BANKRUPTCY POLICY REFORMS AND CORPORATE RESTRUCTURING IN POSTCRISIS KOREA

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Introduction

In the unfolding process of the Korean financial crisis in 1997, an inefficient corporate bankruptcy system played a damaging role in the Korean economy. Before the crisis, in 1996 and during the first three quarters of 1997, numerous large firms faced with bankruptcy actively sought shelter under court-administered rehabilitation procedures. However, Korea's poor bankruptcy system failed to maintain the most advantageous order among the increasingly large number of financially distressed firms as they were targeted to undergo the rehabilitation procedure. Uncertainty and delay in dealing with failing firms added to the distortion in the economy's resource allocation process before the crisis broke out.

In other words, the exit barriers for large firms seemed to have decreased the efficiency of resource allocation before the onset of the crisis. Before the crisis, the Korean corporate bankruptcy system had a tendency to work as a de facto exit barrier. For example, before the reform, producers with persistently declining productivity were much more likely to be accepted in some rehabilitation procedures if they were regarded as having "high social value" such as significant production or employment.

Thus, it was natural for postcrisis Korea to launch a sweeping reform of the corporate bankruptcy system. As was the case with other structural reforms in the corporate sector, the reform of bankruptcy policy was pushed forward because of the belief that reform was essential for preventing recurrent economic crises from plaguing Korea's economy.

In the next section, the corporate bankruptcy system in Korea before the economic crisis is explained; then key elements of the postcrisis bankruptcy reforms are discussed. This is followed by conclusions.

Corporate Bankruptcy System before the Economic Crisis

Statutes Contributed to Exit Barriers for Large Firms

Past economic growth in Korea had been possible through the growth or restructuring of existing firms instead of through the dynamic process of entry and exit. In the developmental era, when profitable new markets were emerging rapidly, the poor corporate bankruptcy system did not significantly distort the resource allocation of the economy because resources could be easily reallocated from declining sectors to emerging profitable sectors. Under these circumstances, through rationalization programs, the government played an active role in reallocating resources from failing firms to other existing firms. During the developmental era, most failing firms did not use the bankruptcy procedures that were overseen by the courts.[1]

In particular, most small and medium-sized bankrupt firms were effectively liquidated on a nonjudicial basis. The debt of a bankrupt firm was usually collected individually under the Civil Procedure Act. Most assets of the bankrupt firms were already subject to mortgage or to security, and few assets were left for unsecured creditors. Additional procedures for the collection of debt were not needed.

1. One technical hurdle to the use of judicial bankruptcy procedures was the Act on Special Measures for Unpaid Loans of Financial Institutions, which gave the Korea Asset Management Corporation (KAMCO) the authority to auction off assets of bankrupt firms before court procedures began. In practice, this act prevented the Corporate Reorganization Act from operating because the auction of assets by KAMCO effectively preempted the corporate reorganization process. In 1990, the Constitutional Court declared unconstitutional this provision of the Act on Special Measures for Unpaid Loans of Financial Institutions, which paved the way for the wider use of judicial bankruptcy procedures.

For large firms, however, the too-big-to-fail argument played a role as an exit barrier in the sense that inefficient firms were often allowed to operate with some explicit or hidden subsidies from the government. Some large, bankrupt firms were periodically bailed out by the government through various rationalization measures. Such measures—for example, those undertaken in the mid-1980s—also undercut the use of formal bankruptcy procedures.

Beginning in the early 1990s, the poor corporate bankruptcy system began to distort the resource allocation process of the economy. The distortion grew until the outbreak of the financial crisis in 1997. Some failing firms began to use court-administered bankruptcy procedures, but the court-administered bankruptcy system was often abused by the controlling shareholders of failing firms.

By laying down the Rule on Corporate Reorganization Procedure in 1992, the Supreme Court began to move in the direction of improving judicial bankruptcy procedures. Among other things, the new rules established the conditions for the initiation of corporate reorganization proceedings. These included high social value, financial distress, and the possibility of rehabilitation.[2] This new rule established the tendency for court-ordered corporate bankruptcy settlements to function as de facto exit barriers for large firms. For example, producers with persistently declining productivity were much more likely to be accepted into the rehabilitation program if they were regarded as having high social value, which was defined as significant production or employment.

Controlling Shareholders of Failing Firms Created Exit Barriers

Before the economic crisis, controlling shareholders of large but failing firms often sought shelter under court-administered rehabilitation procedures. However, an inefficient bankruptcy system failed to maintain discipline in selecting from among an increasingly large number of financially distressed firms the best firms to target for rehabilitation.

Some notorious episodes of abuse of the corporate reorganization procedure by the controlling shareholders of failing firms led the Supreme Court to amend the system in 1996. In particular, the court argued that the shares of controlling shareholders responsible for a firm's failure should be wiped out. This revision produced an unanticipated outcome: the owners of failing firms looked for other possibilities that would allow them to maintain their control.

They found such an alternative in the composition procedure. The composition procedure was originally designed for small and medium-sized firms with simple capital structures, but there was no explicit limit on firm size until the law was revised later. What made the composition procedure popular was the fact that the existing management maintained control.

As shown in ***Table 1,*** filings for composition exploded from 9 cases in 1996, to 322 cases in 1997, to 728 cases in 1998. In the first three quarters of 1997, before the onset of the crisis, many large firms facing bankruptcy sought to file for the composition procedure. Among these firms, the case of Kia Motors deserves special mention because it played an important role in the unfolding crisis in mid-1997. The debtor (Kia) and the creditors initially wanted to apply for different procedures: Kia initially filed for composition, but shortly thereafter the creditors chose to file for corporate reorganization. When both procedures were filed in this way, the filing for corporate reorganization overrode the one for composition. In the end, the court accepted Kia Motors into corporate reorganization, but the uncertainty and delay in dealing with large, failing firms such as Kia clearly added to the uncertainty in the economy before the crisis broke out.

Postcrisis Bankruptcy Policy Reforms

The economic crisis of 1997 put the existing corporate bankruptcy system, both judicial and nonjudicial, under great strain. The number and scale of bankruptcies soared. Table 1 shows that the filings for

2. Economic efficiency was not a requirement for corporate reorganization.

judicial bankruptcy procedures rose dramatically in 1997. This internal pressure on the system was a driving force behind the changes in laws and procedures although the International Monetary Fund and the International Bank for Reconstruction and Development also demanded improvement in the corporate bankruptcy system as a condition for a program of financial support.

After the economic crisis, the Korean government made reform efforts to remove exit barriers along two separate lines: one has been the court-administered bankruptcy procedure, and a second has been the informal pre-bankruptcy arrangements for corporate restructuring. The workout procedure has played an important role in dealing with the largest failing firms, and the court-administered bankruptcy system has had an impact on the way medium-sized failing firms are restructured.

In this paper we focus on the policy reforms in the court-administered bankruptcy system. Except for small firms with simple capital structures, the court-administered bankruptcy procedures would usually take place in the final stages; failing firms could resort to them if interested parties could not agree on the informal pre-bankruptcy arrangements for corporate restructuring. For the informal pre-bankruptcy arrangements, one of the most effective disciplines should come from the court-administered bankruptcy procedures. In this sense, the court-administered bankruptcy system plays a crucial role in the whole bankruptcy system. In settlements administered out of court, the interested parties' incentives would be directly affected by the structure of court-administered bankruptcy settlements.

1998: Economic Efficiency Criterion and Removal of Exit Barriers for Large Firms

The most important element in the postcrisis court-administered bankruptcy system has been the economic efficiency criterion. The court established an economic efficiency criterion that firms were required to meet in order to qualify for judicial bankruptcy procedures. The court implemented this tightly. The old system had been based on high social value and prospects for rehabilitation, but the new system considered the additional requirement of economic efficiency. Now it is required that the value of a distressed firm as a going concern must be compared with its liquidation value before any judicial bankruptcy proceedings can be initiated.

This new criterion contributed much to removing the de facto exit barrier for large firms that had existed in the precrisis court-administered bankruptcy system. Remember that, in the prior system, the producers with persistently declining productivity were much more likely to be accepted into a rehabilitation procedure if they were regarded as having high social value such as significant production or employment.

***Table 1*: Bankruptcy Filings in Korea, 1995–2002**

Bankruptcy procedure	1995		1996		1997		1998	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Reorganization	79	76.0	52	65.8	132	26.8	148	14.9
Composition	13	12.5	9	11.4	322	65.5	728	73.3
Liquidation	12	11.5	18	22.8	38	7.7	117	11.8
Total	104	100.0	79	100.0	492	100.0	993	100.0
Bankruptcy procedure	**1999**		**2000**		**2001**		**2002[a]**	
	Number	**Percent**	**Number**	**Percent**	**Number**	**Percent**	**Number**	**Percent**
Reorganization	37	9.1	32	13.2	31	12.3	19	15.3
Composition	140	34.4	78	32.2	51	20.2	23	18.6
Liquidation	230	56.5	132	54.6	170	67.5	82	66.1
Total	407	100.0	242	100.0	252	100.0	124	100.0

Source: Supreme Court of Korea.
a. From January to October.

The 1998 revision represented the most substantial change in the system since the enactment of the corporate bankruptcy laws in 1962. But, because the government was pressed for time in the wake of the crisis, it did not succeed in initiating a fully comprehensive revision; this fact accounts for the second round of reform in 1999. Through these two revisions, the role of the courts in the corporate bankruptcy process increased significantly. If it had not been for the workout procedure introduced as an out-of-court settlement process in 1998, the role of the courts would have even been even larger.

Besides the economic efficiency criterion, the 1998 revision tried to speed up proceedings. Time limits were introduced for critical steps in the proceedings, including the issuance of stays, the report of debts and equities, and the approval of the reorganization plan. Other important changes in the 1998 revision included:

- Establishment of a creditors' conference in order to induce a more active role for the creditors;
- Introduction of a court receivership committee as a special adviser on the critical steps in the proceedings in order to enhance the capacity of the court to deal with bankruptcy cases;
- Strengthening and making more transparent the process of wiping out the shares of controlling shareholders; and
- Alteration of the Composition Act in order to prevent abuse of the composition procedure, and to prevent large firms with complicated capital structures from entering composition; Table 1 shows the impact of this change: the number of composition filings decreased sharply from 728 in 1998 to 140 in 1999.

1999: Mandatory Liquidation System

Despite these changes, the 1998 revision left room for further reform. In fact, to some extent the 1999 revision filled the gap between initial reform proposals and what was eventually passed in the 1998 revision. In the 1999 revision process, there was initially a debate on the inclusion of an automatic stay in the new law. Under an automatic stay, the debtors' assets upon filing are automatically protected from the creditors' rush to secure their claims. The pros and cons of the automatic stay were both strong. The final compromise was to speed up the initiation of the proceedings to take place no later than one month after the filing.

On the one hand, an automatic stay can contribute to the rehabilitation of failing firms after bankruptcy. On the other hand, a debtor might use the court to avoid a formal default and thereby evade criminal punishment under the Illegal Check Control Act. According to the Illegal Check Control Act, which was developed to overcome the informational asymmetry between the debtor and the creditors, the managers or owners of failing firms who issued bad checks were to be held criminally liable. Dealing with highly unreliable accounting information, creditors would be much less willing to lend money to debtors without such recourse. The debtors are in effect forced to make a credible commitment to repayment by risking incarceration in case of default.

The new revision also facilitated an efficient transition between corporate reorganization and liquidation. After the initiation decision, the court must compare the value of the firm as a going concern with its liquidation value. If the liquidation value turns out to be larger than the going-concern value, the court must declare liquidation of the firm. Donga Construction was the first large firm to go down this path; the company was liquidated in early 2001. This change could be regarded as one that contributes to an efficient working of the market mechanism.

The system of mandatory liquidation for failing firms produced an unintended outcome: failing firms did not want to use the judicial rehabilitation procedures because they feared the possibility of forced liquidation.[3]

3. The system of mandatory liquidation for failing firms was relaxed several years later.

2005: Unified Bankruptcy Act

Bankruptcy policy reforms in 1998–99 emphasized the implementation of the economic efficiency criterion to qualify for judicial bankruptcy procedures. However, one of the serious side effects of the postcrisis bankruptcy policy reforms was that failing firms did not want to use the judicial rehabilitation procedures because controlling shareholders and management feared the possibility of losing control. Resolving this problem remained one of the major future tasks in the Korean judicial bankruptcy system. To address this problem, the Unified Bankruptcy Act was passed in the National Assembly in 2005, to take effect in April 2006. As in the bankruptcy process in Germany, the Unified Bankruptcy Act combines the Corporate Reorganization Act, the Composition Act, and the Liquidation Act although the total consolidation of the individual bankruptcy acts remains incomplete.

The most important feature of the Unified Bankruptcy Act is the reintroduction of the debtor-in-possession (DIP) system, which was discarded after the crisis in Korea. The Supreme Court is eager to see the successful reintroduction of the DIP system and the active use of in-court bankruptcy procedures by failing firms.

Concluding Remarks

As discussed in the prior section, the most important element in the postcrisis court-administered bankruptcy system was the implementation of the economic efficiency criterion. The court established an economic efficiency criterion that firms had to meet in order to qualify for judicial bankruptcy procedures, and it implemented that criterion tightly. A comparison of the value of a distressed firm as a going concern with its liquidation value is now required for the initiation of all judicial bankruptcy proceedings.

Instead of economic efficiency, the old system was based on high social value and prospects for rehabilitation. Note that the prospects for rehabilitation could vary depending on the size of subsidies from the creditors and the government. Compared with the old system, the new system removed the opportunity for interested parties (for example, controlling shareholders, labor unions, local governments, and the central government) to resist the exit of the firms without economic value. In other words, the new system contributed much to removing the de facto exit barrier for large firms that had existed in the in-court bankruptcy system before the crisis. Under the new system, producers with persistent declining productivity were less likely to be accepted into a rehabilitation procedure despite being regarded as having high social value.

Successful reform of court-administered bankruptcy procedures has made a large impact on the success of corporate restructuring in general. Faced with bankruptcies, failing firms resort to in-court settlements only after exhausting all the possibilities for out-of-court settlements. Maintaining discipline in the court-administered bankruptcy system has had far-reaching consequences on the out-of-court bankruptcy system because the discipline of the court-administered settlements has worked as an effective and credible threat to failing firms in other stages.

Dr. Lim is with the Korea Development Institute. This paper is based on the author's earlier work, "The Corporate Bankruptcy System and the Economic Crisis," in Economic Crisis and Corporate Restructuring in Korea: Reforming the Chaebol, ed. S. Haggard, W. Lim, and E. Kim (Cambridge: Cambridge University Press, 2003); and (with Chin Hee Hahn), Bankruptcy Policy Reform and Total Factor Productivity Dynamics in Korea, Working Paper 9810 (Cambridge, Mass.: National Bureau of Economic Research, 2003).