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Restructuring across borders

Korea

Corporate restructuring and
insolvency procedures | January 2022



Contents

Introduction	3
Enforcement of security	4
Workout	5
Rehabilitation	6
Bankruptcy	9
Cross-border issues	10
Key contacts	11
Further information	12

Introduction

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

- (1) workout (an out-of-court restructuring procedure);
- (2) rehabilitation (pursuant to Chapter 2 of the Debtor Rehabilitation and Bankruptcy Act); and
- (3) bankruptcy/liquidation (pursuant to Chapter 3 of the Debtor Rehabilitation and Bankruptcy Act).¹

The Debtor 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) to make the procedure for bankruptcy and rehabilitation of insolvent companies more efficient and streamlined. Since then, the DRBA has undergone many partial revisions, with the most recent revision made on 4 February 2020.

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 corporate entities.

Unless a petition for commencement of a rehabilitation proceeding has been filed for the financially troubled company and a comprehensive stay order has been issued by the court (preventing creditors from initiating enforcement proceedings against the debtor company), creditors with the benefit of security may enforce their securities. Security enforcement is essentially a self-help remedy rather than a procedure for collective restructuring or insolvency and, when available to a creditor, it is often the best method for 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 Debtor Rehabilitation and Bankruptcy 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 ahead of 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 and Mine Estate Mortgage Act. This act allows 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 Mortgage on Motor Vehicles and Other Specific Moveables Act, and the Aircraft 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 the method for transfer of such rights. For example, shares are transferred by delivery of share certificates; hence, one method of establishing a pledge on shares is to enter into a pledge agreement with delivery of share certificates to the pledgee.

Depending on the rights to be pledged, in addition to the agreement creating the pledge, certain measures, such as notice, registration, and so on, may be required. The two main types of rights that are pledged are claims and shares in a company. Starting from 2019, listed shares and bonds should be traded only

through the electronic registration system and no certificates are issued. Thus, a pledge of listed shares requires electronic registration instead of delivery of share certificates.

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 a commencement of bankruptcy, secured creditors may continue to take steps to enforce their security. In contrast, where rehabilitation proceedings have been commenced, secured creditors cannot enforce their rights and will be bound by the terms of the rehabilitation plan (such rehabilitation plan to be approved by creditors and confirmed by the court). 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.

The DRBA includes provisions to eliminate uncertainties over the permissibility of close-out netting. Under the DRBA, notwithstanding rehabilitation or bankruptcy proceedings, certain derivative transactions and other qualified financial transactions (including the provision or disposition of collateral in connection with such transactions) entered into pursuant to a master agreement (eg the ISDA Master Agreement) will be enforceable in accordance with the terms of the transactions and, will not be subject to termination, rescission or avoidance unless there was collusion between the debtor company and any other party for the purpose of harming 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 (the **CRPA**) or private agreements between the interested parties, including the debtor company and its creditors. Since the CRPA provides basic guidance for the workout proceeding, the private agreements between the interested parties usually reflect the provisions of the CRPA.

The CRPA was enacted in 2001 and sets out the procedures for an out-of-court restructuring method known as a 'workout'. The initial CRPA expired at the end of 2005. However, the CRPA was re-enacted several times with revisions and extended expiration dates. The current one will expire in October 2023.

Workout proceeding pursuant to the Corporate Restructuring Promotion Act

To initiate a workout under the CRPA, the "main bank" (typically the bank which issued the most credit) of the debtor company first reviews the credit risk of the debtor company and, if the debtor company shows "signs of potential default," the main bank notifies the results of its review to the debtor company. Then the debtor company may apply for commencement of a workout. Upon receipt of such application, the main bank calls for a first meeting of the debtor company's financial creditors, which the CRPA defines as any creditors (whether they are financial institutions or not) that have extended credit to the debtor company. The financial creditors collectively constitute a commission (the **Commission**) which may include foreign banks and individuals. When calling the

first meeting of the Commission, the main bank may ask the financial creditors not to exercise their rights until the first meeting of the Commission is convened.

At the first meeting, the Commission may decide that the financial creditors should stay any exercise of their rights against the debtor company for up to four (4) months. Within this four (4) month period, the Commission should decide a restructuring plan (how the debtor company will recover from its financial difficulties). Within one (1) month from this decision of the restructuring plan, the Commission should enter into a restructuring agreement with the debtor company for the implementation of the restructuring plan.

The Commission may decide to inject new funds into the debtor company. Newly injected funds rank immediately behind secured claims but ahead of other unsecured claims of financial creditors.

Decision-making of the Commission

In principle, all Commission decisions must be made on the basis of affirmative votes of the financial creditors representing at least 75% by amount of the total claims of financial creditors, and any decision on the adjustment of the terms and conditions of credit agreements additionally requires affirmative votes of at least 75% by amount of all secured claims. Furthermore, in order to protect the interests of financial creditors with a relatively small claim amount, when a major creditor owns 75% or more of the total claims of financial creditors, the quorum for passing a resolution at the Commission would be 40% of the total number of financial creditors, including the major creditor.

If a financial creditor does not wish to be bound by certain decisions of the Commission, it is entitled to demand the main bank to buy out its claims.

Rehabilitation

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

Rehabilitation is normally initiated by the company itself 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 or shareholders/equity holders holding claims or shares/equity interests in an aggregate amount equal to or greater than 10% of the company's capital.

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 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 by creditors that have already been commenced; and/or

- a comprehensive stay order barring all enforcement or execution actions by creditors.

Upon commencement of the rehabilitation proceeding, the court will appoint an 'administrator' to manage the debtor company under court supervision.

The administrator will be appointed from the existing management of the debtor company, unless: (a) the management was seriously responsible for the financial difficulties of the debtor company; (b) the creditors' council, comprised of principal creditors, insists on the appointment of an external administrator for justifiable reasons; or (c) the appointment of an external administrator is otherwise considered by the court to be necessary to achieve the debtor company's rehabilitation.

When the debtor company is a party to an executory contract, which is defined as a contract providing for mutual obligations of the parties and, both of such obligations are not fully performed, the administrator may elect to terminate the executory contract or continue it.



Rehabilitation (cont.)

The DRBA also contains provisions authorising the administrator to invalidate or avoid certain transactions or acts which he/she considers to be 'fraudulent transactions' and 'preferences', including, amongst others:

- (1) transactions entered into by the debtor company in circumstances where the debtor company knew that the transaction would be prejudicial to creditors, unless the party benefiting from such transactions did not know of the prejudicial effect;
- (2) transactions entered into by the debtor company on or after its suspension of payments or, after an application for a bankruptcy or rehabilitation proceeding (collectively, the **Suspension Event**) which are: (a) prejudicial to creditors; or (b) involved with the creation of a security interest or satisfaction of an obligation, provided that the party benefiting from such transactions knew of the Suspension Event or the prejudicial effect of such transactions);
- (3) transactions entered into by the debtor company on or after, or during the 60 days prior to, the Suspension Event which create a security interest or satisfy an obligation when the debtor company is not required to carry out such transactions or is not required

to carry out such transaction at such time or in such a manner, provided that the creditor benefiting knew of the preferential effect of such transactions and the Suspension Event, if such transactions occurred after the Suspension Event; or

- (4) any gratuitous transactions (for example, a grant of a gift) entered into by the debtor company on or after, or during the 6 months prior to, the Suspension Event.

Claims in a rehabilitation can be divided as follows:

– **Rehabilitation claims** are claims against the debtor company arising out of causes that took place before the commencement of the rehabilitation proceeding. Rehabilitation claims are to be paid out only as provided for in the rehabilitation plan.

– **Rehabilitation secured claims** are: (a) rehabilitation claims secured by the debtor company's property; and (b) claims against a third party that arose out of causes that took place before the commencement of the rehabilitation proceeding and, which are secured by the debtor company's property. Rehabilitation secured claims are to be paid out only as provided for in the rehabilitation plan.

– **Common interest claims** are claims specifically listed as such in the DRBA. They are mostly claims for expenses and costs necessary for implementing the rehabilitation. However, certain common interest claims, such as certain tax claims and wages of employees, are recognised for policy considerations. Thus, common interest claims include claims that arose before or after the commencement of the rehabilitation proceeding. Common interest claims are to be paid as they become due, without being subject to the rehabilitation proceeding. In this sense, they have priority.

– **Post-commencement claims** are claims that arose out of causes that took place after the commencement of the rehabilitation proceeding but cannot be qualified as a common interest claim, a rehabilitation claim, or a rehabilitation secured claim. Post-commencement claims are to be paid out after rehabilitation claims and rehabilitation secured claims.

– **Shareholder claims/equity holder claims** are claims of shareholders/equity holders. The rehabilitation plan may modify or wipe out these claims.

From the commencement of the rehabilitation proceeding, creditors are prevented from enforcing their claims. Creditors holding rehabilitation claims (the **Unsecured Creditors**) and creditors holding rehabilitation secured claims (the **Secured Creditors**) should file their claims and are repaid in accordance with the rehabilitation plan approved by creditors and confirmed by the court.

Secured Creditors, Unsecured Creditors, shareholders/equity holders, and the debtor company itself may propose a rehabilitation plan. However, in most cases, the administrator prepares and submits a draft rehabilitation plan. Meetings of the Unsecured Creditors, the Secured Creditors, and the shareholders/equity holders (the **Meetings**) are convened by the court in connection with the rehabilitation plan.

The DRBA provides for three Meetings. The court may replace the first meeting with an alternative reporting procedure. The second and third Meetings are to review and vote on the plan, respectively, but are usually consolidated into one. If the proposed rehabilitation plan is approved at a Meeting, the approved plan is submitted to the court for confirmation.



Rehabilitation (cont.)

Generally, the rehabilitation plan must be approved by all the classes at the Meeting and usually there are only three classes: the Secured Creditors class, the Unsecured Creditors class, and the class of shareholders/equity holders. The thresholds for approval are: (a) in a Secured Creditors class, at least three-quarters of the total amount of all the Secured Creditors' claims in the class; (b) in a Unsecured Creditors class, at least two-thirds of the total amount of all the Unsecured Creditors' claims in the class; and (c) in a shareholders/equity holders class, at least half of the total shares/equity of the debtor company present at the Meeting. If at the time of commencement of the rehabilitation proceeding, the debtor company's total amount of debt exceeds the total amount of assets, the shareholders/equity holders do not have a right to vote on the rehabilitation plan. The court may confirm the rehabilitation plan without the consent

of all classes at the Meeting (but there should be at least one class approving the plan) if the plan protects the dissenting class as prescribed in the DRBA. When confirmed by the court, the rehabilitation plan shall be binding on all classes, including any dissenting class.

In comparison to the workout proceeding, rehabilitation is a relatively formal and lengthy process 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, and now has jurisdiction not only over debtors located in Seoul, but also over debtors located outside of Seoul where the debtor

owes a debt of KRW50 billion or more (approximately USD44.5 million) to 300 or more creditors. The Seoul Bankruptcy Court is currently handling major rehabilitation and bankruptcy cases and is expected to lead the insolvency practice in Korea.

Adoption of the Stalking-Horse Bid Method

In 2017, 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 solicits bidders to place higher offers during the bidding process. When there is a bidder who offers a higher price 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 at the higher price. This Stalking-Horse Bid method can maximise the value of the debtor company's assets.

Autonomous Restructuring Support

From 2018, the Seoul Bankruptcy Court began an autonomous restructuring support (the **ARS**) scheme consequent to which, when a debtor company files for a rehabilitation proceeding, the court postpones commencement of the rehabilitation proceeding for approximately three (3) months, thereby allowing the debtor company to have a chance to negotiate a voluntary restructuring with its creditors. The ARS offers the debtor company a last minute chance to reach a restructuring agreement and avoid or shorten the rehabilitation proceeding and is now being increasingly used by debtor companies.

Bankruptcy

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

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

Upon commencement of a bankruptcy proceeding, the court will appoint a 'bankruptcy trustee' to: (a) liquidate the debtor company's assets (which form the bankruptcy estate); and (b) distribute the proceeds from liquidation under the supervision of the court.

Unsecured creditors will need to file their claims. On the other hand, secured creditors may enforce their security interests directly and may file their claims, as unsecured creditors, for any amount outstanding following enforcement of their security interests.

The bankruptcy estate should distribute the liquidation proceeds in accordance with the priority of claims prescribed in the DRBA. Creditors holding claims of the same priority shall be treated and paid *pari passu*.

Similar to common interest claims in a rehabilitation proceeding, certain claims are designated as estate claims under the DRBA. Estate claims include expenses and costs necessary for maintenance, liquidation and distribution of the bankruptcy estate and other claims recognised for policy considerations, including certain tax claims and wages of employees. Estate claims are to be paid as they become due, without being subject to the bankruptcy proceeding.

The bankruptcy trustee has the same power as the administrator in a rehabilitation proceeding with respect to the choice between termination and continuation of an executory contract.

With respect to avoidance of transactions and other acts, the bankruptcy trustee is also authorised similar to the administrator in a rehabilitation proceeding.

2020 Amendment

In order to facilitate the inflow of new funds into debtor companies undergoing rehabilitation proceedings, the DRBA confers new fund claims (claims of entities lending into a debtor company undergoing a rehabilitation proceeding) with the status of common interest claims. Further, new fund claims have the highest priority among common interest claims. When, upon failure of a proposed rehabilitation proceeding, the debtor company enters into a bankruptcy proceeding, common interest claims are converted into estate claims. Till very recently, the highest priority of new fund claims was not recognised in a bankruptcy proceeding. In February 2020 however, the DRBA was amended to provide new fund claims with the highest priority among estate claims in the bankruptcy proceedings. Please note that (only in the context of bankruptcy proceedings), this highest priority status of new fund claims is shared with certain claims of employees.



Cross-border issues

The DRBA adopted the principle of modified universalism codified in the UNCITRAL Model Law on Cross-Border Insolvency, thereby departing from the strict territoriality principle of the former Korean insolvency laws.

The DRBA attempts to accommodate foreign insolvency proceedings by allowing: (a) the representative in a foreign insolvency proceeding (the **Foreign Trustee**) to apply to the Korean courts for recognition of the foreign insolvency proceedings; and (b) providing certain assistance to a recognised foreign insolvency proceeding.

Recognition allows a Foreign Trustee to participate in a pending Korean insolvency (rehabilitation or bankruptcy) proceeding or, to file a petition for the commencement of a new Korean insolvency proceeding. In addition, a Foreign Trustee may apply to the Korean courts for certain orders to preserve the debtor company's assets located in Korea after or prior to the recognition.

Moreover, on or after the recognition, the Korean courts may appoint an international insolvency trustee who will manage, liquidate, and distribute the debtor company's business and assets under the court supervision.

When both foreign and Korean insolvency proceedings are pending with respect to the same debtor company, the DRBA authorizes the court to discuss with a foreign court and coordinate proceedings. The DRBA provides that when there are foreign and Korean insolvency proceedings with respect to the same debtor company, creditors who received certain repayment through a foreign insolvency proceeding or from the debtor company's assets located overseas cannot receive distribution in the Korean insolvency proceeding unless and until the other creditors of the same class with the same priority are repaid in the same proportion of their claims as the repaid creditors. This is commonly known as the hotchpot rule.

The rehabilitation proceeding of Hanjin Shipping Co Ltd. (**Hanjin Shipping**), then the largest shipping company in Korea, which commenced in 2016, illustrates how major cross-border issues are handled in Korea. A key requirement for the successful rehabilitation of Hanjin Shipping was the prevention of enforcement over its vessels by creditors overseas. To achieve this, immediately after filing its petition for commencement of rehabilitation proceeding with the Korean court, Hanjin Shipping also petitioned courts in major jurisdictions, including the United States, Germany, Japan, Singapore, and Canada for recognition of the Korean rehabilitation proceeding. These courts ultimately recognised the Korean rehabilitation proceeding and issued stay orders. In addition, in this rehabilitation proceeding, there was an issue regarding the remittance of funds that Hanjin Shipping was to receive from the sale of its shares in its United States-based subsidiary. It was necessary for Hanjin

Shipping to obtain approval from a New Jersey court (where Hanjin Shipping's Chapter 15 case was pending) on such remittance. In order to discuss this matter, a conference call was held between the judges of the Korean court and the New Jersey court. Eventually the approval was granted and this was the first case of cooperation between a Korean court and a foreign court on insolvency issues.

As observed in the Hanjin Shipping case, the Seoul Bankruptcy Court is ready to engage in international cooperation with foreign courts on cross-border insolvency proceedings. The judges of the Seoul Bankruptcy Court participate in the Judicial Insolvency Network (the **JIN**), a network of insolvency judges from across the world, which serves as a platform for the furtherance of court-to-court communication and cooperation. In 2018, the Seoul Bankruptcy Court incorporated the JIN Guidelines into its practice guidelines for cross-border insolvency proceedings.

Key contacts

If you require advice on any of the matters raised in this document, please contact any of our partners or your usual contact at Allen & Overy, or email rab@allenoverly.com.

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Further information

Developed by Allen & Overy's market-leading Restructuring group, "**Restructuring Across Borders**" is an easy-to-use website that provides information and guidance on all key practical aspects of restructuring and insolvency in Europe, Asia, the Middle East and the U.S.

To access this resource, please [click here](#).

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