

# Priority in Insolvency Proceedings

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## Abstract

*Insolvency unveils the genuine virtue of the concept of priority. Attempts, however, have proved that the task of arranging relevant claims in a single line of order according to their priority is quite difficult and complicated in insolvency proceedings. The reason lies in the fact that the concept of priority contains three factors; time, amount and method of collection. In standard non-insolvency compulsory executions, the priority structure affords certain claims to clearly precede others in time and amount. In this case, the superior creditor is entitled to be paid in full before and to the exclusion of other junior creditors. There is no other method of collection.*

*Priority structures differ with respect to each particular insolvency proceeding. Like non-insolvency execution procedures, the bankruptcy proceeding relates to the distribution of the value of the property belonging to the debtor as of the date of the proceeding. Secured claims are not restricted by the bankruptcy proceeding. As such, it is possible to arrange estate claims and bankruptcy claims in a single line of order. The rehabilitation proceeding, which aims to rehabilitate the debtor and to repay creditors using not only the assets belonging to the debtor at present but also future earnings, retains a complicated priority structure. Since creditors are to be paid according to the terms and conditions of the rehabilitation plan over a period which may extend for as long as ten years, the governing rule of priority in the rehabilitation proceeding is difficult to understand without distinguishing the separate components of the concept; time, amount and method of collection. Creditors with the right of reclamation or right of separation are not subjected to the rehabilitation proceeding. Creditors with common benefit claims are subjected to the rehabilitation proceeding but not to the rehabilitation plan. These creditors in effect enjoy priority over other creditors who are subjected to the rehabilitation proceeding with respect to the method of collection. Nevertheless, to generalize that common benefit creditors have priority over other creditors in terms of time and amount would be inaccurate. The chance that other creditors will be paid no later in time and no less in amount than common benefit creditors exists. Although Article 217 of the DRBL provides the respective priorities of secured rehabilitation claims, rehabilitation claims and stock/equity, the list does not mean that creditors in a higher position are to be paid prior to and more than those in a lower position. The rehabilitation plan may provide general rehabilitation creditors payment before secured rehabilitation creditors. According to precedents and prevailing theories, the hierarchy given in Article 217 does not mean superior creditors are entitled to absolute priority, but rather fair and equitable discrimination between each rank is required. Creditors in the same class can be treated differently as far as the discrimination is reasonable. The bottom floor of such flexibility is the*

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*assurance of the liquidation value. It is fair to say that priority in the rehabilitation proceeding is not as rigid as in the bankruptcy proceeding and partly negotiable as far as the liquidation value is assured. The rehabilitation plan, a reflection of the negotiations, shows the final list of priority, which is decided in separate terms of time and amount. In comparison, priority in the rehabilitation proceeding for individuals is rather simple because secured creditors are not restricted by the proceeding and the payment plan covers only general creditors.*

*We found that priority in insolvency proceedings cannot be explained by a list that simply lines one claim after another. It is necessary to consider the factors of time, amount and method of collection in order to understand the priority structure in insolvency proceedings. Rights of reclamation and the right of separation in effect give priority to its holders because properties related to such rights are beyond the reach of even creditors with the highest priority. Any property that is not included in insolvency estates also ignores priority. Beside insolvency laws and laws directly related to debt collection, several laws have provisions that alter the priority of certain types of creditors with respect to the amount or method of collection. These also provide causes that make it difficult to explain priority in insolvency proceeding with a linear list. A separate approach to the issue of priority in terms of time and amount will serve as the solution to ease such complexity.*

## **I. Introduction**

When the debtor has enough assets and is fully capable of performing all its obligations, the problem of priority among creditors does not attract much attention. In this case, since the solvent debtor provides adequate satisfaction, the need for creditors to stand in line does not surface. However, when the debtor lacks sufficient resource, creditors are faced with the risk of losing the value of their claim depending on where they stand in line. Consequently, it is only natural that the question of priority is frequently brought up when the debtor becomes involved in insolvency proceedings. The term insolvency proceeding is used in this article when collectively referring to bankruptcy proceedings and rehabilitation proceedings. The Debtor Rehabilitation and Bankruptcy Law (“DBRL”), which took effect in April 2006, provides for proceedings for bankruptcy and rehabilitation either for a legal entity or an individual as well as a separate rehabilitation proceeding for an individual.<sup>1)</sup> Priority is the key in determining how creditors, employees, shareholders and

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1) For general information on the insolvency laws of Korea, see, SooGeun Oh, *An Overview of the New Korean Insolvency Law*, 16-5 NORTON JOURNAL OF BANKRUPTCY LAW AND PRACTICE (2007).

government agencies will be able to satisfy their rights in the event the debtor becomes insolvent. Insufficiency unveils the genuine virtue contained within the concept of priority, and more so with respect to rehabilitation proceedings as discussed below.

In non-insolvency compulsory executions, creditors are paid according to the priority it is entitled. Whereas the Civil Code and the Commercial Code provide the fundamentals for ranking rights, other various statutes also contain provisions that give specific claims favorable treatment. Expressions used to define priority vary. For example, various laws contain expressions such as “entitled to be paid in full,”<sup>2)</sup> “precedes other rights,”<sup>3)</sup> “is entitled to preferential compensation,”<sup>4)</sup> “has the right of preference,”<sup>5)</sup> or on several occasions specifically lists the rank of priority.<sup>6)</sup> The priority structure among claims can be broadly arranged as below:<sup>7)</sup>

- Administrative expenses (Art. 53, Para. 1 of the Civil Enforcement Act)
- Wages or salaries earned three months prior to the commencement of the proceeding, retirement benefits or accident compensation assessed three years before the date of the commencement of the proceedings (Art. 37, Para. 2 of the Labor Standards Act), certain claims for lease deposits on housing or commercial buildings (Art. 8, Para. 1 of the Housing Lease Protection Act and Art. 14, Para. 1 of the Commercial Building Lease Protection Act)
- Taxes assessed on and arising directly from the collateral, such as an

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2) Paragraph 1 of Article 303 (Contents of *Chonsegwon*), Article 329 (Contents of Pledge of Movables), Article 356 (Contents of Mortgage) of the Civil Code, Article 340 (Satisfaction of Claim out of Other Property than Pledged Article), Paragraph 2 of Article 507 (Remuneration and Expenses for Commissioned Company) of the Commercial Code.

3) Article 140 (Status of Consignee), Article 344 (Different Classes of Shares), Article 468 (Right to Preferential Payment of Employee), Paragraph 2 of Article 782 (Charter Party and Notice of Readiness for Loading Goods, Period for Loading Goods), Article 788 (Duty of Care and Diligence to Goods) and Article 860 (Time-Bar of Salvage Claims) of the Commercial Code.

4) Article 367 (Claim of Third Party Purchaser for Reimbursement of Expenses) of the Civil Code.

5) Article 777 (Auction of Ship) of the Commercial Code.

6) Article 782 (Charter Party and Notice of Readiness for Loading Goods, Period for Loading Goods) of the Commercial Code.

7) CHIYON LEE, CIVIL ENFORCEMENT ACT 319-22 (Pak Young Sa 2008) (in Korean).

inheritance tax or a donation tax (“directly relevant taxes”) (Art. 35, Para. 1, Subpara. 3 of the National Tax Collection Act)<sup>8)</sup>

- Taxes assessed and due before the date of the creation of security interests<sup>9)</sup>
- Security interests created after tax claims
- Claims arising in connection with employment including wages, salaries, retirement benefits, and accident compensations (Art. 37, Para. 1 of the Labor Standard Act)<sup>10)</sup>
- Taxes assessed after the date of the creation of the any mortgage or *chonsegywon*<sup>11)</sup> (Art. 35, Para. 1, Item 3 of the Framework Act on National Taxes)
- Claims for insurance pertaining to health · pension · employment and/or industrial compensation (Art. 73 of the National Health Insurance Act, Art. 81 of the National Pension Act, Art. 30 of the Industrial Accident Insurance Collection Act)
- General claims

As seen above, in non-insolvency compulsory executions creditors against the same debtor are organized to create a single priority structure. The creditor standing before in line is entitled to satisfy its claim while junior creditors are restricted from the chance to satisfy their rights until their superiors have been paid in full. Creditors within the same level are paid on a

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8) According to Paragraph 1 of Article 35 of the Framework Act on National Taxes, national taxes and additional taxes are given priority over other public charges or general claims. As an exception, Subparagraph 3 of the above provision sets forth that with respect to secured claims, in the event a mortgage, pledge or *chonsegywon* was created before the date of the assessment of any national tax thereof, the secured claim is entitled to priority over such national taxes. Notwithstanding the above, taxes assessed on and arising directly from the collateral, such as an inheritance tax or a donation tax, always precede secured claims regardless of the date of its assessment.

9) The Supreme Court stated that tax claims (except any directly relevant taxes) and security interests are ranked according to the order they came into effect. For example, when a tax claims is assessed and due before the date the security interest was created the tax claim precedes the security interest. Supreme Court Decision of November 24, 2005 (Case No.: 2005DU9088).

10) The rank of claims for wages thereof is divided. While wages, salaries earned within three months and retirement benefits or accident compensations established within three years of the commencement of the proceeding are given second priority, wages and salaries earned before are only given seventh priority.

11) A type of registered leaseholder’s right to real estate.

pro rata basis. The same holds with respect to bankruptcy proceedings except that in bankruptcy proceedings debt collection is a collective action and calls for the principle of equality among creditors to be given more attention.

By contrast, the order of claims in a rehabilitation proceeding cannot be explained by a priority structure that simply lines up one creditor in front of another. For instance, despite the fact that when rehabilitation proceedings commence penalties are classified as general rehabilitation claims, it would be inaccurate to simply state that secured rehabilitation claims precede penalties, especially since the law prohibits the rehabilitation plan from stipulating any reduction or deferment of penalties. Moreover, contrary to the common belief that secured rehabilitation claims are given higher priority than rehabilitation claims, on certain occasions creditors with rehabilitation claims may be paid prior to secured rehabilitation claims according to the terms and conditions of the rehabilitation plan.

In order to offer a precise explanation on the diverse aspects and complications that define the priority structure of rehabilitation proceedings, it is necessary to first examine the concept of priority. In non-insolvency compulsory executions priority indicates that the superior creditor is entitled to be paid in full to the exclusion of any lower ranking person. From this definition it is possible to identify the two factors that compose the concept; time and amount. In other words, with respect to time, priority allows the creditor precedence in time while with respect to amount priority entitles the creditor superiority in quantity. A superior creditor is entitled to exercise its right before any other lower ranking creditor and be paid in full. These factors contained within the concept of priority are often overlooked and not identified separately, because in compulsory non-insolvency executions anyone entitled to precedence in time usually is entitled to a larger share. As such, generally there is little cause for separation. The same applies to the bankruptcy proceeding.

In non-insolvency compulsory executions or the bankruptcy proceeding, payments to creditors are made only once. The assets of the debtor are given out to the creditors only once and not spread out or dispersed over time. It is true that in practice the actual distribution under the bankruptcy proceeding may occur more than once. Nevertheless, the practice cannot be interpreted as periodical payments because the only reason the distribution to creditors is conducted over a number of months is because the proceeds from the estate is

acquired over time and not at once. However, the situation is different in the rehabilitation proceeding. Owing to the fact that creditors participating in a rehabilitation proceeding are paid over a number of months or years, 10 years at the longest, according to the rehabilitation plan, it is possible to distinguish the time factor from the amount factor. Furthermore, priority in terms of the method of collection also attracts attention, since certain claims are free from the restrictions of a rehabilitation plan.

The reason why claimants enjoy different advantages in terms of time, amount and method of collection can be inferred from the characteristics of the rehabilitation proceeding. The goal of the rehabilitation proceeding is to rehabilitate the insolvent debtor and in order to reach this end the property of the debtor is not exhausted for the purpose of satisfying creditors. Furthermore, creditors are paid according to the rehabilitation plan over several years, at the shortest, to as long as ten years. In recognition of these aspects the law contains provisions that set out the priority of claims in terms of each separate factor.

Discussions in the past on the issue of priority in insolvency proceedings premised a liner priority structure as in non-insolvency procedures. However, it is difficult to explain the problem of priority in the rehabilitation proceeding using the conventional approach. In order to provide an accurate account of the issue of priority in the rehabilitation proceeding we intend to analyze the rank of priority in terms of time, amount and method of collection. As mentioned above, the factors are not particularly recognized in non-insolvency compulsory executions; the time factor and the amount factor are correlated since superior creditors retain the right to be paid in full to the exclusion of any lower ranking creditor. As for the method of collection, this factor does not gain much merit, since in relation to non-insolvency procedures there is no other alternative route for the collection of a particular debt. However, with respect to priority in the rehabilitation proceeding superiority may refer to any superior state either in time, amount or the method by which the creditor is paid. As such, the individual factors contained within the concept of priority attract recognition and weight.

Priority, in a broad sense, can be found in claims excluded from insolvency proceedings. Creditors with certain claims against the debtor are not bound by insolvency proceedings. Creditors with claims that are free from the restrictions of an insolvency proceeding, such as creditors with the right of

reclamation or secured creditors with the right of separation as we will examine in the following chapters, are in effect entitled to enjoy the same advantage as if they were given higher priority within the insolvency proceeding. Similarly, in the event certain assets are excluded from the bankruptcy estate when bankruptcy proceedings commence, the owner of such assets in effect enjoys a superior status. For example, Article 47 of the Corporate Restructuring Investment Companies Law gives corporate restructuring investment companies the right to demand either the bankruptcy trustee or the asset management company to return any asset that was cosigned. Article 12 of the Asset Backed Securitization Law empowers the special purpose company to demand either the bankruptcy trustee or the asset management company to transfer any cosigned asset under its management.

The main point of this paper is to analyze the rank of priority given to various creditors participating in insolvency proceedings according to the DRBL. In the following chapters of this paper we shall analyze the status of creditors in terms of time, amount and method of collection. Chapter 2 examines the priority structure adopted in the bankruptcy proceeding and in Chapter 3 that of the rehabilitation proceeding. Chapter 4 deals with the problem of priority in the rehabilitation proceeding for individuals. Chapter 5 concludes by exploring a couple of specific issues in connection with priority in insolvency proceedings and covers examples where specific laws other than the DRBL contains provisions that alter the rank of claims and briefly reviews the issue of setoffs based on claims subordinated by agreement.

## **II. Priority in the Bankruptcy Proceeding**

### *1. Characteristics of the Bankruptcy Proceeding*

In the bankruptcy proceeding, with only few exceptions, virtually any property belonging to the debtor enters the bankruptcy estate whereby the proceeds are distributed to the creditors lined up according to a liner priority structure. In comparison to non-insolvency collection procedures, debt collection under the bankruptcy proceeding is a collective action that involves nearly every creditor and targets the entire property of the debtor.

The priority structure that governs the bankruptcy proceeding differs from

that adopted in the rehabilitation proceeding. In the bankruptcy proceeding creditors are paid only once and not in installments, whereas in the rehabilitation proceeding creditors receive payments over the duration decided by the rehabilitation plan, which may last for as long as ten years. Furthermore, while the rehabilitation proceeding originally relates to the going concern value of the debtor, the bankruptcy proceeding takes more interest in the present value of the debtor's assets. The fact that distribution within the bankruptcy proceeding is based on the present value, a relatively concrete estimation compared to any valuation based on the upcoming future, relieves the issue of uncertainty by a great degree. Owing to these characteristics, it is easier to recognize the priority structure that lines up claims entering the bankruptcy proceeding.

From the time the court adjudicates the debtor bankrupt, the debtor is severed from its property and the bankruptcy estate is created. The bankruptcy estate, with a few exceptions, is comprised of virtually everything belonging to the debtor as of the adjudication of the case, including any claim arising from conditions precedent to the adjudication (Art. 382). The DRBL adopted the concept of the bankruptcy estate to encompass nearly every property belonging to the debtor at the time the debtor is adjudicated bankrupt. Subsequently, almost every property right is separated from the debtor's capacity and transferred to the bankruptcy trustee in order to ensure creditors a fair distribution.

The bankruptcy estate is the sole source from which creditors are able to collect their claims. Consequently, to be excluded from comprising the bankruptcy estate means that, in reflection to the matter of priority, any property outside the estate is beyond the reach of even the most superior creditor. As we will explore in the following paragraphs, according to Article 383 of the DRBL any attachment-proof property and any property exempt from the estate by the court is excluded from the bankruptcy estate. It should be noted that any property reclaimable pursuant to Article 407, 408 and 409, also does not comprise the bankruptcy estate.

#### *1) Attachment-Proof Property*

Pursuant to Paragraph 1 of Article 383, any attachment-proof property is excluded from composing the bankruptcy estate. 'Attachment-proof property' is determined according to Article 195 and Article 246 of the Civil

Enforcement Act, which explicitly lists the properties and claims exempt from seizures.<sup>12)</sup> By retaining the properties excluded from the estate, the debtor is able to maintain at least the basic quality of life.

## 2) *Exempt property*

Under the DRBL, exempt property refers to any property that has been ordered to be excluded from the bankruptcy estate by virtue of a judgment of the court. The concept is adopted from the Bankruptcy Code of the United States of America.<sup>13)</sup> Pursuant to Paragraph 2 of Article 383, the debtor is allowed to select certain properties<sup>14)</sup> from comprising the estate in order to preserve the basic standard of life.

## 2. *Rights Unrestrained by the Bankruptcy Proceeding*

### 1) *Right of Reclamation*

It is possible to infer that the right of reclamation in effect gives the unpaid seller and the cosigner a superseding priority in terms of time, amount, and the method of collection, to the extent of the value of the reclaimed good.

On the date the debtor is adjudicated bankrupt every property that belongs to the debtor is included in the bankruptcy estate. By looking into Article 382 it can be inferred that the estate excludes any property that does not belong to the debtor, regardless of who is in possession. Pursuant to

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12) For example, clothing, furniture, and any other property necessary for the livelihood of the debtor and its dependant ("debtor") or living expenses of the debtor, to the extent set by the subsequent presidential decree, for the duration of one month cannot be seized (Article 195, Item 1 and 3 of the Civil Enforcement Act).

13) 11 U.S.C. §522.

14) The debtor may request the court to exempt ① its right to claim return of the deposit for lease of the building that are used for residential purpose by the debtor or his dependents, not exceeding the amount set by the rules of the Presidential Decree within the amount set for preferential payment as set forth in Article 8 (Protection of designated amounts among deposit) of Housing Lease Protection Act; and/or ② property set aside in order to supply living expenses of the debtor or his dependent for the duration of six (6) months, but not exceeding the amount set by the rules of the Presidential Decree. According to Article 16 of the Presidential Decree, preferential payment of deposits is allowed up to the maximum of 16,000,000KW within any area designated as overpopulation control region pursuant to the Seoul Metropolitan Area Readjustment Planning Act, 12,000,000KW within metropolitans, and 12,000,000KW for any other area and the value of the property set aside for living expenses for the duration of six months cannot exceed 7,200,000KW.

Article 407, any property with the appearance of ownership on account of the debtor's possession can be recovered by the true owner. The right to reclaim is extended by Article 408 and Article 409; first, with respect to the unpaid seller of goods, and second, with respect to the commission agent. Pursuant to Article 408, when the buyer is adjudicated bankrupt, the seller may reclaim and recover any goods in transit for which the buyer has failed to pay in full. Also under Article 409, if a bankruptcy proceeding is adjudicated with regard to the consignor, the commission agent is empowered to reclaim any goods forwarded to the consignor in transit but yet to be paid in full. In the event where such goods in connection with reclamation rights were disposed of by the debtor before the adjudication of the proceeding or transferred by the receiver, the unpaid seller or commission agent, or any person or entity entitled to the right of reclamation in general, may demand any right to claim counter performance be transferred accordingly (Art. 410).

## 2) *Right of Separation*

Creditors empowered with the right of separation are entitled to a certain advantage with respect to the method by which they realize their rights and receive payment. Under Section four of Chapter three of the DRBL, creditors holding claims secured by collateral are entitled to the right of separation in bankruptcy proceedings. That is, secured creditors are allowed to foreclose outside the bankruptcy proceeding and entitled to be paid in full from the proceeds of the collateral. In comparison, in rehabilitation proceedings claims secured by collaterals are mainly governed by the terms and conditions stated in the rehabilitation plan and creditors are restricted from pursuing satisfaction outside of the proceeding.

In order to qualify as a secured claim and thereby be given the right of separation, the claim should be secured by virtue of a *yuchigwon*,<sup>15)</sup> pledge, *yangdodambo*,<sup>16)</sup> security right with provisional registration, or *chonsegwon* over properties included in the bankruptcy estate. Whereas the secured creditor is entitled to receive the proceeds of the encumbered property, if the proceeds prove to be insufficient the creditor may participate and charge for the payment of the deficiency in a bankruptcy proceeding. In any event, the

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15) A type of statutory created possessory lien.

16) Security by way of assignment.

secured creditor is free to waive its right and participate in the bankruptcy proceeding as an ordinary bankruptcy creditor (Art. 413).

Notably, under the same Section, the DRBL reserves that lessees protected by the House Lease Protection Law and the Commercial Building Lease Protection Law shall have priority over subordinate claimants and/or other creditors with respect to the recovery of lease deposits. Pursuant to Paragraph 1 and 2 of Article 415, tenants<sup>17)</sup> are entitled to recover the value of their lease deposits from the proceeds of the leased house (including the premises) belonging to the bankruptcy estate, as is the case under Paragraph 3 with respect to the Commercial Building Lease Protection Law.<sup>18)</sup> Whereas separation rights under Section four generally allow creditors to collect its claim outside of the bankruptcy proceeding, tenants with the right to preferential payment of lease deposits are not entitled to recover the value of its lease deposits outside of the bankruptcy proceeding, but simply entitled to enjoy preferential payment of their deposits within the proceeding.

### 3. *Estate Claims*

Administrative expenses are inevitably incurred during the course of carrying out bankruptcy proceedings. Also, paying off expenses that provide for the common benefit serves the interest of all relevant parties. In recognition, the DRBL adopts the concept of 'estate claims' wherein such claims may be satisfied irrespective of the distribution procedure of the bankruptcy proceeding and entitled to payments whenever disposable cash is retained. Estate claims are limited to those explicitly provided in the law. Such claims can be divided into two groups: the general estate claims listed in Article 473 and special estate claims set out in specific provisions.

General estate claims can be subdivided into the following three categories according to their nature. The first group consists of expenses and claims in relation to common proceedings:

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17) Tenants should have met the conditions required under Article 3 and Article 8 of the Housing Lease Protection Act.

18) According to Article 3 of the Enforcement Decree of the House Lease Protection Law, the lessee is entitled to preferential payment of its deposit to the extent of 16,000,000KW within any area designated as overpopulation control region pursuant to the Seoul Metropolitan Area Readjustment Planning Act, 12,000,000KW within metropolitans, and 12,000,000KW for any other area.

- The claims for costs of any procedures in court for the common benefit of the bankruptcy creditors (Art. 473, Para. 1)
- Expenses for management, realization and distribution of the bankruptcy estate (Art. 473, Para. 3)
- Claims arising out of an act of the bankruptcy trustee with respect to the bankruptcy estate (Art. 473, Para. 4)
- Claims held by the other party, in the event the bankruptcy trustee performs any obligation under Paragraph 1, Article 335 (Art. 473, Para. 7)
- Expenses for any lawsuit on any property belonging to the bankruptcy estate, which is pending at the time of the adjudication of bankruptcy (Art. 347, Para. 2)
- Expenses for continuing compulsory execution procedures by the bankruptcy trustee (Art. 348, Para. 2).
- Claims for the reimbursement of litigation expenses by the dissenting bankruptcy creditor to the extent of the benefit obtained from any lawsuit on the finalization of a bankruptcy claim (Art. 469)

Claims admitted on account of equity are gathered in the second group:

- Claims made against the bankruptcy estate after the adjudication of bankruptcy due to any management of affairs or unjust enrichment (Art. 473, Para. 5)
- Claims made against the bankruptcy estate due to any act performed for an urgent necessity after the delegation is terminated or the power of attorney is extinguished (Art. 473, Para. 6)
- Claims created by the time a bilateral contract is terminated, in the event such a contract is terminated due to the adjudication of bankruptcy (Art. 473, Para. 8)
- Claims by the counter party for any payment transferred to the debtor in the event any act of the debtor is avoided (Art. 398, Para. 1)
- Claims for the encumbrances attached to for testamentary gifts subject to an encumbrance, when the bankruptcy trustee has received performance and to the extent not exceeding the value of the testamentary gift (Art. 474)

The third group includes claims classified as estate claims in view of social policies:

- Claims collectable pursuant to the National Tax Collection Act or the Local Tax Act (claims whose collection priority are higher than that of the general individual rehabilitation among the ones collectable pursuant to the examples of national tax collection, except Subordinate Claims stipulated in Article 446). However, any claims arising out of any cause after the adjudication of bankruptcy shall be limited to those against the bankruptcy estate (Art. 473, Para. 2)
- Allowance in aid for the debtor and his dependants (Art. 473, Para. 9)
- Payment, severance pay, and accident compensations for employees of the debtor (Art. 473, Para. 10)
- Return claims for deposits and guarantee money against personal liability of employees of the debtor, which have resulted from a cause before the adjudication of bankruptcy (Art. 473, Para. 11)

Estate claims are paid from the bankruptcy estate before bankruptcy claims and free from the proceedings of bankruptcy (Art. 475 and Art. 476). At this point, it is necessary to explore a few issues in relation to the treatment of tax claims. Before the DRBL, the Bankruptcy Law in force equally favored tax claims and claims to be collected following suit of national tax collection<sup>19)</sup> and gave them special treatment irrespective of any individual rank of priority. The question was raised that by treating all claims to be collected following suit of national tax collections equally, the provision failed to recognize that the particular grounds for allowing these claims to be collected following the example of taxes differ in weight, respectively. For example, while fines, loans, and indemnifications under the State Property Law are collected following

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19) The collection of public charges is often conducted following suit of national tax collections or defaults dispositions, except when provided otherwise. For example, the subsequent laws applied to national tax collections are applied to the collection of fines, loans, indemnifications under the State Property Law, as well as insurance costs for health, national pensions, and industrial accident compensations. Claims to be collected following suit of national tax collections can be divided according to their priority status; in relation to the above example whereas fines, loans, indemnification under the State Property Law stand in the same rank as general claims, claims for health insurance, national pension insurance, industrial accident compensation insurance are entitled to superiority in comparison to general claims.

suit of national tax collections these claims lack any substantial basis to enjoy superiority over other general bankruptcy claims. It was argued that the provision was unconstitutional and infringed the rights of other creditors. Acknowledging the problem, the DRBL rectifies the unreasonable practice of placing claims without any priority in collection by providing that only claims to be collected following suit of national tax collection that are given higher priority than general rehabilitation claims in non-insolvency cases will be approved as an estate claim.

The problem of whether arrears, additional taxes, and aggravated additional dues can be classified as estate claims is also discussed among legal commentators. Claims to be collected according to the National Tax Collection Act and claims to be collected following suit of national tax collection were classified as estate claims pursuant to Item 2 of Article 38 of the former Bankruptcy Law. Accordingly, in view of the fact that more often than not the property to be distributed to bankruptcy creditors is scarce, this practically meant that creditors with claims other than the aforementioned claims were given little or even no consideration from the proceeds of the bankruptcy estate, substantially restricting their constitutional right to property. Whereas some amendments were made, the same relatively holds under the DRBL.

The purpose of the bankruptcy proceeding is to give creditors, even if not entirely satisfactory, fair and impartial satisfaction. Accordingly, the law prohibits the insolvent debtor from committing any voluntary disposition and empowers the bankruptcy trustee with the right to manage and dispose any property comprising the bankruptcy estate. It is considered that the positive goal of the bankruptcy proceeding provides enough justification for the restriction and financial loss of creditors with claims other than tax claims or claims to be collected following suit of national tax collection. Claims to be collected according to the National Tax Collection Act or claims to be collected following suit of national tax collection also include arrears, additional taxes, and aggravated additional dues on claims precedent to the bankruptcy adjudication. Nevertheless, there was caution over whether these claims could be classified as estate claims without any further notice of the date on which such claims were assessed. Concerns were raised that the classification was against the constitution in view of the fact that interests, damages and penalties arising after the adjudication were classified as subordinated bankruptcy claims (Art. 37 of the former Bankruptcy Law). In time, cases were

brought to the Constitutional Court.

The first case was brought in 2005, concerning arrears assessed after the debtor was adjudicated bankrupt on conditions precedent to the adjudication.<sup>20)</sup> Paragraph 1 of Article 74 of the former Industrial Accident Compensation Insurance Act, Article 14 of the former Wage Guarantee Act, and Article 65 of the Employment Insurance Act provided for arrears to be collected following suit of national tax default dispositions. On the other hand, Item 2 of Article 38 of the former Bankruptcy Law flatly provided, without any further limitation, that claims to be collected according to the National Tax Collection Act or claims to be collected following suit of national tax collection will be classified as estate claims. As a result, even claims for arrears arising after bankruptcy adjudication were considered as an estate claim and entitled to be paid before bankruptcy claims, irrespective of the bankruptcy proceeding.

In its decision the Constitutional Court concluded that the part that provided claims to be collected following suit of national tax collection as estate claims in Item 2 of Article 38 of the former Bankruptcy Law as unconstitutional. It asserted that insofar as claims for post adjudication arrears are concerned, there was no purposive ground or policy basis to admit the aforementioned claims a superior status. The DRBL cleared the issue by explicitly stating in words that subordinated claims pursuant to Article 446 are not included as a claim to be collected following suit of national tax collections.

Recently, another case was brought to the Constitutional Court with respect to the treatment of additional taxes and aggravated additional dues in the bankruptcy proceeding.<sup>21)</sup> In the past, the classification that allowed additional taxes and additional dues to be treated as estate claims was often criticized, based on the fact that additional taxes and additional dues are both,

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20) Constitutional Court decision of December 22, 2005 (Case No.: 2003HUNGA8).

21) Constitutional Court decision of May 29, 2008 (Case No.: 2006HUNGA6, 11, 17 (consolidated)). The bankruptcy trustee of a company adjudicated bankrupt initiated a lawsuit based on the argument that any claim for additional tax or aggregated additional due arising after the adjudication should be classified as a subordinated claim. The Seoul District Court, following the defendant's request, called for the review of the Constitutional Court. Concurrently, in the case at hand, the review of the Constitutional Court was limited to post adjudication aggravated additional dues on claims arising from conditions precedent to the bankruptcy adjudication.

in essence, forms of administrative penalties imposed by the authoritative agencies, and the classification was against the principle of equality among creditors. Creditors were also disgruntled and argued that the scope of estate claims was stretched too far and only to the benefit of taxing agencies. The former Bankruptcy Law also flatly determined claims to be collected according to the National Tax Collection Act as estate claims. The constitutionality of Subparagraph 3 of Article 38 of the former Bankruptcy Law was once again brought to the Constitutional Court wherein the Court was required to review whether classifying additional taxes and/or aggravated additional dues on national taxes to be collected according to the National Tax Collection Act as estate claims was against the Constitution in May 29, 2008. The Court concluded that the provision was with justifications and was in observance of the Constitution.

The court stated in its decision that in relation to the priority given to tax claims according to the Framework Act on National Tax there was no ground for discriminating additional taxes or aggravated additional dues from the original tax claim and that the provision under review is justifiable and reasonable since the allocation is only a reflection of the priority given to tax claims within bankruptcy proceedings. Furthermore, the court asserted that because estate claims in bankruptcy proceedings are not limited to claims that serve the common benefit of creditors or the management of the bankruptcy estate, the argument that claims for aggravated additional dues cannot be treated as an estate claim was not valid.

However, the dissenting judges<sup>22)</sup> asserted that the bankruptcy trustee is entrusted with the power to manage the debtor's property in order to ensure that creditors are given fair and equitable satisfaction from the proceeds of the bankruptcy estate. They argued that in view of the fact that claims for damages and/or interest arising from delay of payment are classified as general bankruptcy claims, classifying claims for post adjudication aggravated additional dues infringes the constitutional right to property. They held that

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22) A law is rendered 'unconstitutional' with the concurrent vote of six justices out of the nine justices whom comprise the full bench of the Constitutional Court (Paragraph 1 of Article 23 of the Constitutional Court Law). In the case at hand, whereas five justices held the provision to be against the constitution, upon failing to obtain the required six concurrent votes the Constitutional Court rendered the provision as 'constitutional'.

the classification was against the rule of similarity which guides the classification of claims and may in effect turn bankruptcy proceedings into a fair for taxing agencies only.

In order to acknowledge estate claims the bankruptcy trustee must gain the court's approval (Art. 492, Subpara. 13). Estate claims can be paid irrespective of the bankruptcy proceeding (Art. 475) and prior to bankruptcy claims (Art. 476). The bankruptcy trustee is required to acknowledge and receive the court's approval in order to satisfy estate claims (Art. 492, Subpara. 13).

#### *4. Bankruptcy Claims*

Pursuant to Article 423, any right to payment arising on conditions precedent to the adjudication of bankruptcy by the court becomes a bankruptcy claim. With respect to bankruptcy claims, the controversy existed in relation to expenses necessary in order to participate in the bankruptcy proceeding. During the course of establishing the DRBL, some asserted that the expense for participating in the proceeding should be classified as subordinated claims. On one side, commentators argued that treating claims arising after the court's adjudication as general bankruptcy claims provided a conflict against the current legal system, which considers the bankruptcy estate as conclusive and unreasonable to consider expenses from delay, while on the other side some approved of the idea. The DRBL followed the latter. Listening to the opinion that they should be given the same treatment as in the rehabilitation proceeding, the expense was classified by the law as a bankruptcy estate (Art. 438).

Bankruptcy claims can further be subdivided into three groups; bankruptcy claims with priority, subordinated bankruptcy claims and general bankruptcy claims. Bankruptcy claims with priority are claims with priority according to other laws, which are entitled to be paid in full before general bankruptcy claims (Art. 446). An example of a bankruptcy claim with priority can be found in Article 33 of the Insurance Business Law, in which the insurance policy holder is entitled to preferential payment from the assets deposited.

With respect to subordinated bankruptcy claims in view of Article 446, the DRBL presumes subordination both by law and by agreements between the

debtor and the creditor. As stated in paragraph 1, claims that are agreed to have a lower hand are subordinated accordingly in the bankruptcy proceeding. The subordinated bankruptcy claims decided by the law are as follows:

- Interest accrued after the adjudication of bankruptcy;
- Compensation for damages and any penalty for nonperformance after the adjudication of bankruptcy;
- Expenses for participation in the bankruptcy proceedings;
- Fines, minor fines, expenses for any criminal procedures, surcharge, and fines for negligence;
- In cases where the term of any claim without interest is to arrive after the adjudication of bankruptcy, if the claim amounts to the sum of the principal and interest calculated by the legal interest rate from the time of adjudication of bankruptcy to the end of such term, the amount equivalent to the interest;
- In cases of non-interest-bearing claims with indefinite maturity, the amount equivalent to the difference between the amount of the claim and the appraised value at the time of adjudication of bankruptcy; and
- For the claims for regular installment claims, of which the amount and duration has been fixed, when the sum of amounts equivalent to the sum of interests of each payment calculated by the provision of Subparagraph 5 with regard to each regular installment, and amounts of the principals of each payment calculated by the same provision with regard to each regular installment, exceeds the amount of the principals that will bear, at the legal interest rate, interests of which amount is equivalent to the amount of the payment concerned, the amount equivalent to the excess.

Claims within the same level are paid on a pro rata basis. Nevertheless, considering that generally the bankruptcy estate is barely able to cover bankruptcy claims with priority, subordinated bankruptcy claims are rarely given any satisfaction.

### 5. *List of Priority in the Bankruptcy Proceeding*

In the aforementioned decision, the Constitutional Court stated that it is possible to rank rights in bankruptcy proceedings in the following order from top to bottom:<sup>23)</sup>

- Security interests established prior to the adjudication, claims for lease deposits on housing or commercial buildings
- Estate Claims
- Bankruptcy Claims with Priority
- General Bankruptcy Claims
- Subordinated Bankruptcy Claims

Whereas, in general, the rights ranked in the same level are paid from the proceeds of the bankruptcy estate on a pro rata basis, with respect to estate claims the DRBL imposes certain limitations by setting out a priority structure among estate claims. According to Paragraph 2 of Article 477, estate claims under Subparagraph 1-7 and 10 of Article 473 are given priority over other estate claims in the event the bankruptcy estate is determined as insufficient to pay the estate claims in total. Moreover, in view of the fact that estate claims pursuant to Subparagraph 1 and 3 of Article 473, that is, expenses for judicial procedures and expenses for the management, realization and distribution of the bankruptcy estate, serve the common benefit of creditors, the court generally interprets that these estate claims are entitled to enjoy the highest priority. Thus, claims for compensations awarded to the trustee or costs of notifications and postages are given the best chance of payment. Estate claims of the same rank are entitled to a pro rate share of the proceeds of the bankruptcy estate regardless of any particular priority under various laws and regulations (Art. 477, Para. 1). As such, in a bankruptcy proceeding the trustee is not required to respect the priority of tax claims and claims for wages and salaries for the last three months preceding the date of bankruptcy adjudication.<sup>24)</sup>

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23) Constitutional Court Decision of May 28, 2008 (Case no.: 2006HUNGA8).

24) SEOUL DISTRICT COURT BANKRUPTCY DIVISION, BANKRUPTCY LAW AND PRACTICE 165-66 (Pak Young Sa 2006) (in Korean).

### III. Priority in the Rehabilitation Proceeding

#### 1. Introduction

Priority is a key concept in the rehabilitation proceeding. The level of priority preserved for claimants institute a predetermined order to the distribution process to serve the animating goal of rehabilitation proceedings, that is, the distribution of the going concern value of the debtor to creditors and equity holders.

With respect to the allocation of priority, all claims and interests in relation to the debtor can be arranged into three different groups. The first two is comprised by rights which fall beyond the scope of the proceeding and rights that fall under the governance of the rehabilitation proceeding but nevertheless are not subjected to the rehabilitation plan. Claims and interests, specifically secured rehabilitation claims, rehabilitation claims and equity,<sup>25)</sup> which are governed mainly by the terms of the plan within the rehabilitation proceeding make up the last group. The terms of the rehabilitation plan, the treatment of such aforementioned claims or interests, embodies the level of priority given respectively. As such, the guiding principles with respect to the preparation and confirmation of a rehabilitation plan are substantially related to the issue of the rank of priority each participant in the rehabilitation proceeding is to enjoy. In this chapter, in order to identify the governing priority structure within the rehabilitation proceeding in terms of time, amount and method of collection, we aim to explore the classes of claims in a rehabilitation proceeding and the principles that guide the preparation of a rehabilitation plan.

#### 2. Right of Reclamation: Rights Unrestrained by the Rehabilitation Proceeding

Even in the event rehabilitation proceedings commence, certain claims against the debtor or the debtor's property maintain their full status and allow

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<sup>25)</sup> For the purpose of this article, the term 'equity' is used to refer to the term 'stock or equity share' used in the DRBL.

creditors to exercise their right irrespective of the proceeding. These rights are said to have been severed from the rehabilitation proceeding, since they maintain their full force and effect and remain unrestrained by the commencement of the rehabilitation proceeding. By virtue of these rights certain creditors are privileged in the method by which they are allowed to collect their claims.

In general terms, Article 70 of the DRBL provides the right to reclaim any property that does not belong to the debtor as of the date of the commencement of rehabilitation proceedings. As long as the debtor is not entitled to the ownership of a property, the true owner may recover the property from the debtor by making a demand for reclamation. On a couple of accounts, the statutory right of reclamation is granted in a more specific context under the DRBL; first, with respect to the unpaid seller of goods and second, with respect to the commission agent. Pursuant to Article 71 of the DRBL, when the buyer is subjected to the rehabilitation proceeding, the seller may reclaim and recover any goods in transit for which the buyer has failed to pay in full. Also under Article 72 if a rehabilitation proceeding is commenced regarding the consignor, the commission agent is empowered to reclaim any goods forwarded to the consignor and in transit but yet to be paid in full. In the event where such goods in connection with reclamation rights were disposed of by the debtor before the commencement of the rehabilitation proceeding or transferred by the receiver, the unpaid seller or commission agent, or in general any person or entity entitled to the right of reclamation, may demand any right to claim counter performance be transferred accordingly.

In addition to these explicit statutory provisions, it is possible to interpret certain clauses contained in the DRBL as implicitly providing for the right of reclamation. The law gives the receiver the power to set aside and avoid various transactions and also a discretionary right to assume or reject certain executory contracts under which the obligation of the debtor and the other party are both so far unperformed. Pursuant to Article 108, Paragraph 3, Subparagraph 1, in the case of avoidance of actions under Article 100, 103 or 104, by effect of such use of avoidance powers the counterparty is entitled to recover whatever consideration previously transferred under the contract, so long as it is determined that as of the present date it consists the debtor's property. The provision does not, other than granting the counterparty the

right to claim the recovery of considerations, explicitly mention its legal status within the rehabilitation proceeding. It can be argued that these rights can be viewed as reclamation rights on the following grounds. First, the right cannot be classified as a claim under the rehabilitation proceeding according to the general rule of interpretation. The DRBL explicitly provides for the placement of rights that arise from the exercising avoidance powers except from the aforementioned right of the counterparty.<sup>26)</sup> Secondly, understanding the counterparty's right to claim recovery as a reclamation right provides the closest identification of the legal basis on which it stands. Avoidance by the receiver has the effect of rescission. That is, by effect of such avoidance, any prior performance is invalidated and made nonexistent, hence restoring the right over any property exchanged to its original owner. As a result, the property (the counter performance) held in the realm of the debtor retains only a mere appearance of ownership, a characteristic shared among those objects of reclamation rights.<sup>27)</sup>

The above logic can be applied in the event an executory contract is rejected or terminated. Under subsequent provisions Paragraph 1 of Article 119 and Paragraph 2 of Article 121, the counterparty is given the right to claim recovery of any property upon the rejection or termination of an executory contract under which the obligations of the debtor and the counterparty are

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26) Art. 108 ③ If an act of the debtor is avoided, the counter-party may exercise the rights provided in each of the following:

1. Right to claim return of the consideration received by the debtor if it still exists in the debtor's property
2. Right to claim restitution of existing profits, as a holder of common benefit claims, if all the profits that accrue from the consideration received by the debtor still exist in the debtor's property;
3. Right to claim redemption of the value equivalent to the consideration, as a rehabilitation creditor, if profits that accrue from the consideration received by the debtor do not exist in the debtor's property; and
4. Right to claim restitution of existing profits, as a holder of common benefit claims, and the right to claim redemption of the difference between the consideration and existing profits, as a rehabilitation creditor, if a part of profits that accrue from the consideration received by the debtor exists in the debtor's property

Art. 121 ② In cases of rescission or termination according to Paragraph 1, if any consideration received by the debtor exists in its property, the counter-party may demand return thereof, and if it does not exist, the counter-party may exercise its right as a holder of common benefit claims in regard to redemption of the value thereof.

27) Article 70 (Right of Repossession) Commencement of the rehabilitation proceeding shall not have any effect on the right to repossess from the debtor any property, which does not belong to such debtor.

both so far unperformed. The court traditionally holds that the act of rejecting or terminating a contract automatically undoes any transfer of rights and restores ownership of properties to its original owner.<sup>28)</sup> Tracing the underlying change of ownership of the property presents that, as in cases of avoidance, the counterparty's right to recover property still in the debtor's possession can be interpreted as a reclamation right.

In any case, in order to make a demand of reclamation it is necessary for the receiver to acknowledge the counterparty's right. While not compulsory, the receiver's acknowledgement is subject to the court's approval. Pursuant to Paragraph 1 of Article 61, the court may require the receiver to obtain the approval of the court when admitting a reclamation demand. The common practice held by the court requires the receiver to gain the court's approval with respect to acknowledging reclamation demands.

### *3. Common Benefit Claims: Rights encumbered by Rehabilitation Proceedings but free from the rehabilitation plan*

Carrying out a rehabilitation proceeding incurs certain administrative expenses. Also, payment of expenses that provide for the common benefit serves the interest of all relevant parties. In recognition, the DRBL adopted the concept of 'common benefit claims' wherein such claims may be satisfied irrespective of the rehabilitation plan and entitled to payments whenever disposable cash is retained. Paragraph 2 of Article 180 states that payment of common benefit claims shall 'take preference' over the satisfaction of rehabilitation claims or secured rehabilitation claims. The language used in this provision can be translated to mean that creditors with common benefit claims shall be paid before any other creditor participating in the proceeding. Nevertheless, this interpretation does not signify that common benefit claims can be paid in full from the proceeds of the collateral for secured rehabilitation claims before paying the secured rehabilitation creditor.<sup>29)</sup> As such, in the event a debtor's property is solely limited to the encumbered assets of secured rehabilitation claims, a creditor holding a common benefit claim shall not be entitled to any payment or satisfaction at all.

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28) Supreme Court Decision of May 24, 1977 (Case No.: 75DA1394).

29) Supreme Court Decision of April 9, 1993 (Case No.: 92DA56216).

Various provisions in the DRBL sets out common benefit claims in addition to Article 179, which provides a list of common benefit claims. The class of common benefit claims can be separated into three different groups; first, expenses and claims in relation to common proceedings:

- Judicial expenses for the common benefits of creditors and equity holders (Art. 179, Subpara. 1)
- Expenses relating to business operation and the management and disposal of debtor's properties (Art. 179, Subpara. 2)
- Claims for expenses necessary for implementation of the rehabilitation plan (Art. 179, Subpara. 3)
- Claims for expenses, salary, compensation and special bonus of the receiver and the examiner (Art. 179, Subpara. 4)
- Claims arising from borrowing of money and other activities by the receiver for the business and property of the debtor after commencement of the rehabilitation proceeding (Art. 179, Subpara. 5)
- Claims arising from borrowing of money, purchasing of materials and other indispensable activities for continuous business operation of the debtor which was performed by the receiver or interim receiver with the approval of the court after the application of rehabilitation proceeding and prior to commencement thereof (Art. 179, Subpara. 12).
- Expenses necessary for the activity of the Council of Creditors, determined by the court (Art. 179, Subpara. 13).
- Expenses other than those set out in Subparagraphs 1-13, Art. 170 that are inevitably disbursed for the benefit of the debtor (Art. 179, Subpara. 14).
- Claims for expenses of reimbursement in respect of the continued proceedings or measures under Para. 5, Art. 58 (Art. 58, Para. 6)
- Claims for litigation expenses spent by the rehabilitation creditor or the secured rehabilitation creditor, who raised objection, to the extent of the existing benefit in a case where any legal action regarding finalization of rehabilitation claims or secured rehabilitation claims (including a judgment on examination and finalization of claims) inures to the benefit of the debtor's property (Art. 177).

Second, the claims classified as common benefit claims on grounds of equity:

- Claims held by the counter-party in cases where the receiver performs obligations of executor contract (Art. 179, Subpara. 7),
- Claims arising from the supply by the counter-party to a bilateral contract, who bears the obligation of continuous supply, during the period from filing for commencement of the rehabilitation proceeding to commencement of such rehabilitation proceeding (Art. 179, Subpara. 8)
- Claims arising in respect of the debtor after commencement of the rehabilitation proceeding due to administration of affairs or unjust enrichment (Art. 179, Subpara. 6)
- Claims for reimbursement of profits accrued from the consideration received by the debtor if all or part of them exist in the debtor's property in cases where acts of the debtor is avoided (Art. 108, Para. 3, Subpara. 3 and 5)
- Claims for reimbursement of the value of difference between existing profits if part of the profits that accrue from the consideration received by the debtor still exist in the debtor's property in cases where acts of the debtor is avoided (Art. 108, Para. 3, Subpara. 3)
- Claims for the reimbursement of the value of the consideration if the consideration received by the debtor does not exist in the properties of the debtor in cases of rescission or termination of executory contracts pursuant to Art. 119 (Art. 121, Para. 2)
- Estate claims in the suspended bankruptcy proceeding except those of Art. 473, Subpara. 2 and 9 (Art. 256, Para. 2)

And finally, claims classified as common benefit claims based on policy considerations:

- Wage, salary, retirement allowance and accident compensation claims of the debtor's employees (Art. 179, Subpara. 10)
- Claims for return of any deposits and guarantee money against personal liability of the debtor's employees which arise from reasons existing prior to commencement of the rehabilitation proceeding

(Art. 179, Subpara. 11)

- Taxes subject to withholding (Art. 179, Subpara. 9)

The receiver is required to acknowledge whether a claim can be classified as a common benefit claim. While it is not mandatory and in common practice left to the discretion of the court, pursuant to Paragraph 1 of Article 61, the court may require the receiver to gain the approval of the court before acknowledging a claim.

#### *4. Claims or Interests Governed by the Rehabilitation Plan*

##### *1) Secured Rehabilitation Claims*

A secured rehabilitation claim is a claim secured by collateral; *yuchigwon*, pledge, *yangdodambo*, security right with provisional registration, *chonsegwon*, or right of preference, in any property belonging to the debtor as of the date of the commencement of the rehabilitation proceeding. Any claim arising after the commencement of rehabilitation proceedings does not become a secured rehabilitation claim. If a creditor is entitled to a claim against the debtor which is coupled with some form of interest in properties belonging to a third party, the claim is considered as a rehabilitation claim. Insofar as the property is concerned, a claim is treated as a secured rehabilitation claim only when the claimant has obtained a further right against any particular property of the debtor. Therefore, under the DRBL, guaranteed obligations assumed by third parties are not considered as secured rehabilitation claims, regardless of their functional similarity to a security.

A claim is a secured rehabilitation claim to the extent of the value of the property securing the debt pursuant to the language of Article 141 wherein it states as such. In the event it is determined that the amount of the claim exceeds the value of the collateral, the claim is bifurcated and classified as a secured rehabilitation claim to the extent of the value of the collateral and a rehabilitation claim with respect to the deficiency. Subsequently, the classification of secured rehabilitation claims relies on the value of the collateral. Valuation is based on the liquidation value of the collateral. As a general rule the receiver refers to the market value in determining its value as collateral. Nevertheless, the market value is based on piecemeal sales rather than the possibility of selling the entire business. In respect to the

discretionary power given to the receiver when determining the value of the collateral and its relation to the principle of assurance of liquidation value, the court tries to induce the receiver to use a strict hand. Assessments by the examiner are often used in practice.

The following paragraphs present three types of transactions wherein it is disputed whether certain claims can be treated as a secured rehabilitation claim.

#### Financial Lease

Due to the fact that a financial lease is considered to have many diverse features, certain difficulties are presented in relation to the problem of placing claims for lease payments in a particular class. On one hand, on the note that a financial lease claim can be viewed as an executory contract in view of the fact that in a financial lease the lessor grants the lessee the right to use the good for a specified period of time in exchange for a lease payment for each corresponding period, allowing the receiver to assume or reject the contract wherein if assumed the counterparty shall be entitled to a common benefit claim. On the other hand, since it also retains features of a loan contract, there remains the possibility of placing them in the class of rehabilitation claims. From an alternative standpoint, the leased good may be subjected to reclamations rights in light of the fact that the leased object usually belongs to the lessor(the lease company) until the lease payments are finalized.

In the face of such controversy the practice was divided until a precedent was set, after which the court holds its position and classifies financial lease claims as secured rehabilitation claims. The court stated that a financial lease is substantially a plain financing transaction wherein the purpose of leaving the ownership of the object with the lessor is to retain a security interest and decided claims for lease payments should be considered as secured rehabilitation claims.<sup>30)</sup> Furthermore, computation of lease installments is based on the gross purchase value share and an interest added by the agreed lease fee rate for the corresponding period. Whereas, financial obligations are generally divided into the principal sum and an aggregate interest, the same distinction should not be made as far as financial lease claims are concerned.

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30) Seoul Appellate Court Decision of June 27, 2000 (Case No.: 2000NA14622). Hyuntae Bae, *Lease Claims in the Corporate Rehabilitation Proceeding*, 521 BUREO (February 2000) (in Korean).

Therefore, the total value of each lease installment is treated as a secured rehabilitation claim, not separating the value of post commencement interests as a rehabilitation claim.<sup>31)</sup>

#### Sale with title retention

Sales with title retention refers to a sale and purchase contract of tangible property wherein the seller grants the purchaser the right to possess, use and enjoy the property while retaining its ownership. The property retained in the hands of the seller functions as a collateral with respect to the purchaser's obligation, accrediting the seller as a holder of a secured rehabilitation claim, in the event a rehabilitation proceeding is commenced on account of the purchaser's insolvency.

Nevertheless, the court firmly asserts its opinion that unless full payments have been made with respect to the contract, the seller is allowed to exercise its right as the legitimate owner of the property, not only against the purchaser but also to any third party in possession of the property.<sup>32)</sup> According to the court the seller becomes entitled to reclamation rights if the purchaser is subjected to a rehabilitation proceeding. Many legal commentators are divided over the issue of the legal origin and nature of such sales.<sup>33)</sup> Discussions premised on cases of non-insolvency have been proved to be rather insufficient and unable to provide a satisfactory conclusion in circumstances of insolvency. There remains a need for further discussion in the future in order to resolve the problem we are currently facing.

#### Loans secured by bills

As standard business practice in the financial industry of Korea, corporations seeking to receive a loan from financial institutions often endorse and transfer commercial papers issued by a third party to the lender as a form

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31) Supreme Court Decision of September 13, 2004 (Case No.: 2003DA57208).

32) Supreme Court Decision of June 28, 1996 (Case No.: 96DA14807); Supreme Court Decision of September 7, 1999 (Case No.: 99DA30534); Supreme Court Decision of May 30, 2000 (Case No.: 99DA45826); Supreme Court Decision of May 26, 2005 (Case No.: 2004DA61211); Supreme Court Decision of May 26, 2005 (Case No.: 2004DA61211); Supreme Court Decision of June 1, 2007 (Case No.: 2006DO8400).

33) Hak Dong Kim, *The legal relation of sales with title retention*, 27 JOURNAL OF CIVIL LAW (March 2005) (in Korean).

of security to assure payment. When reaching the due date stated in the commercial paper the financial institution collects the sum wherein it satisfies its claim. The question is raised on what happens to the financial institution upon the commencement of a rehabilitation proceeding on account of the debtor's insolvency. Two possibilities can be considered. The first possibility is to determine that the bill decisively belongs to the financial institution and consider the issuer as 'a person who bears an obligation together with the debtor' pursuant to Paragraph 2 of Article 250. In this case the financial institution may collect its claim unhindered by the rehabilitation proceeding. The second view interprets the endorsement and transfer of the bill as a form of *yangdodambo* wherein the institution is classified as a secured rehabilitation creditor. As such, the institution, while entitled to make demands of payment, is not entitled to any satisfaction thereof.

Practice widely follows the latter approach, treating loans entailed by bill endorsements as a type of *yangdodambo* and classifying these financial institutions to have secured rehabilitation claims that can be only satisfied according to the terms and conditions of the rehabilitation plan. Nevertheless, often rehabilitation plans provide for secured creditors to be paid in full upon reaching the respective due date and in effect guarantees preferential payment.<sup>34)</sup>

## 2) Rehabilitation Claims

Primarily, a rehabilitation claim refers to any right to payment, monetary or otherwise,<sup>35)</sup> against the debtor arising on account of conditions precedent to the commencement of a rehabilitation proceeding. So long as the debtor owes an obligation to another on account of conditions precedent to the commencement of rehabilitation proceedings, rehabilitation claims virtually encompass any type of right to payment whether or not it is matured or fixed.<sup>36)</sup> According to Paragraph 1 of Article 118, rehabilitation claims also include certain claims that arise after the rehabilitation proceeding is commenced; post commencement interests, rights to indemnification

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34) SEOUL DISTRICT COURT BANKRUPTCY DIVISION, THE REHABILITATION PROCEEDING - LAW AND PRACTICE 353 (Pak Young Sa 2006) (in Korean).

35) For example, the right to use the facilities of a country club may be classified as a general rehabilitation claim. See Supreme Court Decision of April 11, 1989 (Case No.: 89DAKA4113).

36) Supreme Court Decision of March 10, 2000 (Case No.: 99DA55632).

(compensation for damages) or penalties for breach of performance arising after rehabilitation proceedings commence, and expenses accrued on account of the claimants participation in the rehabilitation proceeding. Rehabilitation claims are further divided, based on their level of priority, into rehabilitation claims with priority and general rehabilitation claims. The distinction generally relies on whether certain rehabilitation claims are given priority under specific statutory provisions. For example, general rehabilitation claims rank lower than claims held by an employee entitled to preferential payment according to Article 468 of the Commercial Code,<sup>37)</sup> as with preferential payment rights for special reserves set out in the Insurance Business Law Article 32 and Article 33 and the Savings Bank Law Article 37-2.

The former Corporate Reorganization Law<sup>38)</sup> and Composition Law<sup>39)</sup> adopted the concept of subordinated rehabilitation claims and ranked such claims even below general rehabilitation claims. Subordination by law was discarded during the course of establishing the DRBL in recognition of the opinion held by legal commentators that the concept lacked sufficient theoretical basis. Such subordinated claims are now classified and placed within the class of general rehabilitation claims. Notwithstanding the above exclusion, the law does not prohibit subordination by agreement. The DRBL states that the rehabilitation plan should respect the order of payment agreed among creditors, in whole or in part, before the date of the first meeting for the related parties, provided that the agreement does not infringe the right of other creditors or equity holders included in the rehabilitation plan.

### 3) *Other Post Commencement Claims*

According to the DRBL, any claim arising after rehabilitation proceedings commence but unqualified to be classified as either a common benefit claim, a secured rehabilitation claim or a rehabilitation claim is collectively referred to as 'other post commencement claims' (Art. 181). In practice, claims that arise after the commencement of the rehabilitation proceeding are generally

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37) According to Article 468 of the Commercial Code, Any person entitled to claim recovery of funds provided as guarantee for the fidelity of an employee or any employee holding a claim arising from relations between the employee and the company shall be entitled to preferential payment from the company's entire assets, provided that such rights do not precede any pledge or mortgage therein.

38) Article 121 of the Corporate Reorganization Law.

39) Article 45 of the Composition Law.

classified as common benefit claims. Hence, the chance of a specific claim to be placed in this class is exceedingly remote. Nevertheless, in the event a claim is placed in this class, the creditors with other post commencement claims shall not be paid or receive any payment before the duration of the period for the administration of payments set by the rehabilitation plan fully expires. Creditors are restricted from receiving payments until the rehabilitation proceeding is terminated, in the case the rehabilitation proceeding was terminated before the confirmation of the plan, and until the actual date payments were finalized in the case payments are finalized before the final date set by the rehabilitation plan.

#### *4) Stocks or Equity*

Shareholders, in the case of joint stock corporations, and equity holders, in the case of other forms of corporation under the Korean Commercial Code, are entitled to participate in the rehabilitation proceeding with their stock or equity.

### *5. General Principles and Rules of Priority within the Rehabilitation Plan*

#### *1) Introduction*

As noted at the beginning of the preceding section, secured rehabilitation claims, rehabilitation claims and other post commencement claims pursuant to Article 181 are bound by the terms and conditions provided in the rehabilitation plan. The goal of the rehabilitation proceeding lies in maximizing the 'going concern value' of the debtor or the property of the debtor and its successful distribution to relevant creditors and equity holders. Attempts to rehabilitate a business generally involve the sale or transfer of assets or businesses, in whole or in part, or implementing changes in order to improve the structure of corporate governance. In comparison, the distribution of the future value of the debtor relates to a priority structure, a hierarchy, among rehabilitation claims, secured rehabilitation claims and equity holders provided within the rehabilitation plan. Insofar as the rehabilitation proceeding and the rehabilitation plan are concerned, this is why the rules of priority and general principles that govern the rehabilitation plan and predetermine the subsequent order of claims merit discussion.

One of the most important rules with respect to the priority structure that governs the rehabilitation proceeding is the principle of fair and equitable discrimination contained in Article 217 of the DRBL. The language used in Article 217 sets forth the issue of the so called absolute priority rule. Adversaries are divided on whether superior claims, pursuant to Article 217, are given absolute priority over those junior to them. Another principle that draws attention is the principle often referred to as the principle of assurance of liquidation value.<sup>40)</sup> In connection with this principle arises the issue of whether adopting the liquidation value as the floor for guaranteeing financial protection within the rehabilitation proceeding is appropriate, in light of the fact that the goal of the proceeding is to rehabilitate the insolvent as a going concern. Finally, the priority of claims relate to the principle of equality provided in Article 218 of the DRBL. The primary issue with respect to this principle has to do with the meaning of equality.

## 2) *The Principle of Fair and Equitable Discrimination*

Under Article 217 of the DRBL, claims and equity are given priority in the following order, from top to bottom:

- Secured rehabilitation claims
- Rehabilitation claims with priority
- General rehabilitation claims
- Equity with preferential rights in relation to the allocation of residual property
- Equity other than those provided above

With respect to the question of the meaning of 'fair and equitable discrimination,' it is necessary to first lay some ground. Under Article 217 of the DRBL, a rehabilitation plan is required to fairly and equitably discriminate creditors and equity holders respecting the level of priority entitled to each class. Also, as a condition required for the confirmation of the court, Paragraph 1, Item 2 of Article 243 states that the rehabilitation plan should be fair and equitable. The phrase 'fair and equitable' can also be found in the

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40) In the United States the principle of assurance of liquidation value is referred to as the 'best interests' test. 11 U.S.C. 1129(a)(7).

Bankruptcy Code of the United States (11 U.S.C. 1129(b)(2)(B)). The United States Supreme Court interprets the phrase to embody the so-called “absolute priority” principle. The U.S. Court stated that when confirming on a cram down basis, the plan must fully compensate classes with senior rights in the debtor before junior classes can be given any value in the reorganized company.<sup>41)</sup> In contrast to the use of the principle of fair and equitable discrimination only in relation to cases of cram downs in the United States, in Korea the majority premises that the principle is generally applied when confirming the plan, whether consensual or not, and explores the possibility of interpreting the principle to embody the absolute priority rule. The Supreme Court of Korea<sup>42)</sup> and legal commentators alike are of the opinion that the DRBL adopts the rule of relative priority. That is, as long as senior rights are favored in comparison to junior classes, the plan may choose to compensate junior creditors before those senior to them are paid in full. They argued that the result of negotiations among relevant parties should be respected, provided that the plan guarantees the amount equal to the value each claimant would receive if the debtor were liquidated. Furthermore, they assert that the rule of relative priority holds also in cram down cases.<sup>43)</sup>

However, as stated in the preceding paragraph, the DRBL uses the phrase ‘fair and equitable’ on two occasions instead of one and this certainly should be taken into consideration when discussing whether the DRBL adopts the absolute priority rule. The Supreme Court of Korea and legal commentators generally base their argument on the idea that ‘fair and equitable’ used in Article 217 and ‘fair and equitable’ used in Article 243 have the same meaning. However, with respect to cases of confirmation on a cram down basis, in view of the fact that the origin of Paragraph 1, Item 3 of Article 243 can be found from the Bankruptcy Code of the United States, fair and equitable should be interpreted to embody the absolute priority rule, while with respect to those

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41) GEORGE M. TREISTER, J. RONALD TROST, LEON S. FORMAN, KENNETH N. KLEE & RICHARD B. LEVIN, FUNDAMENTALS OF BANKRUPTCY LAW 449 (ALI-ABA 1993).

42) The Supreme Court stated that the principle of fair and equitable discrimination should be interpreted to mean either that the senior right is entitled to priority with respect to the distribution of proceeds and residual rights or that no junior class shall be given preferential treatment in comparison to those senior, Supreme Court Decision of December 10, 2004 (Case No.: 2002GEU121).

43) SEOUL DISTRICT COURT BANKRUPTCY DIVISION, REHABILITATION PROCEEDINGS - LAW AND PRACTICE 58-59 (Pak Young Sa 2006) (in Korean).

cases confirmed on a consensual basis, the interpretation of the phrase fair and equitable should not be linked with discussions of absolute priority and relative priority. But in this case, the plan should respect the general concept of equity on the whole.<sup>44)</sup>

### 3) *The Principle of Assurance of Liquidation Value*

According to the DRBL, the terms and conditions of a rehabilitation plan should guarantee creditors and equity holders at least as much as the amount equal to the value each creditor would receive if the debtor's business were liquidated.<sup>45)</sup> If the plan fails to comply with this requirement, the plan cannot gain the confirmation of the court. Often referred to as the 'best interests' test, this principle in reality has the effect of guaranteeing claims and interests payment to the extent of the amount proportionate to the liquidation value.

The statutory provision for the principle of assurance of liquidation value was first adopted by the DRBL. Article 243 of the DRBL states in explicit terms that the rehabilitation plan should guarantee each creditor payment equal to the amount it would retain in the event the debtor were liquidated. Nevertheless, the concept itself predates the DRBL and its origin can be found in relation to 'cram downs' by the court. When accepted by each class on a consensual basis, the court may confirm the plan once it is verified that the requirements for confirmation pursuant to Article 243 have been met. In the event a class does not consent to the rehabilitation plan, the court may, nevertheless, confirm the rehabilitation plan provided that at least one class of claims has given its consent to the plan and the court amends the plan to stipulate provisions protecting the right of creditors or equity holders in each non-consenting class ("Protection Clauses").<sup>46)</sup> The purpose of the protection

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44) SOOGEUN OH, UNDERSTANDING INSOLVENCY LAW 225-26 (Ewha Womans University Press 2008) (in Korean).

45) Article 243, paragraph 1, subparagraph 4.

46) Paragraph 1 of Article 244 specifically states the manner by which creditors in each respective class should be protected; ① In respect of secured rehabilitation creditors, the method of transferring the property, which is the subject-matter of their security rights, to a new company, or transferring it to another person, or retaining it to the debtor, while maintaining such rights to the property; ② Method where, for secured rehabilitation creditors, the court sells the property, which is the subject-matter of security rights; for rehabilitation creditors, the court sells the rehabilitation debtor's property to be used for the repayment of claims; and for share/equity holders, the court sells the rehabilitation debtor's property to be used for allocation of the residual property; at a price not less than the fair price determined by the court (with

clauses is to preserve the substantial value of claims and equity. The court has held and continues to hold two principles when interpreting the cram down clause: firstly, it uses the concept of liquidation value when deciding the financial standard for protection, and secondly, it adopts a piecemeal valuation of the debtor's existing assets when calculating the aforementioned liquidation value of the debtor. The Supreme Court establishes that the calculation of the value of assets of a debtor should be decided upon piecemeal valuation of the corporation's assets in liquidation rather than valuation of the debtor as a going concern.<sup>47)</sup> In response, it is possible to raise two questions. Why should the substantial value of rights be limited to its liquidation value? And even if the liquidation value should serve as a basis, why should piecemeal valuation of the corporation's assets be the sole component for calculation?<sup>48)</sup>

The value of claims and equity accorded protection should be extended to the valuation of the debtor as a going concern, especially in consideration of the fact that the purpose of the rehabilitation proceeding is to rehabilitate the insolvent as a going concern. Furthermore, since liquidations do not necessarily require piecemeal sale of assets and may proceed to sell the entire business as a going concern, the court is mistaken in asserting that the liquidation value should only indicate the piecemeal valuation of the corporation's assets.

#### 4) *The Principle of Equality*

The principle of equality is set forth in Paragraph 1 of Article 218 of the DRBL which provides that the terms and conditions of a rehabilitation plan should be applied equally to claims and equity of a similar nature. The meaning of 'equality' is a central issue that determines the level of differential treatment allowed between similar claims and equity. Whereas the principle

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respect to the property which is the subject-matter of security rights, the price shall be valued on the assumption that there are no encumbrances arising from such rights), and uses the sale proceeds minus disposition expenses for debt repayment, allocation or official deposit with the court; ③ Method of paying the fair value of the claims as determined by the court to the relevant right holders; and ④ Other methods to protect the holders of rights in a fair and equitable manner in accordance with Subparagraphs 1-3.

47) Supreme Court Decision of December 10, 2004 (Case No.: 2002GEU121).

48) SooGeun Oh, *The Principle of Assurance of Liquidation Value*, 28 JOURNAL OF PRIVATE CASE LAW STUDIES 428 (2006) (in Korean).

of fair and equitable discrimination explained above weighs the relation between classes, the principle of equality is a measurement that applies to the treatment of claims within each respective class. The court opposes to imposing a strict and definitive meaning to the term 'equality' and holds that the principle of equality does not require identity of treatment. In a number of rulings the court has forwarded its opinion on the meaning of the term 'equality' used in the aforementioned provision stating that equality should be referred to, not in terms of identity, but in terms of relativity and permits difference in treatment as long as the difference is relative and not severely disparate.<sup>49)</sup> Unless bound by a relevant and reasonable purpose for which distinctions should be made, the terms and conditions of the rehabilitation plan should extend the same treatment towards specific claims included in the class of secured rehabilitation claims or rehabilitation claims.

#### *5) Penalty Claims and Tax Claims*

Pursuant to Paragraph 1, the rehabilitation plan may not impair, including any reduction or deferment of payment thereof, any claim arising from pecuniary punishments, a fine, a minor fine, an additional collection charge, and expenses of criminal procedures, existing at the time rehabilitation proceedings commence ("penalty claims"). In general, rehabilitation claims are subject to whatever deals creditors and equity holders work out on the terms and conditions of payment by virtue of the rehabilitation plan. Although penalty claims are classified as general rehabilitation claims, they are given special treatment whereby the relevant parties are restricted from making any agreement that may impair such rights, and the imposing agency retains their right without any change in their original status as of the effective date of the plan. On this note, it is possible to determine that penalty claims, while classified as general rehabilitation claims, are given a superseding status in terms of both time and amount. With the commencement of the rehabilitation proceeding, penalty claims precede other claims in time and are paid in full to the exclusion of any other creditor, except creditors holding common benefit claims.

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49) Supreme Court Decision of August 28, 1998 (Case No.: 98GEU11); Supreme Court Decision of January 5, 2000 (Case No.: 99GEU35); Supreme Court Decision of December 10, 2004 (Case No.: 2002GEU121).

Paragraph 2 of Article 140 also provides for the special treatment of any tax to be collected pursuant to the National Tax Collection Act or the Local Tax Act, including any claim given a higher priority than general rehabilitation claims and to be collected following suit of national tax collection (“tax claims”). In the event the rehabilitation plan contains provisions deferring collection of tax claims, the governing agency is required to intervene by providing either its opinion or consent. If the deferment lasts longer than three years, the consent of the agency should be obtained, whereas any deferment shorter than the above period only demands to take the opinion of the agency in consideration. In view of such restrictions, it can be referred that tax claims are entitled a superior status in the amount to be collected. In terms of time, tax claims retain a lower rank in comparison to penalty claims, but a superior rank to general rehabilitation claims.

#### **IV. Priority in the Rehabilitation Proceeding for Individuals**

The rehabilitation proceeding covered in the preceding chapter of this article is applied to any individual or legal entity. In contrast, the rehabilitation proceeding for individuals is a proceeding reserved for individuals only. An individual debtor refers to a wage earner or a self-employed earner who has the cause for or possibility of bankruptcy. An insolvent debtor may resort to the rehabilitation proceeding for individuals only to the extent its liability does not exceed one (1) billion won (KRW 1,000,000,000) in the case of secured claims and five hundred million won (KRW 500,000,000) in the case of unsecured claims.

In comparison to the bankruptcy proceeding, which focuses on the present value of the debtor, the rehabilitation proceeding for individuals rely on future earnings, as is the case for the rehabilitation proceeding in Part 2 of the DRBL. Nevertheless, with respect to the rehabilitation proceeding for individuals, the DRBL adopts the concept of a rehabilitation estate for an individual wherein the proceeds are used as the source for making payments to the creditors.

### *1. Rehabilitation Estate for Individuals*

In the rehabilitation proceeding for individuals, any property belonging to the debtor, including any property or income acquired after the date of the commencement, is entered into the rehabilitation estate for individuals. The rehabilitation estate is the source for making payments to creditors under the proceeding. As is the case in the creation of a bankruptcy estate, certain properties are excluded from comprising the rehabilitation estate for individuals. Any property that does not comprise the estate remains out of reach for even the most superior creditors.

Pursuant to Paragraph 3 of Article 580, Article 383 on the composition of the bankruptcy estate in bankruptcy proceedings is applied *mutatis mutandis*; any Attachment-proof property and any property exempt from the estate by the court is excluded from the individual rehabilitation estate. It should be noted that any property that can be reclaimed pursuant to Article 586, is also excluded from comprising the rehabilitation estate for individuals.

### *2. Right of Reclamation and Right of Separation*

Article 586 applies *mutatis mutandis* to Article 408 and Article 409, which provides the right of reclamation and the right of separation for the bankruptcy proceeding to the rehabilitation proceeding for individuals. As such, any property given the appearance of ownership on account of the debtor's possession can be recovered by the true owner. As is the case in the bankruptcy proceeding, in terms of time, amount and method of payment, it is possible to refer that such reclamation rights in effect gives the unpaid seller and the cosigner a superseding priority to the extent of the value of the reclaimed good.

Also, secured creditors are allowed to foreclose outside the proceeding and entitled to be paid in full from the proceeds of the collateral. Pursuant to Article 586, under certain qualifications, tenants are entitled to recover the value of their lease deposits from the proceeds of the leased house (including the premises) belonging to the bankruptcy estate and as is the case under Paragraph 3 with respect to the Commercial Building Lease Protection Law.

### 3. *Rehabilitation Estate Claims for Individuals*

The DRBL adopts the concept of 'rehabilitation estate claims for individuals' in rehabilitation proceedings for individuals wherein such claims may be satisfied irrespective of the proceeding and entitled to payments whenever disposable cash is retained. As such, the debtor is obliged to pay creditors holding rehabilitation estate claims for individuals when they are due and prior to the satisfaction of rehabilitation claims for individuals (Art. 475, Art. 476 and Art. 583, Para. 2). Like common benefit claims in the rehabilitation proceeding or estate claims in the bankruptcy proceeding, rehabilitation estate claims for individuals can be subdivided into three groups. As shown in the table below, while claims for paying expenses in relation to the rehabilitation administrator comprise the first group, the second group consists of claims that are classified as rehabilitation estate claims for individuals based on equity, i.e., claims established when the debtor borrows money, purchases goods, and performs other acts indispensable for the continuous business operations of the debtor with a court approval issued after the filing for the commencement of the individual rehabilitation proceeding and before the decision of the commencement; and expenses other than those set out in Items 1-5 that must be disbursed for the benefit of the debtor. Claims in the third group are mostly claims that have been classified as estate claims as a social policy, such as claims to be collected pursuant to the National Tax Collection Act or the Local Tax Act;<sup>50)</sup> wages, severance pay and disaster compensation for employees of the debtor; claims for return of deposits and guarantee money against personal liability of the debtor's employee that arise out of a cause prior to the decision of commencement of the individual rehabilitation proceeding.

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<sup>50)</sup> However, these claims are limited to those which are not yet due at the time of the commencement of the rehabilitation proceeding for individuals.

**Table 1.** Comparison of Common Benefit Claims and Estate Claims

	Common Benefit Claims	Rehabilitation Estate Claims for Individuals	Estate Claims
Expense Related	<p>Judicial expenses for the common benefits of creditors and equity holders (Art. 179, Subpara. 1)</p> <p>Expenses relating to business operation and the management and disposal of debtor's properties (Art. 179, Subpara. 2)</p> <p>Claims for expenses necessary for implementation of the rehabilitation plan (Art. 179, Subpara. 3)</p> <p>Claims for expenses, salary, compensation and special bonus of the receiver and the examiner (Art. 179, Subpara. 4)</p> <p>Claims arising from borrowing of money and other activities by the receiver for the business and property of the debtor after commencement of the rehabilitation proceeding (Art. 179, Subpara. 5)</p> <p>Claims arising from borrowing of money, purchasing of materials and other indispensable activities for continuous business operation of the debtor which was performed by the receiver or interim receiver with the approval of the court after the application of rehabilitation proceeding and prior to commencement thereof (Art.179, Subpara. 12).</p> <p>Expenses necessary for the activity of the Council of Creditors, determined by the court (Art.179, Subpara. 13).</p> <p>Expenses other than those set</p>	<p>Claims for remuneration and expenses of the rehabilitation administrator (Art. 583, Para. 1)</p>	<p>Claims for costs of any procedures in court for the common benefit of the bankruptcy creditors (Art. 473, Para. 1)</p> <p>Expenses for management, realization and distribution of the bankruptcy estate (Art. 473, Para. 3)</p> <p>Claims arising out of an act of the bankruptcy trustee with respect to the bankruptcy estate (Art. 473, Para. 4)</p> <p>Claims held by the other party, in the event the bankruptcy trustee performs any obligation under Paragraph 1, Article 335 (Art. 473, Para. 7)</p> <p>Expenses for any lawsuit on any property belonging to the bankruptcy estate, which is pending at the time of the adjudication of bankruptcy (Art. 347, Para 2)</p> <p>Expenses for continuing compulsory execution procedures by the bankruptcy trustee (Art. 348, Para 2).</p> <p>Claims for the reimbursement of litigation expenses by the dissenting bankruptcy creditor to the extent of the benefit obtained from any lawsuit on the finalization of a bankruptcy claim (Art. 469)</p>

	Common Benefit Claims	Rehabilitation Estate Claims for Individuals	Estate Claims
Expense Related	<p>out in Subparagraphs 1-13, Art. 170 that are inevitably disbursed for the benefit of the debtor (Art.179, Subpara. 14).</p> <p>Claims for expenses of reimbursement in respect of the continued proceedings or measures under Para. 5, Art. 58 (Art. 58, Para. 6)</p> <p>Claims for litigation expenses spent by the rehabilitation creditor or the secured rehabilitation creditor, who raised objection, to the extent of the existing benefit in a case where any legal action regarding finalization of rehabilitation claims or secured rehabilitation claims (including a judgment on examination and finalization of claims) inures to the benefit of the debtor's property (Art. 177).</p>		
Equity Related	<p>Claims held by the counter-party in cases where the receiver performs obligations of executor contract (Art. 179, Subpara. 7),</p> <p>Claims arising from the supply by the counter-party to a bilateral contract, who bears the obligation of continuous supply, during the period from filing for commencement of the rehabilitation proceeding to commencement of such rehabilitation proceeding (Art. 179, Subpara. 8)</p> <p>Claims arising in respect of the debtor after commencement of the</p>	<p>Claims established when the debtor borrows money, purchases goods, and performs other acts indispensable for the continuous business operations of the debtor with a court approval issued after the filing for the commencement of the individual rehabilitation proceeding and before the decision of the commencement (Art. 583, Para. 5)</p> <p>Expenses other than those set out in Items 1 -</p>	<p>Claims made against the bankruptcy estate after the adjudication of bankruptcy due to any management of affairs or unjust enrichment (Art. 473, Para. 5)</p> <p>Claims made against the bankruptcy estate due to any act performed for an urgent necessity after the delegation is terminated or the power of attorney is extinguished (Art. 473, Para. 6)</p> <p>Claims created by the time a bilateral contract is terminated, in the event such a contract is terminated due to the adjudication of bankruptcy (Art. 473, Para. 8)</p>

	Common Benefit Claims	Rehabilitation Estate Claims for Individuals	Estate Claims
Equity Related	<p>rehabilitation proceeding due to administration of affairs or unjust enrichment (Art. 179, Subpara. 6)</p> <p>Claims for reimbursement of profits accrued from the consideration received by the debtor if all or part of them exist in the debtor's property in cases where acts of the debtor is avoided (Art. 108, Para. 3, Subpara. 3 and 5)</p> <p>Claims for reimbursement of the value of difference between existing profits if part of the profits that accrue from the consideration received by the debtor still exist in the debtor's property in cases where acts of the debtor is avoided (Art. 108, Para. 3, Subpara. 3)</p> <p>Claims for the reimbursement of the value of the consideration if the consideration received by the debtor does not exist in the properties of the debtor in cases of rescission or termination of executory contracts pursuant to Art 119 (Art. 121, Para. 2)</p> <p>Estate claims in the suspended bankruptcy proceeding except those of Art. 473, Subpara. 2 and 9 (Art. 256, Para. 2)</p>	<p>5 that must be disbursed for the benefit of the debtor (Art. 583, Para. 6)</p>	<p>Claims by the counter party for any payment transferred to the debtor in the event any act of the debtor is avoided (Art. 398, Para 1)</p> <p>Claims for the encumbrances attached to for testamentary gifts subject to an encumbrance, when the bankruptcy trustee has received performance and to the extent not exceeding the value of the testamentary gift (Art. 474)</p>
Policy Related	<p>Wage, salary, retirement allowance and accident compensation claims of the debtor's employees (Art. 179, Subpara. 10)</p> <p>Claims for return of any deposits and guarantee</p>	<p>Claims to be collected pursuant to the National Tax Collection Act or the Local Tax Act (Art. 583, Para. 2)</p> <p>Wages, severance pay and disaster</p>	<p>Claims collectable pursuant to the National Tax Collection Act or the Local Tax Act (claims whose collection priority are higher than that of the general individual rehabilitation</p>

	Common Benefit Claims	Rehabilitation Estate Claims for Individuals	Estate Claims
Policy Related	money against personal liability of the debtor's employees which arise from reasons existing prior to commencement of the rehabilitation proceeding (Art. 179, Subpara. 11) Taxes subject to withholding (Art. 179, Subpara. 9)	compensation for employees of the debtor (Art. 583, Para 3) Claims for return of deposits and guarantee money against personal liability of the debtor's employee that arise out of a cause prior to the decision of commencement of the individual rehabilitation proceeding (Art. 583, Para 4)	among the ones collectable pursuant to the examples of national tax collection, except Subordinate Claims stipulated in Article 446). However, any claims arising out of any cause after the adjudication of bankruptcy shall be limited to those against the bankruptcy estate (Art. 473, Para. 2) Allowance in aid for the debtor and his dependants (Art. 473, Para 9) Payment, severance pay, and accident compensations for employees of the debtor (Art. 473, Para. 10) Return claims for deposits and guarantee money against personal liability of employees of the debtor, which have resulted from a cause before the adjudication of bankruptcy (Art. 473, Para. 11)

#### 4. Rehabilitation Claims for Individuals

Pursuant to Paragraph 1 of Article 581, any right to payment arising on conditions precedent to the commencement of the proceeding is classified as a rehabilitation claim for individuals. Claims arising after the commencement of the proceeding are also classified as a rehabilitation claim for individuals so long as it falls within the following list of claims (Art. 581, Para. 2):

- Interest accrued after the commencement of rehabilitation proceedings;
- Compensation for damages and any penalty for a nonperformance after the commencement of rehabilitation proceedings;

- Expenses for participation in the rehabilitation proceedings;
- Any fine, minor fine, additional collection charge or expenses of criminal procedures

As a general rule, rehabilitation claims for individuals are given pro rata shares of the rehabilitation estate for individuals. Nevertheless, the law further subdivides rehabilitation claims for individuals into claims with priority and subordinated claims. For example, national and local tax claims, duties, additional charges and claims for insurance pertaining to health, pension, employment and/or industrial compensation are classified as rehabilitation claims for individuals with priority, while post commencement interests, fines, minor fines, additional charges and expenses of criminal procedures are allotted as subordinated claims. Considering that the rehabilitation estate for individuals is often insufficient to cover rehabilitation claims with priority, a subordinated rehabilitation claim is rarely given any satisfaction. The DRBL applies mutatis mutandis Article 446 which lists subordinated bankruptcy claims.

## **V. Related Discoveries on the Issue of Priority in Insolvency Proceedings**

### *1. Priority by Special Laws*

Upon exploring various laws and regulations, we were able to find that certain statutes contained provisions that entitled specific claims favorable treatment which in effect gave such claims priority over others. The paragraphs below present several types of claims that are entitled to a superior status, explicitly or implicitly, pursuant to relevant laws and regulations.

#### *1) Bankruptcy of Financial Institutions*

Whenever a foreign financial institution is adjudicated bankrupt, more often than not, creditors of diverse nationalities become involved. In such cases, certain laws provide that domestic creditors retain superiority to other claimants. Priorities given to the domestic customers of financial institutions

in the case financial institutions become insolvent are as follows:

a) In the event any branch or business office of a foreign financial institution is liquidated or becomes bankrupt, any asset, capital, reserve or surplus must be used to, first and foremost, pay domestic creditors. In the case the creditor is of a foreign nationality, the law requires the creditor to reside in Korea (Article 62 of the Banking Law).

b) In the event any branch or business office of a foreign securities company in Korea is liquidated or becomes bankrupt, any asset held within the Korea must be used to pay the counterparty of a security transaction. In this case, the counterparty is required to have resided in Korea at the date of the transaction (Paragraph 5 of Article 28-2 of the Securities and Exchange Law).<sup>51)</sup>

c) In the event any branch or business office of a foreign asset management company is liquidated or becomes bankrupt, any asset kept within the Korea must be used, first and foremost, to pay any creditor residing in Korea (Article 156 of Indirect Investment Management Law)

d) In the event a depository securities company is adjudicated bankrupt, the securities company must withdraw and return to its customer any customer deposit from the depository institution (Article 44-3 of the Securities and Exchange Law)

e) In the event a depository finance investment company is adjudicated bankrupt, the investment company must withdraw and return to the investor any deposit from the depository institution (Article 74 of Law on Capital Market and Investment Finance)

## 2) *Claims of the Subcontractor*

Claims for the price of subcontracts are also given higher priority in insolvency proceedings. In the event the contractor is <sup>a</sup> unable to pay the subcontract price due to bankruptcy, suspension of payment, or any other reason of a similar nature including revocation of the constructor's

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51) Paragraph 3 of Article 65 of the Law on Capital Market and Investment Finance is written in a similar context. The Law on Capital Market and Investment Finance is scheduled to replace the Securities and Exchange Law from February 4, 2009.

construction license and ⑥ the subcontractor demands the project owner to pay the subcontract price, the business operator is obliged to pay the subcontract price to the subcontractor proportionate to the construction already carried out (Paragraph 2, Item 3 of Article 35 of the Framework Law on the Construction Industry).<sup>52)</sup> Pursuant to this provision the subcontractor in effect is entitled to preferential payment before other creditors with general claims against the contractor. Paragraph 1, Item 3 of Article 31-5 of the Information Communications Business Law contains similar provisions. As these provisions entitle subcontractors to collect their claims against the debtor from the debtor's debtor, the subcontractor enjoys priority in the method of collection.

### 3) *Claims for Certain Wages and Salaries*

Certain wages and salaries are also given priority. For example, Article 44-3 of the Labor Standard Law allows employees of the subcontractor to demand the immediately foregoing contractor to pay any wage or salary owed by the subcontractor. In the event the subcontractor has notified the immediately foregoing subcontractor of its obligation with respect to any wage or salary incurred on account of the construction contract, and the immediately foregoing subcontractor acknowledges that the subcontractor is unable to fulfill its obligation due to bankruptcy or any other reason of similar importance, upon any demand by the subcontractor's employees the immediately foregoing subcontractor shall be obliged to pay the employee any wage or salary. In this case the obligation of the immediately foregoing subcontractor shall not exceed the total amount of the agreed subcontract price.

In general, wages and salaries are classified as estate claims with the adjudication of the bankruptcy proceeding and precede bankruptcy claims. Estate claims are entitled to superiority only to the extent of the value of the bankruptcy estate and given satisfaction on a pro rata basis if the proceeds of the estate cannot cover all estate claims. Nevertheless, by virtue of this provision employees are entitled to be paid by the immediate foregoing

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<sup>52)</sup> Paragraph 1, Item 4 of Article 35 of the Law provides that the project owner may choose to pay the subcontractor the proportionate subcontract price when it acknowledges that the contractor is unable to pay the subcontract price on account of bankruptcy thereof.

contractor and in effect given higher priority than creditors holding estate claims.<sup>53)</sup>

In addition, the Law on the Sale of Buildings requires the construction company to enter an agency contract with a trust company (Art. 4, Para. 3). Article 2 of the subsequent ordinance provides as a rule on the disbursement of the contract price that in the event it is no longer possible to continue business due to *budo*<sup>54)</sup> or bankruptcy thereof, any residue must be returned, first and foremost, to the buyer. The purpose of this provision is to protect citizens from fraudulent sales when entering sale contracts on apartment houses or stores. According to this clause, the buyer is given priority over any other creditor with a general claim. Nevertheless, it should be noted that the legitimacy of the provision remains in doubt, in view of the fact that the rank of priority given by the law cannot be changed by an ordinance.

## 2. Subordinated Claims and Setoffs

In some instances creditors may agree to the subordination of its claim. While the problem of whether it is possible to classify any claim subordinated by agreement before the commencement of insolvency proceedings as a subordinated claim once insolvency proceedings commence still requires to be discussed in length, assuming that the claim retains a secondary status, an interesting matter with respect to issue of priority can be found in connection with the right to set off. For instance, if a creditor holding a subordinated claim against the debtor also in fact owes a debt to the debtor, it would become necessary to determine whether the creditor is entitled to defend itself by setting off the debtor's claim against the creditor. If the mutual debts are set off then both claims are extinguished and in effect advances the payment of the subordinated claim. Herein lies the core of the issue; is it against the law if the subordinated creditor is satisfied by way of set offs outside insolvency

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53) Claims for wages or salaries are protected by the Wage and Salary Protection Law. According to Article 7 of the aforementioned Law, in the event the employer is bankrupt or meets any requirement specified by the presidential decree, upon receiving demands payment of any wage or salary by the retired employee, the Minister of the Ministry of Labor is obliged, in lieu of the employer, to pay the wage and salary the employer has not yet paid irrespective of Article 469 of the Civil Code on payment by a third party.

54) *Budo* refers to when checks or notes cannot be paid.

proceedings prior to superior creditors, even if it doesn't involve any actual exchange of proceeds. The question remains to be clarified.

## VI. Conclusion

Insolvency unveils the genuine virtue of the concept of priority. Attempts, however, have proved that the task of arranging relevant claims in a single line of order according to their priority is quite difficult and complicated in insolvency proceedings. The reason lies in the fact that the concept of priority contains three factors: time, amount and method of collection. In compulsory non-insolvency collection procedures, the priority structure affords certain claims to clearly precede others in time and amount. In this case, the superior creditor is entitled to be paid in full before and to the exclusion of other junior creditors. There is no other method of collection.

Priority structures differ with respect to each particular insolvency proceeding. Like non-insolvency execution procedures, the bankruptcy proceeding relates to the distribution of the value of the property belonging to the debtor as of the date of the proceeding. Secured claims are not restricted by the bankruptcy proceeding. As such, it is possible to arrange estate claims and bankruptcy claims in a single line of order. The rehabilitation proceeding, which aims to rehabilitate the debtor and to repay creditors using not only the current assets belonging to the debtor but also future earnings, retains a complicated priority structure. Since creditors are to be paid according to the terms and conditions of the rehabilitation plan over a period that extends for as long as ten years, the governing rule of priority in rehabilitation proceedings is difficult to understand without distinguishing the separate components of the concept; time, amount and method of collection. Creditors with the right of reclamation or right of separation are not subjected to the rehabilitation proceeding. Creditors with common benefit claims are subjected to the rehabilitation proceeding but not to the rehabilitation plan. These creditors enjoy priority over other creditors who are subjected to the rehabilitation proceeding with respect to the method of collection. Nevertheless, it is incorrect to generalize that common benefit creditors have priority over other creditors in terms of time and amount. There is a chance that other creditors will be paid no later in time and no less in amount than

common benefit creditors. Although Article 217 of the DRBL provides the respective priorities of secured rehabilitation claims, rehabilitation claims and stock/equity, the list does not mean that creditors in a higher position are to be paid prior to and more than those in a lower position. The rehabilitation plan may provide general rehabilitation creditors to be paid before secured rehabilitation creditors. According to precedents and prevailing theories, the hierarchy given in Article 217 does not mean superior creditors are entitled to absolute priority, but rather that fair and equitable discrimination between each rank is required. Creditors in the same class can be treated differently as far as the discrimination is reasonable. The bottom floor of such flexibility is the assurance of the liquidation value. It is fair to say that priority in the rehabilitation proceeding is not as rigid as in the bankruptcy proceeding and partly negotiable as far as the liquidation value is assured. The rehabilitation plan, a reflection of the negotiations, shows the final list of priority, which is decided in separate terms of time and amount. In comparison, priority in the rehabilitation proceeding for individuals is rather simple because secured creditors are not restricted by the proceeding and the payment plan covers only general creditors.

We found that priority in insolvency proceedings cannot be explained by a list that simply lines one claim after another. It is necessary to consider the factors of time, amount and method of collection in order to understand the priority structure in insolvency proceedings. Rights of reclamation and the right of separation in effect give priority to its holders because properties related to such rights are beyond the reach of even creditors with the highest priority. Any property that is not included in insolvency estates also ignores priority. Besides insolvency laws and laws directly related to debt collection, several laws have provisions that alter the priority of certain types of creditors with respect to the amount or method of collection. These also provide causes that make it difficult to explain priority in insolvency proceeding with a linear list. A separate approach to the issue of priority in terms of time and amount will serve as the solution to ease such complexities.

KEY WORDS: priority, insolvency, rehabilitation, bankruptcy