

A Study on the Target of Avoidance in Korean Bankruptcy Law: When There is No Debtor's Action

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Abstract

The avoidance power in the Korean bankruptcy law is very similar to the American one with some difference. The big difference comes from the Korean concept of 'act'. The Korean law system is based on the continental law rather than the Anglo-American law. The basic target of avoidance in Korea is the act performed by the debtor (APD).

But the wealth might be transferred without APD. If the transfer without APD could not be avoided, the goal of bankruptcy procedure might not be accomplished in many cases. Therefore are there some exceptions. There are two categories of exception. The one is by statute, the other is by court rulings.

This essay tries to explain what could be avoided in the Korean bankruptcy law. It focuses on the cases without APD, because the exceptions by the statute are restricted and the legality of them is out of question.

First, to explain it, this essay shows the structure of the Korean law.

Second, it tries to explain the exceptions by the statute. Especially the civil enforcement act by court is important.

Next, this essay explains the exceptions by court rulings, which are substantially same and identifying with APD. These are important, because they are not fixed one till now. They are just starting to develop. It is necessary to follow it up.

I. Introduction

Avoidance in bankruptcy law is very important to creditors and debtors because it enables the receiver to recover the debtor's assets from creditors. While the power to avoid improves the interests of the general creditors, it worsens those of recovered creditors. If you understand how avoidance works in American bankruptcy law, then you already have a good working

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knowledge of the Korean avoidance system. Although usually ignored by scholars and lawyers, there are historical differences between the two countries' application of avoidance that must not be overlooked while considering whether Korea should adopt the rulings made by the courts in the United States. This essay will discuss an aspect of Korean bankruptcy law not found in the United States bankruptcy system, which is the avoidance's target in the Korean bankruptcy law when there is no debtor's act.

II. The Structure of the Korean Law on the Target of Avoidance targettarget

The Korean bankruptcy law which is called the Debtor Rehabilitation and Bankruptcy Law ("DRBL"), provides the debtor with three procedural options: bankruptcy, rehabilitation, or rehabilitation for an individual.^{1),2)} Bankruptcy and debtor rehabilitation procedures have very similar statutes on avoidance. DBRL Article 584, Paragraph ① says, "Section 2 of Chapter III, Part III³⁾ shall apply *mutatis mutandis* to rehabilitation procedures for an individual." Therefore, DBRL Article 584 ensures that the target of avoidance in each of the three procedures is almost the same. For convenience sake, the word *bankruptcy* hereinafter includes rehabilitation.

The bankruptcy procedure has 4 articles on the target of avoidance. Article 391 states the basic rule:⁴⁾

"Article 391 (Avoidable Acts) A receiver in bankruptcy may avoid certain **acts** as described in the following subparagraphs:

1) They are similar to U.S. Bankruptcy Act's Chapter 7, Chapter 11 and Chapter 13.

2) A right to avoid might be exercised by lawsuit, claim or protest. The claim of avoidance' is the simplified procedure having same effect of the lawsuit of avoidance. DRBL Article 396 Paragraph ① (for bankruptcy) and the Article 105 Paragraph ① (for debtor rehabilitation) provide it. The protest of avoidance is exercised in the lawsuit which the creditor files against the receiver.

A right to avoid might be exercised through one of the three ways. To the contrary, the obligee's right to revoke, which is said to be a kind of a right to avoid in Civil Code, should be exercised only by lawsuit of each obligee.

3) Provisions on avoidance in bankruptcy procedure.

4) Same to DRBL, Article 100 on rehabilitation.

1. **An act performed by the debtor** with knowledge that such act causes loss to creditors: Provided, that the same shall not apply to cases where any beneficiary from the act does not become aware of the fact that the debtor's act causes loss to the creditors at the time such act is performed;

2. **An act by the debtor** that causes loss to creditors and **an act of furnishing any security or extinguishing any obligation by the debtor** after a debtor files an application for suspending payments or a petition for bankruptcy: Provided, that it is limited to the event when any beneficiary from the act learns of the fact that the debtor has filed an application for suspending payments or a petition for bankruptcy at the time that the debtor performs such act;

3. **The act of furnishing any security or extinguishing any debt by the debtor**, which does not pertain to the debtor's obligations and whose means and time do not pertain to the debtor's obligations before or after 60 days from the date on which the debtor files an application for suspending payments or a petition for bankruptcy: Provided, that the same shall not apply to cases where creditors are not aware of the fact that the debtor has filed an application for suspending payments or a petition for bankruptcy and causes loss to them at the time that he/she performs such act; and

4. **A gratuitous act or act for consideration** that can be deemed identical to the gratuitous act, **performed by the debtor** before or after six months from the date on which he/she files an application for suspending payments or files a petition of bankruptcy."

Article 394⁵⁾ states the events meeting requirements for the change of rights might be avoided.⁶⁾ Article 395⁷⁾ states that avoidance may be exercised

5) Same to DRBL Article 103 on rehabilitation.

6) DRBL Article 394 (Avoidance of Requirements for Establishing Alteration of Rights or Requirements for Counter) (1) In cases where any registration or any recording that has the effect of establishing, transferring or altering rights is effected after the debtor files an application for suspending payments or a petition for bankruptcy, when the act of incurring obligations by way of such registration or such recording is performed with the knowledge that the debtor files an application for suspending payments or a petition for bankruptcy, such act may be avoided: Provided, That the same shall not apply to cases where any principal registration or any principal recording is effected after any provisional

when the act is based on civil enforcement.⁸⁾ Article 400 states when avoidance of inherited assets subject to bankruptcy may be exercised and Article 401 is on the repayment to the person who took legacy.⁹⁾

The Article 391 is the main one and the other articles are on the special matters. What the principle is depends on the definition. It is possible to say the articles excluding the Article 391 are exception. But such definition does not pay. I would give the existence of act performed? by the debtor(or act by the debtor) as a standard to principle and exception.

III. 'Act' of a Party

Based on Article 391, you may assume that the target of avoidance refers to 'acts performed by the debtor' ("APD"). Then, what is an *act*? The word *act* is a translation of the German word *Akt*. The meaning of act has a wide range in continental law like in contract, unilateral legal action, etc. The act in avoidance law refers to the debtor's act.

It is said that Anglo-American law (common law) does not have the concept of act. Entering into a contract is one kind of act in common law; however, common law does not have a comprehensive concept of the act.

registration or any provisional recording is effected based on the former. (2) In cases where the act of establishing, transferring or altering the right is performed out of the need to counter any third person after the debtor files an application for suspending payments or a petition for bankruptcy, when such act is performed with the knowledge that the debtor files an application for suspending payments or a petition for bankruptcy after the lapse of 15 days from the date on which the act of establishing, transferring or altering the right is performed, the provisions of paragraph (1) shall apply to such cases.

7) Same to DRBL Article 104 on rehabilitation.

8) DRBL Article 395 (Avoidance of Civil Enforcement Act). The right to avoid may be exercised when a title holding the executory power over an act that is subject to being avoided exists or when the act is based on the act of civil enforcement.

9) DRBL Article 400 (Right to Avoid where Inherited Assets Subject to Bankruptcy). In cases where any inherited assets are subject to bankruptcy, the provisions of Articles 391, 392, 393, 398 and 399 shall apply *mutatis mutandis* to an act performed by any predecessor, any inheritor, the custodian of the inherited assets and the executor of the will with respect to the inherited assets. Article 401 (Avoidance of Repayment, etc. to Person who Takes Legacy). In cases where the inherited assets are subject to bankruptcy, when the act of making any repayment and extinguishing any obligation to the person who takes the legacy causes loss to any bankruptcy creditor who holds preferential claims, such act may be avoided. * The debtor rehabilitation has no such articles because the inherited assets need no rehabilitation.

This is also true in bankruptcy law. The target of avoidance in U.S. bankruptcy law is not an act, but recognized under the concept of a transfer. The transfer could be a debtor's act, but it is not always so. DRBL says that any receiver may avoid APD. The meaning of APD is so clear as set forth in Article 391 that it leaves no room for exceptions.

However, wealth may be transferred without APD. Consistent with the goal of the bankruptcy procedure, such transfers may be avoided although there are some exceptions.

A transfer without APD may occur when counter party (like a creditor) acts or when no one acts. When no one acts, such a transfer cannot be avoided although the receiver may reclaim the property by other means.¹⁰⁾

Some exceptions are provided by DRBL, while others are provided by court rulings. The legality of the exceptions set forth in the DRBL need not be questioned. Rather, the court-made exceptions are questionable because they seem beyond the scope of the law.

The new rulings which were made in the new millennium and decided by the Korean Supreme Court allow the receiver to avoid some transfers without APD, but with restricted conditions.

The Korean legal system has its origins in continental law. Consequently, a party's act is very meaningful in Korean jurisprudence. If the debtor performed an act, it may be avoided. If he did not act, then it may not be avoided. Determining when to avoid based on whether the debtor performed an act improves legal predictability. For that reason, the exceptions to Article 391 should be prudently construed.

The main goal of this essay is to explain when a receiver may avoid a transfer made without APD. There are two categories: the one is the exceptions provided by the DRBL and the other is the exceptions made by the courts. The former category may be divided into three cases: ① civil enforcement act, ② inherited assets subject to bankruptcy, and ③ repayment to person taking legacy; the latter has two cases; ④ analogical application of the DRBL and ⑤ *identifying with APD*.

10) For example, transfer by natural power.

IV. Exceptions by the Law

1. Act for civil enforcement

When the transfer is performed through a public auction, the receiver can avoid it. The law provides that a right to avoid may be exercised (a) when a title of obligation¹¹⁾ holding the executory power over an act that is subject to being avoided exists or (b) when the act is based on the civil enforcement act. Japan and Germany also have the same provisions in their own bankruptcy laws.¹²⁾

The first case (a) is not in and of itself about an civil enforcement act. It is not an exception by this essay's standard because the target of this regulation is APD. (a) is one of the targets regulated by DRBL Article 391. An act may be avoided even when the creditor has the title, meaning that even when the creditor has filed a lawsuit against the debtor and wins to get the title, the act may be avoided. When the act is one through which the title is made, it can also be avoided. The role of DRBL Article 395 is to make clear that the right to avoid may be exercised even to a creditor holding title.

Unlike the first exception discussed above, the second exception, case (b), is about an civil enforcement act. The receiver avoids not a public auction, but the civil enforcement act. Case (b) is an exception to Article 391 because it permits the receiver to exercise his avoidance power on an act performed by a party other than the debtor. In this case, the civil enforcement act is performed by the court through the creditor's initiation. The court may order a transfer of the debtor's property through a forced auction sale. The legal effect of this court mandated action is similar to private sales in that even when the transfer is being performed by the court, the necessity for having the right to avoid

11) The creditor can file a petition to execute the debtor's property when he has the title (the legal title of obligation) by the Civil Enforcement Law. The title is an official document issued by the court. There are many things from which a title might be made. If you win a litigation in a court, you might make a title through the court ruling. A title might be made based on agreement of the creditor and the debtor. They make it to go to the public notary office. But the security right holder needs no title to execute the debtor's property.

12) The Japanese bankruptcy law, Article 165. The German bankruptcy law (Insolvenzordnung, InsO), Article 141.

does not disappear. In terms of being subject to the avoidance power, the public auction bidder's position is neither stronger nor weaker than that of a buyer in a private sale.

The avoidance powers stated in Article 395 (both ① and ②) are exercised when the requisites of the Article 391 are fulfilled. The court must first make a factual determination of whether the creditor knew (or did not know) that the transfer was a fraudulent act or a preferential act based on his awareness.

2. *Inherited assets subject to bankruptcy*

When inherited assets are subject to bankruptcy, a receiver may avoid an act performed by any predecessor, any inheritor, the custodian of the inherited assets, and the executor of the will. In those cases, Articles 391, 392, 393, 398 and 399 shall apply *mutatis mutandis*.¹³⁾

The predecessor is the original debtor when the inherited assets are subject to bankruptcy. The Article is not exception with respect to the predecessor.

It is exception because the others (no predecessor) in the article are not the debtor to make the inheritance assets bankrupt. But after the inheritance procedure begins, they are in the debtor's position. In this respect, this article might not seem exceptional.

3. *Repayment to person taking legacy*

When inherited assets are subject to bankruptcy and the act of making any repayment and/or extinguishing any obligation to the person who takes the legacy cause loss to any bankruptcy creditor holding preferential claims, such act may be avoided.

The repayment to the person who takes the legacy is performed not by debtor (predecessor), but by the others (e.g., like the inheritor). In this respect, this provision may be regarded as an exception.

13) DRBL Article 400.

V. Analogical application of the DRBL Act

1. Supreme Court Decision

Jurisprudence allows analogical application of law to similar situations because the law cannot cover all cases. This remains true for bankruptcy law. As of date, there is only one case of analogical application of DRBL called the *substantial same* theory.

This theory is declared first in 2003.¹⁴⁾ The decision is as follows:

“[1] In company reorganization, a security right holder cannot execute the security right individually (Corporate Reorganization Law, Article 67¹⁵⁾) and he is allowed to use that right only in the procedure (Article 123 Paragraph ②,¹⁶⁾ 112¹⁷⁾). A pledgee’s act to sell securities as a pledge and collect his claims is *substantially same* to a civil enforcement act. The pledgee’s act may be avoided by analogous application of the latter part of the Article 81,¹⁸⁾ which rules that an civil enforcement act may be avoided.

[2] Under the Corporate Reorganization Law, in the case of avoiding a pledgee’s act to sell securities as a pledge and collect his claims, a receiver in a company reorganization procedure may claim equivalent value of the sold securities.”

This decision is influenced by a Japanese court ruling¹⁹⁾ and is the first time

14) Supreme Court Decision of February 28, 2003 (Case No.: 2000DA50275). ‘DA’ in the decision’s title means the kind of the case and the grade of the ruling court. It means the Supreme Court Decision for a civil case. The number 2000 before ‘Da’ is the year when the case came to the Supreme Court. The number 50275 is the serial number of civil cases in the Supreme Court. But it does not mean that the case was 50275th of the year or since the court had been found. The serial number comes from the complicated system. There are many dummy numbers between the real case serial numbers for many reasons.

15) Same to DRBL, Article 58. Corporate Reorganization Law is substituted with DRBL. But the theory has not changed. All court rulings under the old law have the same effect under DRBL.

16) Same to DRBL Article 141, Paragraph ②.

17) Same to DRBL Article 131.

18) Same to DRBL Article 104.

19) Osaka Court of Appeal of December 18, 1997 (Case No.: 1996WA2175).

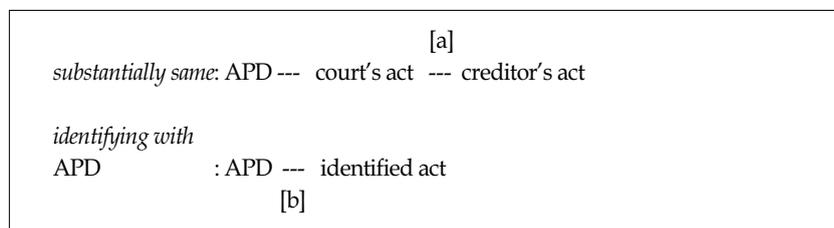
that the Supreme Court had to decide on this issue although the Suwon district court heard the case and ruled in the same way as the Supreme Court did on February 19, 1993.²⁰⁾ It is worth pointing out that the district court judges had thought this way long before the Supreme Court made its decision.

2. Analysis

Unlike the DRBL which deals with civil enforcement acts, the Supreme Court decision deals with a security right holder's civil enforcement of his rights outside the court. The targets are different from each other. While a civil enforcement act is initiated by the creditor's petition and performed by court, a security holder's civil enforcement act is performed by the holder. The actors and legal implication are very different.

However, there are some common features. An civil enforcement act is a forced sale by auction and a sale by a security holder is similar to an civil enforcement act. The difference lies in who the seller is.

The *substantially same* theory can be better understood when compared to the *identifying with APD* theory. The security right holder's act of selling a pledge is not related to the debtor's act and intention. Assuming APD as the starting point, in the *substantially same* theory, the act of the creditor (security right holder) is farther away from the identified act in the *identifying with APD* theory. But in *substantially same* theory, the creditor's act should be compared not to APD, but rather to the court's civil enforcement act. The distance between the court's civil enforcement act and the creditor's act in the *substantially same* theory ([a] in the box) is shorter than that between APD and the identified act in the *identifying with APD* theory ([b] in the box). For this reason, the court must have easily adopted the *substantially same* theory.



20) Case No.: 92PA510.

3. Evaluation

Is the *substantially same* theory right? It had better revise DRBL to adopt it. There have been lots of criticisms against it especially from economic circles because this theory harms security right holders. Their main criticism is that it decreases legal predictability.

Furthermore, some Korean lawyers misunderstood the decision to mean that a receiver may avoid any act of the creditors and that the old Supreme Court decision was repealed by the Supreme Court Decision of February 28, 2003. The old decision²¹⁾ stated the following:

“A bank’s act of exercising the option to take the debtor’s claims to third parties and giving them notice of it on the behalf of the debtor, based on the pre-bankruptcy contract, may not be avoided by the Corporate Reorganization Law, Article 78, Paragraph ①, ii).”

The decision was never repealed and the new decision does not repeal the decision either. The new decision mentions only civil enforcement act. The lawyers have misunderstood the meaning of the *substantially same* theory. Under this theory, the act to be avoided must have the same structure and legal effect to the compared target and it must be applied narrowly. Therefore, the criticism is groundless and no disorder has been reported since the decision.

Analogical application means that complete likeness is not required between the original target and the analogized one. The *substantially same* theory does not require a perfect comparison, but merely one that is substantially the same.

Civil enforcement acts by the court and the security holder are performed by others rather than the debtors. This is a very important point because had the Corporate Reorganization Law, Article 67 dealt with APD, it would have been questionable whether the analogical application use of the *substantially same* theory would have been adopted in this case.

The critical question is the scope of this theory. The adoption of

21) Supreme Court Decision of July 9, 2002 (Case No.: 2001DA46761).

substantially same should be restricted to within a reasonable range rather than applied broadly.

The theory is reasonable because it is based on a stable background with little possibility of overextension. Furthermore, this theory has big room enough for development.

VI. Identifying with APD

1. What is identifying with APD?

Under the *identifying with APD* theory, the receiver may avoid without APD when there is something identified with APD. The important thing is what '*identified with APD*' means. This theory started in Japan.²²⁾ Some district courts in Korea adopted it and the Korean Supreme Court confirmed it. In the Supreme Court decision, it stated that an 'agreement between the debtor and the beneficiary or the others' may be the standard used to identify APD. Thus, it might be called the *agreement with the debtor* theory. This theory is an example for the *identifying with APD* theory

2. Supreme Court Decision

The Korean Supreme Court first accepted the theory in its Decision of July 9, 2002 (Case No.: 99DA77150). The decision is as follows:

Under the Corporate Reorganization Law, the target of avoidance is basically the company's act. When APD does not exist but an act of a creditor or third party does, it may be exceptionally avoided only when it is identified with APD and with special reason, such as when the creditor or third party acts based on the debtor's agreement.

The decision says that an agreement with the debtor could be a special reason to make it avoidable without APD. This decision has been often cited

22) Even in Japan, there have been rare cases to allow the receiver to avoid by this theory. The Japanese Supreme Court Decision delivered on November 15, 1968 is one of the cases.

and is now firmly rooted in practice.²³⁾

3. Analysis

This theory is still premature and has room for further development. As of date, the court has not provided more input besides the agreement with the debtor standard. Having stated that, there are three points to be recognized.

First, this theory does not ponder the possibility that there is APD. After all, APD is not fulfilled by the mere existence of an agreement between the debtor and his creditors or third party. The *identifying with APD* theory is based on a legal fiction stronger than *substantially same*.

Second, one party of the agreement must be the debtor. But the other party does not necessarily have to be the creditor. In most cases, the third party would be a party related to the debtor or creditor or someone without any legal title.

Third, the target avoided by the theory is the act performed by other than the debtor, which has legal effect in the concrete. You do not need to construct APD by agreement between the debtor and the creditor or another third party. This improves the predictability of making the creditor or the third party's act avoidable.

The agreement with the debtor itself is not the target of avoidance. The agreement could be construed as an act, but it is not always the case because it does not always bear legal effect. [When the debtor tries to play with him, the creditor or the third party is able to reject to cooperate with the debtor.]

It is very exceptional to avoid an act that is not APD. To get rid of potential uncertainties, the target by this theory should be clearly outspoken in the decision.

The cause to recognize this theory is *the appropriateness in the concrete*.²⁴⁾ In

23) Those are the Supreme Court Decisions like these; July 9, 2002 (Case No.: 2001DA46761), July 23, 2002 (Case No.: 2000DA55485), May 16, 2003 (Case No.: 2003DA1335), July 30, 2003 (Case No.: 2002DA67482), September 26, 2003 (Case No.: 2003DA29128), February 12, 2004 (Case No.: 2003DA53497).

24) *The appropriateness in the concrete* is an important word in legal practice in Korea, especially for the judges. Put it simply, it is the question who must win the case. New comers are taught to consider it when they make a decision. They are told to think of who must win apart from the superficial logic. If *the appropriateness in the concrete* is not agreed to the superficial logic, for example in the case that the plaintiff would win by the latter, but the defendant should win by the former, they are asked to give it a second

some cases, it is not acceptable that the result of transfer is not avoided just because there is no APD. I do not guess the real cause of *agreement with the debtor* theory is the extent to which the general creditors' interest gets harm from it. It is because it must be avoided even when the harm is minor. The real cause is the blamableness against the debtor. The court has thought that the blamableness of the agreement between the debtor and the creditor (or the third party), which is done with intention to do harm to the general creditor's interest, might be too big to ignore.

4. Evaluation

This theory has been initiated by the court. There were and are no relevant statutes in the DRBL. There had been no jurisprudential theory to accept this theory until the Supreme Court decision was delivered. The court almost made a new law.

Is the *identifying with APD* theory proper? It is a difficult question to answer. In general, evaluations of a legal theory will differ before and after the theory is accepted and put into practice. When the theory has not yet been accepted in practice and depends only on scholarly support, it must be strictly tested. But once the theory is accepted in practice, the standard ought to be less rigid even though the question of whether the theory is *really* acceptable or not remains to be answered.

The court did make some decisions based on the *identifying with APD* theory; however, no noteworthy criticisms of the *identifying with APD* theory have been reported from the academic and economic circles.

In my opinion, however, the *identifying with APD* theory goes beyond the court's reach and the statutes. But the theory is accepted because of the big scope of the debtor's blameworthiness.

One of the reasons why we could not abandon the *identifying with APD* theory is that we have not had the need to avoid under that theory until now. It is not easy to win such a case under that theory even in Japan. The decisions

thought and to seek a new logic. To understand the Korean judges' behavior on the work, it is necessary to understand *the role of the appropriateness in the concrete*.

It implies that *identifying with APD* is not from the statute or pure scholastic thinking, but from the court's practice to need to explain the meaning of *the appropriateness in the concrete*.

have been spoken not to make it avoidable, but to say that a right to avoid may not be exercised if the requirements of the *identifying with APD* theory is not fulfilled. I presume that the court has easily stood up the theory because a right to avoid might be rejected. In this respect, the theory doesn't seem to have played an active role. Then, does this situation render this theory useless? The answer is no. It is presumed that this situation has come with two reasons.

First, it is difficult to prove the existence of the agreement. It would be easy when the other party is against the debtor. But difficulty does not necessarily mean impossible. In Korea, there have been some cases where the agreement was successfully proven to exist between the debtor and the creditor. Those are the cases for the obligee's right to revoke in the Civil Code.²⁵⁾ If it is possible in the case for the obligee's right to revoke, then it may also be possible for avoidance cases in bankruptcy law. The roles of the agreement with the debtor in the two rights are different, but the concept is the same.

Second, we have to take into consideration that the theory is very new and very hard to understand even for professional lawyers.

It takes a long time for a new legal theory to be widely known. It might take more than a generation. The theory would be more widely spoken. In the future, new cases will come with the different special reasons rather than *agreement with the debtor*. The content of the theory will be abundant.

I do not think the starting point of *identifying with APD* is the same as *substantially same*. As of now, there is little to connect the two theories together mainly because *identifying with APD* has no fertile soil. However, with future development, the two theories might converge into a single bigger theory.

VII. Conclusion

This essay tries to explain what could be avoided in the Korean bankruptcy law. It shows the structure of the law on the avoidance and insists

25) Those are the Supreme Court Decisions like these; June 14, 1994 (Case No.: 94DA2961, 94DA2978), June 30, 1995 (Case No.: 94DA14582), April 10, 2001 (Case No.: 2000DA66034), June 24, 2003 (Case No.: 2003DA1205), March 26, 2004 (Case No.: 2003DA65049), May 28, 2004 (Case No.: 2003DA60822), March 25, 2005 (Case No.: 2004DA10985,10992).

that the act performed by the debtor is the basic target of avoidance.

But because transfer of wealth may occur without APD, the law needs to be modified to some extent. The law itself also regulates the exceptions. Besides the statute, the court rulings recognize some exceptions. They are *substantially same* and *identifying with APD*.

This essay summarizes the exceptions and especially focuses on those court rulings. It is because the statute is restricted and the legality of them is out of question. The court rulings are very important as they contribute to a developing area of bankruptcy law that needs to be carefully followed up.

KEY WORDS: bankruptcy, rehabilitation, rehabilitation for an individual, avoidance, transfer of wealth, act, act performed by debtor (APD), *substantial same*, *identifying with APD*