The Magic Art of Korean Bankruptcy

In October of 1997, Korea experienced a national economic crisis. Many major Korean companies filed for reorganization bankruptcy, almost all savings banks ended up in liquidation bankruptcy and even major banks were able to survive only with government bail-out money. Millions were laid off from bankrupt companies and Korea itself seemed on the verge of national bankruptcy. The success story of Korea seemed ruined and people were cynically critical about Korea's vulnerable economic system.

Fifteen years have passed and the picture in Korea today is radically different. While the U.S. and EU economies have been suffering from crisis, the Korean economy is showing power and resilience and making great advancements in many major industries, including electronics and shipbuilding.

How did this happen? There was some luck. There was a lot of sweat. And there was the "magic of Korean bankruptcy," which I, as a bankruptcy expert, am very proud of.

The Fall

Korea applied for IMF bailout funds in December of 1997. The IMF requested that Korea implement financial reform and market opening, and stick with a high exchange rate and high interest rate policy. In the process, the KRW-USD rate, hovering at KRW 800 for USD 1, went up to KRW 2,400 for USD 1. The interest rate also increased sharply from 10 percent a year to 20 percent a year.

Pressured by such a high interest rate and high exchange rate, even relatively solid companies in Korea, let alone failing ones, faced the risk of bankruptcy. With economic turbulence, more than 50 percent of the 30 major conglomerate groups in Korea went broken up as of 1997. A significant number of major large companies were brought to corporate rehabilitation proceedings. At that time, the Bankruptcy Department of the Seoul Central District Court, which handled most of the corporate rehabilitation proceedings, was called the "5th largest conglomerate in Korea" because the total size of assets of the companies under the control of the Bankruptcy Court Department was equivalent to that of the fifth largest conglomerate following Samsung, Hyundai, LG and SK Group as of 2001.

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The Rise

After 2000, the Korean economy started to recover from a seemingly bottomless pit at an unexpected speed. In 2001, Korea graduated from IMF supervision by paying back USD 19.5 billion to the IMF. And the nation's major industries, such as the electronics and automobile industries, embarked on a path of remarkable development. With all economic indicators drastically improved, the foreign currency reserve went up to USD 224 billion in 2006 from USD 1 billion in 1997. The won-dollar exchange rates stabilized to 1,000 won per dollar in 2006 from 2,400 won per dollar in 1997. Korea also saw a reversal of the high interest rate trend.

With these positive signs, the M&A market was opened for companies with solid sales and operations. The market had to go into rehabilitation due to a drastically high interest rate and high exchange rate during the national economic crisis. To keep up with such a trend, the bankruptcy court of Korea, which had been struggling to manage so many companies under rehabilitation, started to allow early rehabilitation proceedings through bankruptcy M&A.

The Magic Art of Korean Bankruptcy Practice

Special attention should be given to debt-equity swap, which was developed during the economic crisis and applied to almost all rehabilitation plans. Debt-equity swap was mainly focused on exchanging debts for nominal shares, providing substantial debt relief to companies under rehabilitation with poor financial conditions. And the creditors taking the swapped stock treated such stock as worthless paper with no anticipation of actual return through them. However, as a large amount of debt turned into equity through these debt-equity swaps, the financial structure of companies under rehabilitation was remarkably improved. This, in turn, provided an environment that made bankruptcy M&A much easier. Since then, in Korea, "debt-equity swap" has been used as a basic debt restructuring measure for both rehabilitation proceedings and bank-led work-out proceedings.

Also, the legal art used in bankruptcy M&A by issuing new shares was like magic transforming the bankrupt companies to a financially strong structure.

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