

# Personal Bankruptcy in Korea: Challenges and Responses

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*The number of credit delinquents in Korea had been growing steadily since 1997 and had reached 3,700,000 by the end of 2003, which was about 8.4% of the population. The government initiated several support programs, but the number of credit delinquents has decreased very slowly. In order to allow for successful recovery of credit delinquents, it is imperative to reduce debts in a more comprehensive manner, to clear the impediments for easy use of personal bankruptcy mechanisms, and to provide incentives to encourage debtors to make progress on their repayment plans.*

*While there has been much change in terms of learning to live with bankruptcy as an inevitable part of a market economy, there is still much to be done. The reality of "moral hazard" in bankruptcy discharge should be uncovered. Legal restraints discriminating against bankrupts must be removed. The repayment period of individual rehabilitation and individual workouts must be shortened to three years. Personal guarantors for debtors in rehabilitation proceedings should be protected as much as the debtors are during the repayment period in rehabilitation proceedings. Debtors need to be able to keep their mortgaged residences during the proceedings.*

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*The history of insolvency has shown that society can benefit as much as or more than debtors themselves from the discharge of unpaid debts because with a fresh start the debtor has an incentive to work hard. The starting point to personal bankruptcy law reform is this belief.*

## INTRODUCTION

### A. The Economic Situation Surrounding Individual Debtors

Individual debtors who do not repay their debts on schedule were referred to as "credit delinquents" in Korea, because most debts were accrued due to credit extended by financial institutions. Credit delinquents were defined as debtors who had not repaid debts of at least KRW 300,000<sup>1</sup> for three months or more.<sup>2</sup> Once a person was registered as a credit delinquent, financial institutions halted all transactions with him or her.<sup>3</sup>

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1 The equivalent of \$272.

2 The credit information sharing system in Korea has a two-tiered structure: public information-gathering agencies and private agencies. The Utilization and Protection of Credit Information Act (UPCIA) has designated the Korea Federation of Banks (KFB) as the central public credit information-gathering agency.

The KFB pools the credit information of individuals and corporations, not only from banks, but also from all other financial institutions and government agencies, according to the UPCIA. All the financial institutions, which are the main providers and users of credit information, have ready access to the KFB database. The KFB also provides relevant information to government agencies such as the Ministry of Finance and Economy, the Bank of Korea, and the Financial Supervisory Services. [http://www.kfb.or.kr/kfb\\_eng](http://www.kfb.or.kr/kfb_eng) (last visited Mar. 31, 2005).

There are three private firms providing individual credit information: The National Information and Credit Evaluation Corporation, Korean Ratings Corporation, and the Korea Credit Bureau.

3 Labeling debtors as credit delinquents has caused so many disadvantages that the term "credit delinquent" has not been used officially since the registration of credit delinquents was abolished on April 28, 2005. Under the UPCIA before the amendment of 2005, financial institutions were to register "credit delinquents" and all financial institutions shared this information. None of the financial institutions wanted to provide credit to credit delinquents.

The 2005 amendment abolished the term "credit delinquent." Instead, financial institutions register debtors who do not pay KRW 50,000 over a three-month period and information on debtors who did not pay at least KRW 500,000 over a three month period is provided to other institutions. There is no official category and term referring to those debtors whose default information is registered or shared, but in practice they are known as "financial debt defaulter" because their nonpayment information can be found in the category of "Information of Debt

The number of credit delinquents in Korea has been growing steadily since 1997 when the foreign currency crisis hit the nation. The number presumably began at approximately 800,000 in 1998, and reached 3,700,000 by 2003, as shown in Table 1, accounting for 8.4% of the South Korean population (forty-five million).

**Table 1: Family Debt and Credit Delinquents**

	1997	1998	1999	2000	2001	2002	2003	2004
Family Debt (billion KRW)	211,166	183,648	214,036	266,899	341,673	439,060	447,568	474,662
Credit Delinquents*	n/a	n/a	1,995,952	2,084,017	2,450,303	2,635,723	3,720,031	3,615,367

\* As of December 31 for each year; the registration system for credit delinquents was established in 1998.

The sharp increase in credit delinquents can largely be attributed to an economic policy encouraging the use of credit cards to boost the stagnant South Korean economy during the years 2000 and 2001. Credit card companies simply issued cards to anyone interested, without any inquiry into the possible credit risks. Credit card holders were more than happy to use credit cards to acquire urgent cash as well as to buy essential goods and services.

Another important factor in examining credit delinquency is the use of personal guarantees for loans, a common practice in Korea. Most financial institutions request personal guarantees when a debtor does not have sufficient credit or collateral. Family members, friends and colleagues

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Default." Through the 2005 amendment, the government intended to encourage financial institutions to decide independently whether to give credit or not based on credit information of each debtor without relying on the category of "credit defaulters." However, financial institutions still refuse to provide credit to those debtors whose nonpayment information is shared.

In spite of the 2005 amendment, the public frequently uses the term "credit delinquents" because it is necessary to categorize those debtors whose default is not temporary. Even the Ministry of Finance and Economy used the term "credit delinquents" in announcing the number of financial debt defaulters. In this paper, "credit delinquent" includes "financial debt defaulter" in spite of the technical differences between the two.

usually provide such personal guarantees without any compensation or security from the debtor. In Korean society it is quite difficult to reject a request for a personal guarantee because a rejection, while perhaps a wise and rational decision, will be taken as a personal offense, a sign of distrust and inhospitality towards the debtor. Unfortunately, this practice, bred by compassion, causes a negative domino effect of pulling the guarantor down along with the debtor when the debtor goes bankrupt.

Table 2 indicates the number of credit delinquents monitored by each financial institution; the same debtor may be registered as a credit delinquent at multiple institutions. Direct loans from banks represent the largest source of debt in Korea. Debts toward credit companies result from credit card use for the purchase of goods and from use of the companies' cash services. Debtors tend to use credit card cash services for obtaining urgently needed liquid funds (so called "card loans"). The "Guarantee Insurance Companies" column represents the number of cases in which such companies repaid debts of defaulting debtors. The majority of customers of mutual savings companies are low-income individuals.

**Table 2: Number of Credit Delinquents in Each Financial Institution**

Financial Institutions	Banks	Credit Cards Companies	Guarantee Insurance Companies	Mutual Savings	Installment Finance Companies	Others
Credit Delinquents*	2,182,990	1,405,196	1,043,903	962,358	789,196	2,473,804

\* As of Dec. 31, 2004

Perhaps the most serious problem with today's credit delinquents in Korea is how young they are; in fact, over 50% of the total number of credit delinquents, as shown in Table 3, are under forty years of age. While traditionally young laborers are expected to bear the responsibility for supporting the older generation and the country, young credit delinquents have become a burden rather than an asset to society.

**Table 3: Number of Credit Delinquents by Age**

Ages	Under 19	20-29	30-39	Over 40	Total
Number	1,994	639,434	1,439,206	1,544,733	3,615,367
Ratio	0.06	17.68	39.81	42.45	100 (%)
Accumulated Ratio	0.06	17.74	57.55	100	100 (%)

\* As of Dec. 31, 2004

Once a debtor is registered as a credit delinquent, financial institutions refuse new loans, require the payment of existing loans, and ban the use of credit cards. The records of credit delinquency can only be expunged when debts are fully repaid. Most delinquent debtors live in a state of despair, without stable jobs, fearing even to secure gainful employment, because their income will be the target of demanding creditors. News reports tell bitter stories of the collapse of families, suicides, and kidnappings — all blamed on excessive borrowing.

### **B. Legal Mechanisms for Personal Bankruptcy**

From a legal perspective, personal bankruptcy in Korea can be settled through two different channels, either judicially or out-of-court. Out-of-court procedures include the arrangement of debts between creditors and debtors on a contractual basis. Some methods for arrangement include the extension of due dates and the reduction of interest rates or of the principal. Until recently, however, Korea had no experience with debt rescheduling and no opportunity to develop appropriate practices of debt reduction and debt-for-equity swaps.

In the past, debt forgiveness by creditor financial institutions, for example, was looked on as highly unscrupulous behavior. Debt reduction or debt-for-equity swapping was first adopted in 1998 for debt arrangement of ailing companies, and only much later was it applied to individual debtors. Similarly, although the bankruptcy law had been in force since 1962, it was not until 2001 that a discharge of debt was rendered during a personal bankruptcy proceeding.

Given the current situation, the government has pushed financial institutions to reschedule individual debts. The Financial Supervisory Service, a governmental agency in charge of the supervision of financial

institutions, established the Credit Counseling and Recovery Service (CCRS), a consortium of 3,566 financial institutions<sup>4</sup> in October 2002 to implement so-called Individual Workouts. "Bad Banks" were established to collect and rearrange non-performing loans against individual debtors.<sup>5</sup> The Financial Supervisory Service launched a special support program for low income credit delinquents. Creditor banks have negotiated with debtors to rearrange repayment schedules on a collective basis as well as an individual basis.

**Table 4: Personal Insolvency Mechanisms in Korea**

	Programs	Duration	Eligible Applicants
Out-of-Court Procedures	Individual Workout	Oct. 2002 — present	Those with less than KRW 300 million in debt
	Bad Bank (Hanmaeum Finance)	May–Nov. 2004	Those with less than KRW 50 million in debt
	Collective Debt Rescheduling	Oct. 2003 — Oct. 2008	Those with less than KRW 100 million in debt
	Individual Debt Rescheduling	Mar. 2003 — present	Those with less than KRW 10 million in debt
	Support Program for Low Income Credit Delinquents	Apr. 2005 — present	Unemployed under 30, poor self-employed, recipients of national basic living security aid
Judicial Procedures	Bankruptcy	1962 — present	No limitation
	Individual Debtor Rehabilitation	Sept. 2004 — present	Debts less than KRW 1 billion of unsecured debts or KRW 500 million of secured debts

<sup>4</sup> Nineteen commercial banks, twenty-four insurance companies, nine credit card companies, thirteen installment finance companies, nine lease companies, 106 saving banks, three asset management companies, twenty guarantee companies, 1292 agricultural cooperative unions, ninety fishery cooperation unions, 1176 community saving & loans, 132 forest unions, 672 credit unions and one "other."

<sup>5</sup> "Bad Bank" is a casual expression that refers to a financial company established for handling bad debts.

Judicial procedures for personal bankruptcy include the bankruptcy proceeding and the Individual Rehabilitation Proceeding, which are based on separate statutes.

### **C. Purpose and Scope of this Paper**

This paper aims to explain the legal mechanisms that exist for dealing with personal bankruptcy in Korea, to analyze the tension between out-of-court procedures and judicial procedures, and to discuss some relevant legal issues. The legal basis for, functions of, and statistics related to several types of out-of-court procedures including: individual workouts, Bad Banks, collective arrangements, and special arrangements for low income credit delinquents, are explained in Part I. The personal bankruptcy proceeding and the Individual Rehabilitation Proceeding, both judicial procedures, are introduced in Part II. The author analyzes the tension between out-of-court procedures and judicial procedures, and also discusses some relevant legal issues, in Part III. The Conclusion discusses the challenges to be met and several possible responses.

## **I. OUT-OF-COURT PROCEDURES**

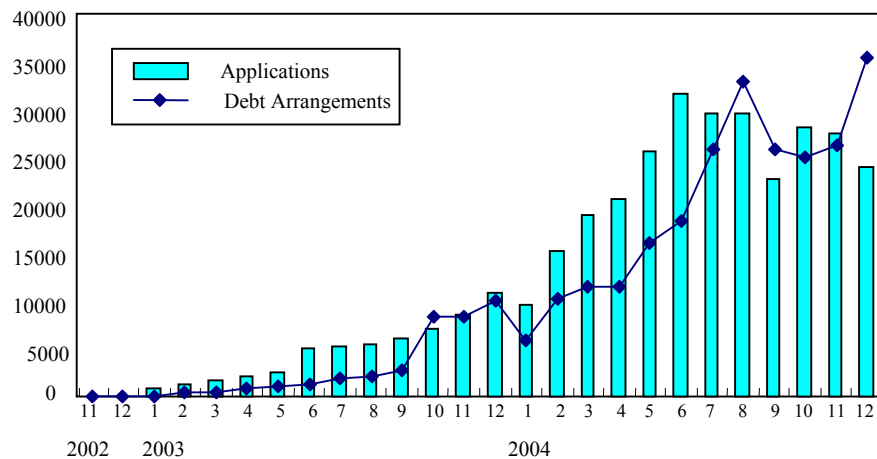
### **A. Individual Workout**

Individual Workouts can be used by credit delinquents with debts under KRW 300 million and those whose creditors include more than two financial institutions. To qualify for an Individual Workout, however, the applicant must have an income above basic living expenses. The CCRS and the debtor negotiate a repayment plan that usually extends due dates up to eight years and reduces debts to some extent.<sup>6</sup> Once the repayment plan is established, the registration of credit delinquency is cancelled.

Since the CCRS began to accept applications on November 1, 2002, the number of applications and debt arrangements has steadily increased, as shown in Table 5.

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<sup>6</sup> The CCRS internal guidelines provide that debt may be reduced by up to one third of the total amount of the principal and interest.

**Table 5: Number of Individual Workouts**

### B. Bad Banks

The Bad Bank program was designed to stimulate credit recovery for debtors with a relatively small amount of debt. The program ran for six months, starting May 20, 2004. The Korea Asset Management Corporation (KAMCO) and financial institutions established a Bad Bank named *Hanmaeum Finance*. Financial institutions sold non-performing loan claims to the Bad Bank for nine to fifteen per cent of their face value and invested the remaining amount of debt in the Bad Bank. The Bad Bank issued asset-based securities, using the acquired claims as collateral for the provision of funds.

Debtors with debts of less than KRW 50 million who were registered as credit delinquents as of March 10, 2004 were eligible to apply for the Bad Bank program. Certificates of income were not required. As the Bad Bank bought the claims against the applicant, it became the new creditor. The Bad Bank then reduced unpaid interest that had accrued prior to the date the application was filed and extended due dates for up to eight years. Finally, the applicant's status as a credit delinquent was deleted from the registry.

During the six months that the program ran, 209,758 credit delinquents applied for the program, which was less than the 400,000 anticipated. Despite special efforts on the part of the Bad Bank to encourage debtors to apply for the program, many debtors could not be reached, or did not have sufficient income for repayment, even under the generous conditions offered.

On March 23, 2005, the government announced the second Bad Bank, using similar legal and managerial mechanisms, to implement another



support program for low-income credit delinquents. The second Bad Bank started operations on May 16, 2005.

### C. Individual and Collective Debt Rescheduling

Debt rescheduling based on a discretionary decision of financial institutions was rarely exercised because there were no related incentives, techniques or mechanisms available. In 2003, the Financial Supervisory Service (FSS) stepped in to encourage financial institutions to run debt rescheduling programs for credit delinquents.

It has been reported that the FSS has set specific guidelines for individual debt rescheduling for each financial institution and has created various agreements with these institutions. Neither these agreements, however, nor the statistics for individual debt rescheduling have been made public. While data is not as yet accessible, most suspect that the proposed individual debt rescheduling program lacks feasibility and practicability and that the agreements, due to the fact that the FSS does not possess the high level of financial expertise and know-how debt rescheduling requires, are not likely to contain any particularly meaningful rules. Most debt rescheduling by a single financial institution is said to create revolving loans<sup>7</sup> without substantially cutting the principal or accrued interest.<sup>8</sup>

On the other hand, collective debt rescheduling among financial institutions was managed by a special purpose company,<sup>9</sup> Sangnoksus SPC, established by the Korea Industrial Bank and LG Securities Corporation, in addition to five banks and five credit card companies. In a word, this program established a creditor-initiated individual workout. The participating banks and credit card companies sold their bad claims against individual debtors with multiple creditors to Sangnoksus SPC, and in turn Sangnoksus SPC issued securities based on these bad claims. The bad claims were managed by Korea Credit & Rating Corporation, an asset manager working with the CCRS. Though this program covered 860,000 credit delinquents, the statistics on the outcome of collective debt rescheduling are not available as they were collected by the CCRS together with the outcome of Individual Workouts.

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7 The use of cash services of a credit card company to repay debts against other credit card companies.

8 Woodong Park, *Problems and Improvements of Current Credit Recovery Support Scheme*, 130 *Citizens & Law* 115, 118 (2004) (Korean).

9 A Special Purpose Company (SPC) or Special Purpose Vehicle (SPV) is a company established for a single purpose, such as investment, trust, or debt arrangement. The SPC or SPV is usually liquidated when this purpose is met.

#### **D. A Support Program for Low-Income Credit Delinquents**

A support program for low-income credit delinquents was announced by the government in February 2005 and came into effect on April 1, 2005. The program was designed to support three types of debtors: (1) credit delinquents under the age of 29, who have enlisted in the military or are in debt due to student loans or personal guaranteed loans to their parents; (2) low-income self-employed credit delinquents with an annual income of less than KRW 48 million; and (3) recipients of national basic living security aid.

Depending on the type of debtor, debt repayment is extended for one to two years, during which interest is discharged or reduced to 5%; debts can be repaid over an eight to ten year period, and interest during the repayment period is discharged completely when the principal is fully paid. Except for the third type of debtor, which is managed by KAMCO, the support program is mainly handled by the CCRS.

## **II. JUDICIAL PROCEDURES**

### **A. The Bankruptcy Proceeding**

#### *1. Adjudication of Bankruptcy*

The Bankruptcy Act governs bankruptcy proceedings as they apply to both individual and incorporated entities. Debtors file most personal bankruptcy cases, though the Act provides that the debtor, the creditor, or a third party may file the petition for bankruptcy. When a bankruptcy petition is filed, the court may issue an order that temporarily suspends disposition of the debtor's assets. If it is determined that the debtor is still unable to repay debts (suspension of overdue payments is also presumed to indicate inability to repay), the court will declare bankruptcy.

During the course of the adjudication of bankruptcy, the court appoints a Bankruptcy Trustee after consulting the Administration Committee.<sup>10</sup> A period for the filing of claims — not less than two weeks and not longer than four months from the date of the adjudication of bankruptcy, the date of the first creditors' meeting, and the date for the examination of claims are all set

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<sup>10</sup> The Administration Committee is an entity of the court established for the assistance of judges in bankruptcy proceedings.

by the court. Information on the adjudication of bankruptcy is made public, and the creditors, the debtor and other concerned parties are notified.

### *2. Procedures after Adjudication*

Upon the court's adjudication of bankruptcy, a bankruptcy estate is established. All of the debtor's property and the right to manage and dispose of the bankruptcy estate are vested exclusively with the Bankruptcy Trustee. All actions are subject to court supervision. The Bankruptcy Trustee, upon assuming office, immediately takes possession of and manages the bankruptcy estate. The Bankruptcy Trustee is given discretion to determine when and how to liquidate the bankruptcy estate.

### *3. The Creditors' Meeting*

At the first creditors' meeting, the circumstances that led to the adjudication of bankruptcy, interim developments, and the present status of the bankrupt and the bankruptcy estate are reported by the bankrupt trustee. Creditors are required to file their claims within the period set by the court and the validity of claims filed by the creditors can be examined. If the Bankruptcy Trustee or creditors do not object to the claims that are filed, they will become final. If the Bankruptcy Trustee or a creditor opposes a filed claim, the holder of the claim can take action to obtain a court judgment.

The creditors' meeting is held primarily in order to pass resolutions on important issues like requests for the dismissal of the Bankruptcy Trustee, the confirmation of the debtor's business and the disposition of burdensome assets. Adoption of a resolution at a creditors' meeting requires a majority vote in favor of the resolution. The aggregate amount of claims of the creditors voting for the resolution must exceed fifty per cent of the total amount of the claims of all the creditors present at the meeting. However, if a resolution adopted at a creditors' meeting is contrary to the general interest of the creditors, the court may prohibit its implementation.

The Bankruptcy Trustee, after the general examination of claims, should immediately distribute money recognized as fit for distribution. Proceeds from the bankruptcy estate are distributed by the Bankruptcy Trustee to creditors in proportion to the size of their claims according to a distribution schedule approved by the creditors themselves, whereas for the final distribution court permission is required. After the final distribution and a report at the creditors' meeting by the Bankruptcy Trustee, the bankruptcy proceeding is concluded with a court decision.

In most personal bankruptcy cases, however, the aforementioned distribution procedure is not applied, because the debtor has no property available to establish a bankruptcy estate. In cases of this nature, the

court renders a decision of bankruptcy and a cancellation decision of the proceeding at the same time, a so-called "simultaneous cancellation." There are no Bankruptcy Trustee, filing of claims, creditors' meeting or distribution processes involved in simultaneous cancellation case. Only the process of discharge remains.

#### 4. Discharge of Debt

After the bankruptcy proceeding is concluded or canceled, the debtor can apply for a discharge. The Bankruptcy Act provides that the court discharge unpaid debts unless the bankrupt committed bankruptcy-related crimes, committed fraud on loans within a year of the bankruptcy, submitted a false list of creditors, or was discharged within ten years. However, the court was so reluctant to discharge debts that the first discharge decision was not rendered until 1998, thirty-six years after the Bankruptcy Act was first enacted. The first discharged bankrupt was a housewife who had guaranteed her brother's debts.

For several years following this first discharge decision, the court struggled with the negative sentiments surrounding discharge. The legal and economic justifications of discharge have not been fully appreciated by judges. Partial discharge of debts was sometimes issued in cases where judges were reluctant to grant a full discharge; however, partial discharge does not have any statutory grounds and lacks transparency. As judges have become more familiar with discharge as well as with the bankruptcy proceeding itself, they have tended to become more generous regarding discharges.

Table 6 shows that the ratio of discharges to decided cases has increased continuously and has reached over ninety-seven per cent. Yet it is not clear how many partial discharges are included in the total number of discharge decisions made.

**Table 6: Discharge in Personal Bankruptcy Cases**

Year	Applications	Decided Cases (A)	Discharged (B)	Discharge Ratio (B/A)
2000	191	134	77	57.5%
2001	220	118	80	67.8%
2002	449	317	245	77.3%
2003	1,823	1,088	974	89.5%
2004	7,476	4,520	4,412	97.6%

## B. Individual Debtor Rehabilitation Proceedings

In March 2004, in response to a display of concern by politicians, the National Assembly separated the Individual Rehabilitation Proceeding from the other five parts of the new insolvency law bill proposed in 2003 and passed the Individual Debtor Rehabilitation Act, just before the dissolution of the National Assembly.<sup>11</sup>

The Individual Rehabilitation Proceeding can be used by wage earners or the self-employed who have grounds for filing a petition for bankruptcy due to a deficit of less than KRW one billion in secured debts, or KRW 500 million in unsecured debts. Secured debts are claims secured by liens, pledges, mortgages, *yangdodambo*,<sup>12</sup> security rights with temporary registration, *chonsegwon*,<sup>13</sup> or rights of preference.

The proceeding commences by the debtor submitting an application and required documents. A Rehabilitation Administrator appointed by the court reviews the documents submitted, including the repayment plan, and asks the applicant to rectify defects or revise documents when necessary. In addition, the administrator investigates the debtor's property and income, applies for an order to exercise the right of avoidance,<sup>14</sup> participates in the avoidance procedure, presides over creditors' meetings for Individual Rehabilitation, and disburses money deposited by the debtor to the creditors according to the repayment plan.

The repayment plan, which must be submitted within fourteen days from the date of filing the application, includes a list of the debtor's property, income and expenditures. The court can order revisions of the repayment plan, and the debtor may revise the repayment plan before it is confirmed by the court. The repayment plan must include instructions that repayments must be initiated within one month from the date of the confirmation of the plan, and thereafter continue regularly. However, the court may allow an alternate repayment plan in cases where the income does not accrue on a monthly basis, as is the case for farmers.

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11 The bill of consolidated insolvency law was proposed again in November 2004 and the National Assembly passed the bill on March 2, 2005. The new law, the Debtor Rehabilitation and Bankruptcy Act, incorporates the current Individual Debtor Rehabilitation Act, which was repealed when the new law became effective on April 1, 2006.

12 Transfer of property for security.

13 An exclusive property right to use leased space.

14 The right to avoid a fraudulent transaction or preferential payment that is against the general interests of creditors.

There has been a heated controversy concerning the repayment period. The draft bill, which first proposed the Individual Rehabilitation proceeding in 2003, provided a five-year repayment period. However, the period was extended to eight years when the Individual Debtor Rehabilitation Act was passed. The Ministry of Finance and Economy (MOFE) had insisted on this in order to protect Individual Workouts, which are based on an eight-year repayment period.<sup>15</sup>

When the Individual Rehabilitation Proceeding was first implemented in September 2004, the harshness of the eight year repayment plan provoked severe criticism and discouraged many debtors from applying. The Supreme Court rectified the situation by amending the Supreme Court Rule on the Individual Rehabilitation Proceeding.<sup>16</sup> According to this Rule, in cases where the debtor is deemed unable to pay off the principal within five years, the repayment period is set for five years and any debt which the debtor cannot repay within these five years is to be discharged. In the original Supreme Court Rule, which was promulgated right after the enactment of the Individual Debtor Rehabilitation Act, the repayment period was basically eight years. However, the Supreme Court realized that the repayment period could be shorter because the Act only stipulates the maximum period: "The repayment period in the repayment plan shall not exceed eight years from the first day of repayment."<sup>17</sup> The new insolvency law favors the argument that forcing a minimum standard of living for eight years is similar to imposing inhumane servitude, and provides a maximum five year repayment period.

After the filing of claims by creditors is complete, creditors can file objections to the list of creditors by applying for an investigation and confirmation judgment by the court on unsecured claims. The investigation and confirmation judgment is a summary judgment rendered by the judge handling the case.

The debtor must attend the meeting of the creditors and answer the creditors' questions. The repayment plan is not subjected to a vote, but the creditors can raise objections against the repayment plan presented by the debtor. The court, without the consent of the creditors, decides on whether or not to confirm the plan.

Requirements for confirmation vary depending on whether objections are raised by creditors or the Rehabilitation Administrator. If none are raised,

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<sup>15</sup> See *supra* Section I.A.

<sup>16</sup> According to Article 108 of the Constitutional Law of Korea, the Supreme Court can enact Rules on the process of litigation and internal regulations of the courts insofar as the Rules do not contradict Acts.

<sup>17</sup> Individual Debtor Rehabilitation Act, art. 71, para. 7.

the court can confirm the repayment plan when: (a) it is legitimate, fair, equitable and feasible; (b) all expenses of the Proceeding have been paid; and (c) the total amount of repayment, evaluated on date of the confirmation of the repayment plan, is not less than the total amount that is distributable in the case of bankruptcy.

In order for the court to confirm the repayment plan in the event that an objection is raised: (a) the appraised amount of repayment to the objecting creditor should not be smaller than the amount to be distributed in case of bankruptcy; and (b) any disposable income obtained by the debtor during the repayment period should be used to repay debt according to the repayment plan.

The repayment plan takes effect from the date of confirmation. However, the change of rights is not made until a decision of discharge is finalized. Upon confirmation, all property belonging to the individual rehabilitation estate reverts to the debtor, and any compulsory execution, temporary seizure, or temporary disposition against the debtor's property becomes void. The debtor must deposit money with the Rehabilitation Administrator to pay off individual rehabilitation creditors and the Rehabilitation Administrator disburses the deposited money according to the confirmed repayment plan.

The court grants a discharge *sua sponte*, or upon the request of interested parties, when the debtor has repaid in full according to the repayment plan. Even when repayment is not complete, after hearing the opinions of the interested parties, the court may decide to grant a discharge if the debtor fails to complete repayment due to reasons not attributable to the debtor, and the amount repaid to the creditors by the date a discharge is granted is not less than the amount to be distributed to the creditors from the probable bankruptcy.

However, claims not entered on the list of individual rehabilitation creditors, taxes, fines, tort damage claims, and wage claims are not discharged. A discharge does not affect the right that a creditor holds against a debtor's personal guarantor or against any other person liable concurrently with the debtor, or against collateral provided to a creditor, as the Individual Rehabilitation Proceeding does not address these rights.

### III. CHALLENGES AND RESPONSES

#### A. The Politics of Personal Bankruptcy

The personal bankruptcy issue is political in nature. About four million credit delinquents, all voters, comprise eleven per cent of the total number

of voters in the nation (35,600,000). This large number has attracted the attention of politicians, especially those of the governing party. Elections gave birth to new out-of-court support programs for credit delinquents.

Before the elections in March 2004 and 2005, each political party tried to outdo the other in showing concern for credit delinquents. The government and the governing party are more interested in this issue because nearly half of all debt defaulters (numbering 1.9 million) are between twenty and forty years of age. This age group is the largest constituency backing the current President. The Bad Bank program was announced on March 10, 2004 and the Individual Debtor Rehabilitation Act was passed on March 28, 2004, just before the April general election for the National Assembly. The low-income credit delinquent support program was announced on March 23, 2005, before the by-election for the National Assembly of April 30, 2005.

Although several measures could be taken to make judicial insolvency proceedings more effective, the government and the legislature have not been eager to do so, presumably because they assume that relief provided through the judicial insolvency proceedings will not be construed as the result of their efforts.

The government has addressed the personal bankruptcy issue not as social welfare policy but as financial regulation policy. Several out-of-court procedures have the common attribute of being initiated by the Financial Supervisory Service (FSS). The FSS, the executive organization of the Financial Supervisory Committee, is a governmental agency in charge of the supervision of financial institutions. However, it is doubtful whether planning such procedures, a task far different from normal financial regulation, is included in the scope of the FSS's responsibility. Even considering the political urgency of personal bankruptcy policies and the fact that debt arrangements are among the most advanced types of business judgments made by financial institutions, government intervention cannot be easily justified. Theoretically, the government does not have the authority to intervene in the decision-making regarding arrangement of credit delinquents' debt by creditor financial institutions.

Yet government intervention on debt arrangement was made possible through its powerful influence over financial institutions, especially in the banking sector, which has generally been referred to as "government-led banking."<sup>18</sup> Since the Economic Development Plan in 1962, the Korean

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18 For a more detailed explanation of government-led banking, see Il Chong Nam & Soogeun Oh, *Bankruptcy of Large Firms and Exit Mechanisms in Korea* 19 *passim* (2000).



government has used banking institutions as a source of funding for industrial policies. As a regulator and major shareholder of commercial banks, the government, instead of emphasizing profit maximization of banks, focused on the use of financial institutions to implement industrial policies. The CEOs of banks were nominated by the government on the basis of their political and policy contributions, rather than the performance of their banks. Even though government-led banking has gradually disappeared since the economic crisis in 1997, the government and banks are so accustomed to the former days of intervention that such government-initiated programs were adopted without much resistance.

Government intervention seems to have caused a vicious cycle. During the period of the government-led economy from the 1960s to the 1990s, the government rescued many big failing companies through various policy measures, including rescue loans, tax cuts, and the extension of due dates. When farmers began to lose their competitiveness in the 1980s, as a result of industrialization and fair trade, they demanded rescue loans, and the government has taken corresponding policy measures several times. These rescue measures have caused moral hazards pertaining to both creditors and debtors, and have proved to be an example of government failure that could not make any significant improvement in overindebted farmers' situations. Some credit delinquents seemed to expect similar government rescue measures, and the government has at least partially met their expectations through the government-initiated programs, despite obvious concerns of history repeating itself.

## **B. The Repayment Period**

Most of the out-of-court programs in Korea have an eight-year repayment plan.<sup>19</sup> The government originally insisted on repayment of the entire principal and disallowed discharge of the unpaid principal through Individual Workouts. When the Individual Workout was designed, it was assumed that the average applicant would be able to repay the principal in eight years, and thus this was the period chosen for repayment plans. As a result, the program was open only to debtors who could repay the principal debt within eight years.

The CCRS found out later that a discharge of the unpaid principal was inevitable in most Individual Workout cases, so it started to allow the reduction of the principal and gradually increased the ratio of debt reduction. A rough estimation based on Table 7 and Table 8 tells us that a median debtor

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<sup>19</sup> See *supra* Part I.

earns KRW 1,250,000 a month and owes approximately KRW 40 million. If the debtor has two dependants, the minimum cost of living would be about KRW 1,000,000 and would leave around KRW 250,000 for repayments per month. It would take 160 months to repay the principal debts. If the creditor agreed to extend due dates without reducing the principal debt, the debtor would have to live with only minimum living expenses for 15 years in order to repay principal debts, not even taking interest payments into account. This is a situation the law cannot permit. If society wants debtors to work enthusiastically, comprehensive reduction and discharge of excessive debt is crucial.

**Table 7: Debts of Applicants for Individual Workouts**

Amount of Debt	Number of Applicants in 2003	Number of Applicants in 2004
Below KRW 20 million	10,926 (17.5%)	81,109 (28.2%)
KRW 20 million — 30 million	10,516 (16.8%)	62,110 (21.6%)
KRW 30 million — 50 million	19,755 (31.6%)	82,211 (28.6%)
KRW 50 million — 100 million	18,351 (29.3%)	53,168 (18.5%)
Over KRW 100 million	3,002 (4.8%)	8,754 (3.1%)
Total	62,550 (100.0%)	287,352 (100.0%)

\* Average Debt was KRW 46,299,000 in 2003 and KRW 36,377,000 in 2004.

**Table 8: Monthly Income of Applicants for Individual Workouts**

Income	Number of Applicants in 2003	Number of Applicants in 2004
KRW Below 1 million	18,621 (29.8%)	132,040 (45.9%)
KRW 1 – 1.5 million	21,912 (35.0%)	98,472 (34.3%)
KRW 1.5 – 2 million	12,809 (20.5%)	41,939 (14.6%)
KRW 2 – 3 million	7,650 (12.2%)	13,525 (4.7%)
Over KRW 3 million	1,558 (2.5%)	1,376 (0.5%)
Total	62,550 (100.0%)	287,352 (100.0%)

Even assuming that enough discharges are granted, which is not yet the case, the eight year repayment plan instituted by government-initiated programs is much too long to encourage debtors to work diligently and make an effort to repay some debt. Alleviating the distress of debt defaulters by extending due dates or merely reducing debts is not enough to provide them with a fresh start.

Due to the rather long repayment period of eight years, the feasibility of various repayment plans of Individual Workouts is still doubtful. It is difficult to accurately predict what may occur during the eight years. The debtor might become unemployed, become hospitalized or go through a divorce. Moreover, none of the government-initiated programs cover creditors who are not financial institution creditors. Consequently the repayment plans do not reflect claims of these creditors, and the debtor must prepare an additional repayment plan for such claims.<sup>20</sup>

### C. Tension between Proceedings

The introduction of the Individual Rehabilitation Proceeding has had a significant impact on Individual Workouts. Tension and competition exist between Individual Workouts and the Individual Rehabilitation Proceeding. The concept of individual rehabilitation was first introduced in the first draft of the new insolvency law bill, announced in September 2002. Individual Workouts began running in November 2002. When the National Assembly enacted the Individual Debtor Rehabilitation Act in 2004, MOFE, along with the FSS and the CCRS, insisted on the extension of the repayment period from five years to eight years. The enactment of the Individual Debtor Rehabilitation Act in March 2004 aroused concerns concerning the future of Individual Workouts and various ways to keep Individual Workouts active were suggested. One of the suggestions was to require Individual Workouts as a prerequisite for Individual Debtor Rehabilitation Proceedings.<sup>21</sup> When the government prepared the second bill of insolvency law in 2004, MOFE so strongly insisted on a reconciliation process in advance of the Individual Rehabilitation Proceeding that the Government adopted it.

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<sup>20</sup> Individual workouts allow the repayment plan to include repayment of the claims of non-participating creditors unless the amount of such claims is more than 20% of total debts or participating financial institutions raise an objection.

<sup>21</sup> Kwangyeul Joo, *Individual Debtor Rehabilitation Act and Individual Debtor Rehabilitation Proceedings*, 602 *Banker* 26, 31 (2004) (Korean); Seungdo Park, *Improvements of the Individual Rehabilitation Proceeding 2*, 594 *Bankers* 72, 74 (2003) (Korean).

The reconciliation process was to be an out-of-court procedure, aimed at reaching an agreement between a debtor and his creditors on the rescheduling of debts. The process was designed to be run by an independent entity like the CCRS. The adoption of the reconciliation process by the 2004 bill brought criticism, and the National Assembly deleted it in the course of deliberation on the bill.

The most important contribution of the Individual Rehabilitation Proceeding to personal debt rescheduling is the introduction and encouragement of debt reduction. Creditor financial institutions were not familiar with the practice of debt reduction before the crisis of 1997 but have since become aware of its usefulness through debt rescheduling of ailing firms. However, personal debts were still not reduced because the effect of personal debt rescheduling was not as clear and directly beneficial to creditors as that of corporate debt rescheduling. Even in cases in which creditor financial institutions cut back on interest owed, the reduction of the principal was taboo. The appearance of the Individual Rehabilitation Proceeding changed this situation. It provided for the automatic discharge of remaining debts, regardless of outstanding interest or principal, upon completion of payment in accordance with a confirmed repayment plan. Individual Workouts, which were in competition with the Individual Rehabilitation Proceeding, started to reduce even the principal in rescheduling personal debts.

In spite of the merits of the judicial proceedings — including comprehensive coverage of all types of creditors and relatively short repayment periods — they do not seem to be esteemed as highly by credit delinquents as those of Individual Workouts. In April 2005, judicial proceeding cases amounted to approximately ten per cent of Individual Workout cases, which shows that there are advantages to Individual Workouts. Individual Workouts urge creditors not to enforce claims against guarantors and to allow debtors to keep mortgaged homes, as long as they keep up with their repayment plans. In addition, debtors are not required to meet with judges or court officers.

#### **D. Discharge and Moral Hazard**

The Individual Rehabilitation Proceeding has raised complex issues for the public as well as for lawyers, discharge and moral hazard being first among these. It should come as no surprise that the public has had difficulty accepting the notion of a discharge, especially considering the historical aspects of this issue and the public's lack of familiarity with the discharge concept. The concept of discharge was first introduced through the Statute

of Ann in England in 1705. It took almost two hundred years before discharge was accepted as a core principle of bankruptcy law when the US Bankruptcy Act provided discharge as a right of the bankrupt in 1898.<sup>22</sup> Though bankruptcy discharge was first introduced in Korea in 1962, the public was not aware of it until the court rendered a discharge decision for the first time in 1998.

When the Individual Rehabilitation Proceeding was introduced, criticism focused on its more generous discharge policy and on the moral hazard which discharge could cause.<sup>23</sup> The argument that discharges in bankruptcy proceedings will cause moral hazards assumes that discharge might cause people to borrow too much and might lead debtors to put less effort into repaying their debts. Such an opinion ignores, intentionally or unintentionally, the cost that a debtor must pay for discharge. Debtors who receive discharge must suffer from a bad credit rating. The discharge removes only legal liability and does not stop creditors from refusing to transact with discharged debtors under normal conditions. The debtor must be prepared to compromise his or her reputation, especially among individual creditors like friends and colleagues. The stigma placed on individuals going through judicial procedures cannot be ignored; the most frequent question by applicants for personal bankruptcy proceedings or rehabilitation proceedings is whether or not they will have to go before the court or meet a judge.<sup>24</sup> Considering such

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22 It was 1705 when a provision on discharge appeared in the Statute of 1705, 4 Ann., c. 17, § 7, Part II.B (Eng.) for the first time in the history of bankruptcy. The discharge provisions were amended several times until settled in the United States Bankruptcy Act of 1898. Charles J. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 Am. Bankr. L.J. 326 (1991).

23 Most literature dealing with the Individual Debtor Rehabilitation Proceeding mentioned the "moral hazard." Every paper concluded that Individual Debtor Rehabilitation Proceedings should be run so as to minimize moral hazard. Even a legislative researcher of the National Assembly, who worked for the enactment of the Individual Debtor Rehabilitation Act, wrote about the background of the Act as follows:

Credit delinquents are personally responsible for their overindebtedness. Discharging their unpaid debts causes moral hazard so that they might have the impression that debts do not have to be repaid. And it also creates a relative disadvantage to debtors who repaid all of their debt. However, we need to address the credit delinquents issue because the overflow of credit delinquents is not a personal matter but a cause of social instability, including crime, and a factor that could impede potential economic growth.

Byungjo Heo, *Individual Debtor Rehabilitation Act*, 450 Nat'l Assembly Rev. 108, 108 (2004) (Korean).

24 Even in litigious counties where the use of judicial processes is a part of daily life, like the United States, only a small portion of individuals who could file for

costs of bankruptcy discharge, the moral hazard argument is groundless and fictitious. Theoretically, moral hazard can exist, but practically, it cannot have any significant impact.

The possibility that debtors may borrow a lot of money without preparing means of repayment (the so called "grasshopper problem") is far less serious in Korea than elsewhere because of the serious disgrace and accompanying costs associated with bankruptcy. And the prospect of debtors obtaining discharge by cheating creditors or the court (the so called "opossum problem") can be resolved to a great extent through the disclosure procedure of the debtor's property pursuant to articles 61-77 of the Civil Enforcement Act, which makes public all assets and real estate belonging to the debtor. The punishment of those who receive discharge fraudulently and the accompanying cancellation of the discharge also deter potentially fraudulent debtors.

The problem of creditor's moral hazard should also be discussed. The creditor is aware that current personal bankruptcy schemes do not provide adequate protection to credit delinquents. As a result, the creditor gives excessive credit to the debtor without proper appraisal of the debtor's financial situation. The law should stop creditors from exploiting the current creditor-friendly insolvency law by discharging debt.

Another attack against comprehensive discharge is that it might harm the financial situation of creditors. Korea has witnessed huge amounts of public funds poured into failing financial institutions. Yet it is not the discharge of personal debts that caused the failure of financial institutions, but the unpaid claims (non-performing loans). Discharge is the process by which uncollectible claims are wiped out after they are proven uncollectible. As financial institutions have already accumulated allowances for bad debts and losses accrued by bad debts have already been reflected in financial statements, they do not incur any new losses due to the decision of discharge. If there is a possibility of repayment of claims, the creditor can raise an appeal against bankruptcy adjudication or a decision of discharge by proving such a possibility.

Arguments against discharge have largely focused on its emotional aspects rather than on its potential economic value and social benefits. Discharge gives debtors incentives to work hard and encourages them to recover their normal economic activities. Thus it can benefit society as a whole.

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bankruptcy choose to do so. Michelle J. White, *Why Don't More Households File for Bankruptcy?*, 14 J.L. Econ. & Org. 205 (1998).

### **E. Straight Bankruptcy and its Weaknesses**

Due to the deep reluctance, prevalent in Korea, to engage in judicial proceedings in general, there has traditionally been a preference for out-of-court settlements in creditor-debtor relations. Moreover, the word "bankruptcy" in Korean contains an extremely negative connotation that the bankrupt has been broken morally or mentally, not to mention financially. Even many creditors in Korea hesitated to turn to the courts for insolvency assistance because it seemed too cruel towards the debtors.

As Table 9 illustrates, the Bankruptcy Act was seldom resorted to in the past. This was due first of all to the social stigma, and second to the lack of incentives to both the creditor and the debtor, which made the procedure ineffective. The first weakness of straight bankruptcy is statutory discrimination that existed against the bankrupt. A person adjudged bankrupt would be expected to resign his position as a public servant, and his license to practice medicine or law would be revoked. About 150 statutes provide for such career termination. Most employment contracts include provisions providing automatic grounds for the termination of employment upon the adjudication of personal bankruptcy.

**Table 9: Number of Bankruptcy Cases**

Year	Cases	Year	Cases	Year	Cases	Year	Cases
1985	11	1990	27	1995	12	2000	461
1986	26	1991	16	1996	18	2001	842
1987	20	1992	14	1997	38	2002	1443
1988	21	1993	26	1998	467	2003	4159
1989	37	1994	18	1999	733	2004	15,266

The second weakness of straight bankruptcy is the narrowness of exempted property, which is the basis of the bankrupt's living after discharge. The new insolvency law exempts property equivalent to basic living expenses for six months and a deposit for rent protected by the Housing Rent Protection Act. However, this exempted property cannot facilitate a fresh start for the bankrupt.

The third weakness is illegal collection activities in practice during the process of bankruptcy. Even though Korea does have a statute prohibiting

cruel collection activities,<sup>25</sup> most debtors are not protected properly from illegal collection activities. The police and the public prosecutor responsible for the investigation and indictment of collectors conducting illegal collection activities lack any enthusiasm. They do not seem to recognize that the debtor has a right to be protected from such cruel activities. This phenomenon results from the concept that the debtor deserves such severe treatment.

In spite of such legal and social impediments to the straight bankruptcy proceeding, the flood of credit delinquents has reversed the trend. More debtors have begun to actively consider the straight bankruptcy proceeding, and some lawyers specialize in straight bankruptcy cases. One personal bankruptcy website now has nearly twenty thousand members listed.

#### **F. Competition among Programs**

The most frequent complaint regarding personal bankruptcy proceedings concerns the complexity of the different proceedings within the personal bankruptcy arena. Public opinion has been against the multiplicity of procedures available to credit delinquents: individual arrangement by a single financial institution; Individual Workouts by the CCRS; debt arrangement by Bad Banks; the Individual Rehabilitation Proceeding; and the straight bankruptcy proceeding. In addition, many debtors have complained about the difficulty of finding an appropriate proceeding.

However, while indeed complex for the layman, each proceeding does have its own individual purpose, appropriateness, and merits. Under the insolvency law regime, private debt rescheduling is achieved in the shadow of the Individual Rehabilitation Proceeding, while the Individual Rehabilitation Proceeding is carried out in practice with the bankruptcy proceeding in mind.

Competition among different proceedings has stimulated creditors' participation in debt rescheduling. Compared with general collection rules governing creditor-debtor relationships, the judicial bankruptcy proceedings (the Individual Rehabilitation Proceeding and the straight bankruptcy proceeding) have merit in their ability to rescue debtors from overindebtedness in a quick and comprehensive manner. On the other hand, the out-of-court proceedings, including Individual Workouts, provide credit delinquents with a breathing spell without putting them into judicial proceedings. Several proceedings for credit delinquents have competed with

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<sup>25</sup> Act on the Registration of Money Lending Business and the Protection of Finance User, art. 10.



each other, trying to induce more applicants to use their programs. Through competition, rules and practice have been improved. Credit delinquents can choose a suitable proceeding among several alternatives. This competition between proceedings with common goals has served to enhance the total benefit to society in general, as well as to debtors in particular.

## CONCLUSION

During the past eight years, since the economic crisis of 1997, there have been many changes in the area of bankruptcy in Korea, regarding both business and personal bankruptcy. There has been a significant learning curve, with the law starting from the most basic concepts and moving quickly on to the most advanced policy issues. Discharge has always been the toughest topic. One learned judge specializing in bankruptcy frequently introduces himself as an evangelist of the bankruptcy-discharge church. It is natural that Korean society needs time to understand discharge, considering it took about 200 years for the UK and the United States to fully comprehend it. Another young judge in the bankruptcy division confessed that when he started to work on personal bankruptcy cases, he mostly worried about how to prevent the moral hazard regarding debtors, but after a few months of experience, he now focuses on how to help bankrupts.

The government's intervention has created some problems unique to Korea. Government rescue loans have had a negative influence on debtors' behavior. Measures initiated by the government have distorted the decision-making process of both creditor financial institutions and debtors. The government must learn to let creditors and debtors fend for themselves. If judicial procedures are fair and efficient, reasonable creditors and debtors will negotiate and settle their cases, voluntarily rescheduling debts, and employing relevant judicial processes only as a last resort. The government must check for any inefficiency or unfairness in the judicial procedures and fix them.

Statistics show that several government-sponsored programs do not significantly reduce the number of credit delinquents. Nevertheless, the government seems to assume that such programs can show that the government is doing something for debt defaulters. The 3,600,000 existing credit delinquents, obviously a serious burden to the national economy, should be afforded relief immediately.

In addition, there are at least 800,000 individual debtors who are repaying card loans at 25-30% interest rates (the normal interest rate is less than 10%) through revolving card loans. They could easily become credit delinquents

with the slightest change in their financial situations, such as temporary unemployment or a temporary reduction in income.

For successful improvement of the financial situation of credit delinquents, it is imperative to reduce debt in a more comprehensive manner, to clear the impediments to easy use of the insolvency proceedings, and to provide incentives to encourage debtors to make progress on their repayment plans. However, criticism regarding the moral hazard issue has created several disincentives, such as long-term repayment plans that take nearly all of the debtor's income for repayment, leaving him or her with only a minimum for living expenses. Discrimination against the bankrupt still remains, both in the written law and in the practice of law.

Insolvency schemes should be designed in a more attractive way if their goal is to solve fundamental problems of credit delinquents rather than merely show concern for political purposes. The ultimate solution is very clear: wipe out remaining debts that the debtor cannot repay in three years,<sup>26</sup> thereby motivating debtors to work hard.

While the present has brought with it much change in terms of learning to live with bankruptcy as an inevitable part of the market economy, there is still much to be done. Legal discrimination against bankrupts must be removed. The repayment period in the Individual Rehabilitation Proceeding and Individual Workouts needs to be shortened to three years. Personal guarantors for debtors in the Rehabilitation Proceeding need be protected as much as debtors are during the repayment period. Debtors need to be able to keep their mortgaged residences during rehabilitation proceedings.

The Individual Rehabilitation Proceeding should offer incentives to induce debtors to apply for rehabilitation instead of straight bankruptcy. The Individual Rehabilitation Proceeding is an alternative to the straight bankruptcy proceeding, which is preferred by debtors since in it they can obtain an immediate discharge even with a regular income exceeding living expenses. The US Bankruptcy Code provides debtors in Chapter 13 (the equivalent of the Individual Rehabilitation Proceeding in Korea) with incentives not available in the straight bankruptcy proceeding.

These issues will be resolved as more Koreans begin to understand bankruptcy rules and their economic significance. The history of insolvency has shown that society can benefit as much as or more than debtors from the

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<sup>26</sup> The repayment period should be long enough to enable repayment to creditors to the extent possible and short enough to give incentives to debtors to honor the repayment plan during that period. Three years, adopted by US and Japan, could be a good compromise between two extremes.

discharge of unpaid debts because a fresh start gives the debtor an incentive to work hard.<sup>27</sup> The starting point to personal insolvency law reform is to acknowledge this truth.

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<sup>27</sup> "Thus the bankrupt becomes a clear man again; and, by the assistance of his allowance and his own industry, may become a useful member of the commonwealth." 2 William Blackstone, Commentaries \*484.

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