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# REPUBLIC OF KOREA

## FINANCIAL SECTOR ASSESSMENT PROGRAM

September 1, 2020

# TECHNICAL NOTE

## INSOLVENCY AND CREDITOR RIGHTS

The content of this Technical Note is based on information available as of end-June/December 2019, before the global intensification of the COVID-19 outbreak. It focuses on the Republic of Korea's medium-term challenges and policy priorities and does not cover the outbreak or the related policy response, which has since become the overarching near-term priority.

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This Technical Note was prepared in the context of an IMF Financial Sector Assessment Program (FSAP) in the Republic of Korea in August 2019 and December 2019 that was led by Udaibir Das. Further information on the FSAP can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>

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## Glossary

ARS	Autonomous Restructuring Support
CCRS	Credit Counseling and Recovery Service
CRO	Chief Restructuring Officer
CRPA	Corporate Restructuring Promotion Act
DRBA	Debtor Rehabilitation and Bankruptcy Act
FSC	Financial Services Commission
FSS	Financial Supervisory Service
KAMCO	Korea Asset Management Corporation
MoU	Memorandum of Understanding
SME	Small and Medium Enterprise
SRP	Summary Rehabilitation Proceeding
UAMCO	United Asset Management Company
UNCITRAL	United Nations Commission on International Trade Law
WB	World Bank

## EXECUTIVE SUMMARY<sup>1</sup>

**The Korean insolvency and creditor rights framework is complex and has undergone several reforms in recent years.** Consistent efforts to enhance the efficiency and effectiveness of the insolvency system have been made since the Asian crisis by the multiple government agencies that oversee the functioning of the insolvency framework in Korea. This note summarizes the key findings of the analysis of select aspects of the Korean insolvency and creditor rights system against the international standard.<sup>2</sup> While the framework for personal insolvency is also discussed (See Annex), its analysis is not prescriptive, as there are no international best practices in this area.

**The regime for creditor rights and insolvency is largely in line with international best practice.**

The rules for registration and enforcement of security are generally efficient and consistent with the standard, with the exception of certain unregistered security interests created under the customary retention of title arrangements known as *Yangdo-Dambo*.<sup>3</sup> The legal framework provides debtors and creditors with a wide-ranging menu of in-court and out-of-court restructuring options, which are generally regarded as efficient and cost effective. However, there are disincentives for early filings and post commencement financing. In particular, director's duties in the period approaching insolvency are not specified; the law is silent on *ipso facto* clauses (clauses providing for automatic termination upon insolvency filing) in executory contracts; and post-commencement financing is not given the same high priority in liquidation as it is in reorganization.<sup>4</sup> Further, in-court reorganization procedures rely on a significant degree of court supervision and there is no insolvency administrators' profession in Korea. Judges rotate to other commercial matters frequently (every 2-3 years in the Seoul Bankruptcy Court, and every 1-2 years in the district courts). Finally, experience and expertise at the regional courts appears to be uneven and some judicial training and capacity building may be helpful.

**Korea is one of the few Asian countries that has a modern insolvency and debt restructuring regime for individuals.** The procedure may be used for both business and consumer debts (or a mix of the two). Court supervised repayment plans or liquidations are both followed by a discharge, and an out-of-court debt-restructuring process is also facilitated. The rights of secured creditors are safeguarded under the current framework. As there is no international best practice with regard to

<sup>1</sup> The author of this note is Anjum Rosha (IMF), member of the FSAP 2019 team led by Udaibir Das. The analysis has benefitted from discussions with the staff of the BOK, FSC, FSS, the Korea FSAP team, and reviewers at the IMF.

<sup>2</sup> The international standard is composed of the World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes (the "World Bank Principles") and the recommendations of the UNCITRAL Legislative Guide on Insolvency Law ("UNCITRAL Legislative Guide").

<sup>3</sup> These arrangements may in certain cases be unregistered and thus creditors are not notified regarding the existence of such security. However, banks and AMCs who are the main secured creditors explained that they do not generally regard *yangdo-dambo* as a constraint to a well-functioning system.

<sup>4</sup> Legislative amendments in February 2020 appear to address the concern regarding the priority accorded to post-commencement financing in liquidation. As few details are available at this time, this amendment has not been factored into the analysis for this paper.

consumer insolvency, no specific recommendations are formulated. As mortgages comprise a significant proportion of bank's exposure to households, the need to balance social considerations related to home ownership with the risk to the banking system is key. Any social protection programs under consideration could be designed to promote continued debt-servicing based on the debtor's ability to pay and be linked to good-faith behavior (e.g. information disclosures, reporting changes in circumstances) so as to limit the potential for moral hazard and strategic defaults.

**Table 1. Korea: Main Recommendations**

Recommendation	Timeline	Action Required	Responsible Institution(s)
Undertake a study of <i>Yangdo-Dambo</i> (retention of title) with a view to adopting any reforms necessary	Medium Term	Administrative	MOJ
Clarify Director's duties in the period approaching insolvency	Medium Term	Amendment to the DRBA	MOJ (primary), and FSC
Limit the enforceability of automatic termination clauses in insolvency	Medium Term	Amendment to the DRBA	MOJ (primary), and FSC.
Ensure same priority to post-commencement financing in liquidation as it has in reorganization	Medium Term	Amendment to the DRBA	MOJ (primary), and FSC.
Establish an insolvency practitioners' profession	Medium Term	New legislation/regulation	MOJ (primary), and FSC.
Limit judicial rotations to allow expertise to develop	Immediate	Administrative	MOJ, courts

## INTRODUCTION

**1. This background note assesses select aspects of the Korean insolvency and creditor rights system against the international standard.**<sup>5</sup> In light of the risks and priorities identified in the 2020 FSAP, four selected issues in the Korean insolvency framework are analyzed, namely: (i) secured credit; (ii) reorganization procedures, with special emphasis on micro and small business rehabilitation; (iii) insolvency of enterprise groups; and (iv) the institutional framework. Annex 1 to

<sup>5</sup> The international standard is composed of the World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes (the "World Bank Principles") and the recommendations of the UNCITRAL Legislative Guide on Insolvency Law ("UNCITRAL Legislative Guide").

this note also briefly discusses the framework for personal insolvency. As there are no international best practices in this area, the analysis of personal insolvency is not prescriptive.

**2. Extensive insolvency legal reforms have taken place in Korea in recent years.** These include establishing the Summary Rehabilitation Proceeding for Small and Medium Enterprises (SMEs) in 2015, strengthening provisions for expedited restructuring in 2016; establishment of the Seoul Bankruptcy Court in 2017; setting up the Credit Counseling and Recovery Service in 2017; establishment of the New Start Counseling center and institution of the S-Track program to facilitate SME restructuring in 2018; and reducing the discharge period for entrepreneurs from 5 years to 3 years in 2018.

**3. There are multiple government agencies responsible for insolvency policies and oversight.** These include the Financial Services Commission (responsible for financial policy and financial supervision including the supervision of financial institutions), the Ministry of Justice, and more recently, the insolvency courts.<sup>6</sup>

**4. The traditional landscape for corporate financing in Korea is changing.** The growth of internet-only banks providing largely unsecured loans, asset management companies and private equity debt investors creating a demand for distressed debt assets, and increased access to capital markets by corporates are some emerging characteristics of the dynamic environment within which the insolvency framework functions.

## SECURED CREDIT

**5. The law governing security creation and enforcement is largely adequate.** The *Civil Execution Act* and the *Act on Security over Movable Property and Claims* establish clear rules for granting security interests over immovable property and movable property respectively. Pursuant to the *Registration of Real Estate Act* (for immovable property) and *Act on Security over Movable Property and Claims* (for movable property), creditors may register the establishment, transfer, alteration or cancellation of their security interest in property. There are clear rules of priority between creditors. The *Civil Execution Act* deals with procedural rules for enforcement of different types of security interests. Court data on real estate foreclosures is available and indicates that on average enforcement takes a little over 1 year. There are no significant delays or backlogs of cases in court (See Table 2).<sup>7</sup>

<sup>6</sup> The Bank of Korea and the Financial Supervisory Service (FSS) also play a limited role.

<sup>7</sup> There are no summary enforcement or out-of-court enforcement procedures.



**Table 2. Korea: Data on Enforcement of Collateral Over Immovable Assets**

Classification		Year	Number of applications	Number of cases handled				Average duration from application to the final judgement by the court (days)	
				Total	Cases with recovery proceeds	Withdrawal	Others (Incl. Dismissals and Transfers)	Paying out Dividends	Others
Real estate	Forced sale	2017	31,473	31,137	10,421	16,328	4,388	370.6	151.6
		2018	30,602	30,767	10,024	15,992	4,751	384.1	156.0
	Voluntary sale	2017	35,094	34,359	21,525	11,035	1,799	370.0	153.3
		2018	38,199	34,369	21,463	11,042	1,864	377.8	156.7

Source: Judicial Yearbook, May 17, 2019

**6. While the creditor rights framework is largely consistent with the standard, there are some customary forms of security that warrant further study.** A special type of retention of title arising from customary law (*Yangdo-Dambo*) is widely used in practice and is recognized by the courts. *Yangdo Dambo* is typically over movables and is unregistered.<sup>8</sup> As it is unregistered, the manner of notification and perfection of a *Yangdo-Dambo* security interest is not in line with the standard.<sup>9</sup> While the main providers of finance do not report this to be a significant obstacle to effective use of the framework, consideration could be given to undertaking a study of *Yangdo-Dambo* to assess whether the lack of registration leads to delays in enforcement, impairment of creditor rights, or any other inefficiencies with a view to introducing any reforms necessary to align this technique with the general law applicable to security interests. Additionally, Korean law recognizes security rights arising from *Jeonse*, a special type of lease arrangement. Under *Jeonse*, the lessee provides a substantial deposit, known as “lease key money” to the lessor, in lieu of paying monthly rent. The deposit can be up to 80% of the market value of the leased property and to secure the amount paid, the lessee acquires a security interest in the real property (the *Jeonse* right). As registration of the lessee’s *Jeonse* right in the real estate registry can be expensive, it is typically

<sup>8</sup> While *Yangdo-Dambo* over an immovable asset such as real property is possible, such claim must be registered. Creation of *Yangdo Dambo* over movable property does not always require the physical delivery of the movable property to the creditor and the movable asset may remain in the debtor’s possession. Quite apart from the *Yangdo Dambo*, under the Act on Security over Movable Property and Claims, a regime for creation and registration of security interests over movables exists and is consistent with the standard.

<sup>9</sup> See World Bank Principle A5: There should be an efficient, transparent and inexpensive means of providing notice of the possible existence of security rights in regard to the grantor’s movable assets, with registration in most cases being the principal and strongly preferred method, with limited exceptions. The registration system should be easily accessible and inexpensive with respect to recording requirements and searches of the registry, and should be secure.

recorded through notification to the Community Service Center instead. The general rules of priority apply with regard to *Jeonse* rights.<sup>10</sup>

## INSOLVENCY SYSTEM OVERVIEW

**7. Korea adopted a unified insolvency law, the Debtor Rehabilitation and Bankruptcy Act (DRBA), in 2006.** The DRBA includes (i) a rehabilitation procedure for corporates and individuals; (ii) a streamlined summary rehabilitation procedure (SRP) for SMEs; (iii) a rehabilitation procedure for individuals with small debts; (iv) a liquidation procedure for individuals and corporates which includes a summary liquidation procedure for SMEs; and (v) provisions for cross-border insolvency that are broadly based on the UNCITRAL Model Law on Cross-Border Insolvency with some modifications (See Table 3).

**Table 3. Korea: Snapshot of Procedures under the DRBA**

Proceedings	Eligible Debtors	Maximum Debt	Claims Resolved	Maximum Repayment Plan Period
<b>Rehabilitation</b>	Corporates and Individuals	N/A	All (secured, unsecured, equity)	10 years
<b>Summary Rehabilitation Proceedings</b>	SMEs	KRW 3 billion	All (secured, unsecured, equity)	10 years
<b>Individual Rehabilitation</b>	Individuals with personal and business debts	Secured: KRW 1 billion Unsecured: KRW 500 million	Unsecured	3 years
<b>Liquidation and Summary Liquidation</b>	Corporates and individuals	N/A	Unsecured	N/A
	Corporates and individuals	No more than KRW 500 million in assets of the estate	Unsecured	N/A

Source: Adapted from materials provided by the MOJ

**8. The Corporate Restructuring Promotion Act (CRPA) provides a statutory framework for out-of-court debt restructuring between a debtor and its financial creditors.** The CRPA was first enacted in 2001 as a temporary law aimed at promoting the reorganization of large corporates. It has been extended for 5-year intervals (with some gaps), and the most recent extension was in October 2018.<sup>11</sup> Initially designed for large corporates and select financial institutions, the scope of

<sup>10</sup> *Jeonse* rights are further complicated by the fact that there may be a pre-existing mortgage on the property, or the lessee may borrow part of the *Jeonse* key money from a bank.

<sup>11</sup> The CRPA is currently scheduled to expire on October 15, 2023.

the CRPA has been expanded to cover all corporates, including SMEs.<sup>12</sup> and all financial creditors, not just financial institutions. Thus, the CRPA has been transformed from its initial conception as a formalized London-Approach-style arrangement for facilitating multi-creditor workouts between banks to a more broad-based statute.

## REORGANIZATION AND CORPORATE WORKOUTS

### A. Description of the System

#### 9. Corporations in Korea have several options for reorganization and debt restructuring.

These include (i) a court-supervised formal rehabilitation procedure under the DRBA involving all creditors, (ii) a hybrid “prepack” process under the DRBA with select creditors, (iii) an out-of-court debt restructuring under the CRPA with financial creditors only, and (iv) a voluntary agreement with select creditors (See Table 4). A brief overview of these is as follows:

- **Reorganization under the DRBA is a court-supervised process.** Either the debtor corporation or its creditors may initiate reorganization if the debtor is unable to pay its debts when they are due without serious hindrance to the continuation of its business, or the debtor is likely to become insolvent.<sup>13</sup> There is no automatic stay on enforcement actions by creditors at the time of the application (although such a stay may be requested), and a stay applies automatically upon commencement. The debtor typically remains in possession of the business unless the court decides otherwise. Creditors are classified into secured and unsecured creditors and each creditor group may be further sub-classified. The reorganization plan is confirmed by the court after it is approved by creditors holding at least 2/3 of the value of unsecured claims and creditors holding at least 3/4 of the value of secured claims (liquidating plans require a 4/5 majority of secured creditors), and in cases where the debtor’s liabilities do not exceed its assets, equity rights holders with at least 1/2 of the equity approve the plan. If the plan does not successfully secure the majorities required, the court may modify and approve the plan, provided the rights of affected dissenting creditors are protected and at least one class of creditors has consented to the plan.
- **An expedited hybrid procedure formally known as “prior rehabilitation proposals” (and colloquially called “P-Plans”) is available under the DRBA.** Creditors holding at least fifty percent of the claims or a debtor with the consent of such creditors may develop a rehabilitation plan out-of-court and submit it to the court for voting by the creditors’ assembly.<sup>14</sup> This process

<sup>12</sup> Until 2015, only debtors with very large loan exposures could use the CRPA. Now, all but the smallest debtors have access to the CRPA. In 2018, the joint administrator-ship procedure under the CRPA was relaxed for SMEs to provide greater flexibility in inspection and evaluation cycles by the principal creditor and enhanced the possibility to keep the debtor’s information confidential.

<sup>13</sup> Insolvency refers to the debtor’s inability to pay debts in an ordinary continuous manner due to the lack of capacity to effect performance (cash-flow test); or the case where the amount of the debtor’s liabilities exceeds the value of its assets (balance-sheet test).

<sup>14</sup> In theory, the court could also accept a commitment to develop the plan in lieu of a full-fledged plan.

is designed to expedite the adoption of a rehabilitation plan and blends the speed and flexibility of out-of-court processes with the advantages of an in-court process such as a court-ordered stay on creditor enforcement actions, and the ability to bind minority creditors to the plan. The P-Plan was conceived in part to facilitate agreements reached under the CRPA to be confirmed by the court under the DRBA.

- **The CRPA facilitates an out-of-court debt restructuring agreement between the debtor and its financial creditors.** The principal financial creditor may notify the debtor corporation of its assessment of the debtor's "signs of insolvency" (i.e., difficulties in performing its obligations in the ordinary course of business such as repayment of a loan borrowed from a financial creditor without additional cash flow outside of ordinary borrowings). The debtor may commence rehabilitation discussions either with the principal financial creditor only (*administrative proceeding by the principal creditor*); or with all its financial creditors (*joint administratorship proceeding*) and propose a rehabilitation plan. The debtor remains in possession of the business, and creditors may agree to standstill on creditor enforcement actions. Confirmation of the plan requires consent of participating financial creditors holding at least 3/4 of the claims by value. Where a single creditor holds 3/4 of the claims, the resolution requires consent of 2/5 of the number of creditors. Dissenting creditors have the right to be bought out by the other creditors. Disagreements between creditors are mediated by the Creditors' Coordination Committee. Only participating creditors are impacted by the restructuring. The FSC may levy fines for failure to abide by the CRPA.<sup>15</sup>
- **A voluntary agreement may be entered into between a debtor and one or more creditors.** Such informal debt restructuring entails confidential negotiations between the debtor and one or more creditors out-of-court following which the parties could consent to changes to the original contract. Such agreements have the benefit of confidentiality and flexibility, but they only bind participating creditors.

**10. The Seoul Bankruptcy Court has devised a new process called Autonomous Restructuring Support (ARS) to promote restructuring.** Under the ARS, a debtor's insolvency petition is accepted by the court but kept in abeyance for 3 months to allow the parties time to reach an agreement out of court.<sup>16</sup> If the parties reach agreement, the petition can be withdrawn. ARS permits parties to benefit from a stay on creditor action while negotiations are ongoing.

**11. Considerable additional support for SME rehabilitation is available.** SMEs make up over 99 percent of the total number of enterprises (about 38 percent are unincorporated micro-enterprises and 25 percent are small enterprises), and account for 51 percent of added value.<sup>17</sup>

<sup>15</sup> A 7-member mediation committee facilitates decisions in case of differences of opinions between financial creditors.

<sup>16</sup> Typically, commencement takes place within 30 days of filing.

<sup>17</sup> <https://www.mss.go.kr/site/eng/02/1020200000002016111504.jsp>. In November 2018, the Small and Medium Business Administration (SMBA), previously a division under the Ministry of Trade, Industry and Energy, was elevated to the Ministry of SMEs and Startups to signal the importance of SMEs.

Domestic banks have significant exposure to SMEs (40 percent of their total loan portfolio). Most SME loans are collateralized against real estate. Against this background, the authorities have developed an extended toolkit for SME rehabilitation. A brief overview of the main elements is as follows:

- **The Summary Rehabilitation Proceedings (SRP) under the DRBA is a streamlined procedure that aims to reduce costs, increase efficiency, and boost the chances of successful plan adoption.** SMEs with debts of no more than KRW 3 billion may access the process. The SRP modifies the corporate rehabilitation procedure described above by eliminating the need for a custodian and an inspector in most cases. An inspection commissioner who is an accountant or a court official may be appointed, with simplified duties under Supreme Court Regulations. In addition, a creditors' council is not required in all cases; and the voting thresholds for adoption of a plan are relaxed.<sup>18</sup>
- **Owners of unincorporated businesses are eligible to use the procedure for individual rehabilitation provided they meet the debt thresholds for the procedure.**<sup>19</sup> This simplified procedure enables individuals to restructure all debts (business and personal) in a single proceeding. The maximum repayment plan period is generally 3 years. However, secured creditors are generally not part of the proceeding, which applies only to unsecured debts. In addition, individuals may also benefit from the Credit Counselling and Recovery Service for their business debts. (For details see Annex)
- **Several government programs offer support for SME rehabilitation.** These provide SMEs with expert advice, help defray the cost of the procedure as well as the cost of restructuring and provide enhanced access to fresh financing on which a restructuring generally depends.<sup>20</sup>
- **To improve access by SMEs to these numerous schemes, in 2017-2018, the Seoul Bankruptcy Court launched S-Track.** S-Track is a program designed to integrate and link various SME support programs offered by different agencies and is available to enterprises with debt of less than KRW 15 billion.<sup>21</sup>

<sup>18</sup> A rehabilitation plan under the SRP may be adopted by unsecured creditors with the consent of either (i) creditors holding at least 2/3 of the value of unsecured claims; or (ii) creditors holding at least 1/2 of the value of unsecured claims and a majority of the persons with voting rights.

<sup>19</sup> Secured debts may not exceed KRW 1 billion, and unsecured debt may not exceed KRW 500 million.

<sup>20</sup> An illustrative list of these includes (i) the SME Rehabilitation Consulting Program; (ii) the SME Equity Retention Scheme; (iii) Preauthorization M&A scheme; (iv) SME Fast Financing Support Program, (v) Negotiation support program, and (vi) programs under the comprehensive re-challenge center.

<sup>21</sup> The program comprises of (i) pre-petition and petition support through counseling on options available to distressed SMEs including the various support schemes; (ii) appointing a restructuring officer that serves as a mediator and offers support to debtors in their negotiations with creditors and assists with exit options for the debtor through business sale; and (iii) financial support towards costs of proceedings and cost of implementation of a restructuring plan and establishing an "Equity Retention" plan that enables the entrepreneur to earn back equity in the business following a debt-to-equity swap.

Table 4. Korea: Restructuring Options

	Out of Court Options		Hybrid Processes		In-Court Process
Options for Restructuring	Voluntary workouts	Workouts under the CRPA	P-Plans	ARS	Reorganization under the DRBA
When available?	Anytime	Upon debtor's application (when creditor determines "signs of insolvency")	Pre-insolvency/insolvency	Insolvency	Debtor is unable to pay its debts without serious hinderance to its business or debtor is insolvent
May be used by SMEs?	Yes	Yes, with provisions for additional flexibility and confidentiality	Yes	Yes	Special procedure known as "SRP" for SME's with debts below prescribed threshold; and entrepreneurs may also use procedure for individual indebtedness.

Source: IMF Staff Summary

## B. Use and Practice

**12. A range of creditors participate in the insolvency system.** In addition to banks that are the traditional financial creditors, asset management companies, distressed debt investors and other capital market players have credit interests in corporate rehabilitation.<sup>22</sup> There is a robust market for NPLs led by the privately-owned United Asset Management Company (UAMCO). Banks may request the state-owned Korea Asset Management Corporation (KAMCO) to purchase their NPLs. UAMCO undertakes corporate rehabilitation including through injection of liquidity into the business and mergers and acquisition (M&A) activity. KAMCO, on a much smaller scale than UAMCO, uses several techniques such as sale-and-lease-back arrangements to facilitate corporate rehabilitation. The K-Growth Fund is a fund of funds investing in the rehabilitation of distressed corporates using similar techniques.

**13. Significant corporate debt restructuring activity takes place through voluntary out-of-court agreements.** The continued stigma associated with insolvency, and a cultural preference for confidential out-of-court workouts contributes to this preference. The use of *ipso facto* clauses<sup>23</sup> in contracts is common contributing to debtors' reluctance to initiate formal proceedings. Stakeholders also noted that debtors prefer out-of-court workouts as they are less likely to impact on shareholder control over the business. Although the reorganization procedure is generally a debtor-in-

<sup>22</sup> Tax creditors also participate in the process. As a matter of practice, their claims are generally paid with priority under a rehabilitation plan (although the DRBA does not mandate such priority).

<sup>23</sup> An *ipso facto* clause entitles a party to immediately terminate a contract on the occurrence of a counterparty's insolvency.

possession procedure, in many cases reorganization involves debt-to-equity swaps which dilute main shareholders or operational restructuring resulting in a change of management of the business. Use of personal guarantees for business debts is a common practice that also disincentivizes early filings. Although evidence suggests that voluntary agreements are widespread, as these negotiations remain confidential, data is difficult to obtain.

**14. Involuntary insolvency petitions against a debtor filed by creditor banks are rare.** In addition to certain cultural norms and the overarching view that private banks also serve an important public function, there are disincentives for banks to initiate formal proceedings. For instance, a formal insolvency filing affects not just the risk classification of the loan, but also the key performance indicators for the branch of bank making the filing.

**15. The court supervised rehabilitation process under the DRBA is generally regarded as efficient.** The DRBA provides timelines for various processes, which are largely observed. The time taken for in-court reorganization is significantly lower in Seoul than in other parts of the country. The establishment of the Seoul Bankruptcy Court and initiation of the “Fast Track Program” by the court are largely credited for speeding up the process. (See Table 5).

**Table 5. Korea: Duration of Corporate Rehabilitation Proceedings**

Year	Average Days from Petition to Commencement Order (Nationwide)	Average Days from Petition to Commencement Order (SBC)	Average Days from Commencement Order to Approval of Rehabilitation Plan (Nationwide)	Average Days from Commencement Order to Approval of Rehabilitation Plan (SBC)
2017	35.2	18.7	212.6	175.7
2018	34.4	19.8	212.1	159.6

Source: Nationwide Court Data and Data from the Seoul Bankruptcy Court

**16. Both financial and operational restructuring is common.** Debt-to-equity swaps are frequently used as a technique to dilute existing shareholders and eventually change the management of the company. Recently, “stalking horse bids” have gained popularity in Korea. If the debtor identifies a prospective buyer – “the stalking horse”- it may, with the permission of the court, enter into a conditional agreement with such buyer. Once such conditional sale and purchase agreement is executed, the receiver holds an open bid auction. If another higher bidder emerges, the receiver may be required to pay the stalking horse buyer a “break-up fee” or grant the stalking horse an opportunity to submit a new “top up” bid. If no higher bidder emerges, the sale to the stalking horse proceeds. Previously, the legal framework did not allow privately negotiated deals in the interests of fairness and transparency. All sales were conducted through an open bidding competitive process, which often failed. Operational restructuring is also common, though less so among smaller enterprises.



**17. Use of P-plans is limited, and priority for fresh money provided in an out-of-court workout is not recognized in a subsequent in-court proceeding.** Preventative restructuring is not the norm. There have been less than a dozen P-plans in the courts although interest in the procedure by both debtors and creditors is increasing. Out-of-court workouts offer providers of new finance little protection in the event an insolvency petition is filed thereafter which could constrain the success of P-Plans.

**18. Challenges to successful rehabilitation persist, including the limited availability of post-commencement financing.** The authorities have recently established a specialized fund at KAMCO to facilitate post-commencement financing on commercial terms to viable businesses. The K-Growth Fund is also actively investing in the rehabilitation of distressed corporates, including pre-insolvent companies. Other challenges include the limited flexibility in practice for parties where the court is involved (i.e., under the DRBA) as there is a high level of judicial influence and discretion, which could put pressure on commercial decisions (e.g. regarding approval of a rehabilitation plan).

**19. SMEs account for about a third of all corporate reorganization petitions filed before the courts.** Within the Seoul Bankruptcy Court, there is a special bench that exclusively hears SME petitions filed under the SRP. Based on data provided by the MOJ, the streamlined process under the SRP is quicker than the regular procedure, taking on average 181 days from application to approval of the plan (compared to 247 days on average for the regular procedure).<sup>24</sup> In general, stakeholders commend its efficiency. As personal guarantees are frequently used and trigger personal insolvency concurrently with business insolvency, the same judicial panel handles both procedures in parallel and with a high degree of coordination. SMEs may also use the individual rehabilitation procedure if they are unincorporated and have debts below the prescribed threshold.

**20. The authorities have made significant efforts to promote SME reorganization.** Filings under the SRP procedure are limited to a few hundred applications per year. It is possible that a large volume of distressed SMEs use the individual insolvency procedure, engage in voluntary workouts, or become defunct without formally filing for insolvency. As with corporates more generally, the chief challenges for SMEs remain lack of early filings which negatively impact the possibility of successful business rescue, and the difficulties in securing post-commencement financing necessary for continued business operations. Further work could be done to assess whether the system effectively triages unviable SMEs for whom speedy liquidation should be the goal.

**21. Although creditors indicate a preference for workouts under the CRPA over reorganization, there have been only a handful of rehabilitation cases under the CRPA procedures in recent years** (See Table 6). The CRPA has been successfully used in the rehabilitation of large companies by financial institutions, but there is a perception of government influence over the private restructuring decisions made under the procedure. The CRPA is generally regarded as a more flexible process than the reorganization under the DRBA. However, creditor coordination

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<sup>24</sup> SRP proceedings are even quicker at the Seoul Bankruptcy Court and take an average of 119 days.



remains a significant obstacle under the CRPA given that decisions on restructuring plans require unanimity or for dissenting creditors to be bought out by the creditors in favor of the plan. A possible way to address this is through standing inter-creditor agreements between major financial institutions, or through holdout clauses in multi-creditor financing agreements, that could facilitate reaching agreement on restructuring plans. There are ongoing discussions on whether the CRPA should be a permanent legislation.<sup>25</sup> A key step in the process is careful consideration of the purpose and role of this legislation in the overall insolvency framework. For instance, the early warning function of the CRPA could be further developed. This could include expanding the set of circumstances that trigger discussions with debtors and addressing the problem of the passivity of banks monitoring the debtors: for instance, debtors could be encouraged to complete a periodic self-assessment online and pro-actively reach out to creditors.

**Table 6. Korea: Data on Corporate Insolvency Petitions**

Filings under the DRBA	2014	2015	2016	2017	2018	Filings under the CRPA*	2014	2015	2016	2017	2018
<b>Reorganization</b> (of which SRP)	873	925	936	878 (246)	980 (291)	<b>Large corporations</b>	1	12	4	8	3
<b>Liquidation</b>	539	587	740	699	807	<b>SMEs</b>	0	3	7	6	6

\* Number indicates applications received where the first creditors meeting was convened.

Sources: Nationwide Court Data provided by the Ministry of Justice and Financial Supervisory Service

## C. Analysis and Recommendations

**22. The reorganization procedure is generally well-aligned with international best practice, and a few changes would further enhance its consistency with the standard.** The DRBA is broadly consistent with the key elements of the standard including with regard to commencement, management of the reorganization, claims verification, treatment of executory contracts, class voting, and discharge for entrepreneurs. Consideration could be given to better aligning the DRBA with the standard in the following areas:

- **Directors' Duties in the Period Approaching Insolvency:** The DRBA does not address the specific duties and obligations of directors in the period approaching insolvency, although general fiduciary duties (and sanctions for violating them) are set out in the corporate law. Principle B2 of the World Bank Principles and Part IV of the UNCITRAL Legislative Guide recommend that the law should include personal liability for directors for wrongful trading. As these provisions create accountability and could serve as an incentive for early filings, their express inclusion in the DRBA may prove useful.

<sup>25</sup> The Financial Service Commission will report to the National Assembly in July 2020 on this issue.

- ***Ipso Facto Clauses:*** The DRBA is silent on the enforceability of automatic termination and acceleration clauses of executory contracts upon insolvency.<sup>26</sup> Such clauses generally serve as a deterrent to early filings and negatively impact the possibility of successful business rescue. Principle C.10.2 of the World Bank Principles and the UNCITRAL Legislative guide recommend that contract provisions that provide for the termination of the contract upon an application for commencement or commencement should be unenforceable, except in special cases such as financial contracts (derivatives, repos).
- ***Post-commencement Financing:***<sup>27</sup> The UNCITRAL Legislative Guide recommends that there should be incentives for post-commencement financing, including priority at least ahead of unsecured creditors and that such priority should be recognized in case the reorganization proceeding is converted to liquidation.<sup>28</sup> While the DRBA permits post-petition financing to have the highest priority in case of reorganization, it does not preserve this priority in case reorganization proceedings are converted to liquidation proceedings.<sup>29</sup>

**23. Finally, the rehabilitation procedure for individual entrepreneurs appears well-suited for the specific needs of small debtors.** Given the challenges in segregating business and personal debts, the DRBA includes one procedure for individuals with low debt value. This is a simplified proceeding designed to be both quick and inexpensive, and provides solutions different from those in the insolvency standard (e.g., there is no creditor voting on the repayment plan), possibly because the procedure is closer to a personal insolvency process than to traditional commercial insolvency. The procedure appears well-suited to use by individuals with small debts and is generally regarded as effective (see Annex I for more details).

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<sup>26</sup> Korean courts have held that *ipso facto* clauses in executory contracts are unenforceable as they impinge on the statutory right provided to the administrator (trustee, custodian) to assume or reject the executory contract. However, it appears that this guidance may not be universally followed and it would be useful for there to be legislative clarity on this issue.

<sup>27</sup> The DRBA was amended in February 2020 to address the concern regarding the priority accorded to post-commencement financing in liquidation. As few details are available at this time, this amendment has not been factored into the analysis for this paper.

<sup>28</sup> UNCITRAL Legislative Guide, Part Two, Chapter II, Paras 63-69. See also World Bank Principle C9.

<sup>29</sup> The DRBA also does not recognize priority to financing agreed out-of-court in a subsequent court-supervised reorganization or liquidation. This is not a requirement in the standard but including such a provision could help promote out-of-court restructuring.

## ENTERPRISE GROUP INSOLVENCY

- 24. As in other jurisdictions, there are limited provisions for the insolvency of enterprise groups in Korea.** The DRBA provides that in cases where an insolvency petition of a company is underway in a particular court, other insolvent entities that are its affiliates may also file their insolvency petition before the same court. The courts have significant discretion in case management and appear to be sensitive to the need to coordinate proceedings.
- 25. Large corporate groups, known as chaebols, do not typically borrow from banks.** The chief risk appears to be the spillover effects of insolvency of an enterprise group on other businesses, including the SMEs that are part of its supply chain.
- 26. While substantive consolidation of all assets and liabilities for enterprise groups is not recognized under the DRBA, if more than one company in a group becomes insolvent, courts have considerable discretion to facilitate procedural coordination.** Coordinated restructuring plans and the appointment of the same insolvency administrator, subject to conflicts of interest checks, are possible. Hearing dates and meetings of creditors may also be synchronized by the court as the judge-led system in Korea allows the court significant discretionary powers.
- 27. The framework appears generally consistent with the standard.** In line with World Bank Principle C.16, and Part III of the UNCITRAL Legislative Guide, coordinated reorganization (and liquidation) between entities forming part of a corporate groups appears possible.

## INSTITUTIONAL FRAMEWORK

### A. Description of the System

- 28. The implementation of the insolvency law is supervised by specialized courts.** The Seoul Bankruptcy Court established in March 2017 is an independent court that adjudicates corporate rehabilitation and liquidation as well as personal insolvency cases. It has 34 judges, and over 200 legal staff as of 2018. Outside Seoul, a bankruptcy division in each local district court has jurisdictions over insolvency cases. In high value cases,<sup>30</sup> the Seoul Bankruptcy court has concurrent jurisdiction even if the debtor's center of main interests is outside Seoul.
- 29. Procedures under the DRBA rely on a significant degree of court supervision.** In what is a novel feature of the Korean system, the court is advised by a custodial committee comprising of independent experts who assist the court in the appointment of custodians and inspectors, examine the draft rehabilitation plan, and facilitate the establishment of a creditors' committee (known as the creditors' consultative council). The courts generally mandate the appointment of Chief Restructuring Officers by debtors and are actively involved in developing a list of candidates, interviewing candidates and making a recommendation on the appointment of the CRO to the

<sup>30</sup> These are cases with more than 300 creditors and where debts exceed KRW 50 billion.

debtor. In addition, the courts rely on bankruptcy administrators who assist judges by performing routine tasks associated with insolvency matters.

**30. Insolvency judges at the Seoul Bankruptcy Court mandatorily rotate from their posts after 2-3 years to other commercial matters.** The period could be shorter in the district courts and rotations may be as frequent as every 1-2 years to other commercial matters. While insolvency judges in Korea – particularly in the Seoul Bankruptcy Court – are well qualified with significant expertise, the frequent rotations may affect the creation of deep and specialized knowledge on insolvency matters. This is a particular concern for courts outside of Seoul.

**31. There is no insolvency administrators’ profession in Korea.** Lawyers act as insolvency administrators and accountants serve as examiners in court. There are no special qualification systems or training systems for lawyers or accountants who provide bankruptcy related services. The Seoul Bankruptcy Court puts together a list of qualified examiners as candidates to be appointed by court through a custodial committee and then updates the list through periodic assessments (usually every two years). Likewise, it evaluates, manages and operates the list.<sup>31</sup> Courts in other parts of the country follow the same protocol.

## B. Use and Practice

**32. The Seoul Bankruptcy Court has emerged as a pivotal player in recent insolvency reforms.** It has developed its own programs (e.g. Fast Track Proceedings, and the S-Track) to complement the DRBA. Nearly 40% of all reorganization and liquidation cases filed in Korea are before the Seoul Bankruptcy Court. There are no serious backlogs in courts nationwide and the average time taken for the resolution of insolvency cases has decreased in recent years.

**33. There is a high degree of digitization and standardization at the court.** Most applications are made online. There are schedules, forms and templates available for use by the parties. The courts collect and report data on insolvency cases.

**34. A number of the Seoul Bankruptcy Court’s recent programs and initiatives arise from practice and not codified.** In a remarkable break from the civil law tradition, the court has created a significant body of practice (e.g. S-Track, ARS, etc.) using its discretionary powers. While strong institutions are an important pillar of a well-functioning regime, it is important for the predictability of the system that the applicable rules be clearly stated and consistently applied.

**35. Experience and expertise at the courts could be further deepened.** Stakeholders are of the view that consideration could be given to extending the period of rotations to at least 5-7 years. Further, efforts towards judicial capacity building in the district courts outside Seoul may be useful in further enhancing the institutional framework. Stakeholders also believe that judicial training and

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<sup>31</sup> Article 17, subparagraph 2 prescribes that a custodial committee shall perform management and supervision of the appropriateness of the work performed by administrators or trustees, examiners and trustees in bankruptcy under the direction of the court.

building expertise in courts outside Seoul should be the next step in strengthening judicial institutions.

## C. Analysis and Recommendations

**36. The expertise at the courts could be further deepened.** It is recommended that the period of rotations be extended to at least 5-7 years. Increased efforts towards judicial capacity building in the district courts outside Seoul could also be useful in further enhancing the institutional framework.

**37. The absence of an insolvency administrators' profession is a significant institutional gap in Korea.** The system does not regulate accreditation, supervision and monitoring of the administrators as a profession. The international standard recommends that criteria as to who may be an insolvency representative should be objective, clearly established, and publicly available.<sup>32</sup> Consideration should be given to developing an insolvency administrators' profession in line with the international standard.

**38. The introduction of an insolvency administrators' profession with requisite expertise and accountability is considered desirable.** Current experience with professionals discharging these functions is mixed. The Korean authorities reviewed the issue in early 2019, but no conclusions were reached in this regard.

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<sup>32</sup> Principle D8 of the World Bank Principles.

## Annex I. Select Considerations on Personal Insolvency

1. **Korea is one of the few Asian countries that has a modern insolvency and debt restructuring regime for individuals.** The DRBA includes a procedure for individual rehabilitation (See Annex Table 1) which may be accessed by debtors with business or personal debts below the prescribed threshold.<sup>1</sup> The rehabilitation procedure is based on a simple structure of submission of claims and liquidation of assets, concluding with the discharge of the debtor.
2. **Through this procedure under the DRBA, unsecured debts may be restructured.** A brief summary of the process is as follows. An eligible debtor may file for commencement of rehabilitation or bankruptcy proceedings. Although all creditor enforcement actions may be temporarily suspended by the court, in principle, secured creditors are not subject to the process (only unsecured debts are included). The debtor prepares a plan which is subject to a vote, and if creditors object to the rehabilitation plan, the court may still approve the plan provided certain conditions are met (e.g. that creditors receive no less than they would in liquidation, the disposable income of the debtor is used to make payments under the plan, and total payments under the plan meet a minimum threshold). The maximum repayment plan period is generally 3 years (recently reduced from 5 years)<sup>2</sup> following which the debtor's remaining debts are discharged.
3. **Despite the modern insolvency provisions in the DRBA, bankruptcy carries several disincentives and the stigma attached to bankruptcy is severe.** Although the DRBA provides that debtors should not be subject to any penalties for bankruptcy, provisions in other legislations maintaining such penalties have not been amended to eliminate these penalties (e.g., bankrupt persons are disqualified from several professions such as the law; and are not eligible to work in the public sector). As a result, there are significantly more rehabilitation applications than those for bankruptcy.

**Annex Table 1. Individual Insolvency: Number of Cases**

	2017	2018
<b>Rehabilitation</b>	81592	91205
<b>Bankruptcy</b>	44246	43397

Source: Nationwide Court Data provided by the Ministry of Justice

4. **In addition to the formal process available under the DRBA, individuals may reach out-of-court debt restructuring agreements with their creditors using the Credit Counseling and Recovery Service (CCRS).** The CCRS is a non-profit established under the *Microfinance Support Act* of 2017. Financial institutions that have entered into the Credit Recovery Support Agreement with the CCRS participate in the program.

<sup>1</sup> Secured debts may not exceed KRW 1 billion, and unsecured debt may not exceed KRW 500 million.

<sup>2</sup> In exceptional circumstances, the discharge period may be extended up to 5 years.

## 5. An individual with business and personal debts may apply to the CCRS for assistance

(See Annex Table 2). The eligibility requirements include that the debt should not exceed KRW 1.5 billion and should be either (i) owed to multiple creditors and should not be more than 90 days overdue; or (ii) owed to a single creditor but is more than 90 days overdue. There is a small application fee (KRW 50,000) which can be waived for indigent debtors. Based on the information provided by the debtor and confirmed by creditors, the council develops a repayment plan for discussion with creditors. Plans typically liquidate the debtor's assets and require the debtor's income to be used to satisfy debts. Up to a maximum of 70% of the individuals' debt may be written off under the plan, which may be 8-10 years. To the extent possible, the plan aims for the debtor to retain the family home. Agreement of a simple majority of creditors is required for plan approval. Dissenting creditors are bound by virtue of a contractual inter-creditor agreement. If the creditors agree to the plan, the original contract is deemed modified. If a debtor has no assets and no income, the CCRS encourages such a debtor to approach the court for a speedy discharge.

**Annex Table 2. Data on Debt Restructuring by the Credit Counseling and Recovery Service**

	2014	2015	2016	2017	2018
<b>Applications</b>	85168	91520	96319	103277	106808
<b>Repayment Plans Approved</b>	73925	77757	81401	89087	93136
<b>Approval Rate</b>	86.8%	85%	84.5%	86.3%	87.2%

Source: Data provided by the CCRS

## 6. The CCRS has been highly successful in the short time that it has been in operation.

Over 100,000 applications are received annually and in over 80% of the cases where a plan is proposed by the council, it has been accepted by the creditors. The CCRS also offers a pre-insolvency program. Through the CCRS debtors may also avail of additional benefits which serve as incentives to stay current on the repayment plan (e.g. access to credit cards and emergency loans, etc.).

## 7. Presently, secured creditors are typically not impacted by the insolvency of the individual.

The law allows creditors to enforce collateral and they are not required to be bound by the rehabilitation plan. The CCRS facilitates voluntary mortgage debt restructuring, typically through maturity extensions to allow debtors to maintain home-ownership. As mortgage debt is the most significant component of bank's exposure to households, it is critical to balance social considerations related to home ownership with the risk to the banking system. The authorities are considering providing more favorable treatment to debtors with mortgages, particularly for vulnerable groups. Any social protection program should be designed to promote continued debt-servicing based on the debtor's ability to pay and be linked to good-faith behavior (information disclosures, reporting changes in circumstances, etc.) so as to limit the potential for moral hazard and strategic defaults.