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The Comparative Status of Secured Creditors in the Bankruptcy Procedure and Its Implication for the Financial Transaction

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Abstract

Official declarations of bankruptcy have and had different meaning and stigma in countries. A decade after the economic upheaval witnessed dramatic changes of scenes surrounding bankruptcy in Korea. The petition of total bankruptcy procedure climbed from 79 in 1996 to 180,055 cases in 2006. All of these turbulent reformation and virtual rebirth of bankruptcy in Korea fall short in one area. These changes do not stir secured creditors' status in bankruptcy procedures. Compared to U.S., secured creditors in Korea enjoy very strong legal protection even after the debtor's insolvency realizes. This article will survey the Korea and U.S. law governing secured creditors under bankruptcy procedure and suggests that these relative differences of legal treatment of secured creditors have enormous impacts on the financial transactions beyond bankruptcy itself, specifically consumer and commercial loan practices. While scholars of law and economics suggest that surviving legal system may be the most efficient ones to reflect particular social demand and incorporate practices of private parties, but the legal procedure and allocation of powers in it determines and entrenches the formation and terms of market transactions though it is not the most efficient practices. This article suggests that the status of secured creditors in bankruptcy influences beyond the bankruptcy itself and affects the incentives of financial transaction and costs. Though comparative lens between U.S. and Korea, this article details that the comparative difference of status of secured creditors under bankruptcy between Korea and U.S. and that roots of this divergence has related to financial market. While some development in Korea's financial market will provide room for further reform to maneuver the pre-bankruptcy entitlement, the differed role of bankruptcy in secured transaction as an entrenched aspect in market will survive any reform and affect the financial transaction and corporate investment decision reciprocally

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I. Introduction

Official declarations of bankruptcy have and had different meaning and stigma in countries. Though not so much harsh as medieval Europe countries,[1] filing petitions of bankruptcy to court in Korea was deemed shameful and the bankrupt had to endure some overt stigmas before the economic crisis began in the mid 1990s. As a result, filing of bankruptcy petition was so rare, only to 79 cases in 1996 including personal bankruptcy.[2] A decade after the economic upheaval witnessed dramatic changes of scenes surrounding bankruptcy as an old Korean proverb says "Ten years is an epoch". The petition of total bankruptcy procedure climbed to 180,055 cases in 2006.[3] The changes reflected turn of social attitudes toward bankruptcy from a sanction and sign against social failure to social welfare system to give fresh start. Bankruptcy law also altered many parts, reflecting the changes of attitudes.[4] The newly amended bankruptcy Act section 1[5] expressly provides that goal of this new Act help financially distressed debtors and their business to give an efficient opportunity to reorganize.

All of these turbulent reformation and virtual rebirth of bankruptcy in Korea fall short in one area. These changes do not stir secured creditors' status in bankruptcy procedures. Compared to U.S., secured creditors in Korea enjoy very strong legal protection even after the debtor's insolvency realizes. This article will survey the Korea and U.S. law governing secured creditors under bankruptcy procedure and suggests that these relative differences of legal treatment of secured creditors have enormous impacts on the financial transactions beyond bankruptcy itself, specifically consumer and commercial loan practices. As scholars of law and economics suggest, surviving legal system may be the most efficient ones to reflect particular social demand and

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1) Teresa A. Sullivan et al., *Less Stigma or More Financial Distress: An Empirical Analysis of the Extraordinary Increase in Bankruptcy Filings*, 59 STAN. L. REV. 213, 215 (2006) (providing anecdotes that the bankrupt was required to be naked and show signs of bankruptcy signs).

2) Korea Court Annual Statistics 1996 (Administration of Korea Court).

3) Korea Court Annual Statistics 2006 (Administration of Korea Court).

4) Undoubtedly, these changes of attitude may not be an exception in global perspective. *See generally* Rafeal Efrat, *Global Trends in Personal Bankruptcy*, 76 AM. BANKR. L.J. 81 (2002).

5) The Debtor Rehabilitation and Bankruptcy Law (hereafter DRBL) §1(effectuated April 1, 2006).

incorporate practices of private parties.[6] But, sometimes the legal procedure and allocation of powers in it determines and entrenches the formation and terms of market transactions though it is not the most efficient practices.[7] This article suggests that relation between secured creditors' legal status under bankruptcy and secured transactions in Korea may fall within the latter, not the former.

II. Basic Differences in Status of Secured Creditors under Bankruptcy

The practice of taking a security interest in the debtors or other's properties has been around thousand years and continues to be widespread. Practitioners and conventional views that a security interest works as a priority claim to the pre-designated assets, thus protecting the creditor's investment when the debtor defaults whether they are belong to U.S. or Korea.[8] This coherence ends when debtors declare bankruptcy. The divergence comes from difference in historical development both law and finance.

1. U.S: Tensions and Conflicts between Secured Creditors and Bankruptcy, Generally

Early battle surrounding the establishment of uniform bankruptcy law between commercial class and agrarian is well known.[9] However, one peculiar thing in early commercial development usually goes unnoticed without much emphasis: U.S. commercial and capital development in Antebellum was based on intricate credit system in the free market.[10] This

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6) *See* Richard A. Posner, Economic Analysis of Law § 19.2, at 532-33 (6th ed. 2003).

7) *See generally* Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641 (1996).

8) *See e.g.*, Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1147-48 (1979) (arguing for full priorities for secured creditors); YUN-ZIK KWAK, TREATIES ON PROPERTY §182, at 463 (5th ed. 1992) (in Korean) (assuming full priorities as general effect of security).

9) *See generally*, Richard C. Sauer, *Bankruptcy Law and the Maturing of American Capitalism*, 55 OHIO ST. L.J. 291 (1994).

10) *Id.* at 294-95; *see also* Larry T. Garvin, *Credit, Information, and Trust in the Law of Sales: The Credit*

historical development makes U.S. financial transaction and investment practice distinct from other countries. As a land of promise, this credit-based financial transaction makes riskier investment possible without the dependence on the security interest.

Reasons on this development may lies in acquisition of unrestricted new land and its lower value in society, comparing more land restricted England as one commentator suggest.[11] Another reason may be non-existent of strong governmental authority to coordinate commercial and industrial capital demand and accumulation, contrary to economic developments in Continental Europe and East Asia shows. Inefficiency of court-based foreclosure[12] and anti-clogging rule established in 17th century common law[13] may make it hard to depend on real estate mortgages, which were most common form of security interest in Antebellum. Whatever reason may lie behind this development in history, secured financing in U.S. before 1950 was kind of second grade market for people who could not get enough credit to enter the financial market. There was almost no consumer lending by bank and asset-based lending was really minuscule, only $5.8 billion of total secured loans outstanding in 1946.[14]

Introduction and success of Article 9 of U.C.C. changed this scene forever. Explosive growth of secured financing after the adoption of Article 9 was seemed to prove the efficiency of security in financing. Before Modigliani and Miller demonstrated that under certain carefully specified assumptions the value of a firm is independent of its capital structure in their famous Irrelevance Theorem,[15] no one in the U.S. legal community questioned the efficiency of secured debt, therefore.[16] After the introduction of Irrelevance

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Seller's Right of Reclamation, 44 UCLA L. REV. 247, 259 (1996) (describing widespread use of credit check in Antebellum).

11) *See* Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 STAN. L. REV. 3, 13 (1986).

12) Even today, foreclosure is not a good option for the mortgagee when debtor defaults. *See generally* Steven Wechsler, *Through the Looking Glass: Foreclosure by Sale as De Facto Strict Foreclosure – An Empirical Study of Mortgage Foreclosure and Subsequent Resale*, 70 CORNELL L. REV. 850 (1985).

13) For general development of this rule, *See* Ann M. Burkhart, *Lenders and Land*, 64 MO. L. REV. 249, 263-66 (1999).

14) Albert R. Koch, *Economic Aspects of Inventory and Receivables Financing*, 13 LAW. & CONTEMP. PROBS. 566, 572 (1948).

15) Modigliani & Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

Theorem in the theory of secured financing, scholarly debates over efficiency and social benefits priorities of security interest and case for and against limitation of priorities continues but brings no general consensus.[17)]

Most of debates and legislative proposal around this dispute are concerned to the secured creditors' legal rights and its limitation in the bankruptcy. The roots of the scholarly debates lie in the nature and treatment of secured credits in the bankruptcy. Though U.S. bankruptcy system is famous or notorious for its generous discharge of debtors, main purpose and function of U.S. bankruptcy procedure is to collect and allocate a bankrupt debtor's assets among its creditors with mandatory procedure, similar to other countries.[18)] As a mandatory judicial procedure, bankruptcy has its own goal and policy to distribute maximum value to creditor groups. To accomplish this, bankruptcy court arranges non-bankruptcy entitlement. The differences in scholarly view are originated from diverging perspectives whether non-bankruptcy law's entitlement should dictate bankruptcy's distributional rule or not and how far bankruptcy court could handle pre-bankruptcy bargain and relation if bankruptcy has its own distributional goal.[19)]

These tensions and conflicts are maximized when debtors file under chapter 11 (businesses) or 13 (individuals), seeking reorganization rather than liquidation. When debtors file under chapter 7, liquidation procedure by bankruptcy court does not change much non-bankruptcy collection process though some barriers block and delay secured creditor's foreclosure as below parts show. Considering this aspect, it is not strange thing bankruptcy has current presence and meaning in legal system only after 1978 reform though first federal bankruptcy law appeared in 1800.[20)] The Bankruptcy Reform Act

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16) Jackson and Kronman were the first to apply the theorem to the secured debt. *See* Jackson & Kronman, *supra* note 8, at 1154-64.

17) Compare Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996) with Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L. J. 425 (1997).

18) *See* Thomas H. Jackson, B*ankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 857-68 (1982).

19) Compare Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987) (arguing bankruptcy of a firm need to coordinate multiple creditors' priorities with bankruptcy because bankruptcy gives birth to different situation with non-bankruptcy law) with Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987) (proposing non-bankruptcy entitlements should dictate distributional rule, except extreme cases).

20) Act of Apr. 4, 1800, ch. 19, 2 Stat. 19 (repealed 1803).

of 1978[21] replaced pre-existed system with many new features. The most notable feature of the Act is to introduce new chapter 11 where pre-filing management works as trustee in the name of debtor in possession and encourage chapter 13 for debtors who have disposable incomes rather than leading them to the liquidation.[22] Before the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)[23] limited bankruptcy's reach, filing of bankruptcy under chapter 11 was 6,637 and filing under chapter 13 was 429,316 in 2005 fiscal year.[24]

Another Aspect of the tensions and conflicts in U.S. comes from federal and state systems. Though Constitution authorized Congress to enact "Laws on the subject of Bankruptcies,"[25] Constitution does not grant the authority to create debtor-creditor relationship. Most of debtor-creditor relationship are defined by non-bankruptcy law and most of them expressly or implicitly defer to the state law. For an example, property of the estate is defined as "all legal or equitable interests of the debtor in property" as of filing,[26] but the Code (U.S. Bankruptcy Statutes) does not provide any definition of it. For the security interest, the Code only defined "lien created by an agreement"[27] and to the essential concept "lien," it only states "charge against or interest in property to secure payment of a debt or performance of an obligation."[28] Therefore, any significant enhancement of law of secured finance by states, like U.C.C. Article 9 interconnects tensions and conflicts to the bankruptcy law, because changes in security law usually means adjustment of competition between secured and unsecured.[29]

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21) Pub. L. No. 95-598, 92 Stat. 2549 (1978).

22) Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 35-36 (1995).

23) Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

24) U.S. Bankruptcy Statistics (http://www.uscourts.gov/bnkrpctystats/statistics.htm #june, last visited March 8, 2008).

25) U.S. CONST. art. I, § 8, cl. 4.

26) 11 U.S.C. §541(a).

27) *Id.* §101(51).

28) *Id.* §101(37).

29) *See* G. Ray Warner, *The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy*, 9 AM. BANKR. INST. L. REV. 3, 22-24 (2001) (stressing generally applicable non-bankruptcy law undermine bankruptcy policy by improvement).

2. Korea: Exemption from Bankruptcy, Generally

1) Dominance of Mortgage in Financial Transaction

As a basic property statute in Korea, Civil Code provides only four kind of statutory security interest; *jeonsegwon*,[30] *yuchigwon*,[31] pledge,[32] mortgage.[33] Among them, only mortgage was and is used widely as security instrument at the financial transaction. Other security interests are not used in financial transaction for their imperfection of public notice for the priority and accompanying inconveniences with taking possession of collateral. Outside of these statutes, a security interest recognized and coined by private parties, called "*Yangdodambo*" is used partially as a substitution of statutory security interests. *Yandodambo* is a kind of conditional sale using constructive possession in personal property and appointing recording in real estate. But, there is no security interest for the personal property, using public filing system, like U.C.C Article 9. To encourage and support entrepreneurs of using factories, the machines are allowed to add in the factory mortgage as a factory estate.[34] But this is an exception. As a result, mortgage has unique dominance in most of financial transaction in Korea.

One of reasons behind this dominance may be relatively limited land supply for the rapid growing cities, which leads to keep upward the price of real estate price continuously.[35] This circumstance makes reliance to the real estate value as security in financial transaction as easy alternative to the credit system.

In addition to it, relatively efficient court's judicial sale and distribution system in judicial foreclosure give support to the dominance of mortgage in market when debtors default. In 2006, 124,761 petitions of real estate judicial

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30) Civil Code, Title II, chapter 6 (a type of registered leaseholder's right to real estate peculiar in Korea).

31) Civil Code, Title II, chapter 7 (a type of statutorily created lien possessory lien, similar to mechanics' lien).

32) Civil Code, Title II, chapter 8 (pledge is a security interest for chattel and accounts, but pledge need at least constructive possession of collateral by secured creditors).

33) Civil Code, Title II, chapter 9.

34) Factory Mortgage Law § 4.

35) Seoul has more than 10 millions resident in 604 square km, comparing New York has only 8.6 millions resident in over 1,200 square km.

sale (93% of all the judicial sales) are filed in court[36] and most of foreclosed real estates include mortgage as security. Most of cases end within one year after the petition and average disposition time is less than 9 month.[37] Contrary to U.S' first-come-first served system, Korea's foreclosure and liquidation process adopt pro rata distribution of all the liens among equal priority claimants whoever initiate the process.[38] Therefore, actually small kind of bankruptcy estate is composed whenever petition of judicial sales of real estate is filed, considering the fact that real estate is usually debtors' only asset to be liquidated and exposed to the creditors. Mortgagees of first priority usually get the full satisfaction of their claims, including fees for servicing unintended acceleration of payment.

2) Secured Creditors' Exemption from the Bankruptcy

Before the Debtor Rehabilitation and Bankruptcy Law (DRBL) enacted, Korea's bankruptcy depended on four different statutes: Bankruptcy Law for business and individuals with the goal of liquidation distribution, Corporate Reorganization Law and Composition Law for business with the goal of reorganization,[39] Rehabilitation for Individuals Law for individuals modeled after chapter 13.

Among the old statutes, only Corporate Reorganization Law affected the secured creditors in pursuing remedies against secured property.[40] In other insolvency procedures, secured creditors were not affected by the insolvency proceeding whether they were secured by statutory or non-statutory security interest.[41] Stay outside of bankruptcy strong-arms, they are called "Exempted Creditors." As Exempted Creditors, secured creditors could pursue their individual foreclosure or other remedy without any regard to the bankruptcy

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36) Statistics 2006, *supra* note 3.

37) *Id.*

38) Civil Enforcement Law §148.

39) The most significant differences of two remedy are that the former only applies to corporation and the latter has no restriction and courts appoints trustee to replace the management in the former while debtor in the possession took the control in the latter. Compare Corporate Reorganization Law (repealed in Mar. 31, 2005) Art. 1, 94 with Composition Law (repealed in Mar. 31, 2005) Art. 12, 32.

40) Corporate Reorganization Law (repealed in Mar. 31, 2005) Art. 123.

41) Jun-Ho Rim, *Treatment of Security Interests under Bankruptcy Procedures*, in MATERIALS ON COURT 83, 88-9 (1999) (in Korean).

procedure as if the bankruptcy procedure did not exist.[42)]

DRBL combined dispersed statutes to one uniform code and improve many procedural barriers, but do not change this Exempted Creditors clause. DRBL has the same statute as repealed Bankruptcy Law. Secured creditors backed by statutory security interest can pursue their remedy against the collateral without any regard to the insolvency proceeding where the cases are filed as the bankruptcy proceeding or rehabilitation proceeding for individuals.[43)] They can act also as unsecured creditors over the deficiency from the sale of the collateral.[44)] Though DRBL impose some obligation to the secured creditors for the protection of unsecured creditors,[45)] DRBL does not provide any sanction to the violation of these obligations, leading to the doubt of the actual effect.[46)]

Insolvency proceeding only affects secured creditors under the procedure of Rehabilitation. One inherent problem of Rehabilitation is its rare petition and not much impact in the actual trade practice. Even in the 1990's economic crisis, it had only 148 cases of petition in climax year 1998.[47)] After that, 30 more or less cases were petitioned annually.[48)] DRBL enlarged the subject of Corporate Reorganization Law from Corporation to every business, including individual proprietorship while absorbing some part of Composition Law.[49)] Filing of Rehabilitation case increased 76 cases in 2006 doubling from 35 cases in 2004 (the last full year before DRBL effectuating),[50)] but still doubt for revitalization effect of amendment remains because the filing of petition by the repealed Composition Law was 81 in 2004. The cause of this non-use lies in that Rehabilitation in DRBL still has many procedural differences with chapter 11, though transformed much similar to U.S.'s chapter 11.[51)] Actually,

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42) *See e.g.*, Bankruptcy Law(repealed in 3. 31, 2005) Art. 84, 86

43) DRBL Art. 411 Par. 2, Art. 586.

44) DRBL Art. 413, 586.

45) *See e.g.*, DRBL Art. 447 Para. 2 (defining reporting obligation of secured creditors about information of claims including expected deficiency).

46) To the old statutes, the same doubt was commented. Jun-Ho Rim, *supra* note 41, at 114-15.

47) Korea Court Annual Statistics 1999 (Administration of Korea Court).

48) Statistics 2006, *supra* note 3.

49) DRBL Art. 74 (providing debtor in possession as default receiver).

50) Statistics, *supra* note 3.

51) For an example, there's no power to the court to grant senior liens to get post petition financing, like 11. U.S.C. §364(d).

financially struggling companies usually use "Work Out" which is orchestrated by association of banks.[52] One good example is that when financial crisis of Pantech Inc., 3rd market-share company of mobile phone production in Korea, exposed to the market, no one in the financial market gave a serious thought on the idea Business Reorganization procedure as alternative.[53]

This relatively trivial impact of Rehabilitation does not threaten the status of secured creditors generally. While some advanced financial sectors and market participants related to the foreign investors may worry unexpected effects from insolvency procedure, most market participants do not feel the pressure not much. Actually, articles and textbooks about judicial sale and foreclosure usually do not spend times to the impact of bankruptcy proceeding.[54] Meaningful judicial opinions[55] and articles[56] in this area are only related to the actual receiver of distributed sale's money of claimed wages and taxes- unsecured but granted first priority by statute- in foreclosure and judicial sale pursued by secured creditors.

3. Cause of Different Status

The distinct differences of treatment of secured creditors may come from the historical roots. Though first federal bankruptcy law was legislated in 1800,[57] the real Code emerged in 1898 with the enactment of the Bankruptcy Act of 1898.[58] Due to the need of remedy of financial chaos and recession, the Bankruptcy Act of 1898 allowed debtor's discharge and showed liberal attitude toward the debtors, marked difference with English tradition.[59] As

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52) Financial Supervisory Service, *Strategy of Revitalization of "Work Out" in Companies*, June 2006 (in Korean).

53) Korea Financial Times, "Financial market considers the Work Out of Pantech", Dec. 13, 2006 (in Korean).

54) *See e.g.*, Court Manual for Civil Foreclosure Vol. I, 231 (indicating existence of the bankruptcy procedure as just negative requirement to initiate foreclosure and no further comment).

55) *See e.g.*, Supreme Court Judgment of June 24, 2003 (Case No.: 2002 Da 70129) (case related to the receiver of the distributed tax claims against the debtors in the bankruptcy proceeding).

56) *See e.g.*, Taeh-Hyun Kim, Status of Statutory Lien Creditors in Bankruptcy Proceeding: Case of Wage Claims, 2002 TRIAL & PRACTICES (Korean).

57) Act of Apr. 4, 1800, ch. 19, 2 Stat. 19 (repealed 1803).

58) Ch. 575, 52 Stat. 840 (1938) (repealed 1978).

we see already above section, U.S. financial transaction developed with the help of the credit system without dependence on the value of collateral during the lapse of times. Also, development of equity receivership assisted by courts' equity tradition allowed modification of secured creditors,[60] which is distinguished from other common law countries.[61] Federal-State dual system may help the widespread use of bankruptcy. As a federal law enacted by the Congress based on Bankruptcy Clause, the Code may abolish the security interest in the bankruptcy procedure or heavily appropriate secured creditors' right.[62]

Contrary to the U.S. experience, Korea's financial transaction started without infrastructure of credit system. Business of credit check was first recognized as a just business in 1977, but not much development or wide use until economic crisis of 1990s.[63] The secured financing filled the caveat while credit system and bankruptcy law did not develop enough and the real estate foreclosure acted as small procedures of bankruptcy for the unsecured creditors as mentioned above section. Bankruptcy was not commonly used name in the trading and life, and not an option for even economically hopeless people. After economic crisis came through the Korea, total petition of bankruptcy, including individual insolvency proceeding, was only 500 cases in 2000, 1,000 in 2001. Adjusting security interest is not an easy option for political leaders in these circumstances even in the Corporate Reorganization. Besides, Korea's courts do not have the same broad authority as U.S. in the name of equity. Basically, Korea's court has the nature of court of law, not of equity. It can not adjust entrenched interests unless legislative statutes specifies its power to wield. Also, Korea has no federal-state dual system to adjust different interests like U.S.

Another reason of divergence may come from degree of deference to the court's competence to solve bankruptcy problem. Bright line statutory draft

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59) Charles J. Tabb, The Historical Evolution of the Bankruptcy Discharge, 65 AM. BANKR. L. J. 325, 394 (1991).

60) Tabb, *supra* note 22 at 22-23.

61) For common law countries' bankruptcy law, see generally Nathalie Martin, *Common-Law Bankruptcy Systems: Similarities and Differences*, 11 AM. BANKR. INST. L. REV. 367 (2003).

62) James S. Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 987 (1983).

63) Credit Investigation Agent Act was legislated in 1977 and replaced by current Use and Protection of Credit Information Act in 1995.

increases private parties' role while muddy drafting increases discretion of judges.[64] The extreme bright line statutory drafting is judge-proof statutes like exemption of secured creditors in bankruptcy. Usually, this exclusion originates from the distrust of bankruptcy judge's competence to trump private parties' ex ante negotiation.[65] Though there are some distrust exists for U.S. bankruptcy judges' competence,[66] bankruptcy judges in U.S. are usually expert of commercial practice and bankruptcy law.[67] This expert credential is scarce in Korea's counterpart. They are generalist judges with only law-centered education background, also deal with civil and criminal cases before internal transfers and reside in bankruptcy part at most 2 or 3 years in life.

III. Comparative Influence of Stay, Avoiding Power, Strong Arm Power

From the petition of insolvency relief, insolvency law affects the secured creditor's legitimate exercise of right and threatens satisfaction of debts secured by collateral. Actual threat of insolvency proceeding to the secured creditors differs much between Korea and U.S. The most vivid differences can be shown in stay, avoidance power.

1. Stay

1) U.S.: Automatic Stay

The Code grants two effects to the filing a bankruptcy petition to the court. One is creating a new estate, consisting of all the interests owned by pre-bankrupt debtor like death of debtor.[68] The interest includes "all legal or equitable interests of the debtor in property as of the commencement of the

64) *See* Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577, 577 (1988) (arguing sharper rule makes entitlement based ex ante negotiation dominate while fuzzy rule makes ex post dispute more easy choice).

65) *See* Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1821-22 (1998) (suggesting contracting alternative to bankruptcy law, which lead to eliminate bankruptcy judge).

66) *See, e.g.*, *Douglas G. Baird, Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573 (1998).

67) Ralph R. Mabey, *The Evolving Bankruptcy Bench: How are the "UNITS" faring?*, 47 B.C. L. REV. 105, 123 (2005).

68) 11 U.S.C. § 541(a).

case, wherever located and by whomever held."[69] The other face of this automatic estate creation is automatic stay of various collecting act by creditors,[70] including withhold of issuing university transcription.[71] Actually, without automatic stay, the automatic creation of estate has not much meaning in real transaction. This stay comes into effect automatically and instantly whether the subjected people have prior notice[72] and whether the people reside within U.S. or not.[73]

Automatic stay locks up all the creditors, secured or unsecured with very few exceptions.[74] This is stark difference from even "Administration," the most commonly used form of reorganization in the United Kingdom.[75] Though Administration stay the collection of secured creditors automatically very similar to U.S., the process allow secured creditors to trump the automatic stay using "floating charges"[76,77] while filing the petition of bankruptcy limit reach of floating lien U.C.C. Article 9.[78]

Unlike helpless unsecured creditors during the bankruptcy, the secured creditors have way to lift the automatic stay to get their value in the collateral.[79] Without bankruptcy court's further action, passage of 30 days after secured creditors seeking relief from the automatic stay deems to terminate automatic stay.[80] However, all the secured creditors do not enjoy

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69) *Id.*

70) 11 U.S.C. § 362(a).

71) Andrews Univ. v. Merchant, 958 F.2d 738 (6th Cir. 1992).

72) Easley v. Pettibone Michigan Corp., 990 F.2d 905 (6th Cir. 1993) (any action in violation of stay is voidable).

73) *In re* McLean Industries, Inc., 76 B.R. 291 (Bankr. S.D.N.Y. 1987) (extending effect of automatic stay to the foreign court's procedure).

74) 11 U.S.C. § 362(b).

75) Richard F. Broude et al., *The Judge's Role in Insolvency Proceedings: Views from the Bench: Views from the Bar*, 10 AM. BANKR. INST. L. REV. 511, 516 (2002) (calling "Administration" as most effective and popular rehabilitation process).

76) For general understanding and current reform proposal of this floating lien, see generally, Final Report of Law Commission, Company Security Interests (2005) (you can find the electronic form of this document at http://www.lawcom.gov.uk/company_security.htm last visited March 19, 2008).

77) John Armour, et al., *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 VAND. L. REV. 1699, 1737-39 (2002).

78) 11 U.S.C. § 552 (limiting pick up additional collateral by means of after-acquired property clause and value tracing to the five concepts).

79) 11 U.S.C. § 362(d).

80) 11 U.S.C. § 362(e).

that kind of luck. In some cases, problem of lifting the stay stages pierce battle between the debtors and secured creditors. As a default proposition, the Code favors secured creditors to this lifting battle. Excluding bankruptcy of delay purpose and of Single Asset Real Estate,[81] court must lift the automatic stay when secured creditor seeks the relief unless the debtor or trustee provides the creditor with adequate protection.[82] Even if adequate protection is guaranteed, court must nevertheless lift the stay if (1) there is no equity in the collateral to realize for the unsecured creditor and (2) the collateral is not necessary for the reorganization.[83] In most of cases, this kind of battle comes with the beginning stage of bankruptcy and it will be hard decision to the court to predict whether the collateral needed and the reorganization will succeed.[84] As a consequence, the battle is centered on the adequate protection. Though the Code does not define exact meaning of adequate protection in § 362 or any other parts, it instead offers methods of adequate protection such as periodic payment, additional or replacement lien or such other means.[85] Among such other means, court recognizes surplus of security over debt in collateral as adequate protection even nothing more done.[86]

Automatic stay limits the secured creditor's reach against secured collateral even if the burden of proof is imposed on the debtor or trustee for the non-lifting.[87] Secured creditor may have adequate protection which assume to be equal amount guarantee to the secured claim, but the compensation actually received by the secured creditor is sometimes less than the value of secured claim before automatic stay begins.[88] The unpredictable result, costs of courtroom competition and discretion of the debtor or trustee to go against the secured creditor gives the debtor or trustee the leverage to wield in negotiation after the filing of bankruptcy. Also, it influences pre-bankruptcy secured-transaction by adding cost and risk to use security.

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81) 11 U.S.C. § 362(d)(3).

82) 11 U.S.C. § 362(d)(1).

83) 11 U.S.C. § 362(d)(2).

84) *See In re* Schockley Forest Indus., Inc., 5 B.R. 160 (M.D. Tenn. 1980).

85) 11 U.S.C. § 361.

86) *See In Re* Blazon Flexible Flyer, Inc., 407 F. Supp. 865 (N.D. Ohio, 1976).

87) 11 U.S.C. § 362(g).

88) Bebchuck & Fried, *supra* note 14, at 911-13.

2) Korea: Limited Stay after Initiation of Process

Basically, filing of insolvency proceeding to the court in Korea has no legal effect in itself. Like most of other civil petition to seek relief from the court, it requires court's decision.[89] Only after motion to initiate insolvency proceeding is granted, insolvency law has real legal effect.[90] This is originated from the absence of creating estate in most of insolvency proceeding. Before DRBL was enacted, the repealed Bankruptcy Law only defined creation of a new estate for liquidation process, but other statutes did not provide any similar concept in its procedure.[91] The Bankruptcy Law created a new estate only by official declaration of bankruptcy to the debtor,[92] but the court had to find existence of cause for liquidation before declaration.[93] In addition, the Bankruptcy Law allowed repealing of bankruptcy at the same time of declaration of bankruptcy when the debtor had not enough properties to pay the cost of bankruptcy process.[94] This repealing made it possible to discharge the debtor without creating a new estate to transfer debtor's property. All of the individual bankruptcy cases were processed this way without trumping any pre-bankruptcy transaction.

While this kind of process worked very well with the protection of pre-bankruptcy entitlement, it showed weakness to achieve business reorganization. This process accompanied with delays and was felted costly in urgent cases where final decision of initiating business reorganization takes months and the debtor needed some kind of protection to defend piecemeal collective actions by creditors.

The newly enacted DRBL introduced individual stay and comprehensive stay for the business reorganization.[95] Comprehensive stay order could be issued only if individual stay order does not realize its goal to protect debtors.[96] However, this stay order is very different from the U.S. counterpart in the scope of affected action. Comprehensive stay only block foreclosure,

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89) *See e.g.* DRBL Art. 9 Para. 1 (demanding decision less than one month from filing).

90) *See e.g.* DRBL Art. 49 Para. 3.

91) Bankruptcy Law (repealed in 3. 31, 2005) ch. 2.

92) *Id.* Art. 1, 6.

93) *Id.* Art. 116, 117.

94) *Id.* Art. 135.

95) DRBL Art. 44 (individual stay order), 45 (comprehensive stay order).

96) *Id.* Art. 45 Para. 1.

lawsuit related to the debtor's property, tax related seizure and administrative agency process concerning debtor's property.[97] Among these lists, the stay of administrative agency process concerning debtor's property could be quite problematic in the future. Unlike other procedure based on civil procedure,[98] administrative agency process was regarded as an area of administrative law and court interprets that civil injunction can not be used to hold off administrative agency's act, because Administrative Lawsuit Law provide peculiar temporary restraining order for the plaintiff of administrative case.[99] How far and much this new provision provides protection for the debtor is dubious. No case is reported for this new provision as of today. Also, comprehensive stay only affects process against the debtor, not reaching other process including third parties.[100]

In Korea, anyway, stay against secured creditors is only available to the Business Reorganization which happens less than 100 cases annually as mentioned above. Besides, it is very limited remedy than U.S. counterpart. It is predicated consequence of absence of creating new estate by filing of bankruptcy. This lack of stay power debilitates the effect of insolvency proceeding in transaction because insolvency procedure never shuffles normal transaction and collective remedy before it reaches final stage. It gives actually protection to the creditors even in the debtor's bankruptcy situation.

2. *Avoidance Power*

1) U.S.: Real Threat to the Secured Creditors

(1) Avoidance

Historically, avoidance has evolved from the Statute of 13 Elizabeth, which punished criminally debtor' defrauding conveyance to delay or evade the creditor's collection.[101] Basic idea of this kind of statute is prevention of debtor's manipulation of his or her asset to keep them from the creditors' reach. Even English bankruptcy statute antedating the Statute of 13 Elizabeth

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97) *Id*. Art. 44 Para. 1.

98) In Korea, for an example, tax related seizure borrows many part of its process and interpretation from court's civil seizure. *See* Tax Collection Law.

99) Supreme Court Decision of July 6, 1992 (Case No.: 92 Ma 54).

100) DRBL Art. 45 Para. 1.

101) 13 Eliz., ch. 5 (1571).

adopted similar provision to recover fraudulent transfers.[102] Thus, it is not a surprise the Code defined avoidance power to fraudulent transfers from the beginning.[103] But, preference avoidance against debtors in bankruptcy situation differs with fraudulent transfer avoidance because it denies to give favor one existing creditor to the expense of another creditors.[104] Despite of this difference, U.S. enacted statute to avoid giving preference in transitional times very early[105] and court interpreted the statute not to need mental state that characterized English fraudulent transfer.[106] Meanwhile Uniform Fraudulent Conveyance Act(UFCA) of 1918 expanded voidable conveyances to the constructively fraudulent conveyances.[107] Finally, Bankruptcy Reform Act of 1978 eliminated the creditor's subjective mind as an element of preference avoidance in section 547 and retained essential features of UFCA in section 548.[108]

Main difference between preference and fraudulent avoidance comes from the focus of voidable transfers. Fraudulent avoidance in state and bankruptcy remedy stress the fact that the debtor has malicious intent[109] or the consideration of transfers is less than "reasonably equivalent value"[110] while the preference avoidance abhor preferential asset conversion on the eve of the bankruptcy for the specific creditor in the cost of other creditors whether it has reasonably equivalent value or not.[111] Thus, preference avoidance permits the trustee or debtor in the possession to review near bankruptcy transfer of debtor and avoid when creditors get improved position through the transfer. The trustee or debtor in the possession has the burden of proof to the

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102) Levinthal, *The Early History of English Bankruptcy*, 67 U. PA. L. REV. 1, 11- 12 (1919).

103) Act of April 4, 1800, ch. 19, § 17, 2 Stat. 19, 26 (repealed 1803).

104) Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 757-58 (1984).

105) Act of Aug. 19, 1841, ch. 9, 5 Stat. 440, 442 (repealed 1843).

106) Arnold v. Maynard, 1 F. Cas. 1181, 1183 (C.C.D. Mass. 1842) (inferring contemplation of bankruptcy by debtor).

107) UFCA §§ 3 (conveyances by insolvent), 4 (conveyances by persons in business), 5 (conveyances by a person about to incur debts).

108) Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, 2598 (preference avoidance), 2600-01 (fraudulent avoidance).

109) Uniform Fraudulent Transfer Act (UFTA) § 7; 11 U.S.C. § 548(a)(1)(A).

110) UFTA §§ 4, 5; 11 U.S.C. § 548(a)(1)(B).

111) *See* Jones Truck Lines, Inc. v. Central States, S.E. and S.W. Areas Pension Funds, 130 F.3d 323 (8th Cir. 1997).

elements,[112] including (1) the debtor made the transfer of an interest of the debt in property while he or she is insolvent to or for the benefit of a creditor for or on account of an antecedent debt (2) the transfer made within 90 days(1 year to the insider creditor[113]) of bankruptcy filing and (3) the creditor receive more than he or she is entitled with chapter 7 process by the transfer.[114]

To the contrary, fraudulent avoidance is very similar to the state fraudulent transfer remedy. The intercourse between two remedies is two-way and actually current dominant UFTA is transformed from UFCA under the influences of section § 548 of the Code.[115] Fraudulent transfer avoidance is divided into two branches like state remedy. One is with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors.[116] The other is with constructively fraudulent intent if transfer is for less than reasonably equivalent value and is made at a time when (1) the debtor is insolvent or as a result of transfer the debtor becomes insolvent[117] (2) the debtor is engaged in business and will have unreasonably small capital to conduct its business after the transfer is made[118] or (3) the debtor is about to incur debts beyond his ability to pay as they mature.[119] The difference between them is that proof of debtor insolvency[120] and fair consideration[121] is not material to the determination of actual intent to defraud, though relevant in proving actual intent. Section 544(b) in the Code gives trustee or the debtor in possession power to use state remedy in avoidance which is longer than bankruptcy avoidance power.

The power of bankruptcy avoidance comes from its broad definition of transfer to include Code to include "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest

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112) 11 U.S.C. § 547(g).

113) 11 U.S.C. § 547(b)(4)(B).

114) 11 U.S.C. § 547(b).

115) *See generally* Cook & Mendales, *The Uniform Fraudulent Transfer Act: An Introductory Critique*, 62 AM. BANKR. L.J. 87 (1988).

116) 11 U.S.C. § 548(a)(1)(A).

117) *Id*. § 548(a)(1)(B)(ii)(I).

118) *Id*. § 548(a)(1)(B)(ii)(II).

119) *Id*. § 548(a)(1)(B)(ii)(III).

120) *In re* Vaniman Int'l, Inc., 22 B.R. 166, 185 (Bankr. E.D.N.Y. 1982).

121) Pashaian v. Eccelston Properties, Ltd., 88 F.3d 77, 86 (2d Cir. 1996).

and foreclosure of the debtor's equity of redemption."[122] Even revocation of corporation's subchapter S[123] or sheriff's foreclosure sale of debtor's property[124] is transfer in the avoidance power. As an equitable power, avoidance power attacks any legal acts in state law, especially targeted to the insider in the bankruptcy.[125] Indirect beneficiary of antecedent debt payment, such as guarantee, may face avoidance action in the bankruptcy.[126] Secured creditors if excised some kind of control or dominion in debtor's management, may face their secured claim to be subordinated like insider.[127]

Another aspect of broadness in avoidance power is court's interpretation of related acts into one act, so called "collapse."[128] This is very effective and threatening tool to control multi-entities related transaction in today's complex finance environment. Transfers between related entities usually have some aspect of favors than arms dealing in the competitive market even when it takes form of secured loans.[129] Even sophisticated investment bank involved Leveraged Buy Out may not evade the threat of avoidance in the bankruptcy.[130]

(2) Strong Arm Clause

In historical development, strong arm clause emerged with ascendance of trustee's status. Before the Bankruptcy Act of 1898, trustee was seen as a mere successor of the debtor as an assignee.[131] It meant the trustee has no more power than the debtor as a derivative of the right of the debtor. Congress clearly changed the status of the trustee in 1898, giving the trustee the powers of existing unsecured creditors and enhanced its position to the judicial lien creditor in 1910.[132] In 1978, the strong arm clause has today's shape by giving the trustee the status of a hypothetical bona fide purchaser of real property.[133]

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122) 11 U.S.C. §101(54).

123) *In re* Bakersfield Westar, Inc., 226 B.R. 227, 230 (B.A.P. 9th Cir. 1998).

124) Butler v. Lomas & Nettleton Co. (In re Butler), 75 Bankr. 528, 531-32 (Bankr. E.D. Pa. 1987).

125) UFTA §§ 4, 5.

126) *In re* Herman Cantor Corp., 15 B.R. 747 (E.D. Va. 1981).

127) *In re* Carolee's Combine, 3 B.R. 324 (Bankr. N.D. Ga. 1980).

128) Orr v. Kinderhill Corp., 991 F.2d 31 (2d Cir. 1993).

129) *In re* Image Worldwide, Ltd., 139 F. 3d 574 (7th Cir. 1998).

130) *See, e.g.*, Wieboldt Stores, Inc. v. Schottenstein, 94 B.R. 488 (Bankr. N.D. Ill. 1988).

131) Stewart v. Platt., 101 U.S. 731 (1879).

132) John C. McCoid, *Bankruptcy, the Avoiding Powers, and Unperfected Security Interests*, 59 AM. BANKR. L.J. 175, 181-82 (1985).

133) 11 U.S.C. § 544(a)(3).

During the BACPA enactment process, proposal of extending this bona fide purchaser status to all cases was made, but failed with agitation of financiers.

This development and recognition of strong arm clause paralleled the growth of secured financing in the U.S. In the common law, the transfer of an interest in personal property without delivery of possession was fraudulent.[134] The introduction of U.C.C. article 9 changed the scenes of secured financing to obtain valid lien easier than before and leaded to the explosive growth of secured financing. This leads to the conflicts and tensions between the Code and U.C.C. article 9. In 1978 reform, the Code was drafted in the recognition of growth in secured financing.[135] Meanwhile, U.C.C Article 9 drafters wanted to cut back the threat from the bankruptcy trustee to prevent secured creditors put in the obscure proposition.[136] These cut back efforts may be culminated in the 1999 revision of U.C.C. Article 9. Though the drafters have different opinion with simplifying filing system and measure to limit the influence of defect of financing statement to the bankruptcy,[137] it weakens the strong arm clause influence by limiting the reach of it.[138]

Strong arm clause gives trustee or debtor in the possession to challenge validness of security interest by policing the compliance of perfection requirement. The meaning of this power comes from two facts. Creation of mortgage in U.S. is very outmoded and complicated process, which leads to the defects in the perfection more easily.[139] Another comes from relatively simple financing statement which does not require exact information to the debtor.[140] This may be based on the reality that the recording system or filing system of U.S. which the security interest relies on notice is very outmoded and various to each jurisdiction. Anyway, strong arm clause gives trustee or debtor in possession another leverage to use, because its use is discretionary.

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134) Twyne's Case, 76 Eng. Rep. 809 (1601).

135) Robert E. Scott, *The Truth About Secured Financing*, 82 CORNELL L. REV. 1436, 1463-64 (1997).

136) Grant Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605, 620 (1981).

137) *See generally Steven L. Harris & Charles W. Mooney, Jr., Revised Article 9 Meets the Bankruptcy Code: Policy and Impact*, 9 AM. BANKR. INST. L. REV. 85 (2001).

138) *See generally Warner supra* note 29, at 25-44.

139) *See In re* Hoffman, 369 F.3d 972 (6th Cir. 2004) (invalidating mortgage of falling short three witness requirement by Ohio law).

140) *See* U.C.C. § 9-503.

2) Korea: Symbolic Spears to Threat

Civil Code in Korea provides very similar weapon to the creditors when the debtor defraud, hinder or delay collective action by the creditor: Cancellation of Fraudulent Act (CFA).[141] Like many other countries, CFA is originated from Roman *actio pauliana*.[142] It has been mainly developed by court's interpretation like common law's fraudulent conveyances based on the two sections in the statutes,[143] but no further effort to codify court's opinion has been yet, unlike UFCA or UFTA. In the statute's word itself, CFA is very similar to the Statute of Elizabeth because it needs debtor's malicious intents to injure the creditors.[144] However, court has interpreted this statute to require only objective harm to the total value of debtor's asset regardless of debtor's subject mind.[145]

Even before enactment of DRBL, the avoidance power in bankruptcy was generally regarded different remedy from the CFA, because it enlarged the scope of avoidable legal act to the action or inaction of disposing legal claims in the court and regardless of intents of the debtor.[146] DRBL enhanced the avoidance power to enlarge the period of avoidable acts to 1 year and shift the burden of proof when the creditors benefited by the avoidable act are insiders.[147]

While this enhancement may give more leverage to the debtor in possession or receiver in some cases, the actual effect and threat to the secured creditors are really miniscule in Korea. First of all, the business reorganization cases where the avoidance power is actually used[148] are very sparse and rare as mentioned in above section. This make the actual threat of avoidance power restricted to the marginal number of secured creditors, though potential threat remain in some advanced financial intermediaries using

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141) Civil Code Art. 406.

142) For detailed explanation of this measure see generally, Radin, Fraudulent Conveyances at Roman Law, 18 VA. L. REV. 109 (1931).

143) Civil Code Art. 406 (element of CFA), Art. 407 (effect of CFA).

144) *Id.* Art. 406(1).

145) *See e.g.*, Supreme Court Judgment of November 15, 1962 (Case No.: 62 Da 634)

146) Supreme Court Judgment of November 10, 2005 (Case No.: 2003 Da 271) (enlarging avoidable legal act by trustee to the payment of existent pre-bankruptcy debt).

147) DRBL Art. 101, 392.

148) *See* Jin Man Lee, *Avoidance Power in DRBL-Focusing on the Subject of Avoidance, Analysis of Civil Cases* Vol. 28 (2002), note 7 (in Korean) (Avoidance cases are seen mainly in business reorganization).

accounts receivable as security similar to U.C.C. Article 9. Another reason is the relatively narrow scope of avoidable act, because the avoidable acts are limited to the legal act or as such of debtor by statutes.[149] Court interpreted the similar statutes of pre-DRBL era to require debtor's legal acts and give third parties' act the same effect only on alter ego of debtor cases.[150] Another is the court's hesitant attitude toward wielding equitable power to stump the result of voluntary transaction. For an example, court do not collapse individual acts into one transaction aggressively in Korea.[151] Finally, Korean law does not require procedural complexity in the financial transaction contrary to U.S. and court's recording system require exact information for the record of security interest, including personal information of debtor and secured creditors. It means no actual use of strong arm power by receiver or debtor in possession. Actually, there is no enactment of similar statute in Korean bankruptcy law like U.S.'s strong arm clause.

This makes the threat of avoidance power in bankruptcy as a symbolic power, not an actual threat to the secured creditors. This situation may change in the DRBL, because it enlarges the reach of avoidance power a bit more than old statutes. But, an upside-down change is not expected in DRBL. As of today, no evidence has been provided to the promise of realization of the avoidance power in DRBL

IV. Implication for the Financial Transaction

1. Understanding Differences in Financial Transaction Environment

In the U.S., the Code plays a significant role in financial transaction because it changes the opportunity cost of the financial transaction by engaging collective process. The debate between scholars on the role of bankruptcy and its reach to the pre-bankruptcy entitlement starts from this same assumption.

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149) DRBL Art. 100, 391.

150) *See e.g.*, Supreme Court Judgment of January 9, 2002 (Case No.: 99 Da 73159).

151) *See e.g.*, Supreme Court Judgment of September 24, 2002 (Case No.: 2002 Da 23857) (denying collapsing argument of plaintiff).

However, one vital fact is easily missed and not mentioned in the debates: U.S. has world's most developed financial market and the private parties and financial intermediaries regulate the order of this market mainly.[152] Moreover, U.S. financial markets are populated by sophisticated rating agency, investment bankers, securities analysts, accountants and even lawyers described by Professor Ronald J. Gilson as "transaction cost engineers."[153] This situation and deep confidence to the market system rebuffs any policy overture and equitable remedies to trump negotiated entitlements between parties and justifies current situation as the efficiency maximizing or cost cutting process. This adulation to the market efficiency sometimes oversimplifies the complicated transactions and underestimates the accompanying risk and overrates concerned parties' ability to contain the risk.[154] In this situation the Code and courts to enforce it is the only significant "visible hand" to market participants because it threatens autonomous market outcomes and redefine entitlements against market negotiations. This fear against the bankruptcy court is most vivid in the securitization where special purpose vehicle is created and designed to make revenue-creating source's asset bankruptcy-proof.[155]

In some aspects, the Code and enforcing courts is the minimal regulation to contain the harsh consequence flowed from this deep capital market and private ordering to the debtors by giving opportunities of fresh start. What kind of alternative one suggests if the bankruptcy remedies did not exist? The answer will be the direct government regulation to lessen the harm done by the market as the Sarbanes-Oxley Act of 2002 does to the storming corporate governance scandal.[156]

Contrary to the U.S., the financial environment surrounding Korea is under direct influence from the government regulation. This difference has its root in the historical development. Though Korea attained to the one of

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152) For the different classification and justification of private ordering, see generally Steven L Schwarcz, *Private Ordering*, 97 Nw. U. L. Rev. 319 (2002).

153) Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L. J. 239, 255 (1984) (calling lawyers as "transaction cost engineers").

154) One sort of this common adulation is for the securitization. *See generally* Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J. L. BUS. & FIN. 133 (1994).

155) For securitization process see generally Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WA. U. L.Q. 1061 (1996).

156) Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

world's developed countries in today's perspective,[157] it started from one of world's poorest countries in the debris of Korean War of 1950. Many elements worked for this rapid economic development. One of distinguished aspects to the financial market was the government based resource distribution scheme between market participants. Before economic crisis in 1990s, the most part of rapid growing economy was originated from the rapid accumulation of corporate asset and enormous investment leaded by big family based closely hold conglomerate called "Chaebols." In 1996, the ratio between the corporate finance and nominal GDP was 36%.[158] This heavy investment left heavy reliance on the debt behind. Average debt equity ratio in product industry was 322% in 1996 and 72% of corporate finance resource came from outside financial market, not from the corporate internal withholdings.[159] The extreme was top thirty Chaebols. Their debt equity ratio was 519% while their share of Korea GNP and Export was 16% and 50%.[160] Most of this outside financial resource depends on the loan or similar nature finance. Even the finance of fixed asset investment relied 70% of the resource on the loan from the banking sectors.[161] This heavy investment demand from corporate section led to the chronic shortage of credit supply in the finance market. Government solved this problem by containing small corporate and consumer finance. In 1996, consumer finance only comprised 23% of all credit.[162] Distribution of credits was orchestrated under government influence in big picture. Before 1990s, government was sole owner of large banks or actual managing power even in private bank.

This situation made any kind of market finance based only debtor's credit from financial intermediary privilege rather than voluntarily negotiated transaction. Most of the finance in this time came from security- backed transaction. Even courts convicted and punished the employees and

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157) In GDP based on purchasing power, Korea is ranked 16th in 2007 estimates. *See* CIA Fact Book.

158) Yong Hwan Kim et al., *Analysis of the Elements in Corporate Finance Decisions*, Korea Industrial Bank, Table 1 (2006) (in Korean). The ratio was even higher before 1996. For example, 38% in 1990. *Id*.

159) *Id*., Table 4.

160) For the role of Chaebols in Korean Economy, see generally Craig Ehrlich & Dae-Seob Kang, *U.S. Style Corporate Governance in Korea's Largest Companies*, 18 UCLA. PAC. BASIN L.J. 1 (2000); Ok-Rial Song, *The Legacy of Controlling-Minority Structure: The Kaleidoscope of Corporate Governance Reform in Korean Chaebol*, 34 LAW & POL'Y INT'L BUS. 183 (2002).

161) Yong Hwan Kim et al., *supra* note 158 at 4-5.

162) *Id*., Table 2.

principals of financial intermediaries as Betrayal of Trust[163] when they made bad loans to the debtors unless they received the security from the debtors to make sure the satisfaction of debts.[164] Most of these cases accompanied some kind of unproven corrupt motives and self-dealing, but court's unfavorable attitude toward credit based loan represented social consent to the privilege of loan when it was not backed by enough equity-cushion by security.

The Economic crisis in 1990s changed these all situation. The failure of leverage-based growth was evident in the turmoil of East Asia financial crisis. Government lost most of its direct grip on the banks and other financial intermediaries during privatization of banks and financial intermediaries. Corporate, including Chaebols, retreated rapidly from heavy leveraged strategy. The average debt equity ratio diminished rapidly. It was 107% in all-corporate section and 95% in big corporate section and the reliance on the internal financial resource of corporate sector climbed to the 63% in year 2004.[165] Meanwhile, the open capacity of financial market originated from the corporate cutting debt strategy has been filled with the consumer lending. During 1996 and 2004, ratio of consumer finance in total finance rise from 23% to 50%.[166] However, government still regulates much of banks and financial intermediaries more directly than U.S. One recent example can be shown in curbing the explosive growth of residence mortgage backed loan since 2007. Regulators forced banks to limit total amount of loans to individuals under same scheduled income indicators.

Historically, this direct regulation and hard grip of government to the financial market and still fledgling financial market displaced the role of bankruptcy in the past. Most credit based financial transaction and reorganization of failed corporate were orchestrated by the government guidance. Even today, the situation does not change much. First of all, most of credit based small or start up company finance is originated actually government assisted funds. Unlike U.S., the small or start-up company relied

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163) Basically, Betrayal of Trust is very similar to the violation of fiduciary duty. In 2007, German court convicted target-company's corporate executive in merger situation using similar statute when he received excessive compensation in relation with successful merger. For more detailed description see generally Franklin A. Gevurtz, *Disney in Comparative*, 55 AM. J. COMP. L. 453 (2007).

164) Supreme Court Judgment of November 13, 1990 (Case No.: 90 Do1885).

165) Yong Hwan Kim et al., *supra* note 158, Table 2, 4.

166) *Id*., Table 5.

70% of finance on the banks in Korea[167] and most of this comes from government directly or indirectly. Annually, Bank of Korea provides special low rate loans to the banks, considering each bank's performance on credits to the small or start-up company.[168] Also, 20% of total loan to the small or start-up companies by banks is insured by government assisted insurance funds.[169] In corporate side, direct government assisted finance comprise 20% of the small or start-up companies' financial resource.[170] When government assistance, family and friend's loan, even high interest illegal loan shark excluded, most of finance of small or start-up companies comes from the mortgage backed loans.[171] This situation makes the role of bankruptcy trivial. More succinctly, trumping the security interest by bankruptcy is rather disastrous to this status quo of financial market. In opposite, the big publicly traded company does not need finance from banks contrary to the past, because they can rely on the direct market and internal resource.[172] Especially, corporate under the Chaebols could rely on affiliate for financial resource through the cross share holdings though they are restrained by some regulation.[173]

These situation and development diverged from U.S. where private ordering in financial market is dominant and historically and politically cross share holding is restricted.[174] Actually, current business reorganization evolved from equity receivership practice in 19th and advanced with constant erosion of SEC regulation power against publicly held corporation in mid 20th where financial market was segmented and influence of government regulation was bounded.[175]

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167) Jong Ku Kang et al., *The Analysis of Effect in Small or Start-Up Company Financial Assist Program*, THE BANK OF KOREA Table 8 (2005) (in Korean).

168) *Id*., at 4-5.

169) *Id*., at 5. Actually total insurance covered by these funds is more than 6% of GDP. *Id.*

170) *Id*., Table 8.

171) *Id*., Table 10. 50% of finance is mortgage backed loan and only 13% is pure credit based.

172) In 2007, the big corporate relies on more than 80% of financial resource to the internal withholding in fixed asset investment. See, Korea Development Bank Research Center, Investment Planning Outlook in 2008 (Jan. 2008) (in Korean).

173) *See e.g.* Law on Anti-Trust and Fair Trade, Art. 9 (restricting cross share holding in Chaebols), 10 (limiting total amount of cross shareholding).

174) For the in depth political account of U.S. corporate finance and current structure, see generally MARK J. ROE, STRONG MANAGERS, WEAK OWNERS (1994).

175) *See* David A. Skeel, *An Evolutionary Theory of Corporate Law and Bankruptcy Law*, 51 VAND. L. REV.

Arguably, financial market in Korea may develop in further and government regulation may decrease in coming years. However, any further movement of enhancement of bankruptcy law's trumping to the secured debt will face significant barriers and obstacle because it upset already deep rooted financial market order. Besides, bank and other financial intermediaries will not change their old practice in upside down manner. Instead, they have extended their old practice to the newly unregulated market as of today. One vivid example may be explosive growth in residential mortgage backed loan by banks. From 2000 to 2006, the residential mortgage backed loans more than quadrupled from 51 trillion won to 214 trillion and ratio on total consumer finance increased from 17.9% to 36.4% at the same time in Korea.[176)]

2. *Implication for the Financial Transaction*

Strong status of secured creditors during bankruptcy in Korea brings many different consequences to the financial transaction compared with U.S. Definitely, these consequences can not be traced to the bankruptcy law alone, because many elements give and exchange influences in financial market and no one can dissect the one effect with others. However, strong status of secured creditors in bankruptcy has left undeniable influence in the financial transaction.

1) Forms of Financial Transaction

One unique peculiarity of Korea's financial market is its short-term contract's dominance. Most of loans based on mortgage last only at most three year and renewal is usually discretionary, up to the creditors' intent. Another distinguished feature is that the payment of principal is usually lump-sum payment, due at the end of contract not on installment or divided payment in most cases. This short term contract and one time payment of principal is based on the easy liquidation of real estate by foreclosure. Korea's judicial foreclosure is relatively efficient and speedy process where competitive sale

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1325, 1352-77 (1998) (streamlining U.S. bankruptcy reorganization development in corporate finance structure).

176) Sung Soo Ko, *Risk Management of Residential Mortgage Backed Loans in Financial Intermediaries*, 2006 FINANCIAL RISK REVIEW WINTER Table 2 (in Korean).

price is usually over liquidation value of real estate. Efficient foreclosure ensures full satisfaction to first priority mortgagee who usually makes loan within the liquidation price based on pre-contract appraisal whether the debtor defaults or not. While many factors contribute to this situation, easy and full liquidation is guaranteed by near immunity of secured creditor from the influence bankruptcy. If filing of bankruptcy may block the collective process or bankruptcy court has real authority to trump the pre-bankruptcy entitlement like U.S., this kind of form in loan may be impossible.

Short term contract period and one time payment based on real estate mortgage has many beneficial points to the financial intermediaries. First of all, it reduces monitoring cost to the debtors to evade debtor's financial distress condition. Without it, banks and other financial intermediaries (hereafter "banks") have to feel more like a joint venture with the debtors.[177] Secondly, banks do not need complicate credit check or complex system of decision to loan based on credit. These benefits for banks are tremendous when banks do not have infrastructure to respond the demand of monitoring and credit check. Considering these benefits, banks will not easily agree any reform to increase their cost by shaking this equilibrium.

Forms of financial transaction may change when bank, the main beneficiary of this system, faces severe competition from other financial intermediaries such that U.S. commercial banks faced during 1980-2000.[178] This potential may be realized because the current financial policy of government indicates introduction of some competition by allowing former security brokerage firms to receive some kind of de facto deposit account.[179] Recent deposit move from bank's no interest bearing demand deposit to security brokerage's CMA raises woes from the banking industry.[180] However this potential is so far away at least right now, because bank has competitive edge against other competitors.[181]

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177) Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 948-52 (1986).

178) *See generally* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, U. ILL. L. REV. 215 (2002)

179) *See generally* Law on Financial Market and Financial Intermediaries, 8635 PUBLIC LAW (2007).

180) Maeil Economy Daily, *Money Move from Banks Drawing Woes*, Dec. 12, 2007 (Korean) (commercial banks have to issue 30 trillion won bonds to respond the withdraw and it raises market interest drastically).

181) In Korea, banks are allowed to participate in diverse financial transactions unlike U.S. commercial banks. Actually, it has aspect of merchant banks before Glass-Stegall Act.

Relatively strong status of secured creditors in bankruptcy in Korea is a one of cornerstones to this system. Any attempt to weakening the secured creditor's status will have to face fierce interest groups' oppositions. Meanwhile, the support to enhance the business reorganization or reduce immunity of secured creditor from bankruptcy is very trivial. Most of big corporate under control of Chaebols will have no interest to facilitate business reorganization because it does not protect controlling shareholder ultimately. To the small corporate and start up, business reorganization will not provide any alternative to restart, because no other financial resource they could find than banks unlike U.S. counterpart. Enlarging Rehabilitation for Individuals like chapter 13 is also very hard. As of today, support for broadening personal bankruptcy is originated from sympathy for the poor people with no recourse. People with real estate are not considered as poor people generally.

Reversely, this fortitude of secured creditors will help the survival of current dominant form of financial transaction. Any change of form in financial transaction accompanies significant costs to the participants, especially to the supplier of resources. Even if the market environments change a lot, banks will not move much while they enjoy the relatively low supply cost by no interest bearing deposit and secured debt backed by mortgage provides profitable market.

2) Distortion in Corporate Investment and Composition of Industry

Strong status of secured creditor in financial transaction may distort corporate investment priorities and composition of industry in national economy. While corporate investment decision is not easily analyzed, the relative easiness of finance may facilitate investment decision to acquire redundant fixed asset for financing advantage regardless of its efficiency or cost. It may lead to the excessive overinvestment to the fixed asset such as real estate or factory facility in corporate because this investment produces gains by enabling new finance and lowering existent finance's cost. High valuation in fixed asset also distorts proper valuation between corporate owned assets. Actually, the high rise of corporate investment in fixed asset during 1990s, pointed as one of reasons of economic crisis in end of 1990s, was possible through high valuation of fixed asset investment by financial intermediaries.

Distortion in finance leaves severe aftereffects especially in starting-up company finance. Starting-ups without any fixed asset in nature may be

disfavored in this financial regime because they have only new idea or invention which is not easily assessed for security use. Thus, financial intermediaries may provide capital for the real estate development firms, construction firms, retailer or industrial firms which have enough fixed asset to provide security for loans such as real estate, but do not finance any new technology firm which only has research teams.[182] This situation will suffocate valuable development in new technology and distort ultimate industrial composition toward heavy composition of fixed asset based industry beyond proper equilibrium.

Also, this distortion may make it hard to transform composition of Korea's industry toward more developed stages the government are planning and desires. Korea's government has declared and suggested to evolve toward an economy composed of more profitable service business based economy such as financial, entertainment, broadcast industry since start of 21st century. The basic differences of planned industry composition and current composition are that the former requires not much fixed asset and need investment more on human asset internalizing intellectual property. In current financial system, the company based on new-economy type of asset composition has to face harsh market to get finance. While government's assist program may help some of them, it will never fully fill up all.

V. Conclusion

Bankruptcy law changes every day, because it depends much of its contents on the bankruptcy judges not just on the law itself. Incoherence and indeterminate variation comes from bankruptcy's nature itself-dealing with the business in flexible and ever-changing business environment. Granting bankruptcy judges the power to trump pre-bankruptcy entitlement may destabilize voluntarily negotiated market order and makes cost to the market participant. It lead each countries' divergence how far she grant the authority

182) Actually, venture capitalist in Japan, which has similar protection for secured creditors and similar finance practice, usually finance retailer or real estate firms unlike U.S. *See* Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 Nw. U. L. Rev. 865, 874-80 (1997).

to bankruptcy judges.

Korea and U.S. showed stark distinction in protection of secured creditors under bankruptcy process. The status of secured creditors in bankruptcy influences beyond the bankruptcy itself and over the incentives of financial transaction and costs. This distinction comes from diverged historic development in financial market and differed government's role in it.

This article does not suggest one system is superior over the other. Any system allowing market autonomy and court's role in it has other supporting institution and developed market.[183] The purpose of this Article just explains the comparative difference of status of secured creditors under bankruptcy between Korea and U.S. and roots of this divergence has related to financial market. While some development in Korea's financial market will provide room for further reform to maneuver the pre-bankruptcy entitlement, the differed role of bankruptcy in secured transaction as an entrenched aspect in market will survive any reform and affect the financial transaction and corporate investment decision reciprocally.

KEY WORDS: Status of Secured Creditors in bankruptcy, tension and conflicts of secured creditors and debtors, Exemption from Bankruptcy in Korea, Historical development in financial market, Judicial sale of real estate, Stay, Avoidance Power, Strong Arm, private ordering of financial market, influence of government intervention, distortion effect by strong status of secured creditors

183) For an example, Delaware's enabling corporate governance law has roots in developed financial market and security regulation. See generally, Katharina Pistor et al., *The Evolution of Corporate Law: A Cross-Country Comparison*, 23 U. PA. J. INT'L ECON. L. 791(2002).