ALLEN & OVERY

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Restructuring Across Borders

Korea: corporate restructuring and insolvency procedures

Contents

Introduction

When a corporate borrower in the Republic of Korea (**Korea**) faces financial difficulties there are three restructuring and insolvency options available:

(1) Workout (as an out-of-court restructuring procedure);

(2) Rehabilitation (pursuant to Articles 34 to 293 of the Debtors Rehabilitation and Bankruptcy Act); and

(3) Bankruptcy or liquidation (pursuant to Articles 294 to 578 of the Rehabilitation and Bankruptcy of Debtors Act).[1]

The Debtors Rehabilitation and Bankruptcy Act (the **DRBA**) was promulgated on 31 March 2005 and came into force on 1 April 2006. The DRBA consolidated the Corporate Reorganisation Act (1962), the Composition Act (1962) and the Bankruptcy Act (1962) with a view to making the procedure for the bankruptcy and rehabilitation of insolvent companies more efficient and streamlined. Since then, the DRBA has undergone many partial revisions, with the most recent revision on 27 December 2016, which took effect on 28 March 2017.

Under the DRBA, foreign nationals and foreign corporate entities involved in bankruptcy and rehabilitation proceedings in Korea are treated as if they were Korean nationals or Korean corporate entities.

Unless a petition for commencement of the rehabilitation proceeding has been filed for the financially troubled company (in which case a comprehensive stay order may be issued by the court preventing creditors from initiating enforcement proceedings against the debtor), creditors with the benefit of security may elect to enforce their security. Security enforcement is essentially a self-help remedy rather than a collective restructuring or insolvency procedure and, if available to a creditor, will often represent the best method of recovery.

[1] In the case of certain financial institutions, the Act on the Structural Improvement of the Financial Industry shall apply in addition to the Rehabilitation and Bankruptcy of Debtors Act.

Enforcement of security

The main forms of security available under Korean law are:

(1) Mortgages over real property; and

(2) Pledges over moveables and intangible property.

Mortgages are most commonly taken in respect of real estate. Creation of a mortgage over real estate does not require possession of the secured asset. A mortgage, once duly recorded in the real estate registry, gives the mortgagee priority in the mortgaged property and the mortgagee may satisfy his or her claim before subsequent mortgagees, other subsequent security holders and the mortgagor's general creditors.

There are also laws providing for special types of mortgages, for example the Factory Estate Mortgage Act and the Mine Estate Mortgage Act. These laws allow the Mortgagee to take security over the entire estate of a business, including land, buildings, equipment and intangible properties in a single mortgage. Other laws, including the Ship Registration Act, the Vehicle Mortgage Act, Aircraft Mortgage Act and the

Construction Machinery Mortgage Act recognise chattels as the subject of a mortgage.

A pledge is the most commonly used security for personal property in Korea. A pledge over moveable property is created through the execution of a pledge agreement and by the pledgee taking possession of the collateral.

A pledge over rights in intangible property is generally established by delivery of the document representing the rights and/or delivery of a written notice of the pledge (with a fixed-date stamp affixed to it) to the third party debtor (eg for pledges over claims). The two main types of rights that are pledged are claims and shares in a company.

There is no registration requirement for security over shares but the pledge agreement may permit registration of the security in the shareholder register of the company. Registration would allow the security holder to receive dividends or other like payments directly from the company and to enforce its rights against the company without proof that he is the holder of the security.

Depending on the nature of the security and the terms and conditions of the security agreement, a secured creditor may elect to enforce its security rights directly or to petition the court to proceed with enforcement. If a petition is made to the court, the court will usually order that a public auction of the secured asset takes place.

Where there has been an adjudication of bankruptcy, secured creditors may continue to take steps to enforce their security. In contrast, where rehabilitation proceedings have been commenced, secured creditors will be bound by the terms of the court-approved rehabilitation plan. The plan must provide for a distribution of an amount not less than that which the secured creditor would have received if the debtor company was liquidated, unless the secured creditor agrees otherwise.

Korean law recognises the concept of trusts.

The DRBA includes provisions to eliminate uncertainties over the permissibility of close-out netting. Under the DRBA, derivative transactions and certain other qualified financial transactions (including OTC derivatives, securities lending and securities repurchase transactions) entered into pursuant to a master agreement (eg the ISDA Master Agreement) and the provision or disposition of collateral in connection with such transactions will be enforceable in accordance with the terms of the transactions. Further, such transactions and the provision or disposition of collateral will not be subject to the receiver's powers to invalidate transactions which are found to be 'fraudulent transactions' or 'preferences' or to assume or reject executory contracts under corporate rehabilitation proceedings unless there was collusion between the debtor company and the secured party for the purpose of harming other secured or unsecured rehabilitation creditors.

Workout

The workout proceeding is a restructuring process of a company without the supervision of the court. The workout proceeding can be carried out pursuant to the Corporate Restructuring Promotion Act or private agreements between the interested parties, including the company and its creditors. Since the Corporate Restructuring Promotion Act provides basic guidance for the workout proceeding, the private agreements between the interested parties usually reflect the provisions of the Corporate Restructuring Promotion Act.

Workout proceeding pursuant to the Corporate Restructuring Promotion Act

The Corporate Restructuring Promotion Act of 19 May 2011 (the **Old CRPA**), which sets out the procedures for the out-of-court restructuring method

known as 'workout', expired on 31 December 2015. The New Corporate Restructuring Promotion Act which came into force on 18 March 2016 (the **New CRPA**), succeeds the Old CRPA and will remain in force until 30 June 2018.

The workout proceedings that commenced prior to the expiry of the Old CRPA are still governed by the Old CRPA. The New CRPA has introduced many new changes to the Old CRPA. The most notable feature among them is the scope of applicable creditors, which has been extended from *financial institution creditors located in Korea* to all financial creditors, regardless of location. Some other key features of the new CRPA are discussed below.

Extending the scope of creditors who may participate in the workout to *all financial creditors*

The Old CRPA provided that the creditors who can participate in the workout proceeding are limited to creditor financial institutions located in Korea (including the Korean branch offices of foreign financial institutions). Since it had been criticised that such limited scope of applicable creditors raised an issue of fairness, the New CRPA extended the scope of creditors to, with certain exceptions, all financial creditors, regardless of their location. As a result, in principle, foreign creditor financial institutions, pensions, private equity funds and even individual bondholders who did not participate in the workout proceeding under the Old CRPA, have now become mandatory participants to the workout proceeding.

Extending the scope of applicable companies to *all companies*

The Old CRPA was applicable to companies with KRW 50 billion or more in financial debt. The New CRPA, however, is applicable to all companies by principle, with an exception of public institutions and companies with less than KRW 5 billion in financial debt.

Reinforcement of the Creditor Protection Process

The new CRPA also provides a wider scope of cases in which a dissenting creditor may exercise its right to request a purchase of claims. Furthermore, in order to protect the interests of financial creditors with a relatively small amount of financial claims, when a major creditor owns 75% or more of the entire amount of voting rights, the quorum for passing a resolution at the creditors meeting would be 40% of the total number of financial creditors, including the major creditor.

The New CRPA requires the 'main creditor bank' to regularly appraise the credit risk of companies it deals with and notify the company of the results. Where a company is found to be showing signs of financial difficulty the company may apply for a workout, in which case the main creditor bank shall convene a meeting of financial creditors. At the first meeting of financial creditors, the creditors must decide whether to commence the joint administration procedure and (by approval of creditors holding three quarters or more of the company's total indebtedness) on which creditors will participate in that procedure. The creditors will also decide whether to enter into a moratorium on enforcement whereby all participating financial creditors would be temporarily prevented from individually enforcing their claims for a period of up to one month (or up to three months if a due diligence investigation of the assets and liabilities of the company is necessary). The period of this moratorium on enforcement may be extended once by no more than one month. During the moratorium, the company and the creditors will consult on and, if possible, finalise and adopt a restructuring plan.

If a dissenting creditor does not wish to be bound by the restructuring plan, it is entitled to demand that the other financial creditors buy out its claims.

A committee of financial creditors that are participating in the joint administration procedure may terminate the procedure by a resolution when (i) it deems the insolvency of the company resolved; (ii) the restructuring plan is carried out as it was planned; (iii) the company requests for termination of the joint administration; or (iv) any other reason for termination occurs.

Rehabilitation

The rehabilitation proceeding in Korea is intended to rehabilitate companies facing financial difficulties by conciliating the interests of their creditors, shareholders and other interested parties.

Rehabilitation is normally initiated by the company applying for commencement of a rehabilitation proceeding on a voluntary basis. If the company is a limited liability company or a joint stock company, application for commencement of a rehabilitation proceeding may also be made by creditors and shareholders holding claims or shares in an aggregate amount equal to or greater than 10% of the company's indebtedness or paid-in capital, respectively.

During the period between the filing of a petition for commencement of a rehabilitation proceeding and the commencement of the rehabilitation proceeding (usually between two to four weeks), the court may, at its discretion, make provisional interlocutory orders to help preserve the assets of the company, including:

- an order preventing the company from disposing of any assets or paying any debt;
- an order suspending enforcement or execution actions that have already been commenced; and/or
- a comprehensive stay order barring all future enforcement or execution actions by secured and unsecured rehabilitation creditors.

From the commencement of the rehabilitation proceeding, all creditors are prevented from enforcing all existing claims, although claims arising subsequent to the commencement of the rehabilitation may be pursued.

Upon commencement of the rehabilitation proceeding, the court will appoint an 'administrator' to oversee the rehabilitation proceeding and to implement the rehabilitation plan under court supervision. The administrator will be appointed from the existing management of the company, unless (i) the management was seriously responsible for the financial difficulties of the company; (ii) the creditors' council, comprised of principal creditors, insists on the appointment of an external administrator for justifiable reasons; or (iii) the appointment of an external administrator is otherwise considered by the court to be necessary to achieve the company's rehabilitation.

Except for derivative transactions and certain other qualified transactions entered into pursuant to a master agreement, an administrator will have similar powers to a trustee in bankruptcy to invalidate transactions which are found to be 'fraudulent transactions' or 'preferences' (see the Bankruptcy section below for more details).

The administrator is responsible for preparing a draft rehabilitation plan. Meetings of the creditors and the shareholders (the **Meetings**) are convened by the court to discuss the rehabilitation, including deliberation on and consent to the draft rehabilitation plan. No other interested parties will usually attend the Meetings. Although employees may not attend the Meetings, the court is required to receive comments on the draft rehabilitation plan from the labour union or the representatives of the employees of the company. In addition the court may request any relevant government agencies to comment on the draft rehabilitation plan if it deems this necessary or if there is any government permit, authorisation or licence required in connection with the rehabilitation plan.

A rehabilitation plan will always provide for taxes and other claims with statutory priority to be paid in priority to the secured creditors' claims, which will rank ahead of unsecured creditors' claims. It is common for a rehabilitation plan to also provide for distributions to be made to preferred employee claims (wages for preceding three months, severance payment entitlements for preceding three years and any accident compensation claims) ahead of secured creditor claims.

The DRBA provides for three Meetings but the court may decide not to hold the first Meeting and the second

and third Meetings are usually consolidated into one. In fact, it is recent court practice not to hold the first Meeting but to replace the first Meeting with notification of important matters to those that have a stake in the rehabilitation proceeding, such as creditors and shareholders. If the creditors and the shareholders approve the rehabilitation plan at the third Meeting, an application may be made for final approval by the court. Generally, the plan must be approved by (i) secured creditors with at least three quarters of the total value of all the secured rehabilitation creditors' claims; (ii) unsecured creditors holding at least two-thirds of the total value of all the unsecured rehabilitation creditors' claims; and (iii) shareholders holding at least half of the total shares of the company. (These proportions are based upon the total value of claims and the total number of issued shares, irrespective of whether or not the creditors or shareholders are present and voting at the Meetings.) If at the time of commencement of the rehabilitation proceeding the company's total amount of debt exceeds the total amount of assets, the shareholders do not have a right to vote for or against the draft rehabilitation plan. The court may approve the rehabilitation plan without the consent of all classes of creditors or shareholders if the plan protects the creditors' or shareholders' interests by one of the methods listed in Article 244 of the DRBA:

- with respect to the secured rehabilitation creditors, a sale, transfer or retention of the relevant asset preserves the secured creditors' rights and security interests;
- it can be shown that a sale or transfer of assets in which secured creditors and unsecured creditors have an interest is to be carried out for fair value (as determined by the court) with the proceeds from the sale or transfer (after deducting expenses incurred for the sale or transfer) available for distribution to the secured rehabilitation creditors, unsecured rehabilitation creditors, and/or the shareholders, as the case may be;
- payment of such fair amounts as determined by the court directly to the relevant creditors and shareholders; or
- any other fair and equitable method that protects the relevant creditors and shareholders.

When approved by the court, the rehabilitation plan shall be binding on all creditors and shareholders, including any dissenting creditors and shareholders.

In comparison to the workout proceeding, rehabilitation is a relatively difficult process as confirmation of the court as well as the consents of the creditors (secured and unsecured) and shareholders are required but it has the significant advantage of binding all parties.

Establishment of the Seoul Bankruptcy Court

The Seoul Bankruptcy Court, the first bankruptcy court in Korea, was established on March 1, 2017. The Seoul Bankruptcy Court replaced the Bankruptcy Division of the Seoul Central District Court, which had jurisdiction not only over debtors located in Seoul, but also over debtors located outside of Seoul where the debtor holds a debt of KRW 50 billion or more (approximately USD 44.5 million) and or with 300 or more creditors. The Seoul Bankruptcy Court is currently handling major rehabilitation and bankruptcy cases in Korea.

With its establishment, the Seoul Bankruptcy Court announced the Practice Guidelines on Insolvency Proceedings. These Practice Guidelines provide effective, specialized, and consistent guidance for insolvency proceedings in Korea.

Introduction of the Pre-Packaged Plan System

The Pre-Packaged Plan, a plan similar to the Pre-Packaged Plan under Chapter 11 of the 1978 Bankruptcy Reform Act in the United States, was introduced on May 29, 2016, following the amendment of the DRBA.

Under the new Pre-Packaged Plan system, when a rehabilitation plan is agreed between a debtor and major creditors out-of-court (thus considered a "pre-packaged" plan), a court can rapidly approve such plan and give effect to it. The new Pre-Packaged Plan system is considered to be a hybrid restructuring proceeding, combining the benefits of the rehabilitation proceeding and the work-out proceeding. Government-run-banks, including the Korean Development bank, have been supportive of the new Pre-Packaged Plan system, and

recently, one such plan has been filed for approval with the Seoul Bankruptcy Court.

Adoption of the Stalking-Horse Bid Method

The Seoul Bankruptcy Court has adopted the Stalking-Horse Bid method in M&A bids for debtor companies undergoing a rehabilitation proceeding. This Stalking-Horse Bid method, which is widely used in the United States, allows a debtor company to enter into a conditional contract with an interested buyer before the bidding process, which leads bidders to place higher offers during the bidding process. When there is a bidder who placed a higher offer than the interested buyer, the interested buyer can choose to receive breakup fees and give up the contract or to provide topping fees to the bidder and execute the contract. This Stalking-Horse Bid method can maximize the value of the debtor company's assets, and though this method, seven successful M&A deals have been carried out so far.

Bankruptcy

The purpose of bankruptcy proceedings in Korea is to liquidate the insolvent company and distribute its assets. The principle of equal treatment for creditors holding claims of the same priority underpins the bankruptcy provisions.

Under the DRBA, a company or any of its creditors may file a bankruptcy application. The court will adjudicate the company bankrupt if it is established that the company is cash flow insolvent[1] or balance sheet insolvent.

Upon an adjudication of bankruptcy, the court will appoint a 'trustee in bankruptcy' to supervise the bankruptcy proceedings and to manage the company's assets both secured and unsecured which form the bankruptcy estate. Unsecured creditors will need to submit their claims in the bankruptcy estate. Secured creditors having a security interest created by retention, pledge, mortgage, or registered leasehold rights (*jeon se kwon*) may enforce their claims against the secured assets directly (ie by right of separation) and may claim against the remaining bankruptcy estate, as unsecured creditors, for any claims outstanding following enforcement of their security.

Creditors holding claims of the same priority shall be treated and paid *pari passu*. The order of priority of payments made to creditors from the bankruptcy estate is as follows:

(1) payment to secured creditors from the realisation of secured assets;

(2) preferential payments (including the costs of the trustee in bankruptcy and other costs of the bankruptcy proceedings incurred by the trustee in bankruptcy, employee salaries and taxes);

(3) payment to unsecured creditors; and

(4) payment of other debts (for example, interest accruing after the bankruptcy order and costs incurred by creditors to prove their debts).

The DRBA also contains provisions invalidating transactions which are considered 'fraudulent transactions' and 'preferences', including, amongst others:

(1) transactions entered into by the company in circumstances where the company knew that the transaction would be prejudicial to the unsecured creditors (unless the transaction counterparty did not know of the prejudicial effect);

(2) transactions entered into on or after the suspension of payments or the filing of a bankruptcy application which are prejudicial to unsecured creditors, involve the provision of security or involve any disposition of the debtor company's assets in order to perform its obligations (provided that the counterparty of the transaction knew that payments by the company had

been suspended or a bankruptcy application had been filed);

(3) transactions entered into by the company providing security or without any connection with the performance of its obligations, on or during the 60 days prior to the suspension of payments or the filing of a bankruptcy application (unless the counterparty of the transaction did not know of the prejudicial effect, suspension of payments or filing of a bankruptcy application); or

(4) transactions entered into by the company during the six months prior to the suspension of payments or the filing of a bankruptcy application for no consideration or no valuable consideration.

Transactions which are considered 'fraudulent transactions' and 'preferences' are voidable and the assets recovered by the invalidation of such transactions will form part of the bankruptcy estate for distribution in accordance with the order of priority set out above. In such event, the counterparty, subject to certain restrictions, is entitled to make a claim against the bankruptcy estate for the assets recovered.

[1] Under Article 79 of the Korean Civil Code, if a company becomes unable to pay its indebtedness in full, the directors of the company should file a bankruptcy application without delay, although this provision is not often complied with in practice.

Cross-border issues

The DRBA eliminates the principle of territoriality on which the former Korean bankruptcy laws were based. Instead, the DRBA adopts an approach based upon the UNCITRAL Model Law on Cross-Border Insolvency.

The DRBA attempts to streamline the coordination between Korean and foreign insolvency proceedings by allowing the representative of a foreign insolvency proceeding (the **Foreign Trustee**) to apply to the Korean court for recognition of the foreign insolvency proceedings. Recognition allows the Foreign Trustee to join Korean bankruptcy proceedings or file a petition for the commencement of bankruptcy proceedings in Korea against the company. In addition, the Foreign Trustee may apply to the Korean court for interlocutory orders to help preserve the assets of the company located in Korea prior to the court's decision to grant recognition. Moreover, upon or after the recognition of the foreign insolvency proceeding, the Korean court, at its discretion or at the request of an interested party, may issue an order to stay or suspend (i) the commencement or continuation of legal actions in Korea concerning the company's business or assets; (ii) execution against the company's assets in Korea; and/or (iii) payment by the company or the transfer or disposition of the company's assets in Korea.

When foreign insolvency proceedings and Korean bankruptcy proceedings occur simultaneously, creditors who have been repaid through the foreign insolvency proceedings or from the company's assets located overseas cannot be repaid under the Korean bankruptcy proceeding unless and until the other creditors holding claims of the same priority in the Korean bankruptcy proceedings have been paid equally in proportion to their respective claim amounts.

A recent rehabilitation proceeding of a leading Korean shipping company illustrates how cross-border issues are handled in Korea. A key requirement for the successful rehabilitation of the company was to prevent the company's vessels from being captured by creditors overseas. To achieve this requirement, immediately after the company filed its petition for commencement of rehabilitation proceedings with the Korean court, the company also petitions for recognition of the Korean rehabilitation proceeding with courts in other relevant jurisdictions, including the United States, Germany, Japan, Singapore, and Canada. These courts ultimately recognized the Korean rehabilitation proceeding and issued stay orders on the company's vessels. In addition, in this rehabilitation proceeding, there was an issue regarding the remittance of funds that the company had earned by selling its shares in its United States-based subsidiary. The company was required to obtain approval from a New Jersey court on such remittance, and to discuss this issue, a conference call was held between judges of the Korean court the New Jersey court. This was the first case of cooperation between a Korean court and a foreign court on insolvency issues.

Key contacts

This factsheet has been prepared with the assistance of the Yulchon LLC's Insolvency and Restructuring Team. Due to the general nature of its contents, it should not be relied or acted upon in any specific situation without appropriate legal advice. If you require advice on any of the matters raised in this document, please call any of our partners or your usual contact at Allen & Overy. Any queries under Korean law may be addressed to Chul Man Kim, at 82-2-528-5748, cmkim@yulchon.com or Ki Young Kim at 82 2 528 5222, kykim@yulchon.com.

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