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Efficiency of Korean New Rehabilitation Proceeding

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Abstract

The rehabilitation proceeding under the reformed Debtor Rehabilitation and Bankruptcy Law ("DRBL"), effective as of April 1, 2006, unified two old rehabilitation procedures used for the recovery of financially distressed firms for more than forty years in Korea. However, two key elements of the previous procedures survived in the unified rehabilitation scheme with some modifications to achieve efficiency of the new rehabilitation proceeding, i.e., receiver instead of debtor-in-possession and relative priority rule ("RPR") for distribution of corporate value according to a rehabilitation plan. Under the new rehabilitation proceeding, the representative of the debtor company can be appointed as receiver of the debtor company unless it is liable for the commission of material mismanagement causing insolvency thereof. In some special cases, the representative can operate the debtor company without an appointed receiver. The RPR is revised in a way to guarantee secured and unsecured creditors at least the liquidation value of their collaterals and the corporate value. Do those modifications maximize the ex post revenue and reduce the ex ante costs, such as overinvestment effects and delay effects, of financially distressed firms? Generally speaking, the ownership and management are not separated even in large and publicly-held corporations in Korea. In such economic and legal environments, the overinvestment effects and the delay effects to experiment overinvestment become great before filing for bankruptcy. It is very important to reduce such ax ante inefficiency so as to ensure that more value of the debtor company can be distributed to its creditors. To minimize the ex ante costs, the rehabilitation proceeding should be more lenient to shareholders of the debtor company. Based on the foregoing considerations, the legislators were set to grant the shareholders incentives to file for rehabilitation proceedings at the right time through the 2006 reform, but the reform still leaves much uncertainty as to the efficiency of the united scheme to debtors and creditors.

I. Introduction

The new rehabilitation proceeding under the DRBL,[1] which took into

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1) The DRBL includes chapters on bankruptcy proceeding (equivalent to Chapter 7 of the U.S.

force as of April 1, 2006, unified two old rehabilitation procedures: (i) a reorganization procedure under the Corporate Reorganization Law ("CRL"), generally used by large companies, and (ii) a composition procedure under the Composition Law ("CL"),[2] generally used by small- and medium-sized companies and individuals. Both rehabilitation procedures regulated the recovery of financially distressed firms in Korea for more than forty years since they were first enacted in 1962.

The unified procedure reduces the ex ante costs of choosing one procedure over the other as well as the ex post costs of shifting from one procedure to the other in case wrong procedure was chosen. The reform also introduced a number of new systems into the rehabilitation proceeding, such as comprehensive stay order, absentee voting, etc. Moreover, basic ideas of debtor-in-possession ("DIP") are incorporated into the receiver system, and secured and unsecured creditors are guaranteed the liquidation value of their collateral and the corporate value. Those modifications are intended to improve the ex ante efficiency of rehabilitation proceeding by giving the debtor an incentive to file for rehabilitation at the earliest stage possible. However, the new rehabilitation proceeding still maintains two fundamental principles of the previous procedures, i.e., (i) receiver system for corporate governance and (ii) relative priority rule for distribution of corporate value among creditors and equity holders.

Part II will discuss the efficiency goal that the DRBL intends to achieve through the rehabilitation proceeding and the general concept of efficiency in the rehabilitation proceeding. Part III will explain major changes to the rehabilitation proceeding under the DRBL and the efficiency effects of such changes. In Part IV and Part V, the receiver system and the relatively priority rule which influence most of the behaviors of debtors and creditors will be analyzed and reevaluated in light with the efficiency goal of the DRBL.

Bankruptcy Code), rehabilitation proceedings for an individual (equivalent to Chapter 13 of the U.S. Bankruptcy Code) and international bankruptcy and rehabilitation proceedings (equivalent to Chapter 11 of the U.S. Bankruptcy Code). The new rehabilitation proceeding is developed based on the old reorganization procedure and improved with the merits of the old composition procedure.

2) The Corporate Reorganization Law and the Composition Law were enacted in 1962, modified several times thereafter and finally abolished on March 31, 2006 as the DRBL became effective.

II. The Efficiency Goal of Rehabilitation Proceeding

1. The Efficiency Policy under the DRBL

1) Redistribution Goal

Article 1 of the DRBL begins with a language "[T]he purpose of this Law is for the efficient rehabilitation of a debtor that faces imminent failure due to financial difficulties through coordination of the legal relations of interested persons, including creditors and share/equity holders." From such language, it can be inferred that the goal of the rehabilitation proceeding is to maximize the ex post value of a failing firm and distribute such value to the existing claimants.

Prior to 1998, one major policy goal of the old corporate reorganization procedure was to protect public interests, such as interests of the debtor company's employees and local economy.[3] Under such policy, some large companies whose discontinuance would adversely affect employment and local economy were allowed to survive through the corporate reorganization procedures notwithstanding the liquidation value exceeded the going concern value of such companies. However, the public interest oriented policy requiring maximization of social welfare was abandoned in 1998 because it protected the public interests to the serious detriment of existing claimants and it was doubted that survival of large companies whose liquidation values exceeded their going-concern values had been helpful in improving the employment and the local economy in the long run.

2) Flexibility of Economic Viability Test

In an effort to undo the public interest oriented policy, the amended CRL in 1998 introduced an economic viability test, which compared going-concern value against liquidation value of a debtor company and if the liquidation value of the debtor company was manifestly greater than its going-concern value, the petition for corporate reorganization was rejected. Once the corporate reorganization procedure was cancelled after commencement, the court had no choice but to adjudicate the debtor company bankrupt.

3) Corporate Reorganization Case Handling Rule (Song Min 92-5).

However, this mandatory conversion from corporate reorganization procedure into bankruptcy procedure caused the debtor company to be reluctant to file for corporate reorganization procedures because the debtor company might be liquidated through the bankruptcy procedure. Thus, the economic viability test attempted to increase ex post efficiency by maximizing distribution to the creditors, but decreased ex ante efficiency by causing the debtor company to be reluctant to file and thus, delay filing for corporate reorganization.

The DRBL abolished the mandatory conversion to diminish the ex ante costs resulting from the delayed filing. According to the modified economic viability test under the DRBL, the court is no longer obliged to declare the debtor company bankrupt although liquidation value of the debtor company is proven to be greater than its going-concern value.[4)] This change has improved ex ante efficiency as the rehabilitation petitioner does not have to worry about mandatory conversion of their rehabilitation proceeding into bankruptcy proceeding against their intention. There may be an argument that abolition of mandatory conversion would impair ex post efficiency because the liquidation of a debtor company whose liquidation value exceeds its going-concern value will be delayed. However, the period of such delay can be limited by any creditor of the debtor company through a petition for conversion into bankruptcy proceeding if the creditor finds that the delay is undue and detrimental to the creditors' interests. Thus, the flexible economic viability test under the DRBL enhances the overall efficiency of the rehabilitation procedure.

2. Ex Ante Efficiency and Ex Post Efficiency

An efficient insolvency system must be able to reduce the costs incurred before as well as after entering insolvency proceeding.[5)] Although the goal of

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4) Article 6(2) of the DRBL.

5) The improvement of ex ante efficiency does not necessarily enhance ex post efficiency of an insolvency procedure. For example, while the composition procedure, which neither changed the management of the debtor company nor extinguished its shares, increased ex ante efficiency by minimizing the overinvestment effect and delay effect, but did impair ex post efficiency of the procedure as the negotiation between the debtor company and its creditors took a longer time and the debtor company was likely to propose an unfeasible composition plan in order to keep the creditors to stay in the composition procedure.

an insolvency procedure is to maximize ex post revenue to be distributed to claimants, ex ante efficiency shall not be undermined because it also influences the courses of action taken by the managers of companies, whether insolvent or otherwise, whose number is simply much greater than the relatively few companies that file for insolvency.[6)]

1) Ex Ante Efficiency

The behavior of managers of a failing company that attempts to avoid or delay filing for bankruptcy can be explained by three potential effects of agency costs of debt and separation of ownership and control: (i) overinvestment or asset substitution effect, (ii) underinvestment effect and (iii) delay effect.

The overinvestment effect refers to the incentive that shareholders of a failing company have to undertake excessively risky investments as a means of avoiding or delay filing for bankruptcy. If the risky investment succeeds, its high return would enable the company to avoid or at least delay bankruptcy filing. If it fails, the company goes bankrupt, but residual claimants are no worse off since it would have gone bankrupt anyway without the investment.[7)] This effect can be also explained as asset substitution effect. Asset substitution occurs when a company exchanges its assets of a stable value for assets of a fluctuating value. Shareholders stand to gain from such substitution because, as residual claimants of the company, they reap the gain if the new substituted asset increases in value, whereas the debt holder will bear some of the resulting loss if the asset decreases in value.[8)]

The underinvestment effect refers to the incentive that the managers of financially distressed company have to pass up safe investments opportunities that are economically efficient because these investments may make creditors better off and equity holders worse off.[9)]

The delay effect explains the tendency of the managers of financially

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6) Robert K. Rasmussen, *The Ex Ante Effects of Bankruptcy Reform on Investment Incentives*, 72 WASH. U. L.Q. 1159, 1163 (1994).

7) Michelle J. White, *The Costs of Corporate Bankruptcy: A U.S.-European Comparison, in* CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES 18 (J. Bhandari & L. Weiss eds., Cambridge: Cambridge University Press 1996).

8) Rasmussen, *supra* note 6, at 1170.

9) White, *supra* note 7, at 18.

distressed company to delay filing for bankruptcy for the purpose of keeping their jobs, particularly so if bankruptcy policy requires that all managers of such company be replaced. If the company is economically inefficient, then delayed filing increases bankruptcy cost.[10] Such delay is not necessarily in the best interest of the shareholders. The managers to whom the shareholders entrusted management of the company may not want to over-invest the assets of the company because more risky investments may accelerate the time of losing their jobs.

These three effects imply that when companies finally liquidate in bankruptcy, few assets may be left to repay unsecured creditors' claims. The more inefficient the bankruptcy system is, the less the unsecured creditors receive. To maximize the revenue to be distributed to the unsecured creditors, bankruptcy filing should be encouraged to be made at the earliest stage possible. For this purpose, the bankruptcy policy should take a lenient approach toward the managers. Obviously, more distressed companies can be encouraged to file for bankruptcy at their earlier stages under a lenient than a less lenient policy environment.

2) Ex Post Efficiency

Ex-post expenses of an insolvency proceeding consist of direct expenses and indirect expenses. Direct expenses include administrative and legal costs of the proceeding, such as payments to lawyer, appraiser or court for the insolvency procedure. Indirect expenses are opportunity costs incurred from the debtor's failure to make its ordinary investment due to the insolvency proceeding. Indirect costs include lost sales, increased cost of capital, difficulties in maintaining relationships with suppliers, customers, etc.

Direct costs rise as the insolvency procedure takes longer.[11] Generally speaking, in case the insolvency procedure is not completed in a swift manner, the ex-post costs are substantially increased.

If the bankruptcy system allows the managers and the shareholders of an insolvent company to continue to operate the company after filing for bankruptcy, the costs discussed in the foregoing paragraph (Ex Ante Efficiency) may be relevant again. For example, if managers are expelled after

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10) *Id*. at 20.

11) White, *supra* note 7, at 25-26.

filing, they have an incentive to delay commencement of the proceeding to keep their jobs. Moreover, the fact that residual value of the insolvent company is left to the shareholders according to the rehabilitation plan implicates the overinvestment problem following the confirmation of the rehabilitation plan. Thus, pro-debtor bankruptcy system should attempt to reduce such ex post costs to achieve overall efficiency of the system.

3) Other Legislations affecting Efficiency

The efficiency of bankruptcy policy is often affected by legal systems other than the bankruptcy laws. In Korea, the practices of directors' guarantee and issuance of bank check for the debtor companies increase ex ante costs of bankruptcy.

Financial institutions with asymmetric information on a debtor company usually request the representative director(s) of the debtor company to issue blank check or to provide joint and several guarantee as security for the company's debts. According to the Illegal Check Control Law (the "ICCL"), the representative director(s) who issued the dishonored checks are criminally punished.[12] In addition, those who provide joint and several guarantees for the company's debt are liable for the company's debt regardless of whether the company is entitled to reduction of its debts according to the rehabilitation plan.[13] To avoid such criminal and civil liabilities, the representative director(s) will likely attempt to delay filing for bankruptcy and to undertake overinvestment of risky businesses with a hope for the company to recover from the insolvent situation.

The ICCL also affects ex post efficiency through its functions in the credit market.[14] From the debtor's perspective, the criminal punishment for issuance of dishonored check works as an effective deterrent discouraging such issuance and thus allows borrowing by the debtor without collateral by providing a certain level of statutory comfort to the creditor. From the creditor's perspective, the punishment on the issuer of dishonored checks can

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12) If a check is dishonored due to shortage of deposit, general suspension of payment or termination of check agreement, any person who has executed or issued such check may be subject to imprisonment up to five years or maximum fine equal to ten times of the amount of such check. Article 2(3) of the ICCL.

13) Article 250(2) of the DRBL.

14) Article 1 of the ICCL provides that "the purpose of this Act is to guarantee the safety of economic life of citizens and the function of check as a security by strictly punishing issuance of illegal checks, etc."

provide protection against moral hazard of the debtor. The major reason why Korean bankruptcy law has not adopted the automatic stay rule of the U.S. Bankruptcy Code is that with the automatic stay, the ICCL can no longer play such material functions in the credit market. If the automatic stay, which prohibits collection on debts[15] pending bankruptcy proceeding, is adopted, creditors cannot demand payment of their checks issued by the debtor that has filed a petition for rehabilitation proceeding. That is, the debtor will be able to avoid punishment under the ICCL immediately upon filing for bankruptcy pursuant to the bankruptcy law, if the automatic stay is introduced in the Korean bankruptcy law. To prevent such abuse of the bankruptcy filing as a means to circumvent the punishments under the ICCL, the DRBL needs to maintain the preservation order in rehabilitation proceeding and debtors should remain subject to the criminal punishments with respect to the dishonored checks which have been presented by creditors prior to the issuance of preservation order.[16] In summary, the ICCL requires the preservation order even though such order will most likely delay the rehabilitation proceeding to a substantial extent.[17]

The lack of specialized bankruptcy courts also causes delay of the rehabilitation proceeding.[18] If Korean legal system establishes a separate bankruptcy court, the administrative functions that courts are currently play in supervising rehabilitation proceeding will be performed more efficiently and thus, improving ex post efficiency of the rehabilitation proceeding.

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15) According to Section 362(a)(6) of Bankruptcy Code of the U.S., any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case is stayed.

16) The decision of the Supreme Court of Korea (Supreme Court Judgment of August 14, 1990 (Case No.: 90 DO 1317)) holds that "even if the check issued is dishonored for payment on the due date, it will be deemed as a violation of Article 2(2) of the ICCL only if the reason for dishonor is lack of deposit, transaction suspension, cancellation or termination of check contract. In case a preservation order is issued under the CRL, the check must be dishonored for the reason of preservation irrespective of whether there are remaining deposits in the bank entrusted with the payment. Therefore, if the check is dishonored after the preservation order was made under the CRL, the issuance of such check will not be deemed a violation of Article 2(2) of the ICCL so long as it is dishonored in accordance with the payment prohibition imposed under the CRL, even if the reason for dishonoring the check is the lack of deposit in the relevant account."

17) In case the preservation order is not issued, commencement order of rehabilitation proceeding can be omitted, which shortens the period from filing to commencement.

18) Korean District Courts maintain specialized bankruptcy departments. However, judges of the bankruptcy departments often handle other cases and, like other judges, are frequently shifted from one court to another.

III. General Description of New Rehabilitation Proceeding

The new rehabilitation proceeding of the DRBL was modeled on the basic structure of the reorganization procedure under the CRL, but improved several phases of the procedure with a view towards achieving overall efficiency of the procedure. Major phases of the rehabilitation proceeding and the efficiency effects of such phases are discussed below.

1. Preservation Order and Comprehensive Injunction Order

Unlike Chapter 11, the automatic stay rule has not been adopted in Korea. When a petition is filed for rehabilitation proceeding, the court usually issues a preservation order constraining the debtor and a comprehensive stay order constraining the creditors within one week after the filing.[19] The preservation order freezes the debtor's assets and prohibits the debtor from repaying its debt or disposing of any property without the court's approval. If the comprehensive stay order is issued, the secured or unsecured creditors are not allowed to proceed with the compulsory execution procedure or to exercise their security right with respect to the secured properties owned by the debtor.

As explained above, the preservation order is inevitably necessary as the automatic stay will eliminates the functions served by the ICCL. To reduce the costs of preservation order, repeal of the ICCL and adoption of the automatic stay should be considered seriously. The comprehensive stay order will not be necessary either with or without the automatic stay.

2. Commencing the Case

After having reviewed the positive and negative requirements of the case, the court issues the commencement order of rehabilitation proceeding within one month after filing. At the time of issuing the commencement order, the court appoints, in principle, a receiver with the power and authority to

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19) The comprehensive stay order was first introduced for an insolvency procedure through the DRBL. Articles 44 and 45 of the DRBL.

operate the debtor company and an examiner who investigates the financial conditions of the debtor company. The incumbent representative director of the debtor is usually appointed as receiver unless financial distress of the debtor can be ascribed to misappropriation, concealment, or mismanagement of the debtor's assets by the management or the Council of Creditors makes a request to discharge the incumbent representative director for a reasonable cause.[20] However, in case where the debtor is an individual, small-and-medium-sized enterprise or other types of persons set out in the Supreme Court Regulations, the court may not appoint the receiver.[21] And if no receiver is appointed by the court for the said debtor that is not an individual, current representative director of such debtor is deemed as receiver and can continue to operate the company under the court's supervision.[22]

Concurrently with its decision on commencement of rehabilitation proceeding, the court sets (i) date of the initial meeting of interested parties, (ii) period during which the receiver is required to submit a list of secured and unsecured creditors and stocks or equity holders, (iii) period during which the secured or unsecured creditors, stocks or equities holders are required to report their claims, and (iv) period of investigation into secured or unsecured claims filed or stated in the list.[23]

3. Examination of Financial Conditions of Debtor

When the commencement order is issued, an examiner is appointed by the court. The examiner appraise the values of all properties that belong to the debtor, produces and submits to the court the property list and balance sheet of the debtor as of the date of the commencement order, and investigates into the following, and reports the results of the investigation to the court prior to the first meeting of interested parties: (1) circumstances leading the debtor to commence rehabilitation proceeding, (2) matters pertaining to the business

20) Article 74 of the DRBL.

21) Article 74(3) of the DRBL.

22) When the receiver is not appointed by the court, a representative director of the debtor company becomes a deemed receiver of the debtor. In this sense, receiver of the Korean rehabilitation proceeding is different from the receiver of a Chapter 11 case although incumbent management can continue to run the debtor company.

23) Article 50 of the DRBL.

and property of the debtor, (3) liabilities of officers of the debtor, if any.[24)]

4. Submission of List of Secured and Unsecured Claims and Report of Claims

The receiver shall prepare lists of secured and unsecured creditors and/or share/equity holders and submit such lists to the court. Any creditor, who desires to participate in the rehabilitation proceeding, must report his/her claims to the court and submit supporting documents within the filing period. Secured or unsecured claims and/or share/equity stated in the lists are deemed filed.

The receiver's duty to prepare the lists of claims and equity was first introduced in the rehabilitation proceeding under the DRBL to improve ex post efficiency. The creditors and equity holders can save the costs of reporting their claims through the receiver's lists containing their claims.[25)]

5. Meetings of Interest Parties

At the first meeting of interested parties, the receiver makes a summary report to the parties on (i) circumstances leading the debtor to commence the rehabilitation proceeding, (ii) matters pertaining to the business and property of the debtor, (iii) liabilities of the debtor's officers, if any.[26)]

At the second meeting of interested parties, a person who has submitted a draft rehabilitation plan explains to the court on such plan and the interested parties may also express their opinion on the plan.[27)] And at the third meeting of interested parties, secured and unsecured creditors, and share/equity holders are required to adopt the rehabilitation plan by votes cast by each class as follows: affirmative votes of 3/4 of the secured claims, 2/3 of the unsecured claims and a majority of total votes of the share/equity holders. Share/equity holders have voting rights only when the asset of the debtor company exceeds its liability at the time of commencement of the case. The

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24) Article 88 of the DRBL.

25) In the old reorganization procedure, each creditor had to report his/her/its claims individually in order to prevent extinguishment of their claims during the procedure.

26) Article 98 of the DRBL.

27) Article 99 of the DRBL.

second and third meetings are usually combined to expedite the procedure.

The court may impose a condition that such plan is to be subject to an absentee vote if deemed reasonable.[28] The absentee vote was introduced through the DRBL to save the costs of convening the third meeting of interested parties.

6. Court Approval and Right Protection Clause

When the draft rehabilitation plan is approved at the meeting of interested parties, the court shall either confirm or reject the rehabilitation plan on the date of such meeting or on another date pronounced immediately thereafter.[29] The court may confirm a rehabilitation plan only to the extent that such plan meets the the requirements under the DRBL including, but not limited to the following: (i) the subject rehabilitation proceeding or rehabilitation plan conforms to the relevant laws; (ii) the rehabilitation plan is fair, equitable and feasible, (iii) the resolution of the secured and unsecured creditors and share/equity holders with respect to the rehabilitation plan was adopted in good faith and in a fair manner, (iv) under the rehabilitation the amount to be paid to the creditors are not less than the amount that would have been paid to each creditor if the assets of the debtor are liquidated.[30]

Even in cases where a draft rehabilitation plan has been approved in a meeting of interested parties, or put to an absentee vote, if there is any class that fails to obtain the statutory amount or number of consent from the persons with voting rights, the court may amend the draft rehabilitation plan, stipulate a provision to protect the rights of rehabilitation creditors, secured rehabilitation creditors and share/equity holders of such class and decide to confirm the rehabilitation plan.[31]

7. Major Differences from Chapter 11

Unlike Chapter 11, the DRBL does not adopt automatic stay rule, debtor-

28) Article 240 of the DRBL.
29) Article 242 of the DRBL.
30) Article 243 of the DRBL.
31) Article 244 of the DRBL. The right protection clause is equivalent to CRLm down of Chapter 11.

in-possession concept, and absolute priority rule for a rehabilitation proceeding in Korea. The new rehabilitation proceeding continues to maintain a preservation order, receiver system and relative priority rule.

Can such differences of the new rehabilitation proceeding be justified based on the improved efficiency of insolvency procedure? The preservation order can not be eliminated so long as the ICCL is in effect. Hereafter, this paper will focus on the receiver system and the relative priority rule in the rehabilitation proceeding under the DRBL.

IV. Efficiency of Trustee System under the DRBL

1. Introduction

Efficient corporate governance minimizes agency cost among interested persons, especially shareholders of a company who have the interests in the residual value of the company and its management who represents the interests of the shareholders by operating the capital invested by such shareholders. Efficient corporate governance will be crucial not only for ordinary solvent companies, but also for insolvent companies in rehabilitation proceedings because insolvent companies need to be on-going in the future.

However, the corporate governance of insolvent companies is different from that of ordinary solvent companies in that the residual value of the insolvent companies belongs to their creditors. The creditors can dismiss the management causing failure of the company through the bankruptcy procedure. To avoid such results, the managers of insolvent company attempt to avoid or delay filing for bankruptcy.

The managers in small- and medium-sized companies where the ownership and control are not clearly separated generally share their interests with the shareholders. They have an incentive to undertake excessively risky investments with remaining resources of the company and to avoid safe investments leaving no residual profits to the shareholders. On the other hands, the managers in large companies where the ownership and control are usually separated have an incentive to maximize the firm’s revenue, rather than protecting the interests of shareholders, and to delay filing for bankruptcy to keep their job as long as possible.

The bankruptcy law affects such behaviors of managers. Generally speaking, as the bankruptcy law takes more lenient approaches toward managers, ex ante costs which may result from overinvestment problem, underinvestment problem or delay problem can be alleviated. To the contrary, when the bankruptcy law is rather harsh toward the managers, ex ante inefficiency will be improved.

2. Corporate Governance under Old Bankruptcy Laws

1) Corporate Governance under the CRL

(1) Trustee System

Pursuant to the CRL which was abolished upon enactment of the DRBL, the court might order a preservation receiver to manage and operate the debtor company when the preservation order is issued.[32] In addition, the court had to appoint one or more receivers upon issuance of the order for the commencement of corporate reorganization proceeding.[33] Once the preservation receiver or receiver is appointed, the management of the company and the management and disposition of the company's assets would exclusively be handled by such preservation receiver or receiver.[34]

The incumbent management might be appointed as a receiver so long as the incumbent management was capable of performing the manager's duties, but in practice, there were virtually no cases in which the incumbent management managed to keep their positions. The general practice was that a receiver was recommended by the creditors' committee or in certain cases, the receiver was appointed by the court based on the recommendation of certain institutions. Banks, trust companies or merchant banks were eligible to serve as a receiver. If the debtor company is a small-to-medium sized company, then one of the members of the management board could be appointed as receiver for such company.[35]

The receiver should perform its duties as a fiduciary in good faith, be under the supervision of the court and report to the court regarding the

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32) Article 39(3) of the CRL.

33) Article 46 of the CRL.

34) Articles 53 and 39(3) of the CRL.

35) Article 95(2) of the CRL.

financial matters of the debtor company immediately upon the termination or complete discharge of its duties.[36)]

(2) Inefficiency

Under the CRL, an incumbent representative director of a debtor company was usually replaced by a receiver appointed by the court, who would manage the debtor company under the supervision of the court. Once a preservation receiver or receiver was appointed, the managers lost their control over the management of the company, and the shares held by majority shareholders who were grossly negligent in managing the company were extinguished in the corporate reorganization proceeding. For the foregoing reasons, the shareholders and the managers had an incentive to delay filing for bankruptcy. Under these circumstances, ex ante inefficiency, such as overinvestment problem, underinvestment problem and delay problem, was quite substantial.

Moreover, it was not clear whether the receiver system enhanced ex post efficiency of the procedural scheme under the CRL. First, it was not easy to find a proper receiver who had the capability to manage the debtor company efficiently. Since the preservation receiver or receiver required some period of time to learn and understand the business of the debtor company after its appointment, the corporate reorganization proceeding could not proceed expeditiously at least during such period. Further, the receiver did not have much incentive to use her best efforts to manage the company because if the debtor company managed to recover and repays its debts within a relatively short period of time, the receiver would lose his job earlier than expected.

Second, in many cases the existing managers of a debtor company were presumably best equipped with the knowledge of all existing problems of the debtor company and potential countermeasures that it might take against such problems. But, such know-how of the managers could not be utilized by the outside receiver.

Third, the scope of supervision by the court was limited to the prevention of any illegal or improper activities of the receiver as there were (and still are) no specialized bankruptcy courts in Korea. It would be very difficult to expect such limited supervision of the court to provide an effective motive for the receiver to maximize its capabilities in managing the debtor company.

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36) Articles 98 and 99 of the CRL.

2) Corporate Governance under the CL

(1) Corporate Governance by Representative Director

With respect to a composition proceeding under the CL, the court had to appoint an administrator and a rehabilitation commissioner upon issuance of a commencement order of composition proceeding after hearing opinions of the management committee and the creditors' committee.[37] However, commencement of a composition proceeding did not deprive the debtor company of the right to manage and dispose of its properties. If such management or disposition was not in the ordinary course of the debtor company's business, the debtor had to obtain an approval of the administrator.[38] Even if such activities are within the range of ordinary course of business, the debtor company might not engage in such activities if the administrator objected thereto.[39] In giving an approval with respect to a material activity of the debtor company, the administrator had to first hear the opinion of a rehabilitation commissioner.[40]

As discussed above, the managers of the debtor company in the composition proceeding were not replaced by an appointed receiver and can continue to operate the debtor company as they used to operate except for some extraordinary activities which were checked by an administrator appointed by the court. Moreover, the shares held by shareholders were not extinguished just because of the commencement of a composition proceeding. Those features of the composition proceeding under the CL provided great incentives for the managers of the debtor company to prefer composition procedure rather than corporate reorganization procedure.

(2) Inefficiency

Under the CL, the existing managers were allowed to continue to exercise its management control over the debtor company, and the shares of its major shareholders were not extinguished. Therefore, there were no practical changes to the corporate governance after the commencement of a composition proceeding. This system enhanced ex ante efficiency as the managers of the debtor company had no incentive to undertake an

37) Article 27(1) of the CL.

38) Article 32(1) of the CL.

39) Article 32(2) of the CL.

40) Article 32(3) of the CL.

overinvestment in risky business, under-invest in safe business or delay filing for composition proceeding.

However, the composition procedure impaired ex post efficiency. First, the composition plan prepared by the managers of a debtor company often contained too rosy terms and conditions in order to prevent the creditors from filing a petition to convert the composition proceeding into corporate reorganization proceeding. As a result, many unfeasible composition plans were confirmed by the court.

Second, it was difficult to expect the debtor company to be rehabilitated through mere debt restructuring if its incompetent managers continue to operate the debtor company. A petition for composition proceeding would be dismissed in case the financial failure of the debtor company was attributable to the material mismanagement of the managers.[41] However, it was not easy to prove "material" mismanagement of a manager and also it was not clear whether the lack of capability of a director or a manager could be deemed as material mismanagement. Given the difficulty of proving manager's fault, the 'material mismanagement' requirement under the CL could not effectively safeguard against unfaithful debtor company's abuse of the composition procedure.

Third, since the shareholders of a debtor company could continue to exercise their voting rights and their shares were not extinguished, they were able to request the debtor company to over-invest into a risky business without being subject to the supervision of the court once the composition plan was confirmed by the court.

Fourth, pursuant to the CL, the creditors of a debtor company could request the court to cancel the composition plan if the terms of such composition plan were not performed, and the court was required to issue an order of bankruptcy if the composition plan was cancelled.[42] However, no creditor was willing to ask the court to adjudicate the debtor bankrupt if the debtor company had no assets at such stage.

Because of those ex post inefficiency issues, many debtor companies who restructured their debts through a composition procedure did not complete their composition plan. Such companies, after consuming all resources, were

41) Article 19(2)(1) of the CL.

42) Article 9 of the CL.

eventually liquidated through a bankruptcy procedure.

3. Corporate Governance under the DRBL

1) Non-Separation of Ownership and Control in Korea

In general, the ownership and control are separated in large and publicly held companies, but, not so in small and closely held companies. In many cases, however, the largest shareholder and related persons of Korean conglomerates are deeply involved in management of their companies. Thus, while the agency costs between largest shareholders and the management are relatively low, they can get relatively high between small shareholders and the management and between the creditors and the management.

Under such circumstances, the interests of managers are generally in line with those of large shareholders. Accordingly, they are not likely to be concerned about their job security by filing for bankruptcy and thus, the agency cost of delay harming the interests of shareholders would not be seriously problematic. Rather, they would have an incentive to over-invest in risky business and avoid investment in safe business prior to filing for bankruptcy. They also have an incentive to delay filing for bankruptcy to use up the company's resources for additional investments. To lessen such ex ante inefficiency, bankruptcy policy needs to be lenient to the shareholders.

2) Corporate Governance Policy

When the DRBL was enacted, the following corporate governance structures were reviewed.[43)]

(1) Corporate Governance by Representative Directors (or Current Shareholders)

During the rehabilitation proceedings, the debtor companies can be managed by current representative directors or shareholders. The inefficiency issues associated with such corporate governance are explained in Corporate Governance under the CL above.

(2) Corporate Governance by Creditors

Since the residual value of an insolvent company belongs to its creditors

43) Shin & Kim, Orrick, Herrington & Sutcliffe LLP, Final Draft of Recommendation for Insolvency Laws (2000), at 204-208 (in Korean).

instead of its shareholders, one may expect that reinforced monitoring function of creditors can have better improve the corporate governance of the insolvent company rather than that of an ordinary solvent company. However, the reinforced monitoring function may result in the following in efficiency costs.

First, creditors of a Korean debtor company can not acquire material information on the debtor company since the accounting standards and the disclosure requirements are not as strict as in the United States.

Second, the creditors consist of secured creditors, unsecured creditors, trade creditors, bank creditors and/or non-bank financial institution creditors, with differing interests from the other. Unless there are certain efficient means that can coordinate and settle internal disputes among the creditors, monitor or intervention by the creditors may not lead to the desired goal of maximizing the value of the debtor company.

Third, it may be difficult for the creditors of financially distressed small to medium sized company to aggressively monitor such debtor company.

Fourth, secured creditors do not have any interest in the management of the debtor company so long as there is sufficient value in their collateral. Therefore, there would be no incentive for the secured creditors to monitor management of the debtor company.

(3) Corporate Governance by Court

The court supervises the overall courses of a rehabilitation proceeding. The court supervises not only legal matters but also management related matters of the debtor company. However, such option has the following shortcomings.

First, in order to efficiently monitor the management of a debtor company, the court should be able to collect information on the debtor. However, as the court does not have an access to internal corporate information, it can only rely on the information provided by interested parties and thus, limiting the effectiveness of its monitoring.

Second, in setting policies for a debtor company, it is necessary for the court to have not only legal knowledge but also comprehensive knowledge on the relevant industry, accounting, management, taxation, etc. It is not easy for the court to acquire such specialized knowledge. And even if the court can be assisted by a third party with such specialized knowledge, the level of knowledge so acquired may not be sufficient for it to effectively monitor the debtor company.

Third, in Korea, there is no independent bankruptcy court. There are bankruptcy divisions within district courts. Furthermore, the periodic rotation system of Korean courts does not usually permit judges to stay at one location for more than two years, and therefore, it is very difficult for the judges to accumulate knowledge and acquire expertise in the area of insolvency.

3) Corporate Governance under the DRBL – Trustee System Incorporating Elements of DIP

The DRBL has adopted a receiver system for corporate governance of a debtor company incorporating important elements of the DIP concept. At the time of commencing a rehabilitation proceeding, the court is required to appoint a representative of the debtor company as receiver, except for the following cases:[44] (i) if financial distress of the debtor is attributable to the misappropriation, concealment, or material mismanagement by the representative of the company's assets, (ii) if the Council of Creditors makes a request discharge of the representative for a reasonable cause, and (iii) if it is necessary for rehabilitation of the debtor company to appoint a third party receiver.[45]

Moreover, in case where the debtor is an individual, small-and-medium-sized enterprise or other persons as set out in the Supreme Court Regulations[46] the receiver may not be appointed by the court. When the

44) Article 74(2) of the DRBL.

45) To check the receiver's activities, the court shall designate an auditor of the debtor who is a legal entity based on the opinions of the Council of Creditors. Article 203(3) of the DRBL.

46) According to the Supreme Court Regulations, the receiver may not be appointed in case where the debtor falls under one of the following subparagraphs (Article 54 of Supreme Court Regulations):

1. Not-for-profit company, unlimited liability partnership company or limited liability partnership company;
2. Companies whose securities are listed on the Stock Exchange or registered on KOSDAQ;
3. When financial gap between asset and liability is not material and the cause of filing was temporary cash flow shortage;
4. When the debtor has technology, marketing power and market share at the time of commencement of the rehabilitation proceeding;
5. When the debtor has agreed on the material terms of the rehabilitation plan with major secured and unsecured creditors;
6. When the debtor has a plan to receive additional investment from competent third party or existing shareholders; and

receiver is not appointed, the debtor (its representative in case of a non-individual debtor) shall be deemed as receiver of the debtor for the purpose of the rehabilitation proceeding.

If the total liabilities of the debtor company exceed its total assets at the time of commencement of the rehabilitation proceeding, such debtor's capital shall be reduced by means of retirement of not less than half of the shares issued by the debtor company or consolidation of not less than two shares into one share according to the rehabilitation plan.[47)] If commencement of the rehabilitation proceeding is attributed to an act for which a manager of the debtor company is held gravely accountable, the capital shall be reduced in such a manner that retires not less than two-thirds of the shares held by the shareholder who has exercised a significant influence on such act or consolidates at least three shares thereof into one share.[48)] This capital reduction is intended to punish the shareholders of the debtor company whose liabilities exceed the assets and the shareholders who are responsible for the insolvency of the debtor company. However, such responsible shareholders of the debtor company may be granted stock options according to the Commercial Code.[49)]

4) Efficiency of Corporate Governance under the DRBL

There are three types of corporate governance under the rehabilitation proceeding in the DRBL: (i) by the manager who is appointed as receiver, (ii) in the absence of an appointed receiver, by the manager who is treated as a deemed receiver, and (iii) by a third party who is appointed as receiver with the manager being discharged. Obviously, these modifications improved ex ante efficiency of the corporate governance under the CRL because the managers were usually dismissed during the CRL era. However, if most managers can be discharged under the catchall provision of Article 74(2)(iii) of the DRBL ex ante inefficiency of the corporate governance under the CRL will persist. . It indicates that the efficiency improvement of the new receiver system is subject to how strictly the courts will require appointment of a third

7. When, in the opinion of the court, it would be helpful for the rehabilitation of the debtor not to appoint the receiver

47) Article 205(3) of the DRBL.

48) Article 205(4) of the DRBL.

49) Article 205(5) of the DRBL.

party receiver. If the debtor companies can not have clear understanding of the courts' interpretation of the receiver appointment requirement, the reform may not able to achieve the expected efficiency goal.

However, the effects of such ax ante efficiency can be countervailed by the capital reduction clauses of the DRBL, which are intended to punish the shareholders of the debtor company whose liabilities exceed the assets and the shareholders who are responsible for the insolvency of the debtor company. When such clauses are applied, the shareholders are likely to lose their ownership interests although they can maintain the control over the debtor company due to the new receiver system. To minimize the ax ante costs, such punishment clauses shall be modified such that the shareholders have an incentive to file for bankruptcy at the earliest stage possible. It is very important to provide the shareholders with an incentive for early filing because the ownership and control are not usually separated in large and publicly held corporations in Korea and the shareholders' inefficient behaviors, such as overinvestment and delay of filing while experimenting with their overinvestment, would impair the interests of creditors seriously.

The receiver system under DRBL, which incorporates elements of the DIP concept, becomes substantially similar to the DIP of Chapter 11 when the third party receiver is appointed in extraordinary cases. However, the receiver system is not identical to the DIP in that under the DRBL, the court directly supervises the receiver and has discretion to change the receiver.

Under the court's supervision, the manager-receiver can not drag out the rehabilitation proceeding to play with creditors' money or to keep his/her position. Thus, the modified receiver system under the DRBL would not harm the ex post efficiency of the corporate governance.[50)]

The modified receiver system also reduces the managers' overinvestment behaviors following confirmation of a rehabilitation plan because the management activities by the manager-receivers are now supervised by the

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50) Chapter 11 has been criticized as it gives too much control to the debtor's managers, enabling them to drag out the bankruptcy cases for inordinate periods of time. However, dragging cases disappeared in the past several years. First, many contemporary businesses depend on knowledge and ideas rather than on hard assets requiring quick negotiation among claimants. Second, creditors use post-petition lending agreements and managerial compensation contracts which makes Chapter 11 cases move faster and managers spend much more time overseeing M&A activities than before. David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917.

courts.[51] In addition, if a manager is appointed as receiver or becomes a deemed receiver, the debtor company can continue to utilize useful business know-how of the incumbent management, which would enhance the ex post efficiency. These days, more businesses rely on the managers' knowledge and ideas than before.

VI. Efficiency of Relative Priority Rule under the DRBL

1. Introduction

The rehabilitation proceeding is a procedure to distribute future profits of a debtor. Under the Civil Code, a secured claim has a priority over an unsecured claim and equity. This absolute priority rule ("APR") is generally respected in bankruptcy cases. However, a relative priority rule ("RPR") has been maintained in the bankruptcy laws of Korea, which do not respect the contractual priorities. And, the DRBL also adopted the RPR. The treatment of secured claims under the bankruptcy laws of Korea will be reviewed in terms of efficiency of the RPR.

2. Status of Secured Creditors under Old Bankruptcy Laws

1) Secured Creditors under the CRL

(1) RPR

Under the CRL, secured creditors could only get repaid according to the reorganization plan by participating in the reorganization proceeding like unsecured creditors. Secured creditors could not exercise their security interests outside the proceeding and their claims would be extinguished if the secured creditors failed to participate in the proceeding. Even if secured creditors enjoyed some degree of priority over other creditors,[52] there was no provision guaranteeing that the secured creditors would receive at least the amount equal to the liquidation value of their collaterals. Since the majority

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51) Substantial failure of the corporate governance under the CL led to the adoption of the receiver system as a basic corporate governance mechanism in the rehabilitation proceeding under the DRBL.

52) Article 228 (1) of the CRL.

rule was applied for not only the unsecured creditors' approval but also the secured creditors' approval, of the reorganization plan.[53] only part of the secured claims were repaid in practice. However, when the court approves the reorganization plan against the secured creditors' objection, the liquidation value of their collateral could be protected.

(2) Inefficiency

The treatment of secured claims under the CRL harmed ex post efficiency because the amount of repayment received by secured creditors could be less than the liquidation value of the relevant collateral. In some cases, secured creditors with huge amount of unsecured claims agreed on a low repayment rate of secured claims to increase the repayment of unsecured claims. In addition, as the APR was not respected, the repayment rate of secured claims was often decided according to the negotiation results among the secured creditor and the receiver or other creditors, which delayed the proceeding.

The ex post inefficiency had an influence on the ex ante efficiency as well. As secured creditors could not be repaid in full in the reorganization proceeding, creditors had a tendency to require the debtor to provide other security such as a check (failure of honoring such check would subject the management of the debtor company to a criminal punishment under the ICCL) or joint and several guarantee from the management in addition to the collateral. In these cases, the management would have a strong incentive to delay filing for bankruptcy in order to avoid or delay civil or criminal liabilities.

2) Secured Creditors under the CL

(1) Separate APR

Under the CL, persons entitled to exercise the "separation right" were not treated as composition claimants.[54] Since secured claims were not included in a composition procedure without consent of each claimant, the secured creditors could at any time exercise their security interests and get repaid by foreclosure of such security interests without participating in the composition proceeding. In practice, however, most of the secured creditors chose to get

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53) In order for a reorganization plan to be approve by the class of secured creditors in a meeting of interested parties, affirmative votes of at least 3/4 of the secured creditors.

54) Article 44 of the CL.

repaid either by participating in the composition proceeding without exercising the security interests on their collateral or through individual agreements with the debtor. They chose to voluntarily participate in the composition proceeding for the following reasons: (i) in many cases, secured creditors held unsecured claims as well. Liquidation bankruptcy that would result from exercising their security interests would deprive such secured creditors of any opportunity to receive any repayment on the unsecured claims; (ii) The debtor company offered secured creditors very favorable terms of repayment based on the going concern value of the debtor. However, through the foreclosure of the security interests, they could only recover the liquidation value of their collaterals; (iii) Even if a secured creditor participated in the composition proceeding, its security interests remained intact. Therefore, if the debtor failed to implement with the composition plan based on its terms, then the secured creditor could exercise their security interests.

(2) Inefficiency

The treatment of secured creditors under the CL caused the debtor to delay filing for composition proceeding as the debtor could not be certain as to whether the secured creditors would agree to participate into the composition proceeding.

The ex post efficiency could not be achieved because it took time for the debtor to persuade the secured creditors to participate in the composition proceeding. To induce the secured creditors to the proceeding, the debtor often proposed an unfeasible composition plan containing favorable terms to the secured creditors, which diminished the possibility of the debtor's recovery.

3. Treatment of Secured Claims under the DRBL

When the DRBL was enacted, the following issues were discussed.[55)]

1) Bankruptcy Policy on Secured Claims – APR vs. RPR

(1) Efficiency of APR

The APR emphasizes the efficiency of secured debts and argues that

55) Shin & Kim, Orrick, Herrington & Sutcliffe LLP, Final Draft of Recommendation for Insolvency Laws (2000), at 204-208 (in Korean).

seniority of secured debts must be recognized as under the Civil Code. According to this position, only after secured debts are repaid in full, unsecured debts can be repaid. The efficiency argument for secured claims is based on the following grounds:

First, priority of secured debts under the Civil Code has been socially and economically recognized. To change such recognition in the rehabilitation system will increase the costs of both creditors and debtors.

Second, secured claims can alleviate the debtor's overinvestment costs because the debtor cannot raise fund for such excessive investment if such debtor's properties are collateralized.

Third, if a debtor utilizes secured debts, new capital can be injected, which will reduce the insolvency risk of the debtor. In this sense, even the creditors of unsecured debts who would suffer the largest loss can share the benefits from the secured debts to some extent and as a result, the secured debts do not always extinguish the value of unsecured debts.

Fourth, if secured creditors have full priority, they do not need to compete with other creditors over the properties of the debtor. Therefore, it will reduce the bankruptcy costs.

For the reasons described above, the absolute priority argument claims that priority of the secured debts must be respected in full even in the rehabilitation proceeding.

(2) Efficiency of RPR

The relative priority argument claims that secured debts are inefficient for the following reasons and thus, there is no need to recognize full priority, and that rather it would be more efficient to recognize partial priority of secured debts.

First, since the shareholders' treatment under the rehabilitation plan is more favorable than their legal entitlement, the shareholders have an incentive to file for bankruptcy at an early stage.[56)]

Second, even in Chapter 11 cases in where the APR is required to be applied, bankruptcy courts routinely approve Chapter 11 reorganization that deviates from the APR, which favors the shareholders.[57)]

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56) Skeel, Jr., *supra* note 50.

57) According to one study conducted by Professor Eberhart, shareholders receive, on average, 7.6 percent of total corporate value in excess of their contractual legal entitlements. Another study – conducted

Third, secured debts diminish some value of non-adjusting unsecured debts. If a certain property of the debtor is provided as security for secured debts, the debtor's property which can be used to repay unsecured creditors will decrease. Economically, in this case it would be fair for unsecured creditors to increase the interest rate. However, there are certain types of unsecured debts whose interest rate adjustment is difficult. It includes (i) unsecured debts with an interest rate fixed before security interest is granted to third parties, (ii) small debts the holder of which does not monitor their debtors, (iii) tort claims and tax claims which have nothing to do with the property of the debtor.[58] As those unsecured creditors cannot adjust their interest rate where the debtor grants a security interest to a third party, they incur losses whenever the debtor grants a security interest to secured creditors. According to this argument, debtors and secured creditors are better off at the sacrifice of unsecured creditors, and thus, there is a need to limit secured creditors' right to a certain extent in the rehabilitation proceeding.

Firth, the going concern value of a company is created by all of the interested parties' participation in the continuing operation of the debtor. Therefore, the difference between the going concern value and the liquidation value of the debtor should be distributed fairly among the interested parties and must not be monopolized by the secured creditors.

Fifth, the secured creditors who have a firm security interest do not have an incentive to monitor the debtor. Therefore, the secured creditors do not

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by Professors LoPucki and Whitford – confirmed that in 21 of the 30 largest bankruptcy cases in the 1980s, equity received some payout in Chapter 11, rarely (though occasionally) amounting to 10 percent of the available assets. Professor Michelle White found that equity receives at least 5 percent of the value of all creditors' claims in all bankruptcy reorganizations, with that proportion increasing as the return to creditors increases. Still another study conducted by Professor Fabozzi found 20 of 26 large bankruptcies deviating from absolute priority in favor of equity, and against unsecured creditors. Whereas in relative terms, the divergences from APR are small, the amounts of money at stake are substantial, reaching $63 million in one case. In almost all the cases examined by Professors LoPucki and Whitford, these costs exceeded the direct costs of bankruptcy. A study by Professor Brian Betker examining a sample of 75 firms filing for Chapter 11 protection between 1982 and 1990 yields the most conservative estimate of absolute priority deviations. Betker's results demonstrate a 2.86 percent mean deviation from contractual entitlements under the absolute priority rule. Robert Weber, *Can the Sauvegarde Reform Save French Bankruptcy Law?: A Comparative Look at Chapter 11 and French Bankruptcy Law from an Agency Cost Perspective*, 27 MICH. J. INT'L. 257, 268-69.

58) Lucian Arye Bebchuck & Jess M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L. J. 857, 882-83.

include covenants to restrict the debtor's inefficient activities in their loan agreements, or do not actively pursue such covenants where the debtor defaults.

Sixth, the going concern value is roughly calculated based on the future earning of the company. Distributing all of the value so calculated to secured creditors while invalidating the unsecured creditors' rights is unfair.

2) Status of Secured Claims under the DRBL

During a rehabilitation proceeding, secured creditors can not exercise their security rights over collaterals and shall be repaid only according to a rehabilitation proceeding.[59] Foreclosures by secured creditors are prohibited by a comprehensive stay order or commencement order of the rehabilitation proceeding.[60]

Secured creditors can participate in the rehabilitation proceeding with their secured claims. In order to participate in the rehabilitation proceeding, secured creditors have to report their name and address and type and cause of their secured claims, collateral and its value, amount of voting right, name of a debtor if the claims are not list on the schedule submitted by the receiver. Unreported or unlisted secured claims will be extinguished.[61]

The secured claims are recognized only to the extent of the liquidation value of their collateral at the time of commencement of the rehabilitation proceeding. The secured claims in excess of such liquidation value are treated as unsecured claims.[62]

For the purpose of approving the rehabilitation plan in a meeting of interested parties, secured creditors are classified as one class,[63] and affirmative vote of at least 3/4 of secured claims is required.[64] Even if the draft rehabilitation plan has not been approved by secured creditors in the meeting of interested parties, the court may approve the plan by amending the draft plan to include a clause to protect secured creditors' right through one of the following methods:[65]

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59) Articles 131 and 141 of the DRBL.

60) Articles 44 and 58 of the DRBL.

61) Article 251 of the DRBL.

62) Article 141 of the DRBL.

63) Article 236 of the DRBL.

64) Article 237 of the DRBL.

(i) transferring to a new company or to a third party the property subject to the security interest of the secured creditors, or keeping the property in the debtor company while such security interest remains effective;
(ii) repaying, distributing to or depositing for, secured creditors the sales proceeds of the collateral less the sales cost after such collateral have been sold at the price of at least the fair market value as determined by the court (without considering the encumbrances on the collateral in such valuation);
(iii) paying the holder of the right the fair market value of such right as determined by the court; or
(iv) any method which would protect the holder of the right fairly and equitably and is similar to the foregoing.

The fair market value referred to in (ii) above is construed as liquidation value of the property since the sale of collateral can be regarded as partial liquidation of the company's property and such method is against those who object to the rehabilitation plan, which is based on the continuance of the enterprise. For the same reason, the fair market values referred to in (iii) and (iv) mean the amount equal to the liquidation value. Therefore, the court may include in the plan a right protection clause that the secured creditors are repaid the liquidation value of the property.

In a new rehabilitation proceeding, liquidation value of collateral is guaranteed to secured creditors.[66] Liquidation values were not available to the secured creditors in some reorganization proceedings during the CRL era if a majority of the secured creditors agreed. In such case, the status of the secured creditors became unstable and the transaction costs increased. Since the new rehabilitation proceeding guarantees at least the liquidation value of collateral for the secured creditors, the problems associated with the relative priority rule can be mitigated to a certain degree.

3) Efficiency of RPR under the DRBL

From the past experience with the composition procedure, Korean

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65) Article 244(1) of the DRBL.
66) Article 243(1)(iv) of the DRBL.

jurisprudence has realized that it is not a good bankruptcy policy to make secured creditors stay out of a rehabilitation proceeding. Although they could exercise their security interest on collaterals, secured creditors postponed such exercise and instead, voluntarily participated into the composition proceeding for a number of reasons such as low liquidation value of collateral, protection of unsecured claims against the same debtor, etc. In consideration for postponing their exercise of security rights, secured creditors used to make unreasonable demands to the debtor, which seriously harmed the possibility of debtor's revival. As a result, many debtors that had undergone composition proceedings fell re-insolvent. This reality indicates that full priority of secured claims may harm ex post efficiency substantially.

To avoid such ex post inefficiency, the secured creditors should be regulated through the rehabilitation proceeding and should be subject to negotiation with other stakeholders as to the distribution of the debtor's business value. However, there should be a guideline for such distribution because, otherwise, negotiation among the stakeholders would cause another delay, which would again increase ex post inefficiency.

The APR can provide a guideline for negotiation among stakeholders in the rehabilitation proceeding. The APR has more theoretical benefits than the RPR because the debtor and the creditors don't have to change their behaviors prior to or after filing for bankruptcy. However, in reality, the APR is not strictly complied even in the U.S and criticisms on the APR have been found correct in Korea as secured creditors and banks do not necessarily act reasonably. Thus, guaranteed liquidation value of collateral under the RPR can guide negotiation between secured creditors and other stakeholders to an efficient outcome.

The liquidation-value guarantee principle may distort the debtor's behavior if the liquidation value of collateral such as machinery and inventory is much less than the going-concern value. In this case, the liquidation-value guarantee principle does not work as an effective way to control the debtor's overinvestment and delay of bankruptcy filing because the liquidation value is too low.

However, the RPR, if applied in a rehabilitation proceeding, can offer a great incentive for the shareholders to file for bankruptcy as soon as possible. In a business environment, where the ownership and control of a company are not separated even in large and publicly-held companies, shareholders' unreasonable behaviors such as, delay of rehabilitation filing and overinvestment into the risky business, have harmed the creditors' interests quite seriously. The best way to reduce such inefficiency cost is to encourage the shareholders to filing for rehabilitation proceeding at the earliest stage. And if the RPR is applied in a rehabilitation proceeding, the shareholders can receive more than their contractual entitlements.

V. Conclusion

In Korea where the ownership and the control are not separated, the interests of creditors are seriously impaired by ex ante costs incurred from shareholders' unreasonable behaviors such as overinvestment and delay of filing to earn time for overinvestment. The new rehabilitation proceeding under the DRBL attempts to reduce the agency costs resulting from such non-separation of corporate ownership and the control by introducing basic ideas of DIP into the receiver system and the liquidation-value guarantee principle into the RPR. Since the shareholders can continue to run the company directly or through their managers according to the new receiver system, the shareholders do not have to worry about losing their control over the company. With the RPR being applied in a rehabilitation proceeding, the shareholders can gain in excess of their entitlements under the Civil Code and the Commercial Code. This shareholder-friendly scheme encourages the shareholders to file for rehabilitation proceeding at the earliest stage possible and thus reducing ex ante costs.

The new proceeding also improves ex post efficiency. The manager-receiver's unreasonable overinvestment and delay of filing to keep his/her job is controlled and supervised by the court. The liquidation-value guarantee principle can minimize the delay of negotiation among the stakeholders.

However, the reform has its own limitation because the bankruptcy law can not guarantee the shareholders their ownership. The DRBL maintains the punishment clauses through compulsory retirement of the shareholders' shares if the debtor company's liabilities exceed its assets or if the shareholders are responsible for causing insolvency of the debtor company. The control by the manager-receiver may not be continued after the closing of the rehabilitation proceeding.

In this sense, the new rehabilitation proceeding still leaves much room for improvement in terms of efficiency and DIP and APR are two of the various alternatives to consider for achieving the efficiency goal under the DRBL.

KEY WORDS: Ex ante efficiency, ex post efficiency, receiver, debtor-in-possession, absolute priority rule, relative priority rule, new rehabilitation proceeding