

Korean Corporate Rehabilitation Proceedings and Cross-Border Insolvency

- From the Perspective of the Hanjin Shipping Bankruptcy Case

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I. Introduction

The 1997 Financial Crisis in South Korea brought a significant increase in the number of insolvent businesses and individuals seeking court assistance to restructure their debt or to liquidate. At the time, provisions governing corporate restructuring, individual restructuring, and liquidation were scattered in separate laws with different scope of applicability, bringing rise to confusion and inefficiency. Also, although more and more insolvency cases involved foreign proceedings, parties, and/or assets, the laws and practices relating to cross-border insolvency were outdated and insufficient to deal with the issues arising therefrom. Realizing the need for a new, consolidated insolvency law, the Debtor Rehabilitation and Bankruptcy Act (“DRBA”) was enacted and promulgated in 2005, to take effect in 2006. The new DRBA combined separate insolvency laws and merged different reorganization proceedings into one. The liquidation proceeding was updated, and new sections on individual rehabilitation (debt restructuring for natural persons with a regular income) and cross-border insolvency were added.

The reorganization proceeding under the DRBA, also known as the “rehabilitation proceeding,” was modeled after the U.S. Chapter 11 proceeding. The concept of “debtor-in-possession” (“DIP”) was adopted, and since then the court’s appointment of a third party administrator to run the debtor’s business became an exception rather than the rule. Over time, this section was further amended to include additional features, many of which come from the U.S. Chapter 11 proceedings as adjusted to the Korean insolvency regime.

The new section on cross-border insolvency that was included in the DRBA is South Korea’s adoption of the UNCITRAL Model Law on Cross-border Insolvency (“Model Law”). With this development and the court’s accumulated experience in cross-border insolvency matters, the Korean bankruptcy court is becoming more capable of dealing with insolvency cases involving businesses with a global outreach.

The Hanjin Shipping (“Hanjin”) Case is a good example of a cross-border insolvency case, where the Korean bankruptcy court, as the originating court, coordinated with foreign courts in an effort to centralize the insolvency proceedings in one court. In Hanjin, the original petition was for the commencement of a rehabilitation proceeding, which the court granted the very next day with a view to expedite recognition proceedings in other countries.

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Petitions for recognition of the Korean insolvency proceeding were filed in foreign courts and many of those courts, including the U.S. Bankruptcy Court for the District of New Jersey, granted prompt recognition. However, the court-appointed examiner was doubtful that Hanjin could have much value as a going concern, and the court eventually dismissed the rehabilitation proceeding and converted the case to a liquidation proceeding pursuant to Article 6(2)(ii) of the DRBA.

Hanjin's liquidation proceeding is currently pending with the Seoul Bankruptcy Court.

II. Corporate Rehabilitation Proceeding

1. Legislative History

As mentioned above, before the enactment of the DRBA, Korean insolvency law consisted of separate laws governing different aspects of the insolvency proceedings. The concept of DIP was unfamiliar to most people and in practice, the court would always appoint a third party administrator over the debtor company. While the Bankruptcy Administrative Commission (the Korean equivalent of the U.S. Bankruptcy Administrator established in Alabama and North Carolina, in very broad terms) existed, creditors' committees were practically non-existent. The new DRBA changed all of this and much more as the law was amended from time to time to adapt to new developments in the legal and socioeconomic environment. The bankruptcy courts also took an active role in adopting new methodologies and updating internal guidelines to improve relevant court practices, especially to "keep the debtor alive on the operating table." Some of the important amendments to the law and related practices are highlighted below in chronological order.

In 2006 the new DRBA came into effect. DIP became the rule and the court's appointment of third party administrators occurred in exceptional cases only. The new law also encouraged the participation of the creditors' committee, but the lawmakers' intentions were not realized in this regard.

In 2009 the DRBA was amended in order to prioritize the claims of the lender injecting new funds in the debtor after commencement of the rehabilitation proceedings. This amendment was intended to encourage DIP financing for the debtor company, but due to other reasons, such as financial regulatory restrictions on commercial banks when they lend money to a rehabilitation debtor, DIP financing is yet to be made readily available to distressed businesses.

In 2011 the Bankruptcy Division of the Seoul Central District Court, adopted the "Fast-Track Business Reorganization" process to (i) reduce the effect of bankruptcy stigma, (ii) increase the possibility of success in rehabilitation, and (iii) maximize the payment to creditors. By encouraging the parties to move as quickly as possible before plan confirmation and then allowing the bankruptcy judge to close the case at the earliest possible date after plan confirmation, businesses could return to its ordinary course of business much sooner. As the process began to move at a faster rate, creditors started to become more engaged and in some

cases, the creditors' committee became notably active. The court also encouraged debtor companies to engage a chief restructuring officer ("CRO") to assist in making financial decisions and to add more integrity and credibility to the rehabilitation process.

In 2015 the DRBA was amended to provide for more simplified rehabilitation procedures for small businesses, which often cannot afford to hire sophisticated lawyers and other professionals to deal with a full-blown rehabilitation proceeding.

In 2016 the "pre-packaged plan" or "P-Plan," as it is called by the Korean bankruptcy courts and the Korean Financial Services Commission, was introduced in the DRBA. The P-Plan provides for early submission of a rehabilitation plan, which shortens the rehabilitation proceeding significantly, as (i) the debtor is required to submit a rehabilitation plan and a list of creditors together with or after the petition but before the commencement and (ii) the creditors may go ahead and file their proofs of claim with the bankruptcy court immediately after commencement.

In 2017 the Seoul Bankruptcy Court was established to replace the Bankruptcy Division of the Seoul Central District Court. As of now, the Seoul Bankruptcy Court is the first and only specialized bankruptcy court in Korea. Similar bankruptcy courts may be established in other parts of Korea in the future, but until then, local district courts will continue to oversee bankruptcy cases in their respective jurisdictions. The establishment of a specialized court with jurisdiction over insolvency cases allows the judges presiding over insolvency proceedings to gain more expertise and to establish uniform court practices.

2. General Overview of a Corporate Rehabilitation Proceeding

A rehabilitation proceeding is a court-administered reorganization proceeding which seeks to restructure debt while allowing the debtors to continue their business as a going concern. A formal rehabilitation proceeding commences with the filing of a petition and the court's order to commence the proceeding in response to that petition. Below are some of the notable features and important processes in corporate rehabilitation proceedings.

Petition for commencement of the rehabilitation proceeding

The debtor and the creditor, whose total amount of claims equal or exceed 1/10th of the debtor's capital, may file a petition for commencement of a rehabilitation proceeding. A shareholder(s) who owns more than 1/10th of the debtor's capital is also eligible for filing the petition.

In order for the rehabilitation proceeding to be commenced, either (i) the debtor must not be able to repay a matured debt without causing significant encumbrance to the continuation of its business, or (ii) there must be a concern that a cause for bankruptcy may arise with the debtor. A cause for bankruptcy exists when (a) the debtor is unable to repay its debts as it comes due, or (b) the debtor's liabilities exceed its assets. (☞ DRBA Article 34)

Provisional orders to preserve debtor's assets and to stay enforcement actions

In a U.S. Chapter 11 proceeding, the automatic stay takes effect immediately when a petition is filed, thereby preserving the debtor's assets from dissipation and preventing creditors from racing to the courthouse to enforce their claims. In a Korean rehabilitation proceeding, there is no automatic stay that takes effect upon filing of the petition. Instead, the petitioner usually files an application, in conjunction with the filing of the petition, for the court's order to preserve the debtor's assets and to stay all enforcement actions. The bankruptcy court is usually very prompt in granting such applications. Sometimes, even if the petitioner did not file such applications, the court may on its own motion issue such orders if the court deems it necessary. (☞ DRBA Articles 43-47)

Effect of the court's decision to commence the rehabilitation proceeding

When there is a decision to commence the rehabilitation proceeding, all enforcement actions are automatically stayed and the debtor's assets provided as security cannot be subject to a sale by a secured creditor without court order. Furthermore, all claims, both secured and unsecured, can only be repaid as set out in the payment schedule of the confirmed rehabilitation plan.

The court's decision to commence the proceeding or dismiss the petition must be made within one month from the date of the petition. When the court issues a decision to commence the rehabilitation proceedings, the court must, after consultations with the Bankruptcy Administrative Commission and the creditors' committee, appoint an administrator to take charge of the management and disposition of the debtor's assets. Since 2011, the court usually issues an order not to appoint an administrator, in which case the representative of the debtor company (DIP) is regarded as the administrator. However, in very exceptional cases where the corporate representative was the cause of the debtor company's financial deterioration, the court appoints the administrator from outside of the debtor's organization. (☞ DRBA Articles 49-50, 58-59, 74)

Classification of claims

In a rehabilitation proceeding, a creditor's claim would fall under the category of (i) an unsecured claim, (ii) a secured claim, or (iii) a priority claim. Unsecured claims are pre-commencement claims, i.e., arising from causes that existed before commencement of the rehabilitation proceeding. Secured claims are pre-commencement claims secured by an asset of the debtor. Secured and unsecured claims are usually prevented from repayment until a rehabilitation plan is confirmed. After plan confirmation the claims are paid out as adjusted by the payment schedule in the plan. Priority claims, however, are usually paid on a rolling basis, regardless of the rehabilitation plan. The DRBA in Article 179 specifically provides for claims that would be treated as a priority claim. One such example would be claims regarding post-commencement debt incurred by the administrator on behalf of the debtor with court approval. Unless otherwise specified, reference to "claims" in a rehabilitation proceeding are usually relevant to secured and unsecured claims. (☞ DRBA Articles 118, 141, 179)

Executory contracts and ipso facto clauses

An executory contract under the DRBA refers to an agreement where neither party had performed its obligation in full at the commencement of the rehabilitation proceeding. Executory contracts receive special treatment in that the administrator has the choice of either cancelling (terminating) or assuming (performing) such contracts. There is however a deadline in exercising such right of choice, which is until the closing of the creditors' meeting held in order to review the proposed rehabilitation plan (normally the second creditors' meeting).

In order to resolve the uncertainty faced by the counterparty to such contracts, the DRBA allows the counterparty to send a notice to the administrator requesting the administrator to exercise his/her right of choice. If the administrator fails to notify the counterparty of his/her choice within 30 days from receipt of the counterparty's request, the contract is deemed as assumed.

If the administrator assumes the contract, the obligation of the debtor becomes a priority claim. If the administrator cancels, the counterparty's claim for damages arising from such cancellation will be treated as an unsecured claim.

The DRBA does not provide for the validity or invalidity of ipso facto clauses. However, among insolvency practitioners in Korea, it had often been construed that in order to protect the administrator's right of choice, ipso facto clauses that allow for termination of the contract in an event of insolvency should be deemed invalid. The mainstream of Korean court precedents appear to follow this position as well. However, it should be noted that the court from time to time had ruled that ipso facto clauses can be valid in contracts which require mutual trust. (☞ DRBA Articles 119, 121)

Investigation and allowance of claims

At the commencement of a rehabilitation proceeding, the court orders the administrator to submit a list of creditors. Separately, each creditor may also file proofs of claim with the court within the reporting period, as set by the court. Filing proofs of claim after the reporting period has lapsed is not allowed in principle. However, if the creditor was not notified of the proceeding and the creditor did not become aware of the rehabilitation proceeding in any other way, the creditor may file the proofs of claim even after the reporting period had lapsed, but no later than at the creditors' meeting to review the proposed rehabilitation plan. When the proofs of claim are filed, the administrator or other stakeholders (i.e., other creditors) may object to that claim. When there is an objection, the creditor whose claim is contested may file an application with the bankruptcy court for allowance of that claim.

If a claim is not included in the creditors' list and the proofs of claim were not filed by the creditor, the claim will likely be excluded from the rehabilitation plan and such claims are discharged upon confirmation of the plan. (☞ DRBA Articles 147-149, 153, 161, 170)

Set-off

Even after a rehabilitation proceeding is commenced, creditors may offset their claims (receivables) with their debt (payables) if at least the creditor's claim comes due before expiration of the claim reporting period. When exercising this right, the set-off notice must be made to the administrator and not the debtor. Set-off is not permitted in circumstances where allowing the set-off would result in unfair satisfaction of claims for the creditor, such as when the creditor incurs new debt (payables) against the debtor after commencement of the rehabilitation proceeding. (DRBA Articles 144-145)

Rehabilitation plan

A rehabilitation plan typically lays out the basic scheme of how the debtor will reorganize its debt in order to continue its business as a going concern and manage its cash flows to maximize the amount of repayment to its creditors. The plan usually includes items such as adjustment of claims, repayment methods, adjustment of shareholder rights, matters regarding M&A, and revisions to the debtor company's articles of incorporation.

After commencement of the rehabilitation proceeding, the court generally appoints an examiner, usually an accounting firm, to assess the overall status of the debtor's assets, the liquidation value, and the going concern value. In practice, the administrator usually prepares and proposes a rehabilitation plan based on the examiner's report. After the administrator submits a proposed plan, it is reviewed at the creditors' meeting and voted upon. The plan is passed by a quorum of (i) 3/4 or more of the total amount of secured claims; (ii) 2/3 or more of the total amount of unsecured claims; and (iii) 1/2 or more of the total number of shares voting at the meeting (provided that if the total amount of debt exceeds the total amount of assets on the date of commencement, the shareholders lose their right to vote).

Once a plan is passed at the creditors' meeting, the court may confirm such plan. When the plan is passed by only one of the two or more classes of creditors, the court may "cram down" and confirm the plan in accordance with the DRBA. (DRBA Articles 193, 220, 223, 232, 237, 242-244)

Implementation of the plan and final decree to close the rehabilitation proceeding

When a rehabilitation plan is confirmed, the rights of creditors and shareholders are adjusted in accordance with the plan. As mentioned before, secured and unsecured claims not included in the confirmed plan shall be discharged.

If a rehabilitation plan is carried out in full, or if there is no foreseeable obstacles in carrying out the plan, then the court issues a final decree to close the case and allow the debtor to exit the rehabilitation proceedings. Once the court issues the final decree, the debtor shall regain control of its assets and business. (DRBA Articles 251, 283)

Dismissal of the rehabilitation proceeding

If during the course of the rehabilitation proceeding (i) a rehabilitation plan is not proposed;

or (ii) the rehabilitation plan is not confirmed at the creditors' meeting, the court shall dismiss the proceeding. The court may dismiss the proceeding if (iii) the court finds that the liquidation value of the debtor clearly exceeds the going concern value.

The court shall order a dismissal if the court finds that the debtor cannot carry out the rehabilitation plan post-confirmation. In this case, since the debtor would have a cause for bankruptcy, the court must convert the case to liquidation. (DRBA Articles 286, 288)

III. Hanjin Shipping Bankruptcy Case

1. Chronology of Main Events

Hanjin Shipping was one of the world's largest container carriers and terminal operators, with a capital of KRW 1.23 trillion at one point after merging with other shipping companies.

Since the global financial crisis around 2008-9, there was an economic downturn and the global container market was faced with overcapacity in container vessels (overflow of supply) and not enough increase in freight volume (lack of demand). To make matters worse, Korean shipping companies entered into many long-term charterparties right before the global financial crisis hit, in anticipation of continued increase in demand. Therefore, at the sudden economic downturn, shipping companies like Hanjin were left with a high cost, low income structure, paying as hires sums of money that could be higher than what could be earned from the chartered vessels. Unable to sustain itself with the increasing amount of losses, Hanjin first applied for a corporate workout with the Korea Development Bank ("KDB"), its major creditor, on April 25, 2016. This out-of-court restructuring process was approved on May 4, 2016, and lasted until August 30, 2016. In August 2016 however, KDB decided that it can no longer support Hanjin. Without the support from KDB, and with no one else to turn to for new funds necessary to continue its business, Hanjin filed the petition for commencement of a rehabilitation proceeding with the Bankruptcy Division of the Seoul Central District Court (now the Seoul Bankruptcy Court) on August 31, 2016.

The court understood that it must act quickly for Hanjin's vessels to continue its operations without the risk of arrest or attachment. Therefore the court responded immediately and promptly issued an order to commence the rehabilitation proceedings. Recognition in various countries followed. However, when the examiner, after investigation, reported that Hanjin's value as a going concern cannot be assessed due to the uncertainty of whether the debtor can continue its business, the rehabilitation proceeding was dismissed, and subsequently converted into a liquidation proceeding on February 17, 2017.

In the liquidation proceeding, which is governed by a separate chapter in the DRBA, the court appointed a lawyer as the bankruptcy trustee, as is the usual case in liquidation proceedings. The bar date for submission of bankruptcy claims lapsed as of May 1, 2017, and on June 1 and July 20, 2017, the first and second creditors' meetings were held respectively.

The bankruptcy trustee is now managing and liquidating the assets of the debtor, in order to liquidate remaining assets and ultimately distributing them to the creditors.

As of now, the bankruptcy estate is estimated at approximately KRW 32.2 billion, and is anticipated to be expanded approximately up to KRW 280 billion, excluding the assets pledged for the secured creditors.

2. Some observations regarding the Hanjin case

Rehabilitation, unlike voluntary corporate workouts, is a court administered proceeding which becomes binding on all creditors. Rehabilitation proceedings had been known to take years for the debtor to exit in the past. However, since the introduction of the Fast Track Program the process has become much faster, with plans being confirmed in a matter of months from commencement. Moreover, with the recent introduction of the P-Plan, debtors can now negotiate with its major creditors before it files for rehabilitation and then propose a plan which will quickly become final and binding on all creditors.

Of course, the specific situation of companies in distress are not the same and the potential debtor must carefully consider all aspects of corporate workouts, rehabilitation proceedings and other available choices when choosing a rescue plan. That said, in Hanjin's case, with the benefit of hindsight, one cannot help wonder what would have happened if Hanjin had filed for rehabilitation proceeding earlier, after which Hanjin could have restructured its debt and avoided a complete depletion in operational funds. Then there is the issue of DIP financing, as injection of new funds is usually required in order for the debtor to come up with a viable plan that major creditors would support, and at the same time, keep the debtor afloat during the relatively short term it must remain in rehabilitation. Unfortunately, DIP financing in Korea does not appear to be as readily available as would be in some other countries.

An issue that arose in relation to the Korean rehabilitation proceeding and the foreign courts that recognized the Korean proceeding was the scope of assets that were subject to the recognizing court's stay order. In Korea, it is generally understood that the assets that are preserved and protected from individual creditor actions are those owned by the debtor. In the United States and other common law countries, the assets of the debtor appears to be understood in more broader terms, allowing room for chartered or leased vessels to be subject to a bankruptcy stay.

In case of bareboat charter hire purchase contracts ("BBC/HP"s) the issue becomes more complicated. There has been a long debate among Korean bankruptcy practitioners regarding whether these BBC/HPs should be considered as "liens" or as "executory contracts." If they are understood as liens, or security to the financial institutions that funded shipbuilding projects, the vessels should be treated as part of the debtor's assets and thus fall within the scope of protection against enforcement by creditors, including maritime lien creditors. If they are understood as executory contracts, the vessels are not assets of the debtor (as they are usually owned by SPCs that are supposed to be shielded from the debtor's insolvency) and thus unprotected, but the administrator has the power to cancel the contracts,

thereby avoiding the expensive charter hires and treating them as unsecured claims that would be paid in terms of cents on the dollar.

Before Hanjin, the prevailing view among insolvency practitioners was that the court had taken the view that BBC/HPs are executory contracts and allowed the administrators to cancel them if they were not beneficial to the debtor. Changwon District Court's holding in the Hanjin Xiamen Case appears to reflect that position, as it had been held that the vessel, which was subject to a BBC/HP contract with Hanjin Shipping, fell outside the scope of the stay that was in place due to Hanjin's bankruptcy. This begs the question of whether the court recognizing a foreign insolvency proceeding can grant broader protection to the debtor under its laws than would be available to the debtor under the laws of the country where the insolvency proceeding was commenced.

As this issue continues to be the subject of heated discussions among lawyers in the insolvency and maritime sectors, it would be interesting to see if this issue can be resolved in a way that would bring the most benefit to all parties concerned.

IV. Cross-Border Insolvency in Korea

The DRBA has incorporated the Model Law. In addition, the DRBA is premised upon the idea that the rehabilitation proceeding has universal effect, reaching beyond the borders of Korea. In practice however, in order for the Korean rehabilitation proceeding to be effective in a foreign country, the administrator, as a representative of the Korean rehabilitation proceeding, must file a petition with the court of that foreign country for recognition of the Korean proceeding and seek the court's assistance.

Since adoption of the Model Law, many rehabilitation proceedings have been commenced for shipping companies in Korea. These rehabilitation proceedings were recognized in many countries, preventing creditors from arresting ships that sail all around the world and providing a breathing spell for the debtor while the debtor negotiated with its major creditors for a workable debt restructuring plan. Hanjin would have been one of such cases, were it not for the early dismissal and conversion to liquidation.

Similarly, the representative of a foreign insolvency proceeding may file a petition for recognition of the foreign proceeding with the Seoul Bankruptcy Court, which has exclusive jurisdiction over inbound cross-border insolvency proceedings in Korea. In conjunction with this filing the foreign representative may seek provisional reliefs which is usually granted within a matter of days. Once the recognition is granted, the representative may seek further assistance of the Korean court in order to preserve and liquidate the debtor's assets in Korea.

Recently the Seoul Bankruptcy Court issued an order recognizing a U.S. Chapter 11 proceeding regarding a Singaporean company, finding that (i) the debtor company had made a significant number of management decisions in the U.S. and (ii) a considerable portion of the debtor company's corporate books and records were in the U.S., where the debtor

company's parent company was located. Based on these facts, the Seoul Bankruptcy Court found that the debtor's place of business, office, or domicile was in the U.S., despite the fact that the debtor's registered office was in Singapore. That said, as the DRBA does not distinguish between a foreign main proceeding and a foreign non-main proceeding, the "center of main interest (COMI)" was not a decisive factor in the court's decision to recognize the foreign proceeding. The more interesting aspect of this case is that although the foreign representative did not apply for provisional assistance in conjunction with its filing of the petition, the Seoul Bankruptcy Court, on its own motion, granted a provisional stay in order to preserve the debtor's assets before it issued the recognition order.

In another recent case where the Seoul Bankruptcy Court recognized a U.S. Chapter 11 proceeding, a situation similar to that of the recognition proceeding in the U.S. Bankruptcy Court regarding the Hanjin case arose. The foreign representative asked the Seoul Bankruptcy Court for repatriation of funds to the U.S. Chapter 11 plan administrator through cooperation between the Korean court and the U.S. Bankruptcy Court for the Eastern District of Virginia. Seoul Bankruptcy Court granted the request after confirming that creditors in Korea had been notified of the proceeding and were provided with a fair chance to participate in the U.S. proceedings.