The views expressed in this paper are the author's own and do not reflect KDI's official position.

Insolvency Mechanisms in Korea

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Il Chong Nam, Soogeun Oh,
and Joon-Kyung Kim

Korea Development Institute

빈 면

Contents

Ⅰ. A Summary of the Overall Economic Conditions and Extent of the Debt Crisis

Although Korea's financial crisis was triggered by a foreign currency shortage in financial institutions, there is little doubt that the financial troubles of debt-ridden business firms, particularly *chaebols*, are at the epicenter of the crisis. A string of corporate bankruptcies occurred in early 1997, starting with Hanbo Steel Co. The corporate sector's financial troubles were immediately translated into an unbearable burden of non-performing loans (NPLs) and the deterioration of capital adequacy in the financial sector. These developments in the corporate and financial sectors undermined international confidence in the Korean economy, resulting in a massive and sudden pull-out by foreign investors.

Weak Financial Structure of Corporate Sector

The weak financial structure of the corporate sector was the core source of its financial vulnerability. According to the flow of funds statistics, at the end of 1997, gross corporate debt amounted to 810 trillion won, equivalent to about 190 percent of GDP[1]. (See Table I-1) The financial vulnerability of Korean corporations can also be seen from the high debt/equity ratios. In particular, by the end of 1997, the average debt/equity ratio of the 30 largest *chaebols* reached 519 percent, about 130 percentage points higher than a year earlier, as shown in Table I-2. Moreover, the debt/equity ratios of those *chaebols* that later became bankrupt and/or subject to court receivership were at an unsustainable level at the time of the crisis: Halla Group (-1,600 percent), Jinro Group (-894 percent), New Core Group (1,784 percent), and Haitai Group (1,501 percent). Another important observation that can be drawn from Table I-2 is that high debt/equity ratios had prevailed – in fact, had been increasing -- for several years before the crisis. The rapidly rising debt/equity ratios of *chaebols* since 1995 can be partially attributed to such unfavorable cyclical shocks as the decreased terms of trade in 1996 and business downturn since the end of 1995. Nonetheless, they were able to survive at least for two years before they collapsed at the time of the financial crisis, even with such an unbearable burden of debt.

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[1] This figure of domestic corporate debt dwarfs the external debt of the corporate sector of 100.4 trillion won, which accounts for only 12.5 percent of its total debt. In this context, Korea's debt overhang problem, if realized, is more likely to be caused by excessive domestic debt rather than external debt.

<Table I-1> Outstanding Liabilities of Korea's Corporate Sector

(Unit: trillion won, %)

	1980	1990	1996	1997	1998
Loans by financial institutions	17.4	97.8	272.9	335.8	312.6
	(38.0)	(44.6)	(42.9)	(41.5)	(39.0)
Banks	11.1	50.1	130.9	161.1	156.1
Investment & Finance Cos.	0.9	9.7	16.4	18.3	12.1
Insurance Cos.	0.5	8.7	24.2	26.5	21.0
Other Loans	4.8	29.3	101.4	129.8	123.0
Bonds	3.3	47.3	195.1	246.1	276.9
	(7.2)	(21.6)	(30.7)	(30.4)	(34.6)
Short-term	1.3	16.5	39.8	73.9	62.2
	(2.8)	(7.5)	(11.0)	(9.1)	(7.8)
Commercial papers	1.1	12.7	64.9	69.0	57.3
Government & public bonds	0.3	3.7	4.9	4.9	4.9
Long-term	2.0	30.8	125.3	172.2	214.7
	(4.4)	(14.1)	(19.7)	(21.3)	(26.8)
Debentures	1.9	29.4	107.4	138.9	184.8
Foreign debentures	-	-	12.3	27.2	23.1
Government & public bonds	7.4	1.5	5.5	6.1	6.7
Trade credits	7.4	27.1	60.8	74.5	69.0
	(16.2)	(12.4)	(9.6)	(9.2)	(8.6)
External debts	8.1	14.6	40.8	73.2	54.6
	(17.7)	(6.7)	(6.4)	(9.0)	(6.8)
Others	7.7	29.2	65.8	80.0	88.7
	(16.8)	(13.3)	(10.4)	(9.9)	(11.1)
Total	45.8	219.1	635.4	809.6	801.8
	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)

Source: Bank of Korea, *Flow of Funds*, each year

<Table I-2> Top 30 *Chaebols*' Debt/Equity Ratio

(Unit: %)

1995		1996		1997		1998	
Chaebols	Debt/ Equity Ratio	*Chaebols*	Debt/ Equity ratio	*Chaebols*	Debt/ Equity ratio	*Chaebols*	Debt/ Equity Ratio
1. Hyundai	376.4	1. Hyundai	436.7	1. Hyundai	578.7	1. Hyundai	316.0
2. Samsung	205.8	2. Samsung	267.2	2. Samsung	370.9	2. Samsung	355.0
3. LG	312.8	3. LG	346.5	3. Daewoo	472.0	3. Daewoo	252.1
4. Daewoo	336.5	4. Daewoo	337.5	4. LG	505.8	4. LG	315.6
5. Sunkyung	343.3	5. Sunkyung	383.6	5. SK	468.0	5. Hanjin	458.3
6. Ssangyong	297.7	6. Ssangyong	409.4	6. Hanjin	907.8	6. SK	249.8
7. Hanjin	621.7	7. Hanjin	556.6	7. Ssangyong	399.7	7. Ssangyong	1,402.8
8. Kia	416.7	8. Kia	516.9	8. Hanwha	1,214.7	8. Kohap	impaired capital
9. Hanwha	620.4	9. Hanwha	751.4	9. Kumho	944.1	9. Hanwha	327.1
10. Lotte	175.5	10. Lotte	192.1	10. DongAh	359.9	10.Kumho	558.0
11. Kumho	464.4	11. Kumho	477.6	11. Lotte	216.5	11.DongAh	625.4
12. Doosan	622.1	12. Halla	2,065.7	12. Halla	-1,600.4	12.Hyosung	281.2
13. Daelim	385.1	13. DongAh	354.7	13. Daelim	513.6	13.Daelim	335.8
14. Hanbo	674.9	14. Doosan	688.2	14. Doosan	590.3	14.Anam	8,550.7
15. DongAh Construction	321.5	15. Daelim	423.2	15. Hansol	399.9	15.Dongkuk Steel	198.8
16. Halla	2,855.3	16. Hansol	292.0	16. Hyosung	465.1	16.Doosan	331.7
17. Hyosung	315.1	17. Hyosung	370.0	17. Kohab	472.1	17.Shinho	impaired capital
18. Dongkuk Steel	190.2	18. Dongkuk Steel	218.5	18. Kolon	433.5	18.Hansol	458.7
19. Jinro	2,441.2	19. Jinro	3,764.6	19.Dongkuk Steel	323.8	19.Kabul	impaired capital
20. Kolon	328.1	20. Kolon	317.8	10. Dongbu	338.4	20.Dongbu	267.5
21. Tongyang	278.8	21. Kohab	590.5	21. Anam	1,498.5	21.Kolon	334.6
22. Hansol	313.3	22. Dongbu	261.8	22. Jinro	-893.5	22.Jindo	impaired capital
23. Dongbu	328.3	23. Tongyang	307.8	23. Tongyang	404.3	23.Tongkook Co.	impaired capital
24. Kohab	572.0	24. Haitai	658.5	24. Haitai	1,501.3	24.Haitai	impaired capital
25. Haitai	506.1	25. New Core	1,225.6	25. Shinho	676.8	25.Woobang	impaired capital
26. Sammi	3,244.6	26. Anam	478.5	26. Daesang	647.9	26.Tongyang	306.0
27. Hanil	936.2	27. Hanil	576.8	27. New Core	1,784.1	27.Saehan	276.7
28. Ku kdong Construction	471.2	28. Keopyong	347.6	28. Keopyong	438.1	28.Byucsan	655.4
29. New Core	924.0	29. Miwon	416.9	29. Kangwon Industrial	375.0	29.Shinwon	impaired capital
30. Byucksan	486.0	30. Shinho	490.9	30. Saehan	419.3	30.Kangwon Industrial	441.6
Total	347.5		386.5		519.0		369.1

Source: Fair Trade Commission.

Massive Corporate Bankruptcies and Increase in NPLs after the Crisis

Upon the onset of the crisis, the exchange rate of the won *vis-a-vis* the US dollar soared to the 1,950 level in December 1997, from a pre-crisis level of about 900. In order to stabilize the currency market quickly, the IMF imposed a high interest rate policy during the initial stage of crisis management. Accordingly, the call rate jumped from 14 percent to 25 percent, and a rise in market interest rates soon followed. Such a drastic rise in interest rates, coupled with asset price deflation and severe credit crunch, caused massive corporate bankruptcies. During the first quarter of 1998, the monthly average number of corporate bankruptcies exceeded 3,000, representing about a 200 percent increase compared to the same period of the previous year (See Table I-3). Massive corporate bankruptcies directly translated into a dramatic increase in NPLs among financial institutions, seriously undermining the soundness of the financial system as a whole. As of the end of March 1999, the total amount of NPLs of all financial institutions was about 65.3 trillion won, or 11.4% of total loans (See Table I-4).

<Table I-3> Bankruptcies

(unit: number of firms)

		Large firm	SMCs	Unincorporated	Total
1996(yearly)		7	5,150	6,432	11,589
1997(yearly)		58	8,160	8,942	17,168
	11	17	697	755	1,469
	12	19	1,540	1,638	3,197
1998(yearly)		39	10,497	12,292	22,828
	1-3	16	4,275	5,158	9,449
	4-6	8	2,847	3,502	6,357
	7-9	8	2,031	2,182	4,221
	10-12	7	1,344	1,450	2,801
1999. 1-9		7	2,486	2,578	5,071
	1-3	2	925	1,005	1,932
	4-6	3	801	858	1,662
	7-9	2	760	715	1,477

Source: Bank of Korea.

<Table I- 4> Non-performing Loans

(Unit: trillion won)

	December 1997			June 1998			September 1998			March 1999[1]		
	Total Loans A	NPLs B	Ratio(%) B/A	Total Loans A	NPLs B	Ratio(%) B/A	Total Loans A	NPLs B	Ratio(%) B/A	Total Loans A	NPLs B	Ratio(%) B/A
Banks	518.6	31.6	6.1	471.6	40.0	8.5	443.3	33.7	7.6	442.3	37.5	8.5
Commercial banks	375.8	22.7	6.0	322.5	27.8	8.6	300.5	22.2	7.4	299.1	25.8	8.6
Specialized and development Banks	142.8	8.9	6.2	149.1	12.2	8.2	142.8	11.5	8.1	143.2	11.7	8.2
Merchant banks	24.1	1.0	4.1	25.9	2.4	9.3	28.0	5.6	20.0	22.6	2.8	12.4
Insurance companies	51.7	4.8	9.3	47.8	6.7	14.0	38.8	3.4	8.8	42.4	5.2	12.3
Mutual savings and loan Companies	28.1	3.3	11.7	25.0	4.7	18.8	22.0	5.3	24.1	21.0	8.4	40.0
Credit unions	12.7	1.3	10.2	12.4	1.7	13.7	11.2	2.5	22.3	10.8	2.9	26.9
Leasing companies	n.a.	n.a.	n.a.	34.4	5.9	17.2	25.8	7.8	30.2	24.7	6.1	24.7
Securities companies	12.1	1.6	13.2	7.7	2.2	28.6	7.3	1.9	26.0	7.7	2.4	31.2
Total	647.3	43.6	6.7	624.8	63.6	10.2	576.4	60.2	10.4	571.5	65.3	11.4

1. NPLs had been reduced by the 44 trillion won in purchases by KAMCO by March 1999.

Source: Financial Supervisory Commission

Financial Landscape of Corporate Sector Before and After the Crisis

In order to investigate the role of weak financial structure of corporate sector in the financial crisis, it would be helpful to document the financial landscape of corporate sector, particularly, *chaebols* in greater detail. To this end, financial data of non-financial firms are analyzed. Specifically, the full sample includes 6,116 non-financial firms in total, all of which are subject to external auditing requirements. In addition, all firms in the sample have been in operation and are not bankrupt financially as of May 1999. The sample period ranges from 1986 to 1998. The full sample is classified into three categories: affiliates of the top 5 *chaebols*, affiliates of the top 6-70 *chaebols*, and non-*chaebol* independent companies.

The analysis aims to assess the financial health of non-financial firms, both *chaebol* affiliates and non-*chaebol* companies, by using various indicators. Perhaps the most useful indicator would be the interest payment coverage ratio (IPCR), constructed as the ratio of operating earnings over interest expenses. The operating earnings used in this paper are EBITDA (Earnings Before Interest payment and Taxes plus Depreciation and Amortization). This definition implies that those firms with a ratio of less than 1 are at risk of going bankrupt at any time and pose serious credit risks to their creditors.

Chart I-1 shows the time profile of IPCRs of *chaebols* and non-*chaebol* companies over the sample period. The ratios in the Chart are the weighted average across firms in each category. Notable features of Chart I-1 are that 1) the top 6-70 *chaebols* have been most vulnerable in terms of debt servicing capacity, and 2) the IPCRs of all three categories have been on a decreasing trend, despite short-term ups and downs. One exception is the IPCR of the top 5 *chaebols* over the period from 1994 to 1995. Such a blip in the IPCRs of the top 5 *chaebols* is largely due to the

unprecedented boom in the semiconductor industry. Indeed, the rising pattern in the IPCRs of the top 5 *chaebols* during 1994-95 disappears when semiconductor-producing companies (Samsung Electronics, Hyundai Electronics, LG Semiconductor) are excluded from the sample.

At the time of the crisis in 1997, the top 5 *chaebols* turned out to be more financially sound than smaller *chaebols* and non-*chaebol* companies, although this is not the case when semiconductor-producing companies are excluded. Specifically, the IPCRs of the top 5 *chaebols*, the top 6-70 *chaebols* and non-*chaebol* companies were 1.6, 0.95, and 1.29, respectively. Accordingly, the top 6-70 *chaebols* were in the most serious trouble at the time of the crisis.

Such financial vulnerability of the top 6-70 *chaebols* has been attributed to prolonged poor business performance and high debt leverage. Business performance of the top 6-70 *chaebols*, measured as the ratio of EBITDA over total assets, has sharply deteriorated since 1995 (See Chart I-2) while their financial leveraging continued to rise (See Chart I-3). Consequently, the return on assets (ROAs) of the top 6-70 *chaebols*' plunged to –2.0 percent in 1997 and –5.91 percent in 1998 from 1.04 percent in 1994 (See Chart I-4).

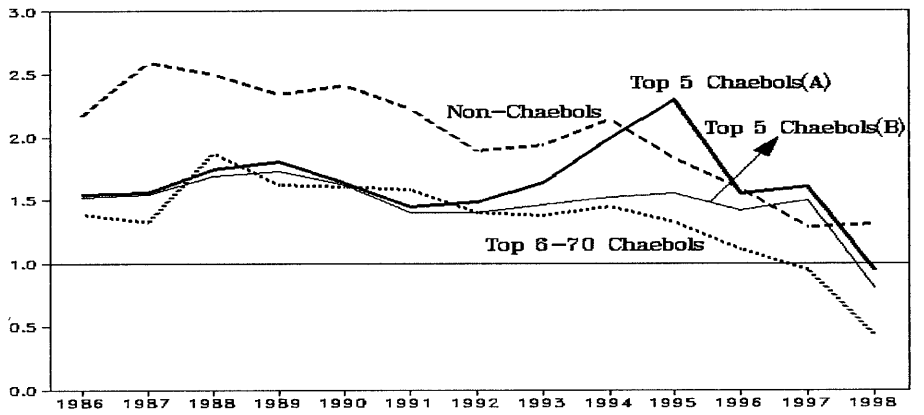
The financial landscape of the corporate sector has been varying across three categories depending on the progress in restructuring. *Chaebols* have experienced a substantial decrease in operating earnings mainly due to a combined effect of a sharp fall in sales revenue and capital loss related to exchange rate depreciation. This was particularly so for the top 6-70 *chaebols*. Despite the debt reduction to some degree as can be seen in Chart I-3, the debt servicing capacity of *chaebols* deteriorated significantly after the crisis. The IPCRs of the top 5 *chaebols* declined to 0.94 in 1998, down from 1.60 in 1997. The decline in the IPCR is most pronounced in the top 6-70 *chaebols* as it fell to 0.43 from 0.95 in just a year. In contrast, the IPCRs of non-

chaebol independent corporations slightly rose to 1.31 in 1998. In fact, non-*chaebol* companies and *chaebols* are showing a different pattern in terms of the ratio of EBITDA over total assets as can be seen in Chart I-2.

However, the corporate sector as a whole suffered from an unprecedented economic setback after the crisis, as clearly illustrated in Chart I-4. Despite debt reduction and restructuring, ROAs turned out to be negative for all categories. The main factor behind such poor ROAs was the high interest rates and large losses from exchange rate depreciation, among others.

<Chart I-1> Interest Payment Coverage Ratios

(unit: times)

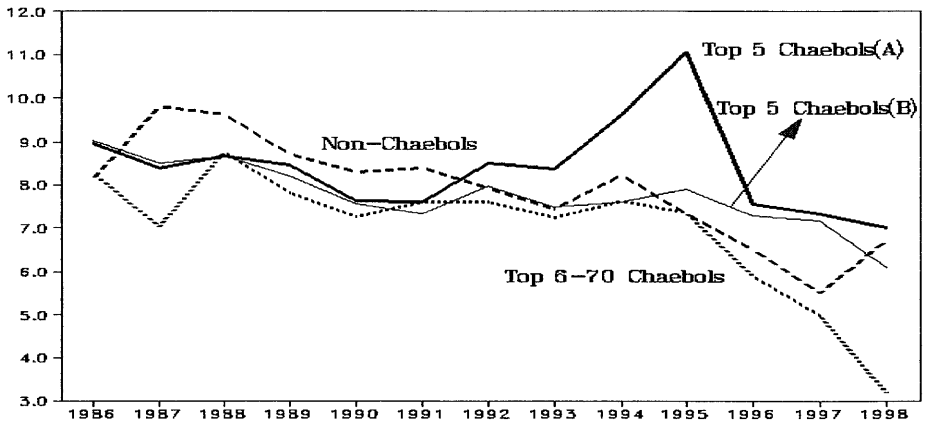


Note: 1) (A) includes all subsidiaries of the top 5 *chaebols*, (B) excludes semiconductor-producing companies among the top 5-*chaebols*,

Data Source: National Information and Credit Evaluation Inc.

<Chart I-2> EBITDA/Total Assets

(unit: %)

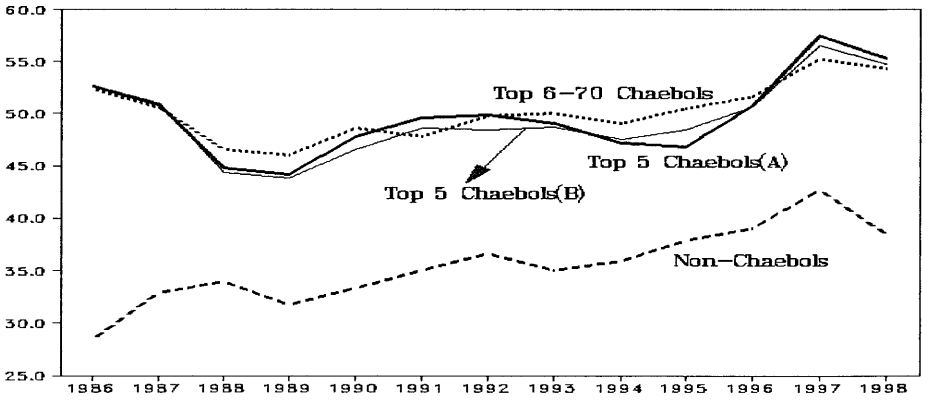


Note: 1) (A) includes all subsidiaries of the top 5 *chaebols*, (B) excludes semiconductor-producing Companies among the top 5-*chaebols*,

Data Source: National Information and Credit Evaluation Inc.

<Chart I-3> Total Borrowings to Total Assets

(unit: %)

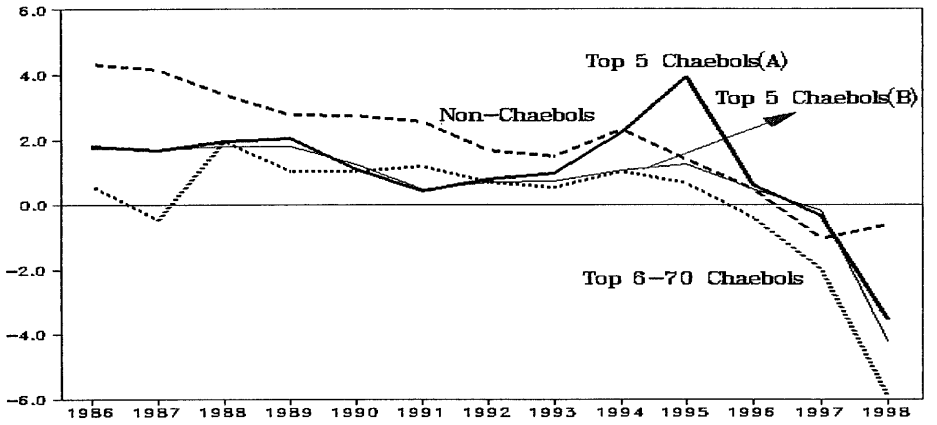


Note: 1) (A) includes all subsidiaries of the top 5 *chaebols*, (B) excludes semiconductor-producing companies among the top 5-*chaebols*,

Data Source: National Information and Credit Evaluation Inc.

<Chart I-4> Return on Assets (ROAs)

(unit: %)



Note: 1) (A) includes all subsidiaries of the top 5 *chaebols*, (B) excludes semiconductor-producing companies among the top 5-*chaebols*,

Data Source: National Information and Credit Evaluation Inc.

Table I-5 provides more detailed information on the significance of financial trouble in the corporate sector before and after the financial crisis in terms of IPCRs. Given the definition of the IPCR, the loans extended to firms with IPCRs of less than 1 are regarded as potential NPLs. Under this premise, signs of financial trouble already existed in 1994 both in terms of business performance and financial soundness. The number of firms with IPCRs of less than 1 already exceeded 1,000 in 1994, or 20 percent of firms included in the sample. This number further increased to about 1,400 (25% of total firms) despite the fact that the economy was experiencing a boom. In 1998, this number jumped to about 1,900, largely due to a drastic rise in interest rates and sharp reduction in profitability. This situation is particularly pressing for the top 6-70 *chaebols*.

<Table I-5> Deteriorating Corporate Performance

(Unit: number of firms, trillion won)

		Interest Payment Coverage Ratio									
		1994		1995		1996		1997		1998	
		≥ 1	<1	≥ 1	<1	≥ 1	< 1	≥ 1	< 1	≥ 1	<1
Top 5 *Chaebols*	Number Of firms	128	23 (15%)	128	27 (17%)	126	29 (19%)	119	43 (27%)	111	38 (26%)
Top 6~70 *Chaebols*	Number Of firms	292	110 (27%)	322	121 (27%)	298	153 (34%)	238	182 (39%)	233	196 (46%)
Non-*Chaebols*	Number Of firms	3,652	905 (20%)	3,811	1,246 (25%)	3,632	1,418 (28%)	3,757	1,758 (32%)	3,898	1,640 (30%)
Total	Number Of firms	4,072	1,038 (20%)	4,261	1,394 (25%)	4,056	1,600 (28%)	4,159	1,983 (32%)	4,242	1,874 (31%)

Note: Figures in parentheses indicate the share of firms and total borrowings in each categorized group.

Data Source: National Information and Credit Evaluation Inc.

At this juncture, it should be noted that factor costs have stabilized considerably since the second half of 1998. Not only have interest rates dropped significantly, but nominal wages have also fallen as firms struggled to survive and workers preferred pay cuts to reductions in employment. Such reductions in factor costs are significantly improving firms' balance sheets and lowering IPCRs. These developments will contribute to the reduction of corporate default risk. Nonetheless, considering the heavy debt service burden of *chaebols*, the potential of large business failures cannot be ruled out as can be seen recently by the serious credit risks posed by the Daewoo Group.

Policy Responses to the Crisis

The Korean economy has successfully overcome the immediate liquidity crisis thanks to financial assistance from the IMF, World Bank and ADB, the successful debt exchange program negotiated with international lenders, and the dramatic turnaround in current account balances. Accordingly, the won has stabilized greatly, holding steady at around the 1,200 level *vis-a-vis* the US dollar, down from 1,950 in December 1997. Currency stability has also led domestic interest rates to drop significantly.

Having achieved such positive results, the Korean government has pursued financial restructuring. As of the end of June 1999, 217 financial institutions had their operations suspended or were closed down (See Table I-6). As part of the restructuring program, the government injected 40.9 trillion won (10 percent of GDP) in fiscal resources to rehabilitate the financial system between late 1997 and the end of 1998 (See Table I-7). First, the Korea Asset Management Corporation (KAMCO) purchased 44.1 trillion won (book values) in non-performing assets from financial institutions at 19.9 trillion won. Second, the Korea Deposit Insurance Corporation (KDIC) provided 21 trillion won for recapitalization (6.3 trillion won), loss coverage for merging or acquiring institutions (6.9 trillion won), and deposit repayments for closed institutions (7.8 trillion won). The government will use an additional 23.1 trillion won by the end of 1999 to lay a solid foundation for a "clean bank" environment. As a result, most Korean banks obtained BIS capital adequacy ratios of 10-13 percent. Such improvement in the bank capital structure, coupled with the stabilization of domestic interest rates, contributed significantly to the alleviation of the credit crunch. Indeed in 1998, the monthly figures for corporate bankruptcies fell from more than 3,000 in the first quarter to about 900 in the fourth quarter.

<Table I-6> Financial Institutions Closed or Suspended

(As of June, 1999)

	Total No. of Institutions (end-1997)				
		License Revoked	Suspended	Merger/ Dissolution	Subtotal
Banks	33	5	-	4	9
Merchant Banks	30	16	1	1	18
Securities Companies	37	3	3	-	6
Insurance Companies	50	4	-	1	5
Investment Trust Companies	6	1	1	-	2
Mutual Savings and Finance Companies	230	25	14	2	41
Credit Unions	1,666	1	-	130[1)]	131
Leasing Companies	25	-	-	5	5
Total	2,077	55	19	143	217

Note: 1) includes bankruptcy and dissolution

Source: Financial Supervisory Committee

<Table I-7> Fiscal Support for Financial Restructuring

Category	Amount Injected 11/1997~12/1998		Amount to be Injected by 1999	Total
Purchase of NPLs by KAMCO	Banks	16.8 (35.5)	12.6	32.5
	NBFIs	3.2 (8.7)		
	Sub-total	19.9 (44.1)		
Recapitalization of Banks and Loss Coverage	13.2		4.3	17.5
Deposit Repayment	7.8		6.2	14.0
Total	40.9		23.1	64.0

Note: Figures in parentheses reflect the book values of NPLs.

Source: Financial Supervisory Commission

However, the declining number of business failures seems to be more largely attributable to the bailout policy for troubled firms. In fact, creditor banks have not only provided co-financing loans to several distressed *chaebols* since the end of 1997, but also entered into a corporate workout program, which has been applied to large-scale troubled borrowers (the top 6～64 *chaebols* and large, non-*chaebol* corporations). Moreover, the scope of the workout programs has been expanded to include small and medium-sized firms (SMCs). Creditor banks have evaluated the financial status of more than 37,000 SMCs by the end of March 1999. In particular, despite the severe economic contraction, the number of large corporate bankruptcies has declined dramatically from 36 during the last two months (November～December) of 1997 to 32 during the first nine months of 1998. Considering the overlaid subcontracting structures, such a decline in large corporate bankruptcies reduced the incidence of chain bankruptcies among SMC subcontractors, thereby contributing to the reduction of overall business failures.

Ⅱ. Debtor-Creditor Relationships

Ⅱ-1. Historical Background

Given the fact that corporate sector in Korea has heavily relied on indirect financing, the primary responsibilities for corporate monitoring rested on lending institutions. However, the reality was neglected monitoring and oversight by financial institutions due to the distorted incentive structure which was largely affected by the policy environment, characterized by the prolonged state control in the financial sector as well as lax financial supervision.

(1) Banking Sector: State Control

In Korea, unhealthy links between government and banks were a legacy of government-led economic development. Since the early 1960s, government-directed credits, or policy loans, have been extensively utilized as an important instrument for industrial policies.[2] The Korean government directly owned all major banks in 1961, directed policy loans to priority sectors such as exporting sector and heavy and chemical industries (HCIs). Policy loans have indeed been substantial during the HCI drive in the 1970s: they constituted about 63 percent of total loans extended by deposit money banks.[3] Most banks were privatized in the early 1980s, but the state influence over the banking sector has remained substantial until recently.

Massive provision of policy loans combined with interest rate control[4] made banks to have little incentive for credit evaluation. Since real interest rates have

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[2] J.K. Kim (1993), and J.K. Kim et al.(1993), Y.J. Cho and J.K. Kim (1995) provide more details on the directed credit programs in Korea.

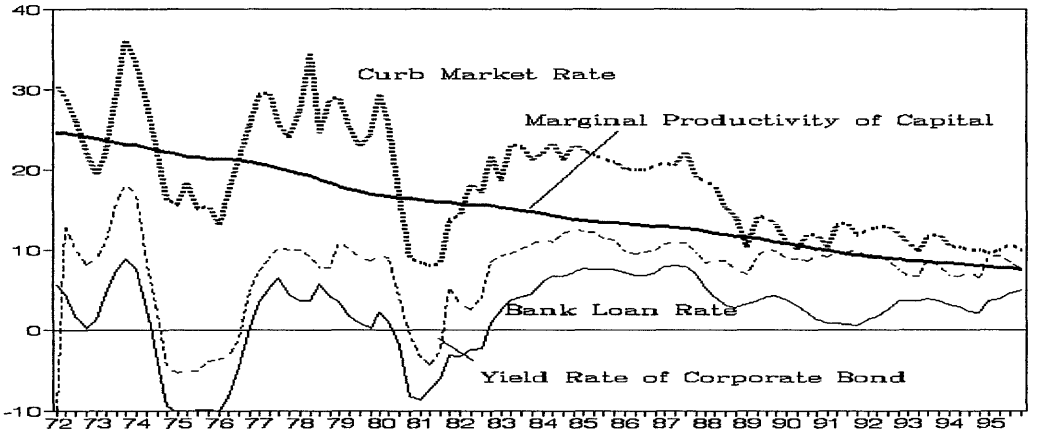
[3] Y.J. Cho and J.K. Kim (1995).

[4] Interest rate deregulation had not been extensively implemented until recently because of the fear on a sharp increase in interest costs in the face of high debt leverage.

remained below the marginal productivity of capital as shown in Chart II-1, over-borrowing has taken place, and the subsequent increases in financial expenses induced further borrowing. Such a vicious cycle ultimately led to an unbearably high leverage and reckless capacity expansion in the corporate sector.

<Chart Ⅱ-1 > Real Interest Rate and Marginal Productivity of Capital[1)]

(Unit: %)



Note: 1) We estimate the marginal product to capital using the Cobb-Douglas production function approach in Cho and Oh (1996). We assume a capital-output ratio of 1/3 and depreciation rate of 0.065. We also estimate the potential GDP and capital stock derived from the KDI quarterly model.

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

For these reasons, the government undertook major corporate bailout exercises in numerous occasions, including the August 3 measure of 1972[5], industrial restructuring in major HCIs in the early 1980s and industrial rationalization measures in depressed industries such as overseas construction and shipping industries during the mid-1980s. The government also provided financial support to creditor banks in order to prevent systemic risks.

The government-led bailout 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 for financial market liberalization. Given the implicit state guarantees on bank lending, banks had little incentive to monitor client firms' investment decisions. Strict prudential regulation and supervision were hardly 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 bailout, 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.

In the mean time, the social concern about the strong economic influence of *chaebols* translated into strict restrictions on the bank ownership structure. Upon the liberation in 1945, the Korean government took over of Japanese owned banks. After long U.S. pressure, the government sold its shares of commercial banks to private sector

[5] It included an immediate moratorium on the payment of all corporate debt to the curb lenders and extensive rescheduling of bank loans. All corporate loans from the curb market were converted to long-term loans, at a maximum interest rate of 16.2 percent, when the prevailing curb-market rate was over 40 percent per annum. About 30 percent of the short-term bank loans to business were converted into long-term loans at a reduced interest rate. This conversion was ultimately backed by the central bank, which accepted the special debentures issued by the commercial banks (C.Y. Kim 1990 and 1994, and Y.J. Cho and J.K. Kim 1995).

in 1957. As a result, Lee Byung-Chul in Samsung Group, Chung Jae-Ho in Samho Group and Lee Han-Won in Daehan Jeboon were able to control over 83% of total shares of Heungop Bank (former Hanil Bank), 51% of Savings Bank (former Korea First Bank) and 29% of Korea Commercial Bank, respectively. Unfortunately, the takeover of banks by a few large industrialists was soon accompanied by worrisome consequences, particularly the concentration of bank credits for their own use. For the next few decades, such undesirable side effects of bank privatization provided a strong social justification for government control over banks. Indeed, major Korean banks were nationalized in 1961 when the new government was established by military coupe.

In 1982, when the privatization of the banking sector was pursued, a ceiling of 8% was imposed on individual ownership of nationwide commercial banks, in order to prevent any single shareholder from exerting excessive influence and control of a bank's management. This restriction was further strengthened as the ceiling was lowered to 4% in 1994 in line with the progress in financial liberalization. Despite this restriction, the ownership distribution of Korean banks is no less concentrated than in the case of advanced countries such as the United States. As of the end of 1996, the combined shares of those who own more than 1% of the total voting stocks of nationwide banks accounted for 39.3% on average, as shown in Table Ⅱ-1. For local banks whose ownership structure is much more concentrated than nationwide banks due to a higher ceiling, combined shares of large shareholders over 1% is 49.7%. Also, among large shareholders top 30 *chaebols* are predominant as can be seen in Table II-2.

<Table Ⅱ-1> Large Shareholders' Ownership of Banks

(As of the end of 1996)

Classification	Large Shareholders over 1%		Large Shareholders over 4%		Ownership Share by 5 Largest Shareholders (%) (by 3 largest Industrial Capital)
	Number	Ownership Share (%)	Number	Ownership Share (%)	
Chohung	11(4)	45.7(14.7)	5(2)	32.4 (10.0)	32.4(12.8)
Commercial	10(3)	35.1(9.3)	5(1)	27.4 (7.0)	27.4(9.3)
Korea First	13(5)	35.6(15.7)	2(1)	12.5 (5.5)	22.4(12.5)
Hanil	14(5)	45.5(15.8)	4(1)	20.8 (4.8)	24.6(11.4)
Seoul	12(6)	30.6(14.2)	2(1)	12.0 (4.6)	20.3(10.3)
5 Largest Nationwide Banks, Average	12(5)	38.7(13.9)	4(1)	21.3(6.5)	25.6
Korea Exchange	9(2)	59.0(2.1)	1(-)	47.9(-)	54.6(n.a.)
Kookmin	9(1)	48.5(2.0)	3(-)	37.2(-)	43.4(n.a.)
Shinhan	6(2)	16.4(4.5)	- (-)	- (-)	15.3(n.a.)
KorAm	9(6)	70.4(45.6)	5(3)	64.4 (41.1)	79.9(41.1)
Hana	16(5)	54.6(19.4)	5(2)	28.5 (11.0)	28.5(14.5)
Boram	17(5)	52.9(26.0)	5(3)	31.4 (20.8)	31.4(20.8)
Donghwa	10(2)	14.9(2.3)	- (-)	- (-)	8.7(n.a.)
Daedong	3(-)	17.1(-)	2(-)	15.2 (-)	n.a.(n.a.)
Dongnam	7(-)	20.0(-)	2(-)	13.8 (-)	17.8(n.a.)
Peace	9(1)	49.0(1.3)	6(-)	42.2 (-)	37.0(n.a.)
Nationwide Banks, Average	10(2)	39.3(10.7)	3(1)	24.3(5.4)	-
Daegu	15(3)	40.6(8.6)	4(1)	22.9(5.7)	25.6(8.6)
Pusan	14(3)	52.0(28.8)	2(1)	31.8(23.9)	40.4(28.8)
Chungchong	14(5)	63.9(27.7)	3(1)	36.2(16.5)	43.0(23.3)
Kwangju	13(2)	41.7(9.5)	3(1)	21.7(7.9)	28.6(n.a.)
Cheju	10(4)	51.8(31.7)	3(1)	36.6(26.5)	42.1(30.6)
Kyonggi	13(5)	42.6(20.6)	3(2)	21.6(14.3)	28.7(17.7)
Jeonbook	15(4)	59.4(24.3)	6(3)	41.8(23.1)	37.3(23.1)
Kangwon	17(3)	57.0(14.5)	4(1)	31.2(11.9)	34.9(14.5)
Kyungnam	16(4)	50.4(20.5)	2(1)	19.4(11.6)	29.7(18.2)
Chungbuk	16(5)	54.1(11.3)	4(1)	29.7(4.7)	33.4(9.3)
Local Banks, Average	14(4)	49.7(18.5)	3(1)	27.6(13.5)	33.0
Commercial Banks, Average	12(3)	40.9(11.9)	3(1)	24.8(6.6)	-

Note : Figures in parenthesis indicate the number and ownership share by private industrial capital (including affiliated financial institutions).

Source : The Bank Supervisory Board.

<Table Ⅱ-2> Share of Banks Owned by Top 30 *Chaebols*

(As of the end of 1996, Unit: %)

Conglomerates	Ownership Share
1. Hyundai	Korea First bank(2.20), Hanil bank(2.00), Seoul bank(1.99), Kangwon bank(11.89)
2. Samsung	Chohung bank(2.81), Commercial bank(7.03), Korea First bank(3.96), Hanil bank(4.76), Seoul bank(3.77), Korea exchange bank(1.05), Shinhan bank(3.36), KorAm bank(18.56), Hana bank(3.42), Peace bank(1.28), Daegu bank(5.65), Pusan bank(1.02), Kyonggi bank(1.57), Jeonbook bank(1.20), Kangwon bank(1.22), Kyung nam bank(2.38)
3. LG	Korea First bank(3.03), Hanil bank(2.47), Boram bank(7.58), Cheju bank(1.80)
4. Daewoo	KorAm bank(18.56)
5. SK	Kyonggi bank(3.42)
6. Ssangyong	Chohung bank(1.98), Korea exchang bank(1.04), Hana bank(1.52), Kookmin bank(1.96)
7. Hanjin	Kyonggi bank(5.63)
8. Kia	Korea First bank(1.04)
9. Hanwha	Chungchong bank(16.49)
10. Lotte	Pusan bank(23.93)
11. Kumho	Kwangju bank(7.87)
12. Doosan	Boram bank(11.34)
13. Daelim	Hanil bank(3.57)
14. Hanbo	
15. DongAh	Seoul bank(1.50), Cheju bank(2.31)
16. Halla	
17. Hyosung	Hana bank(5.16), Kyungnam bank(11.57)
18. Dongkuk Steel	Seoul bank(1.27), Pusan bank(3.85), Kyungnam bank(3.92)
19. Jinro	Hana bank(3.51)
20. Kolon	Boram bank(5.80)
21. Tongyang	Donghwa bank(1.03)
22. Hansol	
23. Dongbu	Cheju bank(1.06), Chungbuk bank(1.74)
24. Kohab	
25. Haitai	
26. Sammi	
27. Hanil	
28. Kukdong-Construction	
29. New Core	
30. Byucksan	

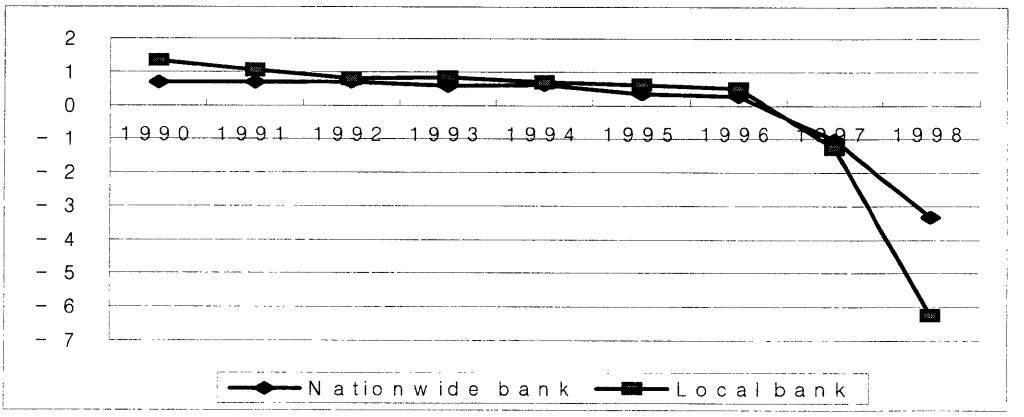
Source: The Bank Supervisory Board

Despite the bank ownership structure comparable to that of advanced countries, large shareholders of most banks have remained passive in exercising their voting rights and monitoring bank management. Government intervention in the appointment of CEOs of banks has prevented bank management from pursuing shareholders' interests. To make matters worse, the board of directors of banks has not been in a position to check the management in an independent manner. Typically, the nomination of directors is in control of inside management. Although there existed a certain number of non-executive directors in case of large nationwide banks, they were not assigned a clearly defined role, nor provided with necessary information for monitoring. Accordingly, internal governance of banks remained ineffective and poor.

In short, the prolonged government control on banks and the recurrent bailouts of both corporate and banking sectors resulted in weak commercial orientation and inadequate market discipline. Such weakness translated into massive potential NPLs and low profitability of banks, as shown in Chart II-2.

<Chart II-2> ROAs of Banks.

(unit: %)



Source: Bank Supervisory Board

(2) NBFIs : Cash Vault of *Chaebols* in the Absence of Financial Supervision

Unlike banks, non-banking financial institutions (NBFIs) were free of ownership restrictions except life insurance companies and investment trust companies (ITCs). As a result, many NBFIs are currently owned or actually controlled by *chaebols* as shown in Table II-3. As of 1997, the 70 largest *chaebols* owned a total of 114 financial affiliates.

Although many NBFIs are owned by large industrial groups, financial supervision on NBFIs has been lax as can be seen from the fact that basic prudential regulations such as capital adequacy requirements were absent until the onset of the crisis. The principal regulator and supervisor of NBFIs has been the Ministry of Finance and Economy (MOFE). However, only a small working-level unit has been assigned the supervisory role within the MOFE, making an effective monitoring almost impossible. In short, the NBFIs have been under the strong influence of *chaebols* while the government supervision was almost absent. Such combination was a disaster in waiting as can be seen from the fact that the financial trouble of Merchant Banking Companies (MBCs) acted as a triggering point for the financial crisis in 1997.

The close links between NBFIs and *chaebols* have created scope for conflict of interests. In fact, it appears that the *chaebols* have exploited their affiliated NBFIs as a financing arm to support and give a favor to other subsidiaries within their group in various ways. For example, *chaebols* have been using their affiliated MBCs, especially their overseas branches, to finance the activities of other subsidiaries within their groups. In this situation, it is hard to expect prudent corporate monitoring by NBFIs.

<Table II-3> Number of NBFIs Owned by Top 70 *Chaebols*[1)]

(Unit: number of firms, the end of 1997)

	Top 5 *Chaebols*	Top 6-30 *Chaebols*	Top 31-70 *Chaebols*	Total
Merchant Bank (29)[2)]	3	7	4	14
Securities (26)	6	5	1	12
Investment Trust Company(24)	4	6	0	10
Life Insurance (31)	2	4	8	14
Fire & Marine Insurance(13)	2	3	0	5
Installment Credit (26)	2	7	3	12
Mutual Saving & Finance (219)	1	5	12	18
Venture Capital (56)	3	4	6	13
Credit Card (7)	3	1	0	4
Finance & Factoring (46)	3	4	5	12
Total (487)[3)]	29	46	39	114

Note: 1) The rank of *chaebols* is based on total borrowings.
2) The figure in the parentheses represents the total number of financial institutions at each financial sector.
3) Leasing companies are excluded because they are owned by banks.

Source: National Information and Credit Evaluation Inc.

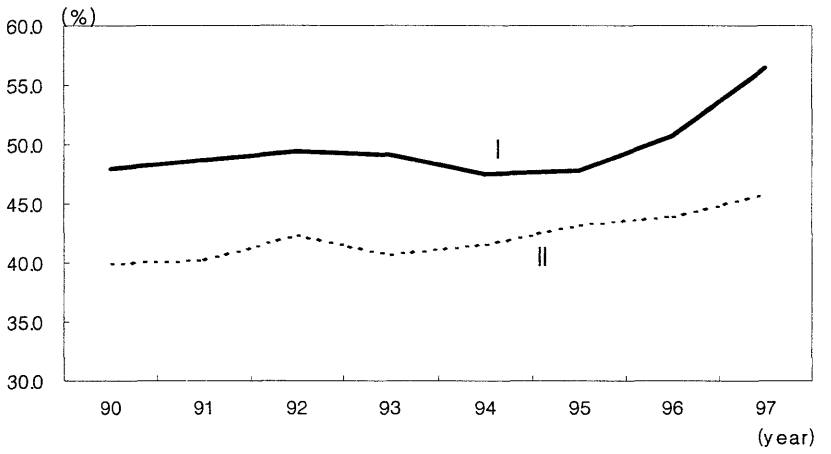
Corporate Leverage and Ownership of NBFIs

In order to analyze the linkage between *chaebol*'s debt leverage and its ownership of NBFIs, more than 5,000 firms in the sample were divided into two groups: Group I covers those firms that own NBFIs while Group Ⅱ includes firms without any ownership in NBFIs. If one or more subsidiary companies of a *chaebol* own NBFIs, then all non-financial affiliated companies of the same *chaebol* are treated to belong to the first group. Then various financial indicators are reviewed and compared across different groups.

Chart II-3 presents the ratio of total borrowings to total assets for each group. It can be easily seen that Group I shows consistently higher debt leverage than Group II, and the gap between the two groups became more pronounced at the time of crisis in 1997. In addition, Group I has been favored in terms of interest costs as shown by

Chart II-4, and the gap between the two groups was also widened in 1997 when Korea's credit situation was particularly tenuous due to the fear for the financial crisis.

<Chart II-3> Total Borrowings to Total Assets for Non-Financial Firms

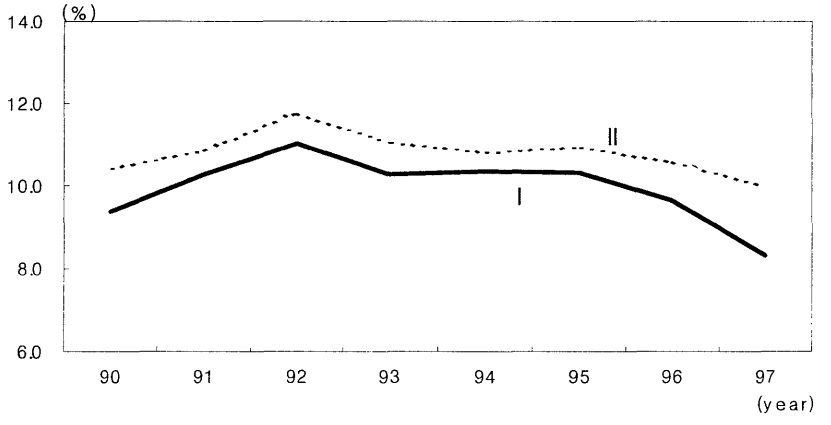


Note: 1) I: Non-financial firms that own NBFIs.

II: Non-financial firms without any ownership in NBFIs.

Data Source: National Information and Credit Evaluation Inc.

<Chart Ⅱ-4 > Interest Costs to Total Borrowings for Non-financial Firms



Note: 1) I: Non-financial firms that own NBFIs.

II: Non-financial firms without any ownership in NBFIs.

Data Source: National Information and Credit Evaluation Inc.

These findings imply that *chaebol*-owned NBFIs have been functioning as a financing arm or cash vault of their affiliated subsidiaries. Particularly, the widened gap between the two groups in terms of debt leverage and interest costs at the time of the crisis can be taken as a crude evidence for the financial support to troubled subsidiaries at a favorable term.

On the basis of these findings, statistical analysis was carried out to test the hypothesis of the linkage between corporate debt leverage and NBFI ownership. In order to identify the effects of the ownership of NBFIs on corporate leverage, it is necessary to control firm-specific factors that can affect the capital structure of firms. Under this premise, the regression analysis includes firm size, the ratio of cash flows of total assets, the ratio of tangible fixed assets to total assets, and firm age as explanatory variables for the corporate leverage. The regression model also includes dummy variables for ownership of NBFIs in order to identify whether NBFIs have excessively lent to the affiliated *chaebols*. Finally, the pooling regression analysis in this study employs panel data over the sample period from 1990 to 1997.

The major regression results are provided in Table II-4. The regression analysis was applied for two dependent variables: total debt leverage and the share of long-term borrowing in total indebtedness. All regression results presented in the Table indicate that, even after controlling firm-specific factors, the degree of corporate leverage is positively and significantly correlated with the *chaebols*' ownership of NBFIs.

First, equation (I) in the Table employs, as an explanatory variable for the ownership of NBFIs, a dummy variable that differentiates only between ownership and non-ownership of NBFIs regardless of the business characteristics of financial institutions. All coefficients turned out to be correct in signs and statistically significant as we postulate. When another dummy variable whose value is 1 if the firms in question are *chaebol*-affiliated and 0 otherwise is added to the equation,

however, the ownership dummy variable lost explanatory power.

A plausible explanation for such result is that the statistically significant effect of the ownership of NBFIs on corporate leverage in equation (I) could reflect simply the too-big-to-fail hypothesis, not the advantage of *chaebols* directly resulting from the ownership of NBFIs. Indeed, in Korea, even those *chaebols* with no ownership of NBFIs have been able to borrow at a favorable term simply because of the pervasive moral hazard in the financial sector that relies on the too-big-to-fail hypothesis. Another explanation is a possibility of multi-colinearity problem. The fact that most *chaebols* own NBFIs suggests that the ownership dummy and the *chaebol* dummy variables are likely to be highly correlated.

Given this diagnosis, equation (II) employs three separate ownership dummy variables for each non-bank financial sector, covering MBCs, securities companies and ITCs, and insurance companies. The regression results show that the ownership dummy variables are of correct signs and statistically significant at least at 10% level for MBCs and securities companies and ITCs, while not significant for insurance companies.

Another set of regression equations were estimated in order to further investigate the effects of the ownership of NBFIs on corporate leverage by taking into account the differentiated business characteristics of NBFIs. As is well known, MBCs specialize in short-term financing such as CP discounting while securities companies and ITCs are focusing on long-term financing such as corporate bond underwriting and brokerage. Such difference in business orientation of NBFIs has an implication for the maturity profile of corporate debt. For example, it is not surprising if *chaebols* who own MBCs have relatively high share of short-term loans in their total liability.

Equation (IV) shows that the coefficients of ownership dummy variables for

MBCs and securities companies and ITCs have correct signs and are statistically significant at least at the 5% level. This result implies that the ownership by *chaebols* of NBFIs affected not only the overall leverage but also the maturity composition of corporate debt.

<Table II-4> Estimation of Corporate Debt Leverage

	Total borrowings/ Total assets				Long-term borrowings/ Total borrowings			
	(I)		(II)		(III)		(IV)	
Log sales (firm size)	0.23**	(2.0)	0.27**	(2.4)	2.95***	(26.5)	2.93***	(26.3)
Cash flow/total assets	-0.91***	(-78.6)	-0.91***	(-78.7)	0.13***	(11.4)	0.13***	(11.4)
Fixed assets/total assets	0.21***	(29.8)	0.21***	(29.9)	0.34***	(49.3)	0.34***	(49.4)
Firm age	-3.24***	(-4.9)	-3.22***	(-4.8)				
Ownership of NBFIs	3.85***	(6.4)			2.67***	(4.6)		
Ownership of MBCs			2.13**	(2.0)			-3.20**	(-3.2)
Ownership of Security firms·ITCS			1.79*	(1.8)			5.24***	(5.5)
Ownership of Insurance firms			0.83	(0.9)			0.45	(0.5)
Constant	31.5***	(15.8)	30.8***	(15.4)	-26.7***	(-13.7)	-26.5***	(-13.5)
Adjusted R^2	0.17		0.17		0.13		0.13	
Number of samples	42,643		42,643		39,332		39,332	

Note: 1) Estimation period : 1990~97 (annual period).

2) t-values are in parentheses. ***, ** and * indicate that the coefficient is significantly different from zero at 1, 5 and 10 percent levels respectively.

3) Firm age dummy: one if age is less than or equal to three years, and zero otherwise

4) Industrial dummy (manufacturing, construction and others) and year dummy variables are included.

Profitability and Soundness of NBFIs

The second round of analysis was carried out in order to identify whether the financial support by *chaebol*-owned NBFIs to their affiliates were profitable or not. To this end, we compare the profitability of NBFIs over two subgroups: *chaebol*-affiliated and non-*chaebol* independent NBFIs. Table II-5 shows that during 1995-97, the average rate of return on asset (ROA) of *chaebol*-affiliated NBFIs was lower than that of independent institutions by 0.1 to 1.0 percentage point.

This pattern consistently appears across all NBFIs except for insurance companies and installment credit companies as can be seen in Chart II-5. In particular, the ROAs of *chaebol*-owned securities companies and ITCs turned out to be negative with large gap compared to independent institutions. Indeed, the null hypothesis that both *chaebol*-affiliated and independent institutions carry an equal ROA was rejected at a 5% significance level. According to these results, our tentative conclusion is that *chaebols*' ownership in NBFIs resulted in low profitability of the institutions in question.

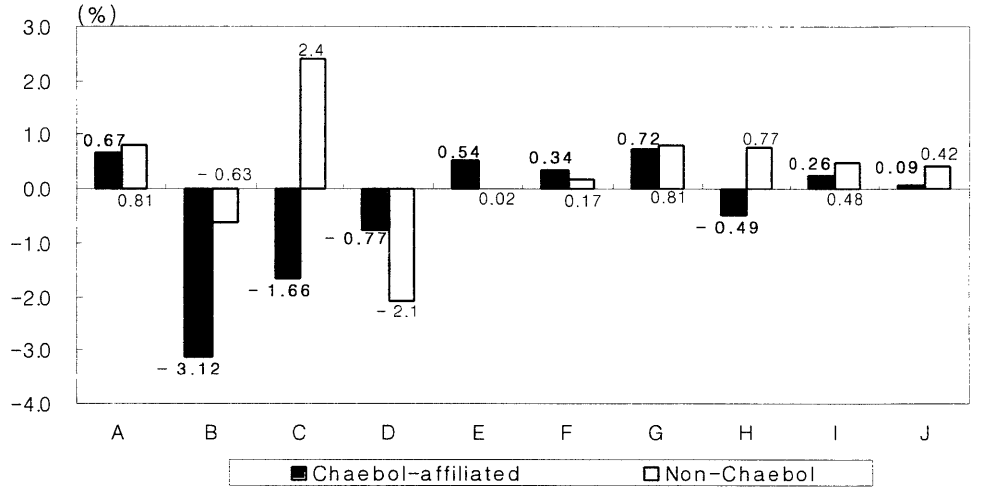
<Table II-5> ROAs of NBFIs

(Weighted average)

	Chaebol-affiliated	Non-*Chaebol*
1995	0.27%	1.00%
1996	-0.68%	-0.10%
1997	-0.47%	-0.37%

Source: National Information and Credit Evaluation Inc.

<Chart II-5> ROAs of NBFIs by Sector (Average for 1995~97)



A : Merchant Bank	B : Securities	C : Investment Trust Company
D : Life Insurance	E : Fire & Marine Insurance	F : Installment Credit
G : Mutual Saving & Finance	H : Venture Capital	I : Credit Card
J: Finance & Factoring		

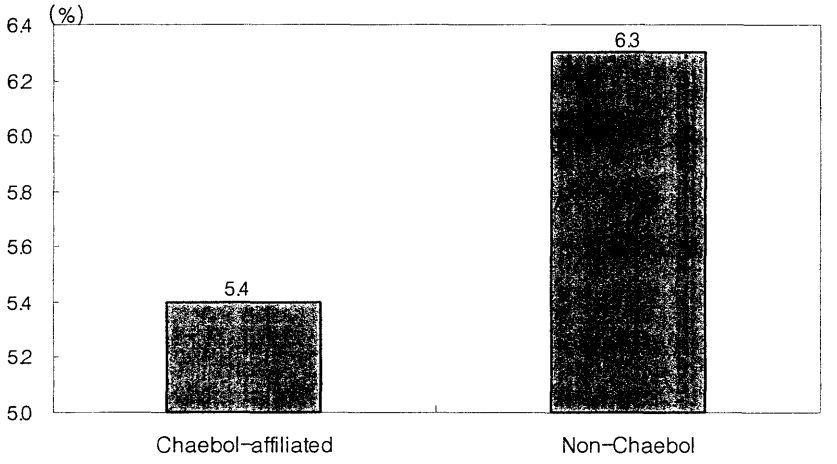
Data source: National Information and Credit Evaluation Inc.

Chaebols' ownership of NBFIs turned out to affect not only the profitability of the NBFIs in question but also their soundness. In case of securities companies and MBCs, *chaebol*-owned institutions show relatively poor capital adequacy compared to independent institutions. Specifically, as of the end of March 1998, the average BIS ratio of *chaebol*-affiliated MBCs was 5.4%, while that of independent institutions was 6.3%. Furthermore, the net operating capital ratio of securities companies also shows similar pattern: 165% for *chaebol*-affiliated institutions versus 234% for independent institutions.

In conclusion, the apparently poor performance of *chaebol*-owned NBFIs in terms of both profitability and soundness seems to be a reflection of serious conflict of interests. External governance on debtor by these NBFIs has been neither adequate nor efficient. These institutions have acted as private cash vault of affiliated *chaebols* under their strong influence, rather than maximizing profits with commercial orientation.

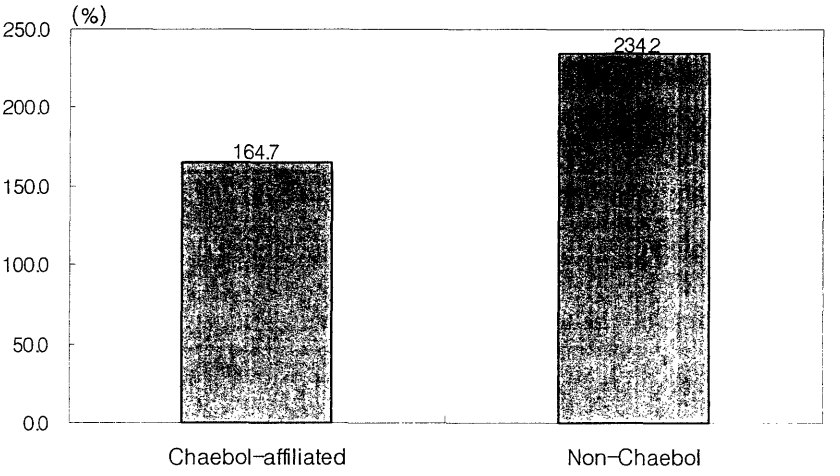
<Chart II-6> BIS Ratio of Merchant Banking Companies

(Weighted average, as of March 1998)



<Chart II-7> Net Operating Capital Ratio of Securities Companies

(Weighted average, as of March 1998)



Ⅱ-2. Policy Responses to the Crisis: Financial Sector Governance System

Since the onset of the financial crisis, various measures have been undertaken to improve both the financial sector's internal and external governance structure. Since January 1998 under the Act Concerning the Structural Improvement of the Financial Industry, the supervisory authority has been able to order the write off equities of shareholders deemed responsible for the insolvency of banks, which the government has recapitalized or decided to recapitalize. In February 1998, in order to encourage shareholders and internal auditors to assume roles of monitoring management, the requirement conditions for exercising minority shareholders' right to initiate a class action were eased. The FSC has also established and executed an efficient sanction system in which the FSC, if necessary, can impose civil and criminal liabilities on the directors.

Besides these measures, much has been done to improve the prudential regulation of financial institutions. 1) A prompt corrective action system and management evaluation system have been introduced (Table II-6). 2) In April 1998, the FSC has increased the regular disclosure items to the scope dictated by International Accounting Standards (IAS) in order to strengthen banks' disclosure system. 3) In July 1998, loan classification standards as well as provisioning requirements were strengthened in accordance with international practices. Forward-looking asset quality classification standards will also be introduced by the end of 1999 (Table II-7). Commercial papers, guaranteed bills and privately placed bonds in trust accounts have been included in the asset category subject to loan loss provisions. The requirement of 100 percent of loan loss provisions for trust accounts with guarantees of principal has been added to those with guarantees of interest. In addition, the evaluation standard for marketable and investment securities held by banks has been changed from the "lower-of-cost-or-market" method to the "mark-to-market" method.

<Table II-6> Prompt Corrective Action in Korea (Revised in March 1999)

Measures	Conditions when measures are taken		Decision-maker	Details of Measures
	BIS ratio	Others		
Management Improvement Recommendation	Below 8%	1. Above the third rate in total, but below the fourth rate in terms of quality of assets or capital adequacy 2. It seems evident that the above cut-off conditions are not satisfied because of the large financial debacle	President of Financial Supervisory Board	1. Restructuring of Organization 2. Cost Reduction 3. Increasing the efficiency of Business unit Management 4. Restrictions in fixed asset investment, entry to new business, and new Financial investment 5. Management of insolvent assets 6. Recapitalization 7. Restriction of dividend payout 8. Special allowance for bad debts.
Management Improvement Measure	Below 6%	1. Below the fourth rate in total 2. It seems evident that the above cut-off conditions don't be satisfied because of large financial debacle	President of Financial Supervisory Board After the Financial Supervisory Commission vote	1. Closure or consolidation of existing business units or Restriction of new ones 2. Retrenchment of Organization 3. Restriction of holding risky assets and management of assets 4. Restriction of deposit rate 5. Reform of subsidiaries 6. Requirement of management turnover 7. Partial suspension 8. Planning of merger, acquisition by the third party, or transfer of business 9. Measures specified in Clause 2 Article 34 of the Act concerning Structural Improvement of Financial Industry
Management Improvement Order	Below 2%	Unsound financial Institutions specified in Clause 3, Article 2 of the Act concerning Structural Improvement of Financial Industry	Financial Supervisory Commission	1. Write-off of shares 2. Prohibition of execution by management and Nomination of manager 3. Merger 4. Transfer of business 5. Acquisition by the third party 6. Suspension for less than 6 months 7. Transfer of contracts 8. Clause 2, Article 35 Specified in the Act Concerning Structural Improvement of Financial Industry

Source: Financial Supervisory Commission

<Table II-7> Loan Classification Standard and Required Provisions

	Prior to July 1998	Since July 1998
Definition[1]		
Normal	-	-
Precautionary (Special mention)	3-6 month part due	1-3 month part due
Substandard	More than 6 months past due, secured	More than 3 months past due, secured
Doubtful	More than 6 months past due, unsecured	More than 3 months past due, unsecured
Estimated Loss	Expected losses	Expected losses
Loan loss reserve requirement		
Normal	0.5%	0.5%
Precautionary (Special mention)	1.0%	2.0%
Substandard	20.0%	20.0%
Doubtful	75.0%	75.0%
Estimated Loss	100.0%	100.0%
Provisioning for outstanding Guarantees	Not required	20.0% of "substandard" 75.0% of "doubtful" and 100.0% of "estimated loss"[2]

1. By the end of June 1999, the FSC will announce a more rigorous loan classification standard that is based on the ability of debtors to generate sufficient future cash flows rather than on their past payment histories.
2. Required from January 1999.

Source: Financial Supervisory Commission.

The closure of insolvent financial institutions opened a new chapter in Korea's financial history, where no single commercial bank had been closed before. As of June 1999, five banks, sixteen MBCs, three securities companies, four insurance companies and one ITC were permanently closed. In addition, three securities companies and one ITC were suspended. If mutual savings and finance companies and credit unions are included, the total number of financial institutions either closed or suspended is 74. Another 143 financial institutions have merged or broken off. (Table I-6)

As with banks, legal reform to punish the executive and employees responsible for the insolvency of NBFIs was implemented. Also, a prompt corrective action system and enhancement of loan classifications used in calculating capital adequacy were introduced. These measures will be helpful for improving poor corporate governance.

In addition, regulations on the portfolio of financial institutions have been tightened after revising the credit management system (Table II-8). The category of assets to be regulated is expanded to include all direct or indirect funding as well as loan or payment guarantees, and the legal limit on facilities has been strengthened. The main purpose of these regulations is to prevent *chaebol*-affiliated financial institutions from financing the activities of other subsidiaries under the same business group unfairly.

<Table II-8> Regulation on Portfolio of Financial Institutions

	Commercial Bank	Merchant Bank	Insurance Company
Assets to be regulated	Credit Facility	Credit Facility	
Legal limit of facility to the same person	Should not be over 20% of commercial bank equity	Should not be over 20% of merchant bank equity	Loan should not be over 3% of total assets of an insurance company
Legal limit of facility to the same affiliate corporations	Should not be over 25% of commercial bank equity	Should not be over 25% of equity merchant bank equity	-Loan should not be over 5% of total assets of an insurance company -The same restriction is imposed on holding stock or debt
Legal limit of large facility	Should not be over 5 times commercial bank equity	Should not be over 5 times merchant bank equity	
Legal limit of facilities to large shareholders of financial institutions or linked affiliate corporations		Should not be over 25% of equity merchant bank equity	

Source: Financial Supervisory Commission

Ⅱ-3. Future Challenges for the Financial Sector

In principle, the potential for the government control on banks has increased significantly after the crisis as three troubled nationwide banks were nationalized in the course of financial restructuring. Indeed, the ownership structure of nationwide banks is much more concentrated after the crisis as can be seen in Table II-9. Under this circumstance, it is hard to expect the improvement of the expertise and capacity of banks for credit evaluation if the government continues to intervene in bank management by exploiting increased ownership, and thereby, the privatization of banks is delayed. This concern is valid even though Korean banks are restructured to restore the soundness and profitability to some degree because the ultimate source of the bank competitiveness will come from expanded human capital and upgraded lending practices.

The intrinsic deficiencies in NBFIs also continue to exist, and are likely to be further signified in that the *chaebol*'s influence on NBFIs has been increasing even more rapidly since the onset of the crisis. In particular, the ITCs under the control of *chaebols* have expanded in terms of their shares in the ITC business. Specifically, Hyundai Group and Samsung Insurance took over three troubled ITCs, one of which were ranked at the third in terms of assets. As a result, the market share of the ITCs affiliated with top 5 *chaebols* has jumped to 31.9% by the end of 1998, up from a mere 2.8% at the end of 1997.

Despite these developments, fire walls designed to prevent insider tradings and the excessive exposure have been unsatisfactory. In particular, given the fact that the market share of the NBFIs is much larger than that of the banking sector, the increasing influence of *chaebols* on NBFIs poses a increased systemic risks. Currently, the share of NBFIs in the domestic deposit market is about 70%. Therefore, the structural deficiencies and weakness of the financial sector will continue to undermine financial

soundness and stability unless an advanced regulatory framework and supervision is established and effectively enforced.

<Table II-9> Large Shareholders' Ownership of Banks (As of the end of 1998)

Classification	Large Shareholders Over 1%		Large Shareholders Over 4%	
	Number	Ownership Share (%)	Number	Ownership Share (%)
Chohung	8(3)	19.8(7.3)	1(1)	4.5(4.5)
Hanvit	2(0)	97.0(0.0)	1(0)	94.8(0.0)
Korea First	2(0)	93.8(0.0)	2(0)	93.8(0.0)
Seoul	2(0)	93.8(0.0)	2(0)	93.8(0.0)
Korea Exchange	4(1)	68.2(1.2)	2(0)	66.0(0.0)
Kookmin	12(3)	36.3(6.0)	3(0)	20.5(0.0)
Housing & Commerical	6(1)	36.5(4.5)	3(1)	30.5(4.5)
Shinhan	7(3)	11.6(5.2)	0(0)	0.0(0.0)
KorAm	13(5)	68.4(41.0)	3(2)	53.5(33.7)
Hana	16(9)	55.7(34.4)	8(5)	43.4(27.4)
Peace	16(4)	43.1(10.4)	1(0)	5.0(0.0)
Nationwide Banks, average	8(3)	56.7(10.0)	2(1)	46.0 (6.4)
Daegu	4(1)	15.9(12.1)	1(1)	9.1(9.1)
Pusan	3(2)	21.1(17.3)	1(1)	15.1(15.1)
Kwangju	6(4)	21.1(16.4)	1(1)	11.4(11.4)
Cheju	4(2)	61.5(58.4)	1(1)	57.3(57.3)
Jeonbook	11(6)	54.4(30.9)	6(3)	41.7(22.5)
Kangwon	7(1)	33.0(12.9)	3(1)	24.4(12.9)
Kyungnam	9(4)	24.3(16.6)	2(2)	10.9(10.9)
Chungbuk	10(4)	38.4(23.2)	3(2)	27.0(19.7)
Local Banks, average	7(3)	34.0(23.5)	2(2)	24.6(19.9)
Commercial Banks, average	12(3)	47.0(19.8)	3(1)	36.9(12.1)

Note: Figures in parentheses indicate the number and ownership share by private industrial capital (including affiliated financial institutions).

* Government owns 46.88% of Korea First Bank, 46.88% of Seoul Bank and KDIC owns 94.75% of Hanvit Bank and 6.88% of Korea First Bank and Seoul Bank respectively.

Source: Bank Supervisory Board.

Ⅱ-4. Regimes for Property Rights Protection

Each creditor has own priorities under the Civil Code and other relevant statutes. Secured claims are paid before unsecured claims. However, wage claims, rental down payments and taxes have priority over secured claims. There is no single rule on priority that applies to all cases. Claims holding the same priority are to be paid on a pro rata basis.

The trustee in the corporate reorganization procedure and the administrator in the composition procedure have the authority to bypass those transactions that are harmful to the creditors. The reorganization plan should threat each category of creditors and shareholders fairly and equitably according to the priority of the claims.

There is always the possibility that debtors and creditors play games that can destroy the value of the financially distressed company under the corporate reorganization or composition procedure by holding out without consenting the proposed restructuring plan. The laws narrow the room by two ways; the time limitation in each process and cram down.

Ⅲ. Formal Insolvency Mechanisms

Ⅲ-1. Introduction

A. Overview

The Korean word for bankruptcy is '*boodo*,' meaning the literally nonpayment of checks or promissory notes. Checks and promissory notes are the major tools of payment for commercial transactions in Korea. They are usually endorsed and transferred several times from debtors to creditors before they are due for payment. Default on payment for checks or promissory notes will result in the issuer of dishonored checks or promissory notes being severely restricted in financial transactions that the issuer can conduct. For example, banks will refuse to deal with the issuer. And the issuers' properties will be subject to public auction for payment of debt to check- or note-holders through a judicial enforcement process. However, most *boodo* cases are settled through private arrangements between the debtor and creditors for payment. Only a handful of *boodo* cases go as far as involving court intervention.

Korea has three statutes on insolvency: the Bankruptcy Act, the Composition Act, and the Corporate Reorganization Act. The Bankruptcy Act deals with the liquidation of individuals and companies. The Composition Act provides composition (arrangement) proceedings for individuals and companies. The Corporate Reorganization Act covers the reorganization process of corporations (joint stock companies). Since these statutes were first enacted in 1962, there had been no significant amendments until 1998.

These insolvency laws had not even been applied much before the foreign currency crisis in 1997 and the concept itself was not familiar to lawyers, not to mention the public. It was said that judges handled just one insolvency case on average during

their judgeship. There were several reasons for that. The Civil Procedure Act was usually used for debt collection on an individual basis. In most cases, collective collection measures were not necessary 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 is left for unsecured creditors.

While the majority of insolvent companies were liquidated on a non-judicial basis, some financially troubled companies were saved by the government in the name of rationalization measures. The government, which had control over financial institutions in a practical sense, took every possible measure to enforce or induce restructuring. The rationalization measures by the government eliminated opportunities for the court to deliberate insolvency cases. The rationalization measures are explained in more detail in the next section.

Only a handful of insolvency cases were filed at the court by owners or CEOs who knew the corporate reorganization process well. Some cases, especially those of big corporations, were initiated by the government.

One technical impediment to a wider use of judicial insolvency procedures was the Article 7-3 of the Act on Special Measures for Unpaid Loans of Financial Institutions. It exceptionally gave the Korea Asset Management Corporation (KAMCO) the authority to hold an auction on a defaulting company's assets even before the company is given a chance to restructure itself. This provision virtually paralyzed the Corporate Reorganization Act since without the consent of KAMCO, the reorganization procedure could not take place because of the auction initiated by KAMCO.

In 1990, the Korean Constitutional Court of Law declared this provision unconstitutional on the grounds that it was unfair and unreasonable. With this ruling, financial institutions, sometimes represented by KAMCO, had to go along with the

judicial process just like any other creditors.

The general assessment of the reorganization process however has been negative, with critics pointing to problems such as outside political influence, abuse of the proceedings to evade criminal punishments, the ambiguity of the rules, delays in the process, the insufficient recovery of claims by creditors, and the low rate of successful reorganization.

Aware of these criticisms, the Supreme Court tightened the process by enacting the Rule on Corporate Reorganization Procedure in 1992(1992 Rule), which provided detailed requirements for initiating the reorganization process and for approving reorganization plans. The 1992 Rule established three requirements for the corporate process: high social value, financial distress and possibility of rehabilitation. It also enumerated detailed factors to be considered for each requirement.

The second bankruptcy of a corporation, Non-No, in a reorganization process put the Corporate Reorganization Act faced public criticism again. The owner/CEO of Non-No corporation fled abroad after having issued many bounced checks. The Supreme Court amended the 1992 Rule to enforce the monitoring function of the court on corporations in a reorganization process in 1996. The 1996 Rule mandated the courts to wipe out shares owned by controlling shareholders responsible for mismanagement of the company. It also excluded the incumbent management from the reorganization process.

The 1996 Rule, however, had an unexpected effect. Since it essentially removed any incentive for the incumbent controlling shareholders and management to reorganize the company, insolvent companies avoided the reorganization procedure and looked for other procedures that would keep the corporate insiders' shares and control of the company intact. Savvy lawyers were able to find them in the composition procedure and

filed for the procedure in major *boodo* cases, such as Kia Motors Corp. in 1997, even though the composition procedure was originally intended for independent businesspersons and small companies. While Kia Motors withdrew the petition and filed for the reorganization procedure eventually, a flood of companies followed the suit as is evident from Table Ⅲ- 1.

<TableⅢ- 1> Number of cases under the bankruptcy-related laws

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
*Boodo**	U/A	U/A	4,107	6,159	10,769	9,502	11,255	13,992	11,589	17,168	22,828
Liquidation	21	37	27	16	14	26	18	12	18	38	467
Composition	-	2	-	-	-	-	-	13	9	322	728
Reorganization	26	27	15	64	87	45	68	79	52	132	148

*number of companies which could not pay checks or notes

Source: Court Administration Agency (1998), Bank of Korea (1998)

Insolvency cases are usually handled by the chief civil division composed of three or four judges in district courts. Only the Seoul District Court has two insolvency divisions exclusively in charge of insolvency cases.

In 1998 Amendments a management committee was established to assist the court in conducting of corporate reorganizations, the committee has twofold purposes. One is to provide experts' testimony to courts, while the other is to help courts with routine managerial work. This separation of duties was arranged as such given that it is doubtful highly valuable experts' testimony and routine managerial work would be possible from the same source. As of September 1999, only the Seoul District Court has the management committee.

The management committee consists of three to fifteen members each of whom must be either a licensed attorney, a certified public accountant or someone who had

served as an officer in a listed company or for over 15 years in a financial institution, according to the Act. The committee advises the district court on matters concerning the debtor company, and is expected to play a substantial role in managing the day-to-day affairs of each proceeding.

The management committee is also empowered (subject to court supervision) to:

a. become the inspector as well as the interim and permanent trustee for small and medium sized companies;

b. review the suitability of the draft reorganization plan and coordinate the provision of information to creditors;

c. issue approvals for certain ordinary actions of the trustee that currently require court's approval;

d. conduct an annual review of the plan and report its status to the court following approval of the reorganization plan; and

e. recommend to the court as to whether the plan should be concluded or discontinued.

B. Comparison and Transferability Between Proceedings

As the corporate reorganization process and the composition process aim at rehabilitation of a debtor, these two processes can not be engaged while insolvency proceedings are undertaken. In the case whereby the court dismisses, disapproves or discontinues the composition process, the court shall declare the debtor bankrupt (Composition Act, Art. 9②). A judges does not usually render the disapproval, discontinuance or dismissal decision offhand; but rather generally recommends that the

defunct composition plan proceed to the bankruptcy process.

In the case of the corporate reorganization process, it is not mandatory for the court to declare bankruptcy. Art. 23 of the Corporate Reorganization Act authorizes the court to declare bankruptcy in case's where the reorganization process has been dismissed, disapproved or discontinued. The court may allow the application for composition proceedings of rendering bankruptcy.

There is no barrier between the reorganization and the composition. So the debtor can file a petition of the composition after their application for the corporate reorganization is dismissed, and vice versa.

The following TableⅢ-2 shows the organization of the three processes.

<Table Ⅲ-2 > Insolvency Process

	Bankruptcy	Composition	Corporate Reorganization
Eligibility 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	Debts, creditor	Debtor	Debtor, qualified creditor(s), qualified shareholder(s)
Business Operation and Disposal of Assets	Receiver (no interim receiver is recognized)	Debtor (under the supervision of interim administrator and administrator)	Interim trustee, Trustee
Qualification of Trustee/Administrator	Individual	Individual	Individual or financial institution
Foreclosure of Mortgages and Other Security Interest	Foreclosure is not Stayed	Foreclosure may not be stayed	Foreclosure is stayed once the proceeding is commenced
Execution of Judgment	Stayed	Stayed	Stayed
Compulsory Redemption of Shares without Compensation	Not applicable	Redemption of shares is nor required	Redemption of all or part of outstanding shares without compensation is 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 practices)	Suspended
Submission of Plan	Not applicable	Composition plan should be submitted at the time of petition for commencement of proceedings (but the plan may be changed)	Plan is submitted after the commencement of proceedings
Repayment Period	Not applicable	No restriction (usually, 4-8 years)	Up to 10 years from the confirmation of the plan
Court's Involvement	Until the completion of distribution	Until the approval of the plan	Until successful Implementation or dismissal of the case

Source: Chiyong Rim

Ⅲ-2. Proceedings under the Corporate Reorganization Act

A. Flowchart

There are two kinds of rehabilitation processes; corporate reorganization and composition. The Corporate Reorganization Act regulates the corporate reorganization process. The following chart shows the flow of the proceedings.

Filing of Petition for Corporate Reorganization
↓
Temporary Protection Measures,
Appointment of Interim administrator,
↓
Appointment of Inspector,
↓ → Dismissal
Order of Commencement of Procedure,
Appointment of administrator
↓
Filing of Examination of Claims
↓
First Interested Parties Meeting
↓
Submission of the Reorganization Plan
↓
Second Interested Parties Meeting
↓
Third Interested Parties Meeting
↓ → Rejection
Admission
↓
Approval
↓
Implementation
↓ → Discontinuance
Conclusion

B. Filing

1) Filing of a petition

Instead of defining the meaning of 'bankruptcy', the Bankruptcy Act provides in which case the count may declare the applicant bankrupt; where the debtor can not repay(Art. 116) and where the total amount of debts of the petitioner is large than the total amount of assets in case of corporation(Art. 117). Art. 30 of the Corporate Reorganization Act stipulates two causes for commencement of the reorganization proceedings: inability to repay the debt in due without incurring significant hindrance to the continuance of the business, and apprehension of bankruptcy in respect of the company.

Corporate reorganization proceedings are normally initiated with a petition for the commencement to the relevant court by the insolvent corporation. This process is for the stock corporation only. The petition may be filed by at least one of the creditors whose claims against the company are no less than 10 percent of the company's equity capital, or by shareholders who hold no less than 10 percent of the issued shares of the company (Art. 30). The court which has venue on the main office of a corporation has exclusive venue on a corporate reorganization case (Art. 6).

The Act does not penalize a late filing. This means a debtor company does not have a legal obligation to file a corporate reorganization petition under the Act. Members of the board of directors, however, have duty of care or fiduciary duty in a general sense under the Commercial Code, which provides on corporate matters. Thus they have to compensate for any damages that come about if a filing is late as a result of negligence of duties.

2) Stay

As the Corporate Reorganization Act does not allow automatic stay, the applicant simultaneously files a petition for issuing a provisional protection order, whereby an interim trustee is appointed; the disposal of assets and repayment of debt by the insolvent company are prohibited; and/or other enforcement procedures are stopped (Art 37, 39). Without this provisional protection order, the reorganization proceedings cannot be effective because most creditors are eager to collect their claims individually. The court issue a provisional protection order after reviewing petition documents and interviewing applicants. Courts shall hear the opinion of the management committee in issuing the order.

If the court turns down or dismisses the application for the provisional protection order, it also dismisses the application for the commencement of the corporate reorganization process. When the court renders the provisional protection order it also nominates an interim trustee and one or more examiners to make assessments for the next stage of the proceedings.

3) Order of Commencement

While the interim trustee takes in charge of the applicant company, the court deliberates whether to render the order of the commencement of the reorganization process. Without the order of commencement, the reorganization procedure does not start. When the court dismisses the petition, the court cancels the provisional protection order too.

The court shall reject any petition for the commencement of proceedings in the following cases:

a. Where the expenses for the reorganization proceedings have not been paid in advance.

b. Where a creditor or shareholder has acquired the claims or stocks in order to file a motion for commencement of proceedings.

c. Where the petition is made primarily with the intention of evading bankruptcy or financial obligations.

d. Where bankruptcy proceedings and composition proceedings are pending before the court, and the general interests of the creditors are served by following those proceedings.

e. Where the value in liquidation of a corporation is greater than its going concern value.

f. Where the petition is made primarily with the intention of evading performance for a tax obligation or obtaining some benefit from the fulfillment of a tax obligation.

The most meaningful factor among these negative requirements is the comparison between liquidation value and going concern value, which is usually done by the examiner.

Following the provisional protection measures, the court appoint the examiner to hear opinions on the situation of the applicant corporation and suitability to the requirements of the commencement of the proceedings. The courts normally appoints accountants as the examiner. In the past, lawyers did the job by hiring accountants. The major tasks of the examiner are due diligence and appreciation of liquidation value and

going concern value.

The courts shall dismiss the petition in case that liquidation value is larger than going concern value. The Act does not prescribe any specific method of calculating those values. The Supreme Court Rule on Corporate Reorganization, however, suggest 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 present value of future cash flow added by the value of not-for-business assets. Other reasonable methods are permissible, but the practice just follow the suggested method. The opinion of the examiner is critical on the comparison of two kinds of value.

The estate is not created in corporate reorganization procedure, unlike the bankruptcy procedure. The assests of the applicant company are protected from the enforcement of creditors or arbitrary payment by the debtor by the provisional protection order and the following order of commencement.

The interim trustee acts as the legal representative of the insolvent company and performs the daily functions of the company (Art. 39-3, 53), in other words, incumbent members of the board of directors lose their functions. As the interim trustees authority is almost the same that of the incumbent trustee, most provisions for the latter are applied to the interim trustee. Commercial banks, merchant banks and trust companies as well as individuals may be appointed as interim trustees. The interim trustee must obtain the approval of the court to perform certain actions specified by the court, such as disposing of the company's assets.

C. Commencement

1) Claims

When ordering the commencement of the reorganization proceedings, the court also appoints one or more trustees and fix the period for the filing of claims, the date of the first meeting of interested parties and the date of examining the claims. All creditors are required to file their claims with the court within the period fixed by the court, which should not be less than two weeks and not more than four months. This period can be extended up to one month for creditors who could not file claims for unforeseen reasons. Shareholders also file their stock with the court at this time. The court will then examine each of the filed claims together with the chairman of the board of directors and the trustee. If claims are made established after the filing period, they shall be filed within one month of origin.

Without filing claims, creditors cannot exercise their voting power, they are excluded in the distribution under the reorganization plan, and finally, they lose their claims. Contrary to this, the failure to file claims in the composition process does not result in the loss of the claims.

Under the reorganization proceedings, creditors are classified into three categories according to their priority: (i) claims of common benefit claims, (ii) secured claims, and (iii) unsecured claims. Common benefit claims are to be repaid irrespective of the reorganization plan and have priority over secured claims and unsecured claims. Art. 208 describes common benefit claims to include administrative fees for the procedure, employee's salary and retirement allowance, and claims which occur after the commencement under the approval of the court. Unsecured claims and secured claims, however, are subject to the corporate reorganization plan except when the court approves separate payments.

The Act classifies creditors and shareholders according to their priority in Art. 159;

a. Secured creditors;

b. Creditors with general priority;

c. Creditor other than those referred to in subparagraphs 2 and 4;

d. Creditor with junior claims;

e. Stockholders possessing those kinds of stocks with preference in the division of the remaining property; and

f. Stockholder other than those referred to in subparagraph 5.

Act. 228 provides that there shall be fair and equal discrimination among these six categories. In practice, however, most reorganization plans apply the following categories: secured creditor, unsecured creditors, and shareholders.

2) Avoidance, Executory Contracts, setoff

The trustee under the reorganization proceedings has the authority to set aside the following transactions(Art. 78):

a. acts that the company undertook knowing that they would cause harm to its creditors except when the beneficiary of such an act did not know at the time of the act that it would cause such harm;

b. provision of security, discharge of a debt or other acts by the company harmful

to its creditors which took place after the suspension of payments or the filing of the petition for corporate reorganization or bankruptcy, except where the beneficiary of any such act did not know at the time of the act that there was the suspension of payments or the filing of such petition;

c. provision of security or discharge of a debt by the company which took place either after, or within 30 days of, the suspension of payments or the filing of the petition for corporate reorganization or bankruptcy when the company was not obligated to do so. This applies whether in terms of the method or timing of the act or otherwise; except where the creditor did not know at the time of the act that there was suspension of payments or filing of such petition or that the act would cause harm to the other creditors of the company; and

d. acts by the company without any consideration or compensation or with only nominal consideration or compensation which took place either after, or within six months of, the suspension of payments or the filing of the petition for Corporate Reorganization or bankruptcy.

The trustees also has the authority to decide whether to perform or terminate any executory contract under which there remain obligations to be performed by the company and the counter party. This means that the trustee has the power to either terminate or seek action on an executory contract. He or she may exercise this power in such a manner as to allow contracts that are advantageous to the insolvent company and terminate those unfavorable to the company, which is generally known as cherry picking.

The Corporate Reorganization Act does not have any provisions particularly mentioning derivatives. Thus derivatives are handled in the realm of executory contracts.

Creditors are entitled to set off debt owed to the company against their claim to the company except: (i) where, the creditors debt to the company was incurred after the commencement of the corporate reorganization proceeding, (ii) where the creditor acquired a third party's claim against the company after the commencement of the reorganization proceeding, or (iii) where the creditor acquired a claim knowing that there was a suspension of payment by the company or a petition for reorganization proceeding was filed, unless the claim was acquired by operation of law or is based on a cause that arose prior to the creditor's becoming aware of the suspension of payment or the filing of the petition; or is based on a cause that arose one year or more prior to the commencement of the reorganization proceeding.

The creditor's right to set off under reorganization proceedings, however, must be exercised on or before the last day of the period specified for filing the claims of creditors.

3) On Managers (debtors)

The act of insolvency is not criminal behavior and the managers of insolvent companies are not considered criminals. However, the Corporate Reorganization Act as well as the Criminal Code does not order any criminal investigation upon the commencement of the corporate reorganization procedure. Criminal charges against corporate director are not usual in Korea even in the bankruptcy situation. But the conflicts between creditors and the management of debtor company sometimes reveal the evidence of embezzlement or breach of trust so that the prosecutor may being an indictment against managers. The situation in insolvency proceeding is almost the same as in normal business process as far as the criminal matters concern.

Directors are to be sued by their own company if they act against their duty as well as law and cause damages to the company(Commercial Code, Art. 399). Derivative

suits may be used by the shareholder(s) with 3% of issued shares or more (0.01 % for the listed companies) if the company does not exercise its claims.

The Corporate Reorganization Act stipulates a summary procedure, named 'assessment', against the directors who are liable for the damages of the debtor company(Art. 72). When the court finds out the damages caused by directors to the debtor company, the court orders the director to pay the damages to the debtor company passing most of time-and money-consuming process in the regular damage recovery suit.

Civil as well as criminal charges against directors had not been exercised frequently especially in relatively large companies including listed companies. The crisis in 1997 has changed the situation to some extent. The rights of minority shareholders have become an important agenda in citizen activism. An activist group brought an derivative action against the former president and directors of Korea First Bank and got the US $ 33 million decision for the compensation of damages to the Bank from the Seoul District Court. The case was reported as the first derivative suit in listed companies. It is doubted whether the accused directors could pay the damages because they do not have liability insurance and enough property as well. However, the legal approaches to the responsibilities of directors are expected to be more frequent as shareholder activism becomes popular after the crisis.

The Korean law confines the liability of each legal entity to itself and does not extend to other legal entities without any statutory provisions. The liabilities of business corporate do not extend to their shareholders and/or directors. Shareholders and directors are not liable for the debts of the corporation. The only possibility that shareholders may be liable for the debts of the corporation is when the principle of piercing the corporate veil is applied. The Korean courts applied the principle in a few cases and extended the liability of the corporate to the shareholder. Directors may be liable for the damage which they incur as mentioned above. However they do not have

direct responsibility for the debts of the corporation.

4) Disclosure Procedure

There has been much criticism that the information on the applicant company and the reorganization process does not flow effectively among interested parties, including the creditors, the trustee, the company and the court. To improve the situation, the 1998 Amendments established the creditors conference.

In one week after receiving the notice of the commencement of the corporate reorganization process, the management committee (or the court) organizes the creditors' conference. The creditors conference consists of up to ten major creditors. The conference is a channel between the court and creditors. It may render creditors' opinion on major processes, including appointing trustees, payment approval, or other matters requested by the court. The court also provides information to the conference for all creditors.

The trustee is the bridge between the court and the debtor company. The court gets the information on the applicant company mainly through the documents which the trustee submit. The court may also question the trustee on any issues before the reorganization procedure starts. The examiner provides basic financial information to the court. The district court can allow creditors to have access to the information necessary to determine whether the company is appropriate for the corporate reorganization.

D. Reorganization/Composition Plan

1) Preparation of the Plan

Based upon the fixed claims and the result of due diligence, the trustee makes the draft of the Reorganization Plan("the plan"). The plan shall be presented to the court within the period prescribed by the court. The period shall not exceed four months from the expiration date of filing claims. The prescribed period may be extended within two months. For small and medium sized companies, it shall not exceed one month.

The Act entitles the applicant firm, creditors and shareholders to submit the plan. However, no case was reported yet drafted by others except the trustee.

2) Contents of the Plan

In the past, creditors, usually banks and other financial institution were negative to cut-off their claims even in the reorganization procedure. The officers of banks did not have authority and ability, in certain situations, to decide the cut-down on a commercial basis under the government-governing corporate structure. They did not have ample knowledge and skill to handle non-performing loans and hesitated to decide something which might incur any suspicion.

Debt for equity swap was of the same nature as the debt cut-off to the banks. Moreover banks did not want to be a major shareholder because they did not want to take any responsibilities for the management of the troubled company. As financial markets were under-developed in the past, bad debts or equities of reorganized companies had no place to be traded.

The only method, for these reasons, used in the plan is to postpone the due and/or to reduce the interest rates. Banks liked to maintain the amounts of loans in the accounting statements even though they were non-performing.

The crisis changed the practice. Non-performing loans have grown so big that

creditor banks have almost been destroyed under the pressure of them. Banks have slowly begun to prefer cash to unreduced amounts in accounting statements. Banks have agreed to cut-down or cut-off their claims in return for collecting some parts of their claims in cash. Debts-for-equity swap is also adopted as a method of restructuring. Banks now hope to collect their claims by selling their shares of the newly restructured company in near future.

The shareholders' rights are to be usually restricted by having their voting rights frozen during the procedure. Art. 221 authorizes the court to amortize over the half of outstanding shares in case that the total amount of debts exceeds that of assets and over two thirds of stocks whose owners are responsible for mismanagement.

Priority among creditors and shareholders is strictly observed in the normal judicial enforcement process. Priority is set in various statutes including the Civil Code, Labor Standard Act, and Housing Rent Protection Act.

In the normal debt collection process, the claimants in junior priority are not entitled at all to get anything before one in senior priority are fully paid. In the corporation matters, the highest priority is given to wage claims, the second is to secured claims, the third is to unsecured claims, and the last is to shareholders. So in normal judicial enforcement process, shareholders take nothing before the unsecured creditors are fully paid.

The plan, however, usually allows junior claimants to be paid even though senior claimants do not acquire full payment. The common discrimination between secured creditors and unsecured creditors are interest rates and duration of payment. For example, secured creditors are to be paid from 3rd year of reorganization through 8th year with interest rates of prime rate plus 2%, whereas unsecured creditors are to be paid from 5th year through 10th year with interest rates of prime rate. The payment to

creditors of common benefits is irrespective to the plan.

It is useful to note that under the same category there would be several sub-categories; primary financial institutions creditors like commercial banks, the secondary financial institutions creditors like investment banks, principle creditors, surety creditors, commercial creditors, financial creditors. The payment schedule would be slightly different from one subcategory to another.

The plan is usually drafted reflecting inflation. The plan normally adds expected inflation rates to the estimated growth rate of sales.

3) Confirmation of the Plan

The plan is to be deliberated and admitted by creditors and shareholders at the interested parties' meeting. There are usually a series of three meetings. The first meeting is for presentation of the trustee's report on the company's financial condition and examination of the filed claims. The second meeting is for deliberation of a draft reorganization plan. The third meeting is for the adoption of a resolution approving the draft reorganization plan.

Once a draft reorganization plan has been admitted at the meeting of interested parties, the court determines whether or not to approve it. The consent of employee is not required for the approval of the plan by the court. Public interests are not the factor to be considered either. Instead, the court shall examine whether the draft reorganization plan satisfies all the statutory requirements as follow(Art. 233);

a. The reorganization proceedings or program conforms with the provisions of the Act;

b. The program is fair, equitable and feasible;

c. The resolution was made in an honest and equitable manner;

d. In respect of programs containing a merger, the general meeting of the stockholders of another company has issued a resolution for the approval of the merger contract; and

e. In respect of programs determining matters requiring the permission, authorization, license or other disposition of the administrative agency, they do not contravene in an important respect the opinion of the administrative agency as prescribed in Art. 194(2)

Most frequently visited requirements are fairness and equality. The Supreme Court reversed the appellate court's decision criticizing the unfairness and inequality of the reorganization plan which had different payment schedule to a foreign creditor(In re Korea Takoma, 92Kue10, 1992.6.15). Another case was also reversed by the Supreme Court for the reason of unfairness and inequity which allowed early payment and higher interest rates to a state-owned bank(In re Samik, 98Kue11, 1998.8.28)

The Corporate Reorganization Act has the provision authorizing the court to approve the plan even though a category fails to reach an agreement on the proposed reorganization plan under the condition that the court determining the clauses to protect the rights of interested parties. The Act enumerates possible method of protecting rights of interested parties;

a. to maintain the collaterals for the secured creditors,

b. to sell the collaterals or corporate assets and distributes the proceeds to the

secured creditors, unsecured creditors and shareholders respectively,

c. to pay fair values of claims determined by the court to claim holders.

Though Art. 234 provides the basis and method of cram-down, the insolvency practice never experienced it. The reorganization practice may not be elaborate yet.

Absolute priority rule is not stated in the Act nor accepted in practice. The normal reorganization plan allows junior claimants get paid some even though senior claimants are not repaid fully. There can be some observations on the reason why senior creditors agree to such plan. In most cases, secured creditors have unsecured claims too. Their concern is to maximize total amount of collection regardless of claims' priority. There should be some compromises between interested parties to prevent hold-out. No case has been filed yet for the reason that the junior claimants get paid under the plan even though senior claimants are not paid fully.

Best interest test is used in the United States as a tool to protect the dissenting creditors in the category which agrees on the plan. It means that the dissenting claimants are guaranteed to receive the amount which they might get in liquidation. The Corporate Reorganization Act does not provide this rule explicitly. However, the liquidation value will be preserved in practice because the total value distributed in the reorganization process shall be bigger than the liquidation value if the distribution is fair.

The feasibility test can be applied throughout the whole process from the filing of a petition to the successful conclusion of the plan. If the court find out that there is no possibility of rehabilitation before issuing the provisional protection order or commencement order, it shall dismiss the petition. Even before the reorganization plan is admitted by interested parties' meeting, the court shall discontinue the process if the court recognize that there is no possibility of rehabilitation(Art. 272). Feasibility is one

requirement for the approval of the plan by the court(Art. 233). Even after the implementation of the plan, the court shall discontinue the procedure unless the plan is feasible(Art. 273, 276).

Economic test is performed at the time when the court decide the order of commencement. The test is to compare liquidation value and going concern value. If the liquidation value is greater than the going concern value, the court shall dismiss the petition of corporate reorganization(Art. 38). Economic test cannot be applied to the reverse situation. Even though the going concern value is greater than the liquidation value, the court can not enforce the plan without the agreement among creditors and shareholders.

E. Post-confirmation Procedures

1) Management

Once a Corporate Reorganization proceeding begins, the authority to manage the operations and assets of the company is vested exclusively with the trustee, subject to the court supervision. Although the Act did not expels the incumbent management or major shareholders as a trustee in reorganization process, the 1992 Supreme Court Rule clearly stated that any attempts should be blocked for the former owner to regain the control of the firm. It reflected the public emotion that someone should be responsible for the failure of the firm. Retired officers of financial institutions were often appointed trustees because creditors' opinion was receptive to the court. The problem is they do not know the business and the firm in the reorganization process.

The 1998 Supreme Court Rule repeals the provisions and recommends that the court appoint the trustee considering the opinion of the firm, the management committee and creditors' conference. Though it does not exclude the former manager as

the candidate of the trustee, it is still so cautious that it suggests to appoint a co-trustee recommended by the creditors' conference in case that an incumbent manager is appointed as the trustee.

In addition to the regular salary, the court may allow special bonus or stock option to the trustee for the compensation of his/her achievements. According to the internal guideline of Seoul District Court, the special bonus would be permitted up to the amount of 100 Million Korean Won.

There is no fixed term of the trustee in normal reorganization plan. The court supervises the trustee in general sense. The trustee shall manage the firm with the care of good manager. He is liable for any damages which he causes by neglecting his duty of care(Art. 101, 43). The court is entitled to dismiss the trustee in case of serious causes(Art. 101, 44). It is generally understood that serious causes mean bribery or false reporting.

2) Monitoring the Firm

The 1998 Amendments introduced the creditors' conference as a channel between creditors and the firm. As the trustee is responsible to the court, not to the creditors, creditors did not have appropriate way to communicate with the court and the trustee. The creditors' conference, composed of major creditors up to the number of 10, may diffuse the information to creditors and hand over the opinion of creditors to the court. In addition to the presentation of their opinion to the court, creditors can file a formal petition in some instances including discontinuance of the procedure and the exercise of avoiding power. One and half year practice seems not show any success as much as expected.

3) Implementation

Once the reorganization plan is approved by the court, it will be implemented by the trustee under the court supervision. If the reorganization plan has been implemented completely or if it is deemed certain that the plan will be successfully implemented, the court may conclude the reorganization proceeding. As reorganization plans are usually organized with the length of 10 years, it takes several years to implement it completely. M&A would be the common cause of the early conclusion of the plan. Upon the conclusion of the process, the authority of managing the company reverts to the company's directors.

If, on the other hand, it becomes apparent, either before or after the approval of a reorganization plan, that the company can not be rehabilitated, the court may decide to discontinue the reorganization proceeding. Even with the cessation of the procedure, the change of claims or discharge according to the plan will be still effective. The cessation of the procedure does not have a retroactive effect.

Ⅲ-3. Proceedings under the Composition Act

A. Flowchart

The process of the composition procedure is similar to that of the corporate reorganization, as shown in the following flowchart. Differences from the corporate reorganization procedure are highlighted.

Filing of Petition with Composition Plan
↓
Temporary Protection Measures,
Appointment of Interim Administrator
↓
Appointment of Examiner
↓ → Dismissal
Order of Commencement
Appointment of Administrator
Filing of Claims
↓
Creditors' Meeting
↓ → Rejection → Dismissal
Admission
↓ → Disapproval → Bankruptcy
Approval
↓ → Cessation → Bankruptcy
Implementation

B. The Stage of Filing

Only the debtor is eligible for the composition petition. An individual as well as a company can be a petitioner. If the debtor is a legal entity, a unanimous resolution by all of the board members is required. A petition for commencement of composition should state the terms and conditions of a composition ("composition plan") such as the

method of payment and the nature and extent of collateral (The Composition Act, Art. 13). A composition condition can be modified under the approval of the court. The petitioner should also provide the court with a detailed statement of the assets and a list of creditors and debtors.

Companies are allowed to file not just in circumstances of bankruptcy, but also when the company can show that such circumstances may occur. All composition cases are heard at the main office of the district courts (to ensure that cases are dealt with by experienced judges).

Automatic stay is not allowed in the composition procedure either. Before deciding on a petition for commencement of composition, the court may issue a temporary protection order appointing an interim administrator and/or prohibiting disposal of assets and repayment of debt by the insolvent company. Order to stop other enforcement procedures is not allowed by interpretation.

An interim administrator can be appointed at the time when the Court issues the temporary prolection measures. This interim administrator will have virtually the same powers as the powers currently granted to the administrator appointed following commencement.

The court appoints an examiner to prepare a report on the appropriateness of commencing with a composition proceeding. On the basis of such a report, the court will decide whether to approve the petition for commencement.

C. The Stage of Commencement

Upon issuing the order of the commencement of composition, the court appoints an administrator and sets the period for filing claims and the date for the creditors'

meeting. All such information regarding the commencement of composition should be announced through a public notice and conveyed to the known creditors and other concerned parties.

Creditors intending to participate in the composition proceedings to preserve and enforce their claims against the debtor must file the claims with the court by the date fixed by the court. Priority claims which need to be paid before general claims are not subject to composition proceedings. Thus secured claims are out of the scope of the composition procedure.

Contrary to the corporate reorganization procedure, there is no process for the confirmation of claims. The list of claims is not deemed to the title of debts. If a debtor does not file its claims by the fixed date and its claims are not included in the list of debts, the debtor does not lose its claims. The filing is just for the participation in the creditors' meeting and, for exercising voting rights.

Under the Composition Act, the creditors have the right to set aside any acts of the insolvent party that took place after the filing of the petition and are not in the ordinary course of business. The creditors may also set aside any acts taken by the insolvent party after the commencement of the proceeding without the required consent of the administrator. Such right of the creditors has no effect on a secured creditor's right to foreclose on the collateral.

Provisions on the Management Commission and the Creditors' Conference as detailed in the Corporate Reorganization Act are applied to the composition procedure too.

An administrator in the composition procedure does not have full authority such as the trustee in the corporate reorganization procedure. The appointment of an

administrator in the composition procedure does not affect the power of the debtor to manage and dispose of assets. The administrator has authority to monitor the activities of a debtor. Transactions outside the scope of the ordinary course of business are subject to the consent of the administrator, and even transactions falling within the scope of the ordinary course of business may not be undertaken if the administrator raises an objection.

D. Composition Plan

The creditors meet on a date fixed by the court and review the reports and opinions of the administrator and the examiner on the condition of the debtor. The creditors will then vote on the proposed terms of the composition. The acceptance of a composition plan by the creditors requires affirmative votes by a majority (in number) of the creditors present representing three-fourths or more of the total amount of claims filed.

A composition plan accepted at the creditors' meeting will be examined by the court to see if it satisfies all the legal requirements. If it is found satisfactory, the court will approve the plan. The court may order the debtor company to provide the shares of major shareholders as collateral to the creditor as a precondition to the commencement of the composition procedure.

Any interested party may appeal the court's decision to approve a composition. If a composition plan is upheld despite such an appeal or if there is no appeal within 14 days after public notification of the court decision, it will become final and effective. Upon a composition plan becoming final, the debtor must discharge his or her debts in accordance with the plan.

Commencement must be decided within three months of the filing with the

possibility of a single, one-month extension. Following approval of the composition plan, the debtor company must report to the court every six months with respect to its payment under the plan.

Creditors with priority claims are not subject to the approved composition plan. A creditor with secured claims, for example, may foreclose its collateral at any time. For this reason, a debtor usually prefer that priority creditors be involved in the composition plan.

E. Post-confirmation Procedures

The business is run by the debtor without any interference by the court after the approval of a composition plan. The implementation of the plan is laid in the hands of the debtor. The court has discretion to discontinue composition proceedings if it finds that the debtor has not met, or may not in the future be able to meet, repayment obligations.

The court may decide to discontinue composition proceedings if the debtor wishes to do so before the creditors' voting on a composition plan or if it is not affirmatively voted on within two months of the first creditors' meeting.

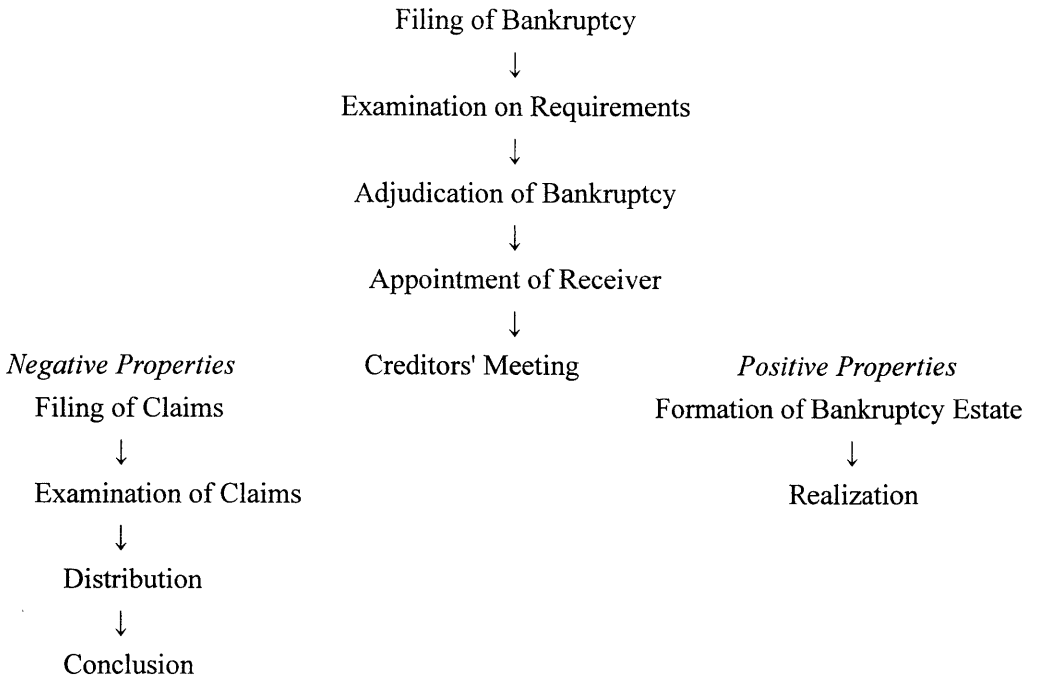
The court may discontinue the proceeding if:

a. the debtor fails to fulfill its payment obligations without a justifiable excuse; and

b. if the court finds that the debtor does not intend to or lacks the ability to fulfill its payment obligation in the future.

Ⅲ-4. Proceedings under the Bankruptcy Act

A. Flowchart



B. The Stage of Filing

Bankruptcy proceedings are intended to collect debtors' assets and distribute them collectively to creditors in the event of the insolvency of a debtor, whether corporate or personal. The general grounds for bankruptcy is the debtor's inability to pay debts. This means that the debtor is unable to make the payments demanded by a creditor or creditors after mobilizing all of its available assets and funds. A suspension by the debtor of overdue payments is presumed to signal the inability to pay. The Bankruptcy Act also provides that a corporation may be declared bankrupt when its entire assets fail to cover all debts. In other words, if the liabilities of a corporation exceed its assets, it may be adjudged bankrupt.

A petition for bankruptcy may be filed by the debtor, its creditor or by a third party. In the case of a corporation, it may also be filed by a corporate director. A petition for bankruptcy is necessary to meet the following criteria:

a. When a creditor files a petition, it must submit *prima facie* evidence of the existence of its claim and valid grounds for bankruptcy.

b. When a director files a petition for the bankruptcy of a corporation, and if the petition is not approved by all of the directors of the corporation, the grounds for bankruptcy must be *prima facie* established by relevant documents.

c. When a third party files a petition, it must submit documents generally showing the available assets of the debtor and a list of the names of the creditors and debtors. When such a petition is filed, the court may issue an order temporarily suspending the disposition of the debtor's assets except as permitted by law or by the court.

Upon review of a petition for bankruptcy, the court will declare the debtor bankrupt if it determines that grounds for bankruptcy exist based on the information included in the petition and further examination by the court. Otherwise, the court will dismiss the petition.

At the time of adjudication of bankruptcy, the court appoints a receiver and sets the period for the filing of claims, the date of the first meeting of creditors, and the date of the examination of claims. All such information regarding an adjudication of bankruptcy should be announced by public notice and conveyed to the known creditors and debtors and other concerned parties.

The court must also notify the appropriate government office or agency, where

relevant, as well as the public prosecutor of the adjudication of bankruptcy. Anyone having a legal interest may appeal the court's decision adjudicating bankruptcy within 14 days of the date of public notice of bankruptcy.

Upon the court's adjudication of bankruptcy, the right to manage and dispose of the bankruptcy estate is vested exclusively with the receiver, subject to court supervision. The receiver, immediately upon assuming the office, must take possession of and manage the bankruptcy estate. The receiver must also have all properties in the bankruptcy estate appraised in the presence of the court clerk, bailiff or notary public, prepare an inventory list and a balance sheet, and submit them to the court. Interested parties have the right to inspect such documents.

The Bankruptcy Act also provides for the right of the receiver of the insolvent company to set aside transactions in bankruptcy proceedings. The substance of these provisions is largely analogous to that of the Corporate Reorganization Act described above. The receiver's power to terminate executory contracts is the same as the trustee's power to terminate executory contracts under the Corporate Reorganization procedure.

C. The Stage of Commencement

All creditors are required to file their claims with the court within the period fixed by the court, which should be not less than two weeks and not more than four months. The Bankruptcy Act, in effect, provides a hierarchy of five separate categories of claims, as described below:

a. Secured claims: Secured creditors can proceed against their security on the same terms as would be available if the debtor were not in bankruptcy.

b. Estate claims: Estate claims are senior to all unsecured obligations and can be

paid by the receiver at any time. They are not subject to the limitations on distribution imposed on other liabilities. Examples of estate claims are costs of judicial proceedings incurred for the common benefit of creditors, expenses incurred in the management, liquidation, or distribution of the bankruptcy estate, claims resulting from the acts of the receiver in managing the bankruptcy estate, and reimbursement claims resulting from a termination of a bilateral contract.

c. Claims given preference by other law: The most significant of such claims are claims for unpaid wages to employees, which are superior to any claims of general creditors.

d. General claims: Although general creditors rank below the three classes of creditors mentioned above, they are nevertheless entitled to set off any amount they owe to the bankrupt against their claims.

e. Less preferred claims: Examples of such claims include interests accruing after the adjudication of bankruptcy, damages and penalties resulting from a failure of performance after adjudication of bankruptcy, and costs of participating in the bankruptcy proceedings.

The creditor's right to set off his debt to the insolvent company under the Bankruptcy Act is substantially the same as under the Corporate Reorganization Act. There is, however, one procedural difference between them. Namely, the creditor's right to set off under the Corporate Reorganization procedure must be exercised on or before the last day of the period specified for filing the claims of all creditors, whereas there is no such time limit in the case of the creditor's right to set off under the bankruptcy procedure.

D. Creditors Meeting and Resolution

At the first meeting of creditors, the receiver reports on the circumstances which led to the adjudication of bankruptcy, interim developments, and the present status of the bankruptcy debtor and the bankruptcy estate. The validity of claims filed by the creditor will also be examined at the first meeting of creditors. If the receiver or any creditor does not object to a filed claim, it will become conclusive. If a filed claim is opposed by the receiver or any creditor, the holder of such a claim may bring action to obtain a court judgement.

A resolution at the creditors' meeting must be approved by a majority of the creditors present. All who are present should have the right to vote. Furthermore, the claims of the creditors voting for a resolution must exceed 50 percent of the amount of the claims of all creditors present at the meeting. If a resolution adopted at the creditors' meeting is contrary to the general interests of the creditors, the court may prohibit implementation of the resolution.

The receiver has the discretionary right to liquidate the bankrupt estate and determine when and how such liquidation should be done. However, this right is subject to certain limitations. For example, the receiver cannot liquidate the assets before the conclusion of the general investigation of the debtor's obligations. If a request for mandatory composition has been submitted prior to the conclusion of the general investigation, the court's ruling on the request is necessary before the receiver can dispose of the assets.

The receiver distributes the proceeds from the bankruptcy estate to the creditors in proportion to their claims. Claims entitled to distribution are differentiated according to whether or not a right of priority exits. A public notice of the total amount of distribution to the entitled creditors is required to be given by the receiver. Permission

from the court is required for the final distribution.

E. Conclusion

A bankruptcy proceeding is concluded with a court decision after the receiver has made final distributions and presented a report thereof at the creditors' meeting. Before such conclusion, a bankruptcy proceeding may also be discontinued by a court decision (i) based on an application of the debtor when the creditors have agreed to discontinue or (ii) based upon an application of the receiver or *ex officio* when the value of the bankrupt estate is smaller than the amount of the expenses for the bankruptcy proceeding.

Ⅳ. Effect of Insolvency Proceedings on the Efficiency and Welfare of Creditors and Debtors

1) Criteria for the Reorganization Decision

The reorganization decision is made at two levels. The first level is when the court issues the order of commencement. The economic test, i.e. the comparison between liquidation value and going concern value, is the main criteria at the first level. To get the order of commencement from the court, the firm should pass the economic test successfully. But if major creditors explicitly disagree with the reorganization in the case passing through the economic test successfully, the court tends to follow the creditors' opinion.

The second level is when the court approve the plan. The plan should be admitted by the every category of creditors in advance. The criteria at the second level is fairness, equity and feasibility.

2) Process of Drawing up the Reorganization Plan

The trustee is entitled to draw up the reorganization plan according to the Act. Most plans are submitted to the court in the name of the trustee. The logical order to draft the plan would be as follow;

a. To estimate future sales and profits,

b. To calculate maximum payments to creditors with available funds,

c. To negotiate the payment schedule with creditors based on the above mentioned figures.

An empirical study, however, reveals a different story. Most plans are prepared by applicant firms not by the trustee. The officers of the firm start to talk with major creditors and get the minimum level of payment. In most cases, the interest rates are the main issue. After the firm decides the fundamental figures including interest rates and duration of payment, it calculates necessary funds and future sales adversely and complete the table.

The payment condition is rather similar regardless of difference of each firm. So the most critical point in the reorganization procedure is the time when each creditors takes its position on whether for or against the process.

3) Corporate Governance

In bankruptcy procedure, the receiver takes in charge of business operation and disposal of assets. In corporate reorganization procedure, the trustee has the full authority of management and representation of the firm. The receiver and the trustee are appointed by the court and under the supervision of the court. In contrast, the debtor still run the business in the composition procedure.

The receiver in the bankruptcy procedure and the trustee in the reorganization procedure are only responsible to the law and the court. Business performance is not the primary concern in some sense. The debtor-manager in composition procedure is mainly responsible to creditors and shareholders although the (interim) administrator monitors him.

4) Quantum

The draft of reorganization plan is admitted with the required consent of each group of interested parties; two thirds of creditors of general claims, three quarters of

creditors of secured claims(four fifths or unanimous voting in extraordinary cases) and a half of shareholders. Shareholders have no voting rights if the total amount of debts exceeds that of assets at the time of commencement of the procedure.

The composition plan can be admitted by the consent by three quarters or more of total filed claims. As the secured creditors can excise their security interests regardless of the composition plan, the consent of secured creditors is not required in the composition procedure.

5) Cram down

The Corporate Reorganization Act has the provision authorizing the court to approve the plan even though a category fails to reach an agreement on the proposed reorganization plan under the condition that the court determining the clauses to protect the rights of interested parties. The Act enumerates possible method of protecting rights of interested parties;

a. to maintain the collaterals for the secured creditors,

b. to sell the collaterals or corporate assets and distributes the proceeds to the secured creditors, unsecured creditors and shareholders respectively,

c. to pay fair values of claims determined by the court to claim holders.

Though Art. 234 provides the basis and method of cram-down, the insolvency practice never experienced it. The reorganization practice may not be so elaborate yet.

6) Division of Economic Value

Under the reorganization plan or composition plan, every economic value is

distributed to creditors until they are fully paid according to the plan. Shareholders can get dividends after the plan is fulfilled. In the bankruptcy procedure, distribution of economic value is strictly executed according to the priority.

7) Stakeholder

The insolvency laws do not take any stakeholder into consideration except when they are creditors or shareholders. Employees have special priority for their wage claims over secured creditors as the Labor Standard Act provides. The Corporate Reorganization Act classified the wage claim into claims of common benefits which is to be paid irrespective of the reorganization plan.

8) Duration of Time

The decision on the commencement of composition shall be made without three months from the petition. This period may be extended up to one month. In corporate reorganization procedure, the provisional protection order shall be issued without two weeks after the petition. The order of commencement for small and medium sized companies shall be decided within 3 months after the petition. The trustee shall submit the reorganization plan within four months after the expiration date of filing claims. The reorganization plan shall be adopted by the interested parties' meeting within one year after the commencement of the reorganization procedure. This period can be extended up to six months. If the plan is not submitted or adopted within prescribed period of time, the court shall discontinue the process ex officio.

<Table Ⅳ-1> Time Period from the Order of Commencement to the Conclusion in cases where the Reorganization Process was Concluded in the Last 5 Years

	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

<TableⅣ-2> Time Period from the Order of Commencement to the Discontinuance in cases where the Reorganization Process was Discontinued in the Last 5 Years

	Number of Cases	In 3 years	In 5 years	In 7 years	In 10 years	In 15 years	In 20 years
1993	12	6	2	2	2	0	0
1994	16	6	2	1	6	1	0
1995	24	5	8	7	0	4	0
1996	18	5	6	3	0	4	0
1997	15	5	5	0	3	2	0
1998.	6	3	1	1	0	1	0
Total	91	3030	2424	144	1111	1212	0

<Table Ⅳ-3> Payment Period in Recent Cases(1996.1.1.~1998.3.31.)

Claims	In 5 years	In 7 years	In 10 years	In 15 years	In 20 years	Total
General	6(13%)	1(2%)	19(41%)	9(19%)	11(24%)	46
Secured	5(11%)	4(9%)	20(43%)	10(22%)	7(15%)	46

< Table Ⅳ-4> Payment Ratio in Recent Cases(1996.1.1.~1998.3.31.)

( )% Unsecured creditors	Up to 10%	Up to30%	Up to50%	Up to 75%	Up to 100%
Financial Institution	3(7.9%)	0	1(2.5%)	2(5%)	33(84.6%)
Commercial Transactions	5(18%)			2(7%)	21(75%)

9) Non-adoption of the Plan

When the composition plan is not adopted, the court shall discontinue the process and transfer it to the bankruptcy procedure. In contrast, on the occasion of discontinuance of corporate reorganization, the transfer to bankruptcy procedure is not mandatory. The firm would be liquidated privately in most cases.

10) Sales of Assets and Business

Assets, operation or corporate itself may be sold during the reorganization process. In many cases, however, most of the proceedings from the sale of assets or operation are to be given to secured creditors. Prospective buyers want to purchase the company after debt are restructured. So in some cases, the future owner plays an important role in drawing up the reorganization plan. after the plan is approved by the court, the new owner takes the control of the firm which has sound financial structure.

11) Impact of the Start of the Proceedings

After the provisional protection order, most business transactions are exchanged on a cash basis, so the extent of business activities is shrinked.

12) Incentives

Respective incentives of managers and shareholders, various creditors, employees, and the government in facing the insolvency proceedings, including the incentives of some stakeholder to play protracted waiting games or wars of attrition.

V. Markets for Ailing Firms and Their Assets

V-1. Korea Asset Management Corporation

KAMCO is the government agency mandated to acquire and dispose of non-performing loans of the Korean financial sector. KAMCO was established in April 1962 as a subsidiary of the Korea Development Bank to dispose of insolvent assets of financial institutions. On the wake of the financial crisis in late 1997, KAMCO was mandated to acquire and dispose of Non-Performing Loans (NPLs) of the financial sector.

The Non-performing Assets Management Fund of 33.5 trillion won was set aside to acquire NPLs of distressed financial institutions as shown in the following table. The fund plays a crucial role in enhancing liquidity and restoring stability in the financial sector. A major portion of the Non-performing Asset Management Fund came from the issuance of KAMCO bonds. KAMCO is authorized by the National Assembly to issue up to 32.5 trillion won worth of bonds and has so far issued bonds worth over 19 trillion won.

<Table V-1> Funding Sources of KAMCO as of June 30, 1999

(unit: billion won)

Funding Sources	Authorized Amount	Disbursed Amount
Contribution from Financial Institutions	573.4	573.4
Borrowing from KDB	500	500
KAMCO bonds issuance	32,500	19,359
Total	33,573.4	20,432.4

Source: KAMCO

Since being reestablished in November 1997, KAMCO has purchased about 46 trillion won of non-performing loans from 71 financial institutions. Approximately 80 percent of the NPLs acquired came from the banking sector. The remainders were from other financial institutions including merchant banks, insurance companies, securities companies, etc.

<Table V-2> Status of NPLs Purchased as of June 1999

(Unit: billion won)

Date	Designated institution	Loans Purchased	Acquired price
Nov. 26 1997	Cheil Bank, Seoul Bank	43,943	29,103
Nov. 28 1997	30 Merchant Banks	26,988	17,555
Dec. 15 1997	30 Banks	39,510	24,743
Sub Total ('97)		110,441	71,401
Feb. 19 1998	2 Insurance Companies	28,166	4,121
Jul. 23 1998	Seoul Bank	10,400	4,989
Jul. 31 1998	Cheil Bank	11,335	6,066
Sep.29 1998	23 Banks, 2 Insurance Companies	230,136	90,850
Nov. 6 1998	Kwangju Bank, Cheunju Bank,etc	4,969	2,616
Dec. 29 1998	5 Special Banks	45,308	19,030
Sub Total ('98)		330,314	127,672
Feb.12 1999	Chohung Bank	876	428
Mar 31 1999	Chungbok Bank	78	25
May 19 1999	P.B.O bonds of 5 Banks	17,514	2,804
June 30 1999	Hanmi Bank, 50 Mutual Credit Association	2,110	1,134
Sub total ('99)		20,578	4,391
Total		461,333	203,464

Note: P.B.O indicates Put Back Option

Source: KAMCO

KAMCO will employ the most appropriate way to dispose of its assets through such methods as individual REO property sales, foreclosure auctions, portfolio sales, equity partnerships and ABS issuance. KAMCO has disposed of NPLs worth 3.4

trillion won as of July 1999.

<Table V-3> NPLs Disposition

(Unit: Billion Won)

Category		Face Value	Sale Value
Liquidation Of Asset	98-1(Distribute Residential Interest)	207.5	25.4
	98-2(Equity Partnership)	541.2	201.2
	99-1(Outright Sales)	772.4	123.8
	ABS 99-1(Domestic ABS issues)	300.7	320.0
	Secured NPL 99-1(Outright Sales)	1,038.8	524.9
Sub Total		2,860.6	1,195.3
Asset Sale	Foreclosure Action	1,878.0	953.7
	Public Sale	261.1	119.3
Sub Total		2,139.1	1,073.0
Voluntary Repayment		1,143.9	1,121.3
Total[1]		6,143.6	3,389.6

Note: 1. Estimated price

Source: KAMCO

V-2. Vulture Fund

The market for the assets of insolvent firms has risen in prominence as corporate and financial sector restructuring by managing insolvent assets has become a major issue. Before vulture funds (companies specializing in corporate restructuring) were fully utilized in Korea, they commonly just entered the domestic market and purchased insolvent assets owned by banks or merchant banks. For example, the Commercial Bank of Korea sold the insolvent assets of the Canadian branch corporation of Sammi Atlas for US$20.69 million to Merril Lynch, an American investment bank. However, the inexperience in managing insolvent assets made Korean firms evaluate their assets much differently from foreign buyers, resulting in bargaining failure in most cases.

As of September 1999, eleven vulture funds and one association have been enrolled after the establishment of a vulture fund was allowed by the Industrial Development Act announced February 2, 1999. The market for insolvent assets seems to grow based on domestic capital. The main tasks of a vulture fund is to acquire[6] those firms in need of restructuring through a stock-purchase, merger or transfer of operation, and to sell them again after normalization[7]. In addition to this, a vulture fund can invest in these firms and buy real estate, capacity, etc. that the firms are willing to sell in order to reduce debt-ratio. And it can also buy insolvent assets owned by the Korea Asset Management Corporation or financial institutions, mediate M&As between firms, and conduct agency business of reorganization, composition, and bankruptcy procedures.

Firms considered in need of restructuring[8] are those that went into bankruptcy more than once in the past three years, filed for reorganization, composition, or bankruptcy in court, or were declared in need of management normalization by the council of creditor financial institutions.

At the same time, a vulture fund can set up an association with other investors to finance restructuring. Mandatory investment of the vulture fund is required here to prevent conflicts of interest between the vulture fund and association[9]. The legal entity of an association like this is an association in civil law. All of the clauses of civil law apply to this organization except for those specified in the Industry Development Act. In September 1999, the First Komet M&A Ltd. was enrolled as an association for corporate restructuring.

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[6] Acquisition of firms related to the vulture fund such as subsidiaries is banned. (Clause 3 of Article 10 in the enforcement ordinance of the Stock Exchange Act)

[7] The obligation of selling off acquired firms within five years of the acquisition is imposed on a vulture fund. A delay is allowed for no longer than one year. (Article 17 of the Industrial Development Act)

[8] A vulture fund can conduct restructuring operations for only those "firms to be restructured" specified in article 14 of the Industrial Development Act.

[9] The minimum size of the restructuring is 10 percent of the association's total investment fund.

VI. Informal Insolvency Proceedings

VI-1. Workouts

A. Legal basis for workouts

The workout program is based on the Financial Institutions' Agreement for Promotion of Corporate Restructuring ("Corporate Restructuring Agreement") signed on June 25, 1998, among creditor financial institutions, including commercial banks, investment trust corporations, and merchant banks. It was supposedly modeled after the London Approach, in which the central bank plays an arbitrator's role in the voluntary negotiations between debtor companies and their banks. But the Korean program differs in a number of ways in its implementation. First, every financial institution was urged to participate in this agreement, including insurance companies and security brokerage companies, unlike the case of the failed Anti-Bankruptcy Agreement of 1997, which was signed only by commercial banks. Second, the Financial Supervisory Commission (FSC) has in effect assumed a central role in the process since it is in charge of both corporate and financial sector restructuring, even though the Corporate Restructuring Committee is the official arbitrator according to the agreement. Third, the government retains another way to directly influence the process, as it is the majority shareholder of many of the largest commercial banks. The government became the absolute majority shareholder of many commercial banks as a result of the restructuring.

The workout program was an attempt to prevent a systemic corporate bankruptcy amid mounting non-performing loans in the aftermath of the economic crisis, and was conceived partly out of the concern that the existing formal insolvency procedures were not developed and efficient enough to handle such a large number of firms in financial distress at the same time.

The workout program is implemented according to the following flow chart.

Flow Chart of Workout

Selection of target firm by main bank

↓

Convention of Council of Credit Financial Institution

↓

Investigation of the financial condition of Firm

↓

Confirmation of workout plan

↓

Conclusion of memorandum of understanding(MOU)

↓

Monitoring

Process of Workout

(1) Selection of target firms

The workout procedure is first initiated when the main bank of a debtor company or financial institutions having loans amounting to more than 25 percent of the company total credits select a targeted firm and call for a council of credit financial institutions. The targeted firms mainly consist of firms that are economically viable but are temporarily suffering from financial distress. The workout procedure should provide a more reasonable loan call rate than what a legal procedure such as composition and reorganization would entail. But selection of the targeted firms is largely dependent on the main bank discretion.

(2) Council of credit financial institutions and decision of workout procedure

When the main bank selects the targeted firm and notifies the credit financial institutions, the council of financial institutions is convened and decides the workout procedure. When the council of financial institutions is convened, debt collection of the financial institution on the loan are immediately suspended for a maximum of six months.

The council of financial institution decides whether or not the workout procedure will begin. The approval of the proposed workout plan requires at least a 75 percent votes of creditors in amount, otherwise the firm is excluded from the workout procedure. In the event of neither a 75 percent agreement nor 75 percent objection rate, the agenda is rolled over to the second or third convention of the council. If the second and third convention of council cannot decide on the workout procedure, the main bank may request arbitration of from the Committee of Corporate Restructuring. In addition, the council of financial institutions also selects the institution that will examine the situation of the targeted firm during the standstill.

(3) Investigation of target firms

The purpose of assessing the condition of the firms is mainly to verify their real liquidation value from a conservative perspective. The subjects of investigation are the company assets, liabilities, future going-concerns and liquidation value, and other liabilities such as those not listed in the books or contingent liabilities. Based on the results of the investigation, each creditor knows the minimum value of what he can collect and compares the various alternatives provided by the main bank with that basic information. During the investigation, the main bank prepares a workout plan with the assistance of an external advisory group.

(4) Confirmation of workout plans

A workout plan prepared by the main bank is negotiated in the council of creditors. The plan can include a wide range of restructuring measures: debt rescheduling, interest reductions, additional financing, dissolution of cross-loan guarantees in the case of conglomerates, debt-equity swapping and capital reduction, appointing a manager, asset and business sales, and injection of fresh capital from foreign investors. After the workout plan is established, the council of financial institution approves the workout plan with the approval of 75 percent of the company total debts.

(5) Conclusion of Memorandum of Understanding (MOU)

Once the plan is approved, the main bank concludes a Memorandum of Understanding (MOU) on corporate restructuring with the targeted firm. The workout procedure principally requires the shareholder, manager and other employees to be equally responsible for the loss of creditors. So, the MOU must include and specify elements of self-rescue, reduction of capital and adjustment of personnel. In concluding the MOU, the main bank must specify the management target measurable with quantitative and qualitative measures and the time schedule to carry out the target to protect the credit financial institution and fulfil the workout procedure correctly.

(6) Monitoring

After conclusion of the MOU, the main bank makes and dispatches a management team to the targeted firm for monitoring. In addition, the main bank may construct a regular reporting system, appoint and dispatch an independent director, and construct a committee to assess the management and monitor the process of executing the MOU.

B. Scope of Workouts

As of October 1999, 93 companies were under the workout procedure, 81 of which have an approved workout plan. The total amount of loans of those 81 companies subject to the workout plan is W38.4 trillion. (Table VI-1, VI-2)

<TableVI-1> Workout Programs in Progress as of October 1999

(Unit: Companies)

	Selected	Unqualified	Resolved	Applied	Plan Fixed	List of Unqualified Companies
Firms Affiliated with 6th to 64th *chaebols*	59	5	-	54	43	Tongil Heavy Industries Co., Ilsung Construction Co., Ilshin Stone Co., Hankook Titanium Industry Co., Anam Electronics Co.
Firms Not Affiliated with a *chaebols*	44	4	1	39	38	Kyunggi Chemical Industrial Co., Daljay Chemical Co. Korea Leasing CO., Samhyup Development
	103	9	1	93	81	

Several obstacles to a better workout outcome are pointed out: 1) the lack of experience and commercial knowledge among bank personnel involved in the process; 2) reluctance to supply new money to the debtor firm by any financial institutions except the main bank; 3) the ineffectiveness of the formal procedure and the threat it poses to the creditors and the debtor firm in the event the informal procedure fails; and 4) the lack of effective corporate governance within the institutional creditors. Banks may not provide strong enough incentives to their employees to strive actively for a successful workout. Given the nature of the Corporate Restructuring Agreement as a private contract, the last two obstacles may in particular give the current controlling shareholders of a debtor company some incentive to hold out in the hopes of exacting a bigger concession from the creditors.

<Table VI-2> Confirmed Results of Workout Plan

Unit: billion won, a hundred million dollar

List	No. of affiliates	Main Bank	Fixed Plan	Amount of Loans			Debt Restructuring							New Loans	Trade Financing
				Loans	Cross Loan Guarantees	Total	Interest rate cuts	Interest Release	Debt/Equity Swaps	CB Conversion	Loan Release	Repayment of Loans	Etc.		
Dongah Construction Ind., Co.	1	Seoul	980911	44,758	8,229	52,987	43,928	8,257	802					1,600	
Keopyung	3	Chohung	981014	3,822	4,862	8,584		824	748	111	3,048	578	3,375		
Sepoong	2	Chohung	981017	4,605	92	4,697	4,605	92						59	6.9
Kabool	2	Hanvit	981017	13,780	2,655	16,435	10,357	1,890	163	3,260	765				50.0
Kohap	4	Hanvit	981021	47,775	3,553	51,328	42,819	4,751	1,450	2,308				3,260	194.0
Shinho	3	Cheil	981024	12,441	2,717	15,158	7,541	4,720	494	2,403				700	70.0
Peeres Cosmetics	1	Hanvit	981027	590	123	713	540	58		50	65				
Shin Won	3	Korea Exchange	981028	9,544	4,060	13,604	4,854	2,739	1,540	3,150	1,321			540	30.0
Jindo	3	Seoul	981106	10,739	3,202	13,941	6,718	4,273	908	2,042					86.0
Kangwon Industries	4	Chohung	981112	17,208	575	17,783	17,208	575						1,239	12.0
Woo Bang	1	Seoul	981116	8,398	734	9,132	5,838	1,242	419	1,633				1,200	
Korea Computer Inc.	1	Shinhan	981117	1,083	70	1,153	1,083	70							8.8
Byucksan	3	Hanvit	981126	9,054	2,356	11,410	7,454	2,356	100	1,500				500	
Taegu Depart. Store Co.	2	Daegu	981127	3,352	683	4,035	3,152	261		200	422				
Samil Kongsa	1	Korea Development	981204	488	28	516	488	28							9.0
Seshin	1	Busan	981204	536	45	581	581								
Dae Kyung Special Steel Co.	1	Korea Development	981210	739	0	739	739								
Dongwha	3	Chohung	990920	1,675	2,939	4,614	1,458	2,943	110				103	76	47.6
Young Chang Akki Co.	1	Korea Exchange	981216	1,661	321	1,982	321	1,982	1,661	321				210	9.0
Sung Chang Enterprise Co.	1	Hanvit	981223	2,001		2,001		2,001	2,001					88	5.0
ShinWoo	3	Hanvit	981223	2,875	2,499	2,475	2,499	5,374	2,475	2,499	29	371		152	10.0
XETEX Co.	1	Hanvit	981228	895	838	895	838	1,733	895	838					
Dong Bo Construction	2	Housing Commercial	981229	1,244	1,022	1,244	1,022	2,266	1,244	1,022				318	

List	No. of affiliates	Main Bank	Fixed Plan	Amount of Loans			Debt Restructuring							New Loans	Trade Financing
				Loans	Cross Loan Guarantees	Total	Interest rate cuts	Interest Release	Debt/Equity Swaps	CB Conversion	Loan Release	Repayment of Loans	Etc.		
Dongbang	3	Cuohung	981230	3,625	236	3,861	1,767	236	147	181			1,530	90	14.0
Namsun Aluminum Co.	1	Korea Development	990105	1,863	58	1,921	1,413	58	60	390				80	8.8
Muhak Co.	1	Kyungnam	990109	255	650	905							905		
Il-dong Pharmaceutic al Co.	2	Cheil	990123	4,012	190	4,202	3,662	176	79	250	35			117	50.0
Hanchang	4	Busan	990123	3,906	500	4,406	3,906	500							11.0
Choong Nam Spinning Co.	2	Chohung	990128	2,759	645	3,404	447	645					2,312	80	17.0
Seo Han	1	Daegu	990203	2,081	35	2,116	1,731	35		350				350	
Hwa Sung Industrial Co.	1	Daegu	990209	4,941	256	5,197	4,641	256		300				590	
Tongkook Corporation	3	Cheil	990213	12,507	5,975	18,482	11,107	6,191	338	846				856	80.0
Ssangyong	2	Chohung	990302	16,741	946	17,687	8,929	862	5,636				2,260		
Anam	2	Chohung	990307	22,441	6,313	28,754	10,747	6,313	1,419	1,081			9,194	500	
Shin Song Food Co.	2	Korea Exchange	990329	515	0	515	515							20	
Miju	4	Seoul	990419	2,113	397	2,510	1,415		72	360			663	241	5.9
Korea Industry Co.	1	Busan	990624	942	412	1,354	730						624		1.0
Korea Development Leasing Co.	1	Hanvit	990729	38,536	2,380	40,916	31,344	4,156	3,036						
Shin Dong -Bang	4	Hanvit	990826	6,180	1,016	7,196	3,180	1,615	721	1,680				200	67.0
Total	81			322,680	61,612	384,292	253,173	60,802	18,271	22,466	5,656	578	20,966	13,066	792.0

Note: 1. Cross-loan guarantees mean guarantees for non-objective affiliates of workout companies.

2. Total Amount = interest rate cut + interest release + debt/equity swaps + CB conversion + Loan Release + Repayment of loans + etc.

3. Etc. includes the sustained interest rates and so forth.

4. Interest rate cut and interest release are the objectives of deferred payment.

5. New loans unit: billion won, Trade Financing unit: a hundred million dollars

Source: Financial Supervisory Commission

Ⅵ-2. Other Schemes

A. Rationalization Measures of the 1970s and 1980s

At the outset, it is helpful to look at the institutional arrangements dealing with insolvency problems in Korea from a historic perspective. Before the modernization drive began in the 1960s, there were few firms in Korea to talk about. Firms of relatively large size appeared as a result of the rapid industrialization policy of the Park Chung Hee government, which pushed for the development of many industries that the president believed were necessary for Korea.

Faced with either the lack of a well developed financial market that could channel the savings of the general public to projects that he wanted, or the dearth of private financiers who had money to finance those projects, President Park resorted to quite a unique form of capitalism. He took over the financial market and ran banks and most of the other NBFIs virtually as government businesses while using them as a means to channel the savings of the general public to his favorite projects. He forced financial intermediaries to lend money to the firms in those industries he sought to develop. Lending by banks owned and operated by the government, such as the Korea Development Bank, to such projects was not uncommon either.

Such heavy involvement in the financial market by the government naturally led the government to consider corporate bankruptcy in its industrial policies. It is also important to remember that at the time, the Park Chung Hee government had near absolute power in Korea, enabling it to implement a wide range of actions at will, unchallenged by anyone. Thus, the government tackled the insolvency of large firms by using a set of measures generally called "rationalization" rather than formal proceedings supervised by the court.

<Table VI-3> below summarizes the content of the two waves of rationalization policies that had been implemented by the Park government. The rationalization measures focused on making the firms in the target industry financially viable again. To achieve this objective, the government used a combination of measures, including debt reduction, tax benefits, forced mergers, forced reduction in capacities aimed at improving firm profitability, and management takeovers in financially troubled firms by the lending banks.

Another important measure taken by Park was the 8.3 measure of 1972, so called because it was announced on August 3. Park's emergency decree nullified all existing debt contracts, except in the cases of small amounts, and substituted for them with contracts that were much more favorable to the debtors.

<Table VI-3> Rationalization policies of the Park Government

Measures for Rationalization of corporations in 1969-1971	- conducted in 3 steps: • first step (1969): liquidation of 30 corporations in the PVC, veneer board, car, steel, chemical fiber industry, etc. • second step (1970): designating 56 corporations as failing firms and liquidating them • third step (1971): liquidating 26 failing corporations - conducted by the investment and management section of the Korean Development Bank (KDB), full or partial management of the KDB and a commercial bank, and reorganization under the Bankruptcy Act.
8.3. measures for industry rationalization in 1972	- appointing 61 total industries as objects of corporate subsidization and rationalization • 30 industries in the heavy industry such as steel, non-steel metal, shipbuilding, electronic industry, etc. • 8 industries in the PVC, chemical fertilizer, and petrochemical industry • 10 industries in the light industry such as fiber, etc. - giving financial subsidies and tax benefits when the industry pursues optimization of production facilities, specialization or integration, mergers, improvement of financial structure, R&D, etc. • financial subsidy from the fund for industrial rationalization • exemption from corporate and acquisition taxes in a merger, and increasing the special depreciation rate and government subsidy on fixed investment

Source: Nam (1993).

Overall, rationalization measures more closely resembled restructuring of financially troubled firms and debt restructuring necessary to keep the firm in operation than they did liquidation, which was rarely used. However, it is also important to note that rationalization went beyond restructuring of individual firms as it aimed at restructuring the target industry and entailed significant changes in the industrial organization of the industry.

The government's command of the financial sector continued under Park's successors, although the industrial policies aimed at developing target industries lost much of their steam in the 1980s. Rationalization measures continued to be employed by the Chun Doo Hwan government as a major response to the insolvency problems of large firms. <Table Ⅵ-4> below summarizes the rationalization measures implemented by the Chun government in the 1980s. The content of the measures was basically the same in nature and scope as that of the Park administration.

It is noteworthy that under the Park and Chun administrations, the rationalization measures were taken unilaterally by the administrative branch of the government and often lacked firm legal grounds or legally adequate procedures. All of the key decisions were made by the government, including those of whether to liquidate or restructure the firm, and the terms of restructuring or mergers when mergers were a part of the package. In fact, there were no principles or guidelines that governed the rationalization measures. Naturally, there was little transparency.

On the surface, banks were the biggest losers as they were forced to absorb most of the losses involved. But since the banks virtually operated as a government business and their losses were eventually covered by the public's money, it was the general public who ultimately paid for the losses. Such an outcome is expected and consistent with an economic system of government-led industrialization.

<Table VI-4> The Rationalization measures of the 1980s before Industrial Development Institute

Adjustment of investment in heavy industries	- industries targeted: generator and construction, heavy equipment, car, middle electronic equipment, diesel engine, and refining copper industries - adjusting over-investment in the heavy industries brought up in the 1970s by mergers and forced specialization - continual government subsidies in the form of a financial rescue during adjustment of investment and interest rate reduction in 1982
Measures of rationalization of depressed industries in 1984-1985	- industries targeted: marine transportation and overseas construction businesses - restructuring failing firms in marine transportation and overseas construction businesses by merger and acquisition - assistance to merged and acquiring firms in the form of loans from financial institutions, writing off debt principal beyond assets and deferment of repayment of principal and interest, etc., and tax benefits such as tax deductions based on the Tax Deduction Act
Restructuring failing firms in 1986-1988 (restructuring not based on Industry Development Act)	- implementing and dividing the restructuring process by firm and industry levels - restructuring failing firms in the marine transportation and overseas construction industry by merger and acquisition • degree of restructuring firms: 57 firms (49 firms appointed as target firms of rationalization and the remaining 8 firms liquidated) restructured by acquisition • degree of restructuring industries: 21 firms as a complementary measure to rationalization of marine transportation and overseas construction businesses - government support as follows: • financial support: writing off debt principal beyond assets and deferment of repayment of principal and interest according to support criteria of debt beyond asset • tax benefit: tax deduction such as deduction of corporate tax from selling real estate and unused assets, acquisition tax from taking over equity and income tax of acquiring firm • providing to commercial bank special loans from the Bank of Korea (BOK) to indemnify loss due to loans to restructuring firms

Source: Nam (1993).

Rationalization policies became more formal after 1986 as the Industrial Development Act was introduced. The act specified the conditions for the rationalization measures to be applied and the types of measures that could be employed. The key cases to which the act was applied are summarized in the following <Table VI-5>. Note that the rationalization measures include the ones aimed at limiting competition, such as specialization orders, preferential treatment in procurement, and bans on additional capacities, as well as those aimed at scrapping existing capacities.

< Table VI-5> Rationalization Measures under Industrial Development Institute

Industries	Period	Status	plan	Performance
Automobiles	86. 7 ~ 89. 6	Over-fixed investment Excessive competition	- specialization of production according to kind of car - specialized reduction of main mechanical parts	- maintaining specialized production system with Hyundai Motors, Daewoo Motors, Kia Motors, and Donga Motors - settling down specialized production
Heavy construction equipment	86. 7 ~ 89. 6		- limiting producer with respect to kind of equipment - enlargement of R&D investment to 5% compared with sales - support of increasing capital to improve financial structure and invest in R&D	- maintaining specialized production system with Samsung Heavy Industry And Daewoo Heavy industry. - 4.9% ('86)→5.4% ('87) - increase in equity of Samsung Heavy Industry by 50 billion won : average ratio of equity to asset of both firms increased from 15.3% ('85) to 17.3% ('87)
Diesel engine	86. 7 ~ 89. 6		- specialized production according to kind of industry - pursuing gradual localization of parts	- specialized Production system with Hanjung, Hyundai Engine (large size), Ssangyong (middle size) - Raise ratio of localization of Parts · middle size: 55% ('86) → 75% ('88) → 82% ('89) · large size:65% ('86) → 85% ('88) → 87% ('89)
Heavy Industry And Electronic Equipment Manufacturing	86. 7 ~ 89. 6	Over-fixed investment Excessive competition	- Specialized production according to kind of equipment - Repressing increase in production facility - Enlargement of R&D investment to 5% compared with sales - Normalization of Management of Hyosung Heavy Industry	- Specialization with 6 firms Including Hyosung Heavy Industry - No increase in production Facility - Being expected to reach 2.8% In 1989 1.7(%)('85) → 2.6(%)('88) Improving financial structure by KEPCO's preferential purchase of Hyosung product: Decrease in cumulative deficit from 45.1 billion won('85) to 27 billion won('87)

Source: Nam (1993).

Rationalization policies based on the Industrial Development Act became insignificant in the 1990s as successive administrations put less emphasis on the kind of industrial policies aimed at developing target industries, which had been so fervently pursued by the Park government. However, as a result of the rapid industrialization policies of Park and the policies of all of the previous administrations on financial markets, most large firms were heavily in debt and highly exposed to the probability of insolvency even in the 1990s. This, combined with the continued domination of the financial market by the government, left the door wide open for government intervention in the event that large firms became insolvent.

B. "Big Deals" of 1998

Plans for mergers by large firms in several industries, called "Big Deals," have been announced. The plan was based on agreements by the firms involved and did not officially involve the government. However, some believe that the government played some role in setting up "Big Deals." The table below summarizes the "Big Deal" plan announced on October 7, 1998. The industries covered by the plan share the common characteristic that they require a large amount of initial investment to start a business, and that a large proportion of initial investment becomes a sunk cost once the investment is made.

< Table VI-6> "Big Deal" Plan

Business line	Plan of the Deal	Controlling Body
Semiconductor	Samsung Electronics Co. → Samsung Electronics Co. Hyundai Electronics Ind. ⌐ LG Semiconductor Co. ⌐ M&A →	Hyundai Electronics Ind. (Decided in March 1999)
Power-Generation Equipment	Hyundai Heavy Industries Co. ⌐ Korea Heavy Industries & Construction Co. M&A →	Korea Heavy Industries & Construction Co.
	Samsung Heavy Industries Co. ⌙	
Petro-Chemicals	SK, LG, Daelim, Lotte, Hanwha →	SK, LG, Daelim, Lotte, Hanwha
	Hyundai Petro-chemical Co. ⌐ Samsung General Chemical Co. ⌙ M&A →	Sole corporation establishment
Aircraft Manufacturing	Korea Air Line Co. →	Korea Air Line Co.
	Samsung Aerospace Industries Co. ⌐ Daewoo Heavy Industries Co. M&A →	Sole corporation establishment
	Hyundai Space & Aircraft Co. ⌙	
Railway Vehicles	Hyundai Precision & Ind. Co. ⌐ Daewoo Heavy Industries Co. M&A →	Sole corporation establishment (Share ownership ratio: 4:4:2)
	Hanjin Heavy Industries Co. ⌙	
Ship-Engines	Hyundai Heavy Industries Co. →	Hyundai Heavy Industries Co.
	Korea Heavy Industries & Construction Co. M&A →	Korea Heavy Industries & Construction Co.
	Samsung Heavy Industries Co. ⌙	
Oil Refining	SK, LG, Ssangyong →	SK, LG, Ssangyoung
	Hyundai Oil Co. ⌐ Hanwha Energy Co. ⌙ M&A →	Hyundai Oil Co.

Note: On December 7, 1998, the swap between Samsung Motors and Daewoo Electronics was announced as an additional Big Deal plan.
Source: Financial Supervisory Commission. 1998. 12.

Assuming that the Korean government implicitly had interest in seeing some of the proposed big deals go through, one is naturally led to ask why a government would be interested in successful mergers and acquisitions between firms with sizable market shares. Normally, a government would be interested in deterring mergers and

acquisitions that would significantly harm competition. Are the big deals motivated by industrial policy concerns aimed at making the Korean firms in target industries competitive in the world market?

Another crucial question relevant to the arguments concerning big deals is why we have not observed efforts by the firms involved or their management to merge before big deals were proposed. The most common criticism directed at big deals is that they would severely reduce competition in the relevant industries. If big deals indeed reduce competition severely and increase the combined value of the firms to be merged, the firms must have an incentive to merge. However, mergers are rare in Korea.

The main reason why the Korean government may be interested in big deals is that the firms in question are heavily indebted and cannot pay back their debts. As the dominant shareholder of several banks, some of which have recently been effectively nationalized in the course of restructuring since the onset of the crisis, the government was and still is keenly interested in minimizing the losses of the banks. In other words, the government could have reason to hope for mergers between ailing firms with huge amounts of debt if the merger increases the combined profit streams as a way to minimize the losses to the banks.

However, such a merger would require a *chaebol* family to relinquish its ownership and control of a large firm which it has controlled with little of its own at stake. Further, in cases where the net value of the firms after the debts are negligible or negative, the controlling *chaebol* family would have no incentive to hand over the shares under its control because it would receive little in return for giving up control over huge amounts of assets. Under such circumstances, it would be difficult for the management of the firms to agree on conditions for a merger. In fact, big deals have not been proceeding smoothly precisely for this reason.

Even if a big deal goes through, as has been the case with semiconductors, there remains the question of whether the benefits from the merger more than offset the loss of efficiency from the reduced competition. In the case of the semiconductor industry, there seem to be few experts who believe that the merger would substantially reduce competition in the market because the relevant market is the world market.

Our final comment on big deals is that the Korean government could have followed an alternative path in coping with the firms that were included in the proposal for big deals, namely workouts. 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. If they were to agree on a merger, it should then be up to the FTC to determine whether to allow the merger based upon efficiency criteria.

Ⅶ. Bank Insolvency Regimes

The relevant law in Korea is the Act on Structural Improvement of a Financial Industry. Originally known as the Act on Merger and Transfer of Financial Institutions in 1991, this law underwent comprehensive revision in 1996 with a different title to encourage healthy financial institutions to merge and weak institutions to exit. Although there were several financial institutions with serious problems, and despite growing concern regarding the poor business practices of Korea's banking industry, this Act was never used to restructure or liquidate any financial institutions. Most of the problems were not exposed publicly or dealt with judicially. Some financial institutions were merged or acquired by other institutions under the guidance of the Ministry of Finance.

The financial crisis finally provided an opportunity to apply this act openly. The law gives the Financial Supervisory Commission (FSC) the authority to order management improvement measures, including the amortization of stocks, suspension of directors, appointment of a trustee, transfer of businesses and third party acquisitions. The FSC may also suspend a bank's business for a stipulated period and ask the Minister of Finance to cancel the bank's license.

On December 22, 1997, the FSC issued a management improvement order to Seoul Bank and Cheil Bank, two of the five largest banks. Two months later, the FSC issued management improvement orders to twelve banks that did not meet the BIS ratio. After reviewing management normalization plans and performing on-the-spot examination of assets, the FSC announced the liquidation of five banks and their acquisitions. Seven other banks have been restructured through mergers, new investment of foreign capital and trimmed business operations.

The application of the Structural Improvement of a Financial Industry Act raised

controversy over the legitimacy of some of its provisions. The Act provides that through an agreement between two parties and with the public notice appearing in newspapers, all assets and debts of an insolvent bank are transferred collectively to the acquiring bank. This provision is criticized for lacking creditor protection measures that are generally provided under the Civil Code and Commercial Code. Another point of contention involves allowing the transfers to take place without a special resolution from a general meeting of shareholders, which is required by the Commercial Code in the event a company transfers all or a part of its business. The issue of constitutionality has also been raised regarding the provision that the FSC solely determines the take-over bank. These criticisms, however, have not stood in the way of continuous implementation of the Act.

After an on-the-spot examination of assets, the Ministry of Finance and Economy cancelled the licenses of sixteen out of a total of thirty merchant banks between February and August 1998. The surviving fourteen merchant banks have also been continuously monitored for proper execution of their Rationalization Plans and maintenance of the BIS ratio.

The crisis drove two securities houses into bankruptcy, and the FSC suspended the business license of two other brokers. Four securities brokers whose net capital ratios fell below 100 percent were asked to submit Management Rationalization Plans. Business at two of these firms was suspended in September 1998, and the other two firms are being monitored for their implementation of the plans.

Following the evaluation of eighteen life insurance companies and four insurance companies that lacked payment ability, the FSC ordered the suspension of four companies and their acquisition by a third party in August 1998. The remaining sixteen insurance companies have been implementing Management Improvement Plans. Two surety insurance companies have undergone restructuring by merging with their

subsidiaries and laying off workers. The government had KAMCO purchase the unclaimed rights of reimbursement of these entities amounting to 1 trillion won.

As leasing companies are not subject to the Act on Structural Improvement of a Financial Industry, the Credit Management Fund carried out an on-the-spot assessment of the financial status of twenty-five leasing companies according to the Specialized Credit Financial Business Act. After reviewing the management rationalization plans of the ten leasing companies, they were liquidated or transferred to a bridge lease company. The leasing companies whose majority shareholders were the five liquidated banks were also included among the ten.

Among the thirteen investment trust corporations, one license was revoked and six companies voluntarily liquidated their operations. The remaining six companies have been implementing their management rationalization plans.

There are 230 mutual credit unions in Korea. Twenty unions in poor financial condition have been undergoing "management monitoring" (kyungyoungkwanri) according to the Mutual Credit Union Act. The government also established a bridge union in September 1998 to liquidate those unions with little chance of recovery. Thirty-six of 1,653 credit co-ops (sinhyup) have been under Management Supervision (Kyungyoung- jido). Twelve co-ops are being liquidated.

Ⅷ. Problems, Future Tasks, and Trends

Insolvency laws expand in periods of economic turmoil. Most countries follow this pattern, and Korea is not an exception. The preliminary study aimed at amending insolvency-related statutes began in 1996, before the onset of the crisis, to enhance the efficiency of the exit mechanism in the economy. The financial crisis and the agreements with the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank) only hastened the effort, which was concluded in early 1998. In this section, we first summarize the main features of the most recent amendments to the Corporate Reorganization Act as well as the discussions on the proposed revision that has been submitted to the Congress recently.

Ⅷ-1. Key Aspects of the Recent Amendments to Corporate Reorganization Act

The following is a synopsis of the 1998 amendments to the Corporate Reorganization Act and the Composition Act.

a. Economic Viability Test

Instead of the likelihood of rehabilitation and public interests considerations, an economic viability test was adopted as a criterion for initiating the reorganization process, which compares the liquidation value of a company's assets and the value of a reorganized company as a going concern.

b. Administration Committee

An administration committee, similar to the U.S. Trustees in some respects, was

established to provide courts with expertise and administrative services. It is composed of accountants and lawyers with experience in corporate reorganization.

c. Time Limitation

To expedite the reorganization process, the following time limits were stipulated. Orders of stay should be issued as a provisional measure within 14 days of filing of the petition, while orders for initiating the composition proceedings should be issued within 3 months of filing the petition (extendible up to one month). Reorganization plans should be submitted within four months (extendible up to 2 months) of the commencement of the proceeding and the vote on a reorganization plan must be taken within a year of commencing the reorganization process (extendible up to 6 months in case of extreme circumstances). For reorganization plans, restructuring should be completed within 10 years. These limitations, however, tend to be interpreted not as mandatory but as recommended provisions by the courts.

d. Amortization of Shares and Mandatory Assessment

The 1996 Rule provided that the court should amortize shares owned by controlling shareholders in charge of management. The rule was criticized because it lacked a statutory foundation. The 1998 amendment stipulated that more than half of existing shares should be amortized in cases where the amount of debts exceeds that of assets, and more than two-thirds of shares of the controlling shareholders should be amortized if they are liable for bankruptcy.

Assessment is a summary procedure to examine the liability of directors and auditors for bankruptcy and to order them to pay damages. Although stipulated in the 1996 Rule, it has never been applied. The 1998 amendment made the assessment mandatory in the reorganization procedure to induce proper conduct in management.

e. Creditors' Conference

Creditors had complained that sufficient information was not given to them both before and after the commencement of reorganization. The Creditors' Conference is designed to serve as an information channel for creditors, linking the court-appointed trustee and the company. It is also expected to function as a forum for creditors to discuss their concerns in the process.

Ⅷ-2 Proposals for Further Revision

The Government has prepared another revision draft this year which are scheduled to be officially proposed to the National Assembly in November. Following is a summary of several key features in the proposed revision.

The Corporate Reorganization Act does not allow an automatic stay on the filing of a reorganization petition. Thus a debtor normally files a petition of provisional protection measures at the same time when the reorganization petition is filed. It takes less than a few weeks for the court to issue the order of provisional protection measures. After the stay order, the court appoints an examiner who performs due diligence and reports to the court whether the going concern value is greater than the liquidation value. The court decides on the commencement of the reorganization procedure after reviewing the report. It takes at least three or four months after the stay order.

There has been criticism the reorganization procedure of Korean companies is too slow. In response, the government has tried to speed up the initial process. The automatic stay was initially considered. However, the legal society as well as public opinion showed negative responses to the automatic stay. It was viewed by many to be

too favorable to the shareholders and managers of debtor firms as a debtor firm can easily obtain protection from creditors by just filing a petition. Subsequently, the government gave up on automatic stays and instead chose to shorten the time for the court to issue the commencement order to as little as one month. The commencement order has the power to stop all actions against the debtor's assets like the automatic stay. Pursuant to the Draft Amendment, the court seems willing to grant the ruling to most companies filing the petition.

To prevent the abuse of filings, mandatory adjudication of bankruptcy has been introduced by the 1998 amendments. The 1999 Amendment Draft further provides that the court shall send the reorganization case to liquidation procedure in the case that the reorganization procedure fails to proceed. The 1999 Draft Amendment makes the effects of reorganization procedure valid, in the event that the process moves from corporate reorganization procedure to the state of liquidation.

To speed up the negotiation process, the Draft requires lower standards for the approval of a reorganization plan. A reorganization plan may be approved by a minimum of three-fourths rather than four-fifths of secured creditors at the creditors' meeting, as required by the current law.

The exercise of right of avoidance is to be activated. The court is authorized to order the reorganization trustee to exercise the right of avoidance upon creditors' motion if the trustee fails to exercise the right of avoidance in a timely fashion. The avoidable payments are to be extended to the payments performed within 60 days before the application of bankruptcy, up from 30 days.

As the Commercial Code adopted the division and the division-merger of corporations, the Draft permits the debtor company to be divided and/or to be merged with other companies under the reorganization plan.

It also introduces security deposit to the court for the purpose of preventing parties from appealing to delay the procedure.

The Draft Amendment of the Composition Act and Bankruptcy Act have been drafted based on similar reasoning as in the Corporate Reorganization Act.

The period is mandated to one month for the court to determine whether to commence composition procedure after the filing of the petition. The Composition Act already has the provision that the court shall declare bankruptcy in the event that the composition procedure fails to proceed. The 1999 Draft Amendment makes the effects of composition procedure valid when the process moves from composition proceeding to the bankruptcy procedure.

There was criticism by some experts that the composition procedures are abused and only led to the delay the liquidation of insolvent companies. The Draft Amendment authorizes the court to order the appellant to deposit a certain amount of money, which might be put into the bankruptcy estate in case of the dismissal of the appeal.

The court may dismiss the petition for composition procedure if it finds the gross mismanagement of directors as a cause of financial distress. It may also discontinue the composition procedure even after the commencement if mismanagement or massive debts are uncovered.

As for the Bankruptcy Act, a few provisions are being implemented in the 1999 Draft Amendment.

Claims of wages, severance payments and compensation for injury at workplaces are to be added to the category of the estate claim, which has priority over a general bankruptcy claim.

The court may order the bankruptcy trustee to exercise the avoidance of power as in the corporate reorganization procedure and the composition procedure.

The application of small bankruptcy procedure, which has a summary process, is to be extend to the company the value of which bankruptcy estate is less than 200,000,000 korean Won

As mentioned earlier, Korea has three statutes on insolvency that have different historical backgrounds and purposes. There have been a lot of discussions on the desirability and feasibility of having a unitary Act. A special project to draft the unitary insolvency act would be launched next year. As the government plans to propose the unitary insolvency act in a few years, the 1999 Draft Amendment covers just a few restricted areas in order to evade any practical confusion. Thus the 1999 Draft Amendment is temporary in nature.

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