexities that keep not only the SME owners and managers but also creditor financial institutions from revealing any corporate distress and expediting turnarounds.

Notwithstanding commonalities in restructuring SMEs and large enterprises (LEs), there also exist numerous specifics that apply when restructuring SMEs. Generally speaking, problematic SMEs are less likely to be revitalized. The reasons are manifold. First, they do not have many intangible assets. Compared with SMEs, large companies invest more in research and development (R&D) and marketing to add more value in terms of intangible assets such as goodwill, patent rights, sales networks, and others. The SMEs' low level of intangible assets then implies that the economic benefits gained through painful restructuring may not be as rewarding. Second, the fact that the business size and scope of SMEs are smaller suggests they could experience difficulties when reorganizing business and employment. Since SMEs specialize in, at most, a few business lines with a limited number of workers, large-scale downsizing of business lines and/or employment is neither feasible nor affordable. Third, SME restructuring is not cost effective in most cases. Even though the firms targeted for restructuring are small, there exist basic sunk costs once stakeholders determine to participate in the procedure. Also, there would be more uncertainties for distressed SMEs relative to weak LEs, and thus an even larger certainty

equivalent premium. Fourth, SMEs are less resilient to bad news. Once a small firm is known to be financially distressed and undergoing restructuring, its trading partners stop doing business using credit, and creditors try to freeze or curtail available credit lines. In contrast, LEs are more likely to maintain operations at a normal level even under financial hardship. Thus, LEs have a better chance of proceeding with restructuring while maintaining sales turnover.

On top of the inherent disadvantages of restructuring distressed SMEs, the external conditions and incentive structure play a role in retarding their successful rehabilitation. Since SME failures are hardly related to systemic risks unless they are susceptible to contagion on a large scale, policymakers pay less attention to restructuring the sector from the perspective of economic efficiency. If they do consider SMEs, they are more concerned about social stability and individual welfare of the disadvantaged. The incentives of SME owners and managers work to keep them from taking part in the restructuring process up until the firms are about to be liquidated. Without the possibility of restarting the business, corporate failure is regarded as a personal failure. Then, it would be completely rational for them to seek as little interference as possible, no matter how poorly the firm was performing. These behaviors are not checked and controlled by any other stakeholders due to a lack of a well-functioning system of monitoring and compliance for SMEs.

4.3.3 Firm Size and Choice of Restructuring Methods

As mentioned above, SMEs are not a homogenous group. They consist of very diverse enterprises in terms of size, location, industry, degree of competitiveness and so on. Thus, choosing a restructuring strategy should take into account the characteristics of a particular firm. This section tries to relate the firm's size to the optimal choice of restructuring methods.

By and large, SMEs are categorized into three groups in terms of size: relatively large firms whose total credit amount borrowed from financial institutions reaches more than 30 billion Won, or close to 30 million US dollars; medium sized firms whose total credit ranges from 2 billion to 30 billion Won, or 2 million to 30 million US dollars; and, small firms whose total credit is less than 2 billion Won, or 2 million US dollars. In terms of restructuring, credit size matters, because it constrains the potential reservation costs involved in restructuring. In other words, as the amount of credit borrowed from financial institutions is greater, the benefits that could be gained from restructuring are also greater, since any form of restructuring involves a certain amount of administrative costs.

In the case of large SMEs under financial distress, the restructuring process attracts financial and strategic investors. In Korea, the representative investors targeting these kinds of opportunities, among others, are corporate restructuring companies (CRC) that were established after the financial crisis, according to the Industrial Development Act.[55] To illustrate the activities of these CRCs, consider the following hypothetical example. A typical profile of one of these large but distressed SMEs looks like this: a firm with an asset size of about 40 billion Won is financially constrained from borrowing more due to the high debt-to-equity ratio of 400% in spite of the firm's development of high technology materials. It is desperate to attract the equity needed to merchandise its products to recoup the initial investments. Here, a CRC can play a role. The CRC injects equity capital of 10 billion Won and participates with the initial owners in the management of the firm. Once business returns to normal, the CRC sells its equity back to the owners and recovers its initial investment. This case offers a situation where financially distressed but operationally viable SMEs that are comparable in size to large companies could be reorganized by market forces.

The restructuring strategy for medium sized firms could be different since investors likely would not participate in corporate restructuring due to low potential returns on investment. Instead, original credit grantors typically try to reorganize the viable part of firms through less active restructuring methods. One advantage of pursuing this type of restructuring for creditor financial institutions, usually banks, is that they have access to more information and debt restructuring instruments than do outside investors. Since the banks have had a long relationship with the obligor, the related administrative costs are smaller. If the firm needs to write-off debt or be given additional credit, the banks may help meet these needs once the assistance has proven to be effective. However, bank-led corporate restructuring efforts do not always achieve the best results because the benefits could be offset by the action of bankers who try to make up for their failures by not lending to prospective and creditworthy borrowers. Additionally, loan officers may tend to evergreen the corporate distress in favor of their own incentives. Despite these shortcomings, bank-led corporate workouts offer the most feasible solution in most of the cases involving medium sized enterprises.

As for small enterprises under financial distress, an effective restructuring method does not exist because the benefits from restructuring do not seem large enough to cover the associated costs. In essence, credit extended to small enterprises is almost analogous with credit given to consumers. Considering this, passive restructuring methods like debt relief and maturity extension are the norm. When debt restructuring does not succeed in rehabilitating the firm, the only remaining option seems to be liquidating the business.

55 In addition to CRCs, there are many other restructuring instruments which have been activated in the course of recent financial and corporate restructuring. Corporate restructuring funds (CRF) and corporate restructuring vehicles (CRV) are some of examples. In that all of these financial arrangements follow market-friendly approaches, they are differentiated from the preexisting restructuring methodologies led by either government or banks. See Kang (2004a) more in detail.

4.4 Institutions for SME Rehabilitation

In restructuring financially distressed medium sized enterprises, Korean policymakers are taking a close look at the corporate workouts scheme[56] that was proven after the crisis to be a useful tool for turning around large corporations.

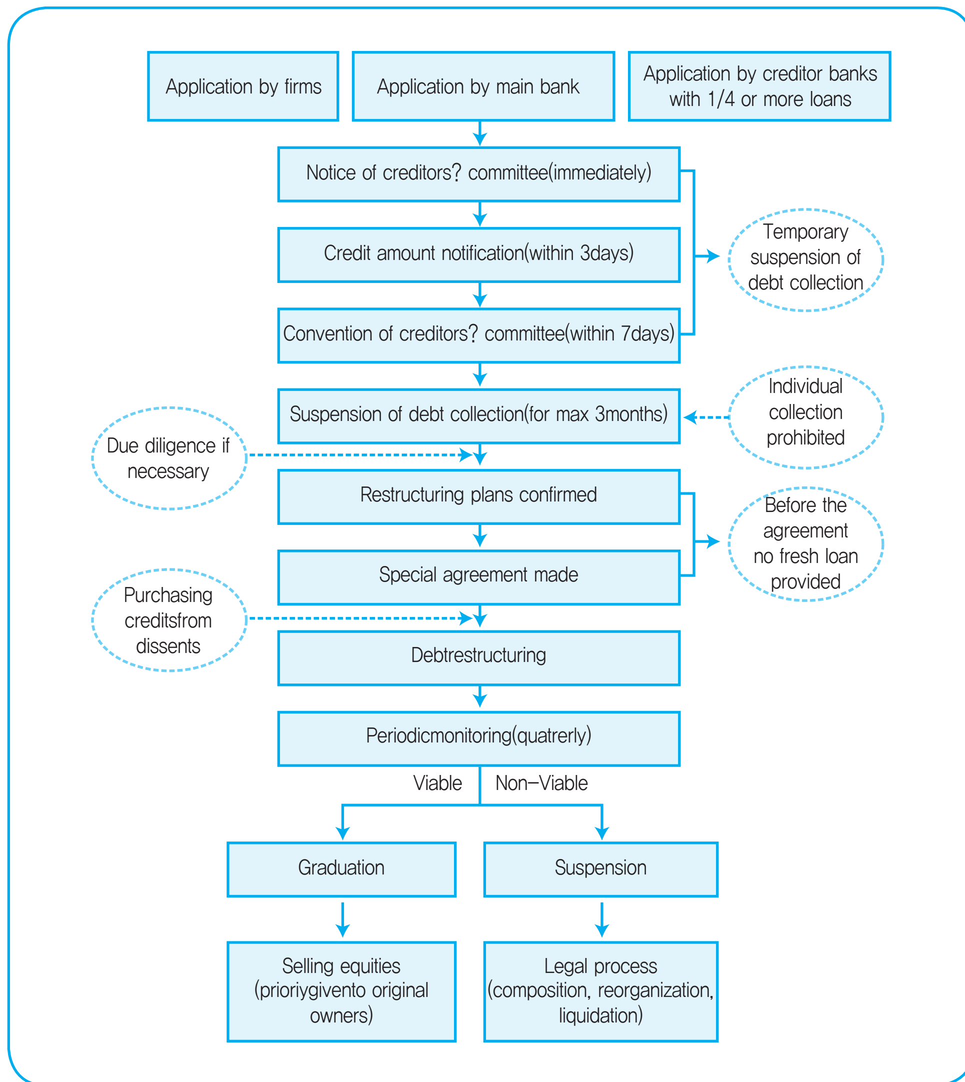
Basically, corporate workouts are collaborative efforts taken by creditor financial institutions, and led by the main banks to relieve the debt burden of obligor firms and to return their businesses back to normal status. The scheme is not only effective but also inevitable when facing systemic risks, as court-led reorganization does not take overall economic performance into concern. For this reason, the adage of "Too-big-to-fail" has prevailed. Despite the drawback that this scheme undermines the equality of creditors, at least in the short-run, it also has the potential to promote their individual interests in the long-run and to contribute to social and financial stability.

In Korea, the use of the corporate workout scheme on distressed SMEs is driven by two reasons: the benefits gained from cost effectiveness, as explained above, and Korea's intimate knowledge of the system. The experiences gained in the course of carrying out corporate restructuring following the crisis have endowed most banks with expertise and techniques for restructuring. Many bankers have become accustomed to handling non-performing assets and harmonizing the relevant stakeholders. Above all, they have benefited from the corporate workout program by having disposed of their own financial distresses. Thus, the corporate workout scheme is the best candidate for corporate rehabilitation programs in the case of SMEs as well.

In order to successfully rehabilitate SMEs, it is imperative to encompass as many financial institutions as possible. In this respect, one should note that Korea has one of the largest credit guarantee funds for SMEs. As of July 2004, the outstanding balance at the Korea Credit Guarantee Fund (KCGF) and Korea Technology Credit Guarantee Fund (KOTEC) reached 48.5 trillion Won, around 7% of annual nominal GDP. This fact implies that the participation of KCGF and KOTEC in the workout scheme is essential for achieving a successful outcome. Without their loss sharing, the benefits gained from the workouts would not be greater than the burden that participating financial institutions would have to bear.

56 Regarding the procedures and performances of the corporate workouts for large corporations, see Lee (2000) and Kang (2004b), respectively.

Figure 5-3 | Flowchart of the Collaborative SME Corporate Workouts



The participation of KCGF and KOTEC may be debatable, for they are not legally creditors until they acquire indemnity rights after making subrogation payments on behalf of the guaranteed borrowers. That is to say, as long as the financially troubled firms are able to make interest payments, the funds do not need to share the losses. Looking at the issue from a different angle, however, these firms are doomed to fail without assistance. Additionally, the size of the losses, even to the funds, would be enlarged after the firms default. Even if the funds are not responsible for their revitalization in the ex ante sense, they are better off by taking part in the collaborative corporate workouts. The prolonged debate as to whether these workouts should be included in the agreement was resolved in June 2004, as the funds were allowed to be a part of the workouts.

The structure of the SME corporate workout scheme resembles that of the corporate workout for large corporations, with some minor adjustments which take into account the specificities of SMEs. [Figure 5-3] summarizes the scheme's flow from beginning to end. The workouts can be initiated by either the debtors or creditors. The firms facing financial difficulties may apply for a corporate workout with their main banks. Also, those banks or financial institutions for which the combined loans exceed 25% of a firm's total debt may initiate a workout. After the workout application is submitted by an SME, the process of rehabilitation proceeds more rapidly than large company workouts and in-court corporate reorganization. Within seven business days, creditors hold the first meeting and decide whether they will provide the debtors with an automatic stay for debt collection. The debt is normally suspended for a month, and two months if due diligence is needed. The suspension period may be extended for an additional month based on approval from those creditors holding 75% or more of the debt. During this period, the main banks prepare the restructuring plan that usually contains a range of options including debt relief, debt-to-equity conversion, additional loan provision, business restructuring, employment adjustment, etc. After an agreement is reached between the creditors' committee and the debtors,[57] the main banks implement the restructuring plan and monitor the progress periodically.

One of the most distinguishing features of the SME corporate workout scheme is the treatment of incumbent owners and managers. No corporate owner or manager is willing to be subjected to reconstruction led by creditors even if the risk of default is imminent, but this type of behavior is even more striking in the SMEs. Also, changing management is quite costly from the creditors' perspective. To offer incentives and accommodate demands, the SME workout agreement contains a clause that allows incumbent managers to keep management rights, while the original owners are allowed to buy back converted equity from debt prior to other investors.

4.5 Restructuring SMEs under CRPA

4.5.1 SMEs in the Crisis

In the latter half of 2008, domestic SMEs were suffering blows from rising raw material prices, lackluster export sales, slowdown of the domestic market and losses due to volatile foreign exchange rates. The uncertainties in the domestic and international financial markets drove the domestic banks to tighten their risk management, thus further stifling SMEs' cash flow. The worsening of the global financial crisis with the bankruptcy of Lehman Brothers was only another crushing blow to the SMEs. Many SMEs that were involved in Knock-In Knock-Out (KIKO) currency option transactions were having major liquidity problems.

57 When there exist opposing creditors against the restructuring plan while more than 75% of creditors approve it, the dissenting creditors may ask the creditors' committee to purchase their credits of which the price is greater than the liquidation value. This arrangement is borrowed from the similar article in the Corporate Restructuring Promotion Act.

To mitigate the SMEs' dire credit situation, the government and the authorities implemented several polices. On October 13, 2008, the Fast Track Program (FTP) was put into effect to support SMEs with temporary liquidity difficulties. Then on November 14, 2008, the target ratio for loans to SMEs was reflected when the MOU on Government Guarantees of Banks' External Debt was signed. On February 12, 2009, guarantee support was expanded to ensure smooth supply of funds. On February 15, extension of maturity on loans was requested to ensure effectiveness of the SME support policies.

On September 11, 2008, the FSS set up a SME Financial Consulting Center to actively support SMEs in the field and on November 17, started to operate an inspection team to monitor the financial situations of SMEs.

At the same time, the policies set in place to help SMEs were also keeping 'zombie' firms alive. The funds flowing into zombie firms were hindering other more promising firms in their business and were eating away at the effectiveness of the policies. Hence, SMEs restructuring was deemed necessary. The FSS saw the latter half of 2009, after the sudden credit crunch had passed, as the best opportunity to restructure SMEs.

4.5.2 SME Restructuring in 2009

In the second quarter of 2009, the implementation of the FTP and the expansion of guarantee support had lessened the liquidity hardships the SMEs were experiencing. The financial market seemed to be slowly regaining stability.

However, the policies focusing on keeping SMEs afloat had also enabled zombie firms to survive. Inefficient business practices and investment were allowed to continue and limited resources were spread thin, hindering profitable SMEs doing business, ultimately delaying economic recovery. If firms that received fund support during the economic downturn fail to perform during the economic recovery phase, the collection of funds becomes difficult leading to the weakening of SMEs loans.

With the conclusion of the credit risk evaluation on the construction and shipbuilding industry and large firms on June 11, resources could now be focused to evaluate the SMEs. The CCSTF announced on June 23, 2009 plans to conduct restructuring on SMEs. Three credit risk evaluations were to be performed to determine firms subject to restructuring.

The firms for first credit risk evaluation were those subject to external auditing with credit exposure of more than KRW 5 billion and less than KRW 50 billion. Of 10,738 firms 861 were selected, looking at financial factors such as the Interest Cover Ratio (ICR), Operating Cash Flow (OCF), and Forward Looking Criteria (FLC). The first evaluation ended July 15. 77 firms received C ratings and 36 firms received D ratings. 113 firms (13.1%) in total were determined to be in need of restructuring. The total bank credit exposure of the firms subject to restructuring was KRW 1.6 trillion. Approximately KRW 270 billion was expected as necessary as additional allowance for bad debts.

The second evaluation was conducted on firms subject to external auditing with credit exposure of more than KRW 3 billion and less than KRW 5 billion. Firms subject to external auditing with credit exposure of more than KRW 5 billion and less than KRW 50 billion (first evaluation) to which qualitative factors such as outstanding balances and bankruptcy are not applicable were also included. The second evaluation lasted until September 30.

Qualitative factors as well as financial factors were considered in selecting firms for the second evaluation. As a result, the number of firms to evaluate greatly increased (1,461). 108 firms received C ratings and 66 firms received D ratings, with a total of 174 firms (11.9%) being determined to be in need of restructuring. The total bank credit exposure of the firms subject to restructuring was KRW 2.5 trillion. Approximately KRW 380 billion was expected as necessary as additional allowance for bad debts.

The third evaluation was conducted on firms subject to external auditing with credit exposure of more than KRW 1 billion and less than KRW 3 billion. Firms that were not subject to external auditing but had credit exposures of KRW 3 billion were also included. Evaluations were conducted on 1,842 firms. The third evaluation lasted until December 15, 2009.

106 firms received C ratings and 119 firms received D ratings, with a total of 225 (12.2%) being determined to be in need of restructuring. The total bank credit exposure of the firms subject to restructuring was KRW 1.9 trillion. Approximately KRW 300 billion was expected as necessary as additional allowance for bad debts.

After the three credit risk evaluations, 291 firms that received C ratings were subject to the Workout process. Two hundred twenty-one firms that received D ratings were to be subject to rehabilitation process or reorganization process without any additional support from financial institutions. By the end of 2010, 134 firms (46.0%) of the 291 firms that received C ratings are amidst the Workout process. The other 157 firms (54.0%) have either graduated or halted the process.

Table 5-16 | Results of the 2009 SME Credit Risk Evaluation

(Unit: count, %)

	Total Number of Firms	Firms Selected for Evaluation			
			C Rating	D Rating	Total (C+D; %)
First Evaluation	10,738	861	77	36	113 (13.1)
Second Evaluation	15,618	1,461	108	66	174 (11.9)
Third Evaluation	21,366	1,842	106	119	225 (12.2)
Total	40,734*	4,164	291	221	512 (12.3)

* 6,988 firms from the first evaluation were also included in the second evaluation

Successful SME Workout Cases

1. Firm A based in Gyeonggi-Do applied for Workout due to Insolvent Obligations of KRW 1.5 billion arising on the main customer going bankrupt and bad sales performance.

   ➔ Bank B evaluated (C rating) and selected the firm to go through the Workout process. Supported the normalization process with debt restructuring. Firm A was allowed to pay outstanding interests in installments for 36 months and interest rates on loans were reduced (4.5% annual for won and 5.5% annual for dollar).

2. Firm C based in Gyeonggi-Do faced bankruptcy with sharp decrease in volume of orders after the global financial crisis, despite having competitive technology.

   ➔ After evaluation, it was determined that it was difficult for Firm C to recover. Bank D pushed for an M&A persuading creditor banks and institutional investors to go ahead with the process. The bank successfully supported for an early normalization.

After the three credit risk evaluations, it was deemed that more uniform and effective criteria for SMEs were needed. Banks each used differing criteria and even then SME specific criteria were lacking.

In May 2010 the FSS led a TF together with the KFB, Creditor Banks Steering Committee and major banks to draw up uniform SME-specific evaluation criteria. The new criteria were reflected in the Creditor Bank Agreement.

The new Agreement states that of the firms with credit exposure of less than KRW 50 billion and with more than credit exposure of KRW 3 billion with a single bank should be subject to regular and spot evaluations. Regular evaluation should be conducted for firms with credit exposure of more than KRW 5 billion and spot evaluation should be conducted for firms with credit exposure of more than KRW 3 billion. The regular evaluation process was to begin in May considering the financial factors and finishing the selection process by July and completing the evaluation process by October.

4.5.3 SME Restructuring in 2010

The creditor banks utilized the new uniform SME-specific criteria commencing their evaluation of firms with credit exposure of more than KRW 3 billion and less than KRW 50 billion on July 1, 2010. The selection process for the regular evaluations was completed by the end of July. As the number of firms selected was quite large, the evaluation was to be split in two. The first evaluation was for firms subject to external auditing and the second evaluation for firms not subject to external auditing. The evaluations were to be completed by the end of October.

Forty-nine firms received C ratings and 72 firms received D ratings. A total of 121 firms were deemed in need of restructuring. 59 Manufacturing Firms (48.8%), 10 Wholesale and

Retail Trade Firms (8.3%), 10 Real Estate/ Leasing Firms (8.3%), 8 Construction Firms (6.6%) were included. The total bank credit exposure of the firms subject to restructuring was KRW 1.4 trillion. Approximately KRW 298 billion was expected as necessary as additional allowance for bad debts.

After the second quarter spot evaluations of firms with credit exposure of more than KRW 3 billion and less than KRW 50 billion considering qualitative factors, 504 firms were selected for evaluation. 40 firms received C ratings and 74 firms received D ratings. A total of 114 firms were deemed in need of restructuring.

Fifty-five Manufacturing Firms (48.2%), 14 Real Estate/ Leasing Firms (12.3%), 12 Construction Firms (10.5%), 9 Wholesale and Retail Trade Firms (7.9%) were included. The total bank credit exposure of the firms subject to restructuring was KRW 552 billion. Approximately KRW 129 billion was expected as necessary as additional allowance for bad debts.

As a result of the evaluation in 2010, 89 firms with C ratings were subject to the Workout process and 146 firms with D ratings were subject to rehabilitation process or reorganization process without any additional support from financial institutions.

Table 5-17 | Results of the 2010 SME Credit Risk Evaluation

	Firms for Evaluation			
		C Rating	D Rating	Total (%)
Regular Evaluation	1,290	49	72	121 (9.4)
Q2 Spot Evaluation	504	40	74	114 (22.6)
Total	1,794	89	146	235 (13.1)

Annex A to Chapter 4: Interview with Mark Walker[58]

Q1. It was reported that Daewoo's foreign creditors were able to sell their credit at 8~10 cents higher than what local creditors expected to recover from the workout on average. This seems to be a significantly preferential treatment vis-á-vis local creditors, given that foreign creditors mostly lent to Daewoo Corp., the most vulnerable company in Daewoo Group at the time of its workout. I want to know your view about how preferential it was, since you were at the forefront of both negotiations.

In the Daewoo restructuring, the recovery rates for foreign creditors were generally determined guarantees provided by parent companies and affiliates-- this generally resulted in a higher recovery rate for creditors who lent to a Daewoo subsidiary with a parent guarantee than for creditors who lent only to a Daewoo parent company. The only exception was Daewoo Corporation and its subsidiaries. As you noted, Daewoo Corporation had the largest amount of indebtedness outstanding (and therefore the lowest recovery rate). Given the importance of Daewoo Corporation's creditors in achieving a global settlement, it was determined that for Daewoo Corporation and each of its subsidiaries, we would use a blended recovery rate of 32.3% for all of the entities, irrespective of the identity of the debtor or whether or not there was a parent guarantee by Daewoo Corporation. This approach was supported in part by the fact that there was quite a bit of "recycling" of money through BFC especially by Daewoo Corporation and its subsidiaries.

Because the Korean workout program entailed quite different treatment of creditors (including debt-for-equity swap, new money financing, interest rate reduction and principal deferment, among other things), to our knowledge, no attempt was made to compare the recovery rates for domestic creditors and foreign creditors on an apples-to-apples basis. As noted below, a critical element of the strategy in the Daewoo restructuring was to "take out" the foreign creditors by purchasing their claims to make the remainder of the workout program a "Korean problem" and then working out the remaining issues among the Korean creditors. This was because the government was under enormous political pressure for a fast restructuring of Daewoo but the foreign creditors were not bound by the workout program. This may explain, in part, why a simple comparison of foreign vs. domestic creditor recoveries may not tell the whole story.

Q2. Apart from the size of the foreign credit, perhaps, there are two major differences in the two cases: one is about who initiated the negotiation with foreign creditors (in the case of Daewoo, KAMCO and in the case of SK Networks, Hana Bank) and the

58 Mr. Walker who is a former partner of Clearly, Gottlieb Steen & Hamilton LLP was a lawyer to represent the Korean side in the cash buy-out negotiations of both Daewoo Group in 1999 and SK Network (formerly SK Global) in 2004.

other is the presence of the relevant law (Corporate Restructuring Promotion Act). Let me start with the former issue. I suspect that the fact that KAMCO, a public corporation, weakened its negotiation leverage against foreign creditors. I recall that government was under enormous political pressure for a fast restructuring of Daewoo at that time. Since foreign creditors knew this as well, I gather they were sure to use it to their full advantage. Does my observation sound sensible? Did you actually witness the hardening of foreign creditors due to the fact that your client was a public corporation rather than a private entity?

In the Daewoo restructuring, the negotiations were led by the late Hogen Oh, who was then the head of the Corporation Restructuring Coordination Committee. It was not until very late in the process (essentially after the basic financial deal with the foreign creditors had been negotiated) that KAMCO was brought into the picture to be the entity that would purchase the foreign creditors' debt. As such, the fact that KAMCO was involved in the Daewoo restructuring did not have a material effect on the negotiations or the terms of the deal; however, it is probably also true that the foreign creditors generally considered Mr. Oh as representing the Korean government. In addition, we agree with your other observations as contributing to the different outcomes in the Daewoo and SK Networks restructurings-- the facts that (a) the Daewoo restructuring had a much larger impact on the Korean economy than the SK Networks restructuring and (b) the government was under enormous political pressure for a fast restructuring of Daewoo (putting all of the Daewoo Group entities in bankruptcy in Korea and around the globe for a classic restructuring was really not an option in the minds of the Korean decision-makers-whereas it was precisely that threat that turned around the foreign creditors in the SK Networks restructuring).

Q3. Your article at the International Financial Law Review actually argues that your threat of filing pre-packaged bankruptcy to foreign creditors was proven to be credible thanks to the Corporate Restructuring Promotion Act. Do you think this threat would have not been workable in the Daewoo case? If so, what elements in the Corporate Restructuring Promotion Act were so critical to yield such remarkable change?

The CRPA had a provision that if the lead creditor bank determines that after the adoption of a CRPA plan, a debtor company should be restructured under court-supervised insolvency proceedings, the CRPA plan would serve as the plan of reorganization under a pre-packaged bankruptcy. The IFLR article notes, however, that in reality, this transition from a CRPA plan to a pre-packaged plan of reorganization was not a simple process. As such, we don't think it was the CRPA itself that was instrumental in making the bankruptcy threat more credible. What did make a difference was the fact that the Korean creditors actually approved the draft plan of reorganization and authorized Hana Bank to file if the negotiations with the foreign creditors did not bear fruit.

Q4. Finally, as you know, Corporate Restructuring Promotion Law has ceased to be effective. There is some talk in the National Assembly that this law should be reactivated, given the need of another corporate restructuring with regard to ill-fated construction companies. There are others opposed to it, though, pointing to improvements made in the country's insolvency law. I would be grateful if you could give your own view, based on your experience in the field.

We understand that the Korean National Assembly recently adopted a new Corporate Restructuring Promotion Act that is set to expire at the end of 2013. We also understand that much improved bankruptcy laws came into force in April 2006. As we noted in our IFLR article, however, given the costs and risks associated with even the most developed bankruptcy systems, there may be a role for the CRPA to play in facilitating speedy and fair out-of-court settlements.

Annex B to Chapter 5: Corporate Restructuring in Other Countries

The United Kingdom, Australia, Japan and the United States operate a formal workout according to legal processes like the bankruptcy act and an informal workout according to a voluntary process amongst creditor financial institutions. The formal process is generally overseen by the court and the informal process is overseen by the agreement's general standards between the creditor financial institutions and firms.

The major countries have not operated something like the CRPA to proceed with creditor financial institutions-led restructuring. In the UK and the US, when problems arise the creditor financial institutions step in to proceed with the informal restructuring process according to agreements. In Germany, an agreement of creditor banks is established to deal with restructuring issues. In Japan, a 'Guideline for Multi-Creditor Out-of-Court Workouts' is established as a standard of the Japanese Bankers Association, acting as a guiding principle for restructuring.

However, there are cases of temporary laws made to support and aid restructuring of a specific firm or industry in the US and Japan.

Table 5B-1 | Restructuring System of Major Countries

	Formal Workout	Informal Workout	Remarks
Korea	Consolidated Insolvency Act	Voluntary Agreement: Corporate Restructuring Agreement, Creditor Banks Agreement Legal: Corporate Restructuring Promotion Act	
United Kingdom	Bankruptcy Act, Corporation Act	Agreement between the creditor financial institution and the firm (when the loans are dispersed, utilize the London Approach)	
Australia	Corporate Act	Agreement between the creditor financial institution and the firm	
Japan	Corporate Reorganization Law, Commercial Law, Civil Rehabilitation Law	'The Guideline for Multi-Creditor Out-of-Court Workouts' (Japanese Bankers Association standard)	Industry Revitalization Law to aid industry restructuring (temporary)
United States	United States Code, Title 11, Chapter 11	Agreement between the creditor financial institution and the firm	Special law (temporary) to aid a specific firm or industry

5B.1. The United Kingdom

a. Formal Restructuring

(1) Administrative Receivership

The Administrative Receivership is the legally adopted form (in the Insolvency Act 1986) determining how UK banks dealt with insolvent obligations in practice. The creditor that possesses the undecided operating property or the floating charge of the entire property is eligible to appoint a receiver to collect on claims when a default or any other situation determined in the loan agreement arises. The receiver then can manage or sell the property or the firm. Once a receiver is appointed, no other restructuring method can be requested by any other creditor or firm. Hence it is a certain and simple method of securing the rights to claim for the creditor possessing the floating charge.

The receiver may continue with operations and later collect the rights to claim of the creditor with the floating charge and rehabilitate the firm itself. However, since only the

creditor with the floating charge may appoint the receiver it does not represent fairly the rights of other creditors.

The Enterprise Act 2002 limits the application of the administrative receivership to rights to claim that occurs after September 2003, effectively nullifying the system.

(2) Administration

The system was first introduced in the Insolvency Act 1986, the purpose of which is to rehabilitate firms. When first introduced, only the administration order, which had the court appoint an administrator to manage the firm, existed. In Enterprise Act 2002, the system was modified to Administration so that creditors or firms could appoint an administrator and later report it to the court.

The administrator is required to call the first creditors meeting to approve receivership plans within 10 days of the commencement of receivership. When the receivership plan is approved, the administrator manages the firm or disposes assets according to the plan.

The creditors or the firm may raise complaints to the court that the administrator is not acting to the best of the creditors' or the firm's interest. Without the consent of the creditors or the court, the receivership terminates one year after its commencement.

(3) Company Voluntary Arrangements (CVA)

The Company Voluntary Arrangement is a contract system that postpones the redemption of debt according to the agreement between the restructuring firm and the creditor. It was introduced in the Insolvency Act 1986, and is mostly utilized for SMEs. This system differs from other methods in that the manager retains management rights in his efforts to normalize the firm. Similar to the London Approach, it postpones the redemption of debt, but it is a formal process reported to the court and the creditor plays no direct role in managing the firm.

The manager may draw up a CVA suggestion for rescheduling if the firm faces receivership or bankruptcy and send the suggestion to all known creditors. The CVA suggestion may be approved with more than 75% votes of the creditors at the creditor meeting. Once the CVA is approved, unguaranteed rights to claim cannot be exercised.

Table 5B-2 | Cases per Methods of Insolvency

	2001	2002	2003	2004
Administrative Receivership	1,914	1,541	1,264	864
Administration	698	643	726	458
Court Appointed Administrator	698	643	479	1
Creditor or Firm Appointed Administrator	-	-	247	457
CVA	597	651	726	597

(4) Compromise or Arrangement

Compromise or Arrangement was operated within the Corporation Act before the Administration process was introduced in the Bankruptcy Act. The process can be operated as a part of the Administration process or as a separate process. Methods of Compromise or Arrangement are determined with more than 75% votes of the creditor group and the shareholders and the approval of the court. With the introduction of the CVA, the utilization of Compromise or Arrangement has decreased. The method is appropriate for situations where the creditors are complicated and different that a single creditor meeting will never satisfy everyone's interests.

b. Informal Restructuring

The term Workout (restructuring) describes a non-statutory agreement to extend financial support to a company, which, without this support, would have to cease trading.

(1) London Approach

The informal restructuring system came to be known as the London Approach in the United Kingdom. It draws on the experience of the past when an efficient and effective means of restructuring is needed. During the economic recession of the 1970s, the United Kingdom was not equipped to deal with the vast number of firms facing liquidity difficulties and the standing systems were geared towards dealing with bankruptcies. The Bank of England stepped in to encourage the creditor financial institutions to act upon agreements, streamlining the restructuring process.

When another economic recession hit UK in the 1990s, many firms that had borrowed from different financial institutions through syndicate loans were faced with great difficulties. Although the likes of Administration, Administrative Receivership and the Company Voluntary Arrangements were all introduced with the Insolvency Act 1986, the system was still very inefficient in terms of time and costs. Hence the need for a more efficient corporate restructuring system other than the standing formal processes was suggested.

As an answer, the Bank of England looked back at the 1970s and promoted an informal and hence efficient corporate restructuring process led by the creditor financial institutions. The Bank provided guidelines to aid in the informal process firmly rooted in the market. It has been assessed that the more efficient informal process helped greatly in stabilizing the financial market.

(2) Characteristics of the London Approach

The London Approach is a basic guideline that aims to rehabilitate the debtor firm and to minimize the loss of the creditor financial institution in case of financial troubles. Creditor financial institutions postpone exercising rights to claims according to agreements amongst creditors and drawing up appropriate measures via outside agencies. The Bank of England may step in to mediate any differing opinions to facilitate a smooth corporate restructuring.

However, the Bank of England and the British Bankers Association have not explicitly documented the guidelines or made it a law. Hence the guideline has been constantly modified freely by the creditor financial institutions and the market participants.

(3) The Restructuring Process

When a firm is faced with grave financial difficulties, the creditor financial institutions first determine whether to proceed with the informal restructuring process before resorting to the formal processes. If the informal process is chosen, an independent outside agency is brought in for due diligence to assess the longterm probability of the firm's rehabilitation. The creditor financial institutions usually defer exercising the rights to claims during the due diligence to not hinder with normal business operations.

If the due diligence reveals that it is better to rehabilitate the firm, the creditor financial institutions discuss specific restructuring processes. A lead bank is chosen so to facilitate the agreements and act as a channel for communication. The creditor financial institutes may form a committee of creditors to discuss important issues about the restructuring. Specific plans for normalization are prepared based on the results of the due diligence. The specific plans include more than the informal standstill. A more aggressive supporting plan is devised. Usually, reduction of interest, extension of maturities, providing new funds and converting investments are some of the methods employed. A business plan other than the financial aid is also included in the normalization plan.

5B.2. Australia

a. Formal Restructuring

(1) Scheme of Arrangement

The Scheme of Arrangement is a court led corporate restructuring process with its basis in the Corporate Act Part 5.1. Every step of the restructuring needs court approval to proceed. It is similar to Korea's old Corporate Reorganization Procedures or the Rehabilitation Procedures. However, the Scheme is thought to be inefficient in terms of time and cost due to the court having to intervene in every step. The Scheme has not been much utilized since the introduction of the Voluntary Administration with the reform of the Companies Act in 1993.

The Scheme of Arrangement is commenced when a creditor meeting is called by court order. In the meeting, rescheduling such as conversion of investment and reduction of interest are discussed. Votes of more than 75% will approve the suggested procedures. After the meeting the results are reported to the court and to the Australia Securities and Investment Commission (ASIC). The court will decide whether to approve after the procedures have been reviewed. Once the procedures are approved in court, all the creditors are required to follow through accordingly.

(2) Voluntary Administration

The Voluntary Administration is a creditor-led corporate restructuring process with its basis in the Corporations Act Part 5.3A. The process was introduced with the reform of the Companies Act in 1993. The process was introduced to provide fast and efficient restructuring of the firm in trouble. Excluding some cases of special exceptions, the restructuring is carried out with only the creditor discussions without the intervention of the court.

The process is commenced when the firm itself or a secured creditor appoints an independent third party Voluntary Administrator. The right of management is transferred to the Voluntary Administrator and the Administrator can call a creditor meeting to discuss the restructuring process. Major decisions are made in the creditor meeting and the restructuring (disposal of assets, management reform) is carried out according to the agreement between the creditors and the firm.

After the first creditor meeting, due diligence is carried out. The restructuring process will be based on these results. A creditor meeting will be called again to discuss whether to go ahead with the restructuring process and the specifics of the process once agreed upon. One of the following three steps will be decided in this meeting: returning the right to manage to the directors' control, restructuring through the Deed of Company Arrangement and the commencement of Liquidation.

The restructuring process is commenced with the signing of a Deed between the firm and the creditors. After the Deed is signed, the Voluntary Administrator and the Committee of Creditors become the Deed Administrator and the Committee of Inspection respectively. The process is terminated by one of the following three conditions: The conditions of the Deed are met, the process can be voted to terminate at the creditor meeting and by court order. During the process, the final decision lies with the creditor and the court or the ASIC does not intervene.

(3) Receivership

The Receivership is a creditor-led corporate restructuring process with its basis in the Corporations Act Part 5.2. The process was introduced to facilitate collecting the claims of the secured creditor. The Receiver disposes or manages the security assets and the related business to facilitate the collection of claims.

The process is commenced when the secured creditor appoints an independent third party Receiver. The right of management is transferred to the Receiver. The Receivership can be utilized when another restructuring process is in progress.

Of the 17,249 cases of restructuring in Australia only 14 cases (0.08%) were court-led processes and 13,339 cases (77.33%) utilized the Voluntary Administration and 3,896 cases (22.59%) utilized the Receivership. This result seems indicate that the creditor-led restructuring process is favored over the court led process due the process being more efficient.

b. Informal Restructuring

Unlike the London Approach and Korea's Workout process, the Informal Restructuring process in Australia does not have any legal basis. The process is carried out according to the consensus of the creditors and the debtor firm. It is known that the Informal Restructuring is more efficient and that the claims are better collected under the process.

The Informal process can minimize damage to the firm reputation so as not to hinder with normal business operations. The Informal process has no explicitly prescribed regulations. An outside agency is consulted with the matters of the restructuring process. Plans for normalization are agreed upon between the creditor and the firm and a deed is signed to ensure the process is carried out.

5B.3. Japan

a. Formal Restructuring

(1) Corporate Reorganization Law

Influenced by laws in the United States, the Corporate Reorganization Law was enacted in 1952 as a special law enabling a strong reorganization. Korea's old Corporate Reorganization Law had adopted the Japanese Corporate Reorganization Law with almost no modification. However, the Law differs from that of the US in that only incorporated companies are subject to the Corporate Reorganization Law. The Corporate Reorganization Law was enacted to specifically with large incorporated companies. The Corporate Reorganization Law is a complex process involving all stakeholders. As such, the process is highly time and cost consuming. The Corporate Reorganization Law underwent an overhaul in 2002 to facilitate a faster process.

The court appoints a Reorganization Trustee to draw up a Reorganization Plan by operating the business and managing and disposing assets. The Trustee pays off the debts according to the Reorganization Plan and reorganizes the business back to health.

The process of restructuring commences on request by the debtor firm, shareholder and the creditor. The court decides whether to commence the process after ordering necessary provisionary injunctions. After the decision to go forth with the restructuring process is finalized, reporting, inquiry, finalizing process of reorganization claims are conducted. The Reorganization Trustee submits the Reorganization Plan to the court. The Plan is approved on majority consent at the meeting of parties interested. The Plan then takes effect on being approved by the court.

Once the Plans is expected to be fulfilled without much hindrance, the reorganization process may be terminated, leaving the firm to reorganize and develop on its own. The Trustee may request the termination to the court, or the court may decide to terminate the

process on its own authority. If, after the reorganization process has been commenced, it is determined that the objectives will fail to be met or it is deemed impossible to fulfill the Plan, the reorganization process may be discontinued.

(2) Corporate Reorganization Procedure

The Corporate Reorganization Procedure is a process within the Commercial Law aiming for reorganization through the Compromise between the debtor firm and the creditors. This is done under the court's supervision for incorporated companies that are facing insolvency or excess debt. The Procedure is operated under the Commercial Law and the Non-Contentious Case Litigation Procedure. There are no standing regulations as to the contents and the form of Reorganization Plans and they are left to the parties involved. The Corporate Reorganization Procedure differs from the Corporate Reorganization Law and the Civil Rehabilitation Law in that the condition for the procedure to stand is not by a majority vote but that it only affects the consenting creditors. The Corporate Reorganization Procedure is more appropriate for SMEs with a smaller number of creditors.

The Corporate Reorganization Procedure can be categorized as the Supervisor method, the Manager method and the Reorganization Steward method. The court can let the directors manage the firm under the supervision of the court appointed Supervisor. In case, the court finds it unfit for the directors to manage the firm, the court may appoint a Manager to operate the firm and manage its assets. If deemed necessary, the court may appoint a Reorganization Steward to work alongside the directors to draw up a reorganization plan and the conduct the process according to the plan.

The Corporate Reorganization Procedure may be terminated upon the completion of the procedure or when the procedure is no longer deemed necessary. The court may approve the request for the Civil Rehabilitation Law when it is deemed necessary to protect the interest of the creditors in general. The Court may declare bankruptcy when the reorganization is deemed infeasible. Even after the commencement of the Corporate Reorganization Procedure, reorganization procedure according to the Corporate Reorganization Law may be requested.

(3) Civil Rehabilitation Law

The Civil Rehabilitation Law was enacted in 1999 and took effect on April, 2000, replacing the Composition Act. The old Composition Act was favored by SMEs for its simplicity, yet its many inherent problems prevented it from being effective. The Civil Rehabilitation Law was enacted to inherit the simplicity of the old Composition Act, while complementing its shortcomings. The Civil Rehabilitation Law can be utilized for any kind of corporate body.

The debtor may request Civil Rehabilitation Procedures when the debtor is facing bankruptcy or when the debt cannot be paid off without seriously hindering with the normal business operations. The court, upon receiving the request, reviews the case and determines if the request is legitimate and orders necessary provisional injunctions. On

the commencement of the rehabilitation process, reporting, inquiry, finalizing process of rehabilitation claims are conducted to prevent any unreported claims from hindering with the process. The rehabilitation process may be terminated by the Supervisor, Trustee or the court in case where no Supervisor or Trustee was appointed. When the rehabilitation process fails to meet the objectives, the process may be discontinued or reduced in scale.

b. Informal Restructuring

Since the Informal procedures lack any binding power, the Japanese Bankers Association provides 'The Guideline for Multi-Creditor Out-of-Court Workouts' to facilitate a fair process. However, the Guideline is only utilized in cases when multiple creditors are involved and it is beneficial for both the debtor and the creditor. The condition for the Informal Restructuring according to the Guideline to be utilized is that the firm has to put forth rigorous self rescue efforts. Managers and shareholders are held responsible for the trouble the firm is experiencing.

The Informal Restructuring may commence when a debtor meeting the conditions set forth by the Guideline requests for the restructuring process to one of the main creditors. A notice jointly signed by the major creditor and the debtor of a standstill is sent out to relevant creditors. The first meeting determines the duration of the standstill and the organization of the creditor committee and the date for the next meeting. The restructuring plan is finalized at the second meeting.

5B.4. The United States

a. Formal Restructuring

(1) Corporate Restructuring Procedure

The Corporate Restructuring Procedure follows the United States Code Title 11. Upon request from the debtor or the creditor, the Corporate Restructuring Procedure provides restructuring plans and conducts procedures according to the plan to normalize the firm. The Debtor in Possession and the Committee of Creditors lead the restructuring process. The Debtor in Possession retains the rights to possession and continues with business operations under the supervision of the Committee of Creditors and the court. The debtor's opinions are always reflected all through the process. The creditors form the Committee of Creditors, which is composed of no more than seven creditors, to discuss the restructuring process and to supervise the debtor. The court plays a very limited role, only intervening to settle disputes.

The restructuring process may be commenced by a voluntary petition form the debtor or by an involuntary petition by the creditor and the shareholders. In case of the involuntary petition, the joint request by eligible creditors and proof of default by the debtor are necessary. The process may commence automatically upon request by the debtor. However, in case the request was made by the creditor and the stakeholders, the court requires a statement from

the debtor and a hearing procedure before reviewing the request to determine whether the restructuring should commence or not.

Once the restructuring process commences, the individual enforcement of claims by the creditors is halted (automatic stay). Normally the Debtor in Possession retains the rights to possession and continues managing the business operation. The Committee of Creditors and the court will be supervising the management. However, if the Debtor in Possession is responsible for the poor management, the court may appoint a Trustee or an Examiner to oversee the operations.

When requested by a stakeholder, the court may appoint a Trustee. In this case, the debtor must be responsible for wrongdoings or poor management, or the appointing of a Trustee must be beneficial for the creditors, firm employees and the divisible property. The court may elect to appoint an Examiner instead of a Trustee. An Examiner may be appointed when the Debtor in Possession needs to be kept in check, yet appointing a Trustee may be an excessive measure.

The plans for the restructuring process are drawn up by the debtor, Trustee, creditors and shareholders and submitted to court. The rights of creditors and stakeholders and specific plans for raising funds for restructuring, the disposal of assets, M&A are included in the restructuring plan.

The reconstruction process is terminated when the firm is deemed fully administered or by the order of the court. When the goals of the restructuring plans are not met, the court may discontinue the process or move forward with the liquidation process.

(2) Prepackaged Bankruptcy

To improve the efficiency of the formal restructuring process, some of the private workout process was adopted into the formal restructuring process. Under the Prepackaged Bankruptcy, the creditor and debtor may prepare a restructuring plan out of court before requesting the restructuring process. This procedure may also be utilized when creditors and debtor may have reached an agreement on the conditions of paying off debt, but some creditors refuse the conditions.

b. Informal Restructuring

There is no law or mediating agency in the US to support the creditor financial institutions leading corporate restructuring. Hence, the creditors and the debtor conduct the restructuring process according to individual deeds signed via informal agreements. The US financial institutions do not play a large role in the restructuring process, unlike Korea where the main creditor bank plays a leading role. This is because generally bonds are issued to raise funds rather than bank loans, hence the bank and the firm maintain an arm's length relationship.

Corporate restructuring is conducted according to the loan agreements between the creditor financial institutions and the firm. In case the loans are from different financial institutions, the main creditor bank takes a leading role in the restructuring process.

The firm itself or the stakeholder decides whether a firm should undergo a restructuring process. A firm with going concern value greater than the liquating value and that has a relatively simple creditor relation is often chosen to undergo the restructuring process. Committees of creditors and shareholders are formed to represent the stakeholders when negotiating with the debtor. When drawing up a workout plan, the mitigation of uncertainties is considered first to prevent the firm from falling into insolvency. Normalization efforts are conducted according to the agreement of the creditors and the debtor. Creditors monitor closely the progress of the normalization efforts and consult outside experts when deemed necessary. The restructuring process is terminated when the firm is able to carry out normal business operations without outside help.

Chapter 6

Conclusion

Conclusion

According to theory, one of the necessary conditions for an efficient economic system is to make the environment more competitive. This competitiveness is more likely achieved with lower barriers for entry and exit, of which the latter is closely related to restructuring schemes. During the period of overcoming the 1997 crisis, Korea had to build a variety of hardware and software for resolving corporate distresses. Thus, it is worthwhile to thoroughly review the changes and their adequacy for corporate restructuring in designing insolvency regimes.

This study looks into a variety of corporate insolvency systems employed after the 1997 financial crisis in Korea, with a focal emphasis on out-of-court restructuring. The lessons learnt from Korean experiences are as follows.

First, there is no one-size-fits-all solution. A successful system in a country is not often applied to other countries due to differences in primitive environments, causes of corporate distress, institutional complications, etc. Thus, the choice of the methods is scrutinized in line with the stage of economic development and the degree of capital market development.

Second, despite its effectiveness out-of-court settlement should be accompanied with strengthened in-court settlement system. One of the warnings for the corporate workout system is the potential for bail-out incentives to be taken by policy makers. Since any restructuring process is unpopular, policy makers will face strong objections, and feel also pressure to fall in easy reconciliatory ways. Participating financial institutions in the out-of- court settlement do not reach the first-best solution due to their incentive problems as explained in the Prisoner's Dilemma game. However, no insolvency regime will be credible and sustainable without imposing losses on the distress makers. In this respect, market discipline should be imposed in any type of corporate workout to the extent that it provides an effective control on reckless risk-taking behaviors, but tends to be hardly implemented.

The very existence of effective in-court settlement system working as the last resort can render all stakeholders to bind to voluntary out-of-court insolvency mechanism.

Third, out-of-court settlement system which is based on voluntariness of relevant stakeholders cannot produce fruitful performance unless it is secured by legal supports. Under the circumstances where the formal insolvency regime cannot work properly, the corporate workouts have been a solution in many countries, including Korea, the United Kingdom, Sweden, Malaysia, and others. Even if the corporate workouts have some limitations in the nature of the system and validity of administrative processes, they have worked as an effective substitute for inefficient in-court restructuring mechanisms. But such good performance is not always taken for granted. Rather, the out-of-court insolvency needs to be strengthened legally in order to have practical solutions. Financial regulations on bank assets, securities trading, etc., should be corresponding to the out-of-court settlement system.

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