Efficient and Inefficient Debt Restructuring: A Comparative Analysis on Voting Rules in Workouts

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A COMPARATIVE ANALYSIS ON VOTING RULES IN WORKOUTS

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ABSTRACT

Two jurisdictions, Korea and America, have contrasting legal rules governing voting in workouts: Voting Mandating Rule and Voting Prohibition Rule. Voting in a bond workout has long been prohibited in the Trust Indenture Act of the United States. In stark contrast, Korea enacted a unique statute that mandated a voting scheme in workout in an effort to resolve corporate insolvencies crisis and incompetent bankruptcy institutions. Voting facilitates the completion of workouts, but it gives majority creditors an opportunity to disproportionately benefit from workouts. I explore the contrariness of the two seemingly unrelated statutes, and bring their respective implications for efficiency to light. Voting Prohibition Rule prevents every inefficient workout attempt but blocks some efficient workout efforts. Voting Mandating Rule facilitates every efficient workout but enables some inefficient workouts as well. Voting Prohibition Rule works better if debts are concentrated to a handful of major creditors. Voting Mandating Rule is better suited if creditors are atomic and individually non-pivotal. Voting Mandating Rule encounters a dilemma in that it was designed to enable more workouts to take place, but in doing so it may cause workouts to become less effective in reducing bankruptcy costs.
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I. INTRODUCTION

Two jurisdictions, the United States and South Korea, have contrasting legal rules governing voting in workouts: Voting Prohibition Rule and Voting Mandating Rule. Voting in a bond workout has long been prohibited by the Trust Indenture Act in America. In stark contrast, Korea has a unique statute that mandates voting in workouts among financial institutions in an effort to resolve corporate insolvencies crisis and incompetent bankruptcy institutions.

A workout is an outside-of-bankruptcy, contract-based debt restructuring for insolvent companies,1 designed to preserve the value of financially-distressed but economically-viable companies by avoiding bankruptcy procedure.2 Otherwise efficient workout attempts often fail, however, in large part because numerous and individually

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1 Arrangements for debt restructuring in workouts include, among other things, stretch-out of maturity date, debt-for-equity exchange, forgiveness of interest, and provision of additional debt.

2 See Stuart C. Gilson, Managing Default: Some Evidence on How Firms Choose between Workouts and Chapter 11 in CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES 308, 319 (JAGDEEP S. BHANDARY AND LAWRENCE A. WEISS ED., 1996) (observing that distressed firms can preserve more of their value by restructuring their debt privately, and avoiding chapter 11).
non-pivotal creditors opportunistically but rationally opt to stay out of workout arrangements.\textsuperscript{3} The voting procedure is thought to help resolve the holdout problem.\textsuperscript{4}

Encountered with unprecedented mammoth-scale corporate insolvencies in late 1990’s, Korea enacted a statute titled the “Corporate Restructuring Promotion Law”,\textsuperscript{5} mandating a binding vote in workouts. This law established a vote-based workout mechanism, having financial institutional lenders bound by a workout arrangement if it was resolved by a three-quarter majority vote. In contrast, the Trust Indenture Act\textsuperscript{6} of America prohibits a binding vote in a bond workout to change core terms of a bond issue.\textsuperscript{7} This provision, aimed at protecting the interests of minority individual bondholders from insiders’ machination, has stopped workout reorganization by voting in the United States where bond issues are the major form of corporate debt. This voting prohibition has been challenged by the academia. Professor Mark Roe asserted that the

\textsuperscript{3} See Robert Gertner and David Scharfstein, \textit{A Theory of Workouts and the Effects of Reorganization Law}, 46 J. Fin. 1189, 1191 (1991) (noting that creditors with small stake have an incentive to hold out); Mark, J. Roe, \textit{The Voting Prohibition in Bond Workouts}, 97 Yale L.J. 232, 236 (1987) (noting that the buoy-up effect for the holdouts causes workout attempts to fail).

\textsuperscript{4} See Gertner and Scharfstein, \textit{id} at 1211 (arguing that the voting procedure can be used to internalize the effects of reorganization and get around the holdout problem).

\textsuperscript{5} The Corporate Restructuring Promotion Law (Korea), as promulgated on August 14 and enacted on October 14, 2001 (Law No. 6504).


\textsuperscript{7} The core terms subject to the voting prohibition include principal amount, interest rate, and maturity date.
voting prohibition could contribute to unnecessary bankruptcies and thus should be repealed.\(^8\)

The dramatic divergence between the two legislations offers an intriguing opportunity to examine the implications that the two approaches may have for the efficiency of workout reorganization. This paper develops a framework for analyzing and comparing the contrasting legal rules in two jurisdictions.

This paper is organized as follows. Part II explains two contrasting legal rules governing voting in workout restructuring. In the absence of a statutory intervention, parties may elect whether to remain in an assent-based voluntary workout (which may be labeled the “Assent Scheme”),\(^9\) or to contract for a voting procedure (which may be labeled the “Voting Scheme”). Legislators may intervene, however, in two opposite ways. The Voting Prohibition Rule (the “Prohibit-Rule”) mandates the Assent Scheme by blocking contract for voting in workout, whereas the Voting Mandating Rule (the “Mandate-Rule”) makes the Voting Scheme compulsory, providing a statutory ground for the binding force of voting in workouts.

Part III describes the corporate insolvencies crisis that led up to, and the major features of, the Korean legislation introducing the Mandate-Rule. In late 1990’s, Korean

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\(^8\) See Roe, supra note 3, at 234, 235 (asserting that the protection of individual investors through the voting prohibition needs to be reconsidered in current situation in which most of public debts are held by institutional investors.)

\(^9\) In the absence of any basis of voting for workout (contractual or statutory), workout has to proceed on a consensual basis with dissenters being able to stay out of the debt restructuring.
economy abruptly underwent a huge wave of corporate insolvencies, enormous and unprecedented in its scope and scale, which eventually lead to an economic crisis. In 1997 alone, 8 of 30 largest business conglomerates (i.e., Chaebols\textsuperscript{10}) became insolvent.\textsuperscript{11} Although such Chaebols badly needed an urgent reorganization, they were very reluctant to file for Corporate Reorganization, Korean counterpart to the Chapter 11 procedure of America, in large part because court practices had not allowed incumbent managers and controlling shareholders to continue running companies during the proceedings and retain ownership in post-reorganization companies. Also, lenders were not inclined to resort to bankruptcy institutions because courts were not believed to have sufficient expertise,

\textsuperscript{10} “Chaebol” is a group of companies under common control of a controlling family or an individual, who holds usually less than majority of ownership but exercises effective control by complicated pyramid and cross ownership structure. It is a term that can characterize the state of corporate governance and ownership in Korea. Pursuant to the Monopoly Regulation and Fair Trade Act, the Fair Trade Commission of Korea announces the list of the 30 largest Chaebols in terms of asset size every April. See Hwa-Jin Kim, \textit{Living with the IMF: A New Approach to Corporate Governance and Regulation of Financial Institutions in Korea}, 17 BERKELEY J. INT’L L. 61, 63 (1999) (characterizing Chaebol as large groupings of related corporations under highly concentrated family or individual control and a unique pattern of unrelated diversification).

\textsuperscript{11} The author was personally involved in the bankruptcy and workout procedures for many of the insolvent Chaebol companies, as a member for a Korean law firm representing them. A substantial portion of the accounts regarding the Korean bankruptcy crisis in this paper is based on the author’s own experience in that capacity.
experience and flexibility, thought to be needed in handling complex business issues involving conflicts of interest. Faced with such rigid court practices, insolvent companies sought an alternate reorganization procedure, the “Compulsory Composition”, which is a court-overseen, debt renegotiation procedure, despite its legal effect being limited to unsecured debts. Although it had almost never been used before, the Compulsory Composition was instantly favored by insolvent Chaebols as soon as they were informed that the procedure would leave the control and ownership intact. But this attempt was later rejected by the court.

Dissatisfied with the bankruptcy institutions, corporate borrowers and financial lenders engaged in workouts, establishing a voting-based workout mechanism by an agreement titled the “Corporate Restructuring Accord.” However, they encountered serious holdout problems posed by non-signatories such as foreign creditors as well as certain procedural defects. Against this backdrop, the “Corporate Restructuring Promotion Law” was enacted to mandate a statutory vote-based workout mechanism which applies to debts held by all financial institutional creditors. Beginning with Hynix Semiconductor Co., Ltd. (formerly known as Hyundai Electronics, Co., Ltd.), a number of insolvent companies went through the vote-based workouts under the law.12

Part IV analyzes the implications of the two legal rules for efficiency of debt restructuring. The analysis begins by identifying two effects that a workout may have on parties’ wealth. Workout may well have a significant impact on the total value of a

12 As of August 2005, the CRPL procedures for 21 companies are under way. See Court Referral for Constitutionality of the CRPL, Donga Ilbo, May 3, 2005.
corporate borrower (“the efficiency effect”). On the other hand, workout may also affect
the allocation of such value among creditors (“the value-diversion effect”). Each of the
two rules has its own value-diversion effect which in turn influences the efficiency effect.
Under the Prohibit-Rule, value may flow from the participating creditors to the non-
participating creditors because the participants’ concession in workout may well boost
the financial ability of corporate borrowers to repay to the creditors who hold out.13 To
the contrary, under the Mandate-Rule, value may shift from minority creditors to majority
creditors. With debt restructuring binding on all creditors, majority creditors who control
the voting procedure may disproportionately benefit from the reorganization, which I
label “private benefits from control of workout.”

The analysis shows when efficient or inefficient workouts may take place under each
rule. The Mandate-Rule facilitates all efficient workouts but it also enables some
inefficient workouts to take place. The latter may happen when majority creditors favor a
workout plan, not because it enhances the total value but because the workout procedure
provides an opportunity to capture disproportionate benefits. The Prohibit-Rule prevents
all inefficient workouts, and in this regard it is superior to the Mandate-Rule. The
disadvantage of the Prohibit-Rule is that it may fail to facilitate some efficient workouts
when the efficiency gain is not greater than the value shifted to the non-participants.
There is a trade-off between the facilitation of efficient workouts and the deterrence of
inefficient workouts: The Mandate-Rule facilitates all efficient workouts but also makes

13 See Roe, supra note 3, at 236 (observing that workout will leave the company to pay debt to the
holdout bondholders in full).
possible some inefficient workouts, while the Prohibit-Rule stops all inefficient workouts but also hinders some efficient workouts. The analysis identifies certain circumstances under which one of the two rules is superior to the other. When creditors are numerous and individually non-pivotal to workout, the Mandate-Rule may work better because the holdout problem may be acute. In contrast, when a handful of financial institutions hold the majority of debt claims with minor bondholders, the Prohibit-Rule is better suited because major creditors may successfully negotiate a workout with each other.

Under the Mandate-Rule, reducing private benefits from control will align the majority creditors’ incentives more closely with the overall efficiency of workout. The workout procedure under the Mandate-Rule can be perceived as effectively alternative bankruptcy reorganization because of the mandatory voting. Ironically, while the Mandate-Rule is designed to establish an effective mechanism for facilitating reorganization outside of bankruptcy, it may result in a less attractive type of workout in terms of saving bankruptcy costs. Workout is basically a bargain among parties, and a voting scheme can still be a part of the bargain so long as it is based on the consensus of participants. Therefore, there can be good reason to suspect that the Mandate-Rule in Korea may not take on the nature of workout. Part V states the conclusion.
II. TWO RULES ON VOTING IN WORKOUT

A. WORKOUT: OUTSIDE-OF-BANKRUPTCY REORGANIZATION

Financial stress of an otherwise economically viable company requires an orderly reorganization of its capital (i.e., debt and equity). Reorganization can be undertaken either inside, or outside of, bankruptcy procedures. While Chapter 11 of the Bankruptcy Code\textsuperscript{14} sets the reorganization framework inside of bankruptcy, the reorganization outside of bankruptcy is referred to as workout.

The financial difficulty and possibly ensuing bankruptcy procedure are thought to involve substantial costs.\textsuperscript{15} Suppliers and consumers are reluctant to transact with a company in financial difficulties.\textsuperscript{16} Skilled workers may leave the firm. The time and attention of managers are diverted to bankruptcy-related matters instead of remaining concentrated on business operations. The direct costs associated with filing for a

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\textsuperscript{15} See Lucian Arye Bebchuk, \textit{A New Approach to Corporate Reorganizations}, 101 HARV. L. REV. 775, 780 (observing that the inevitable delay in bankruptcy involves significant costs).

\textsuperscript{16} See Tim C. Opler & Sheridan Titman, \textit{Financial Distress and Corporate Performance}, 49 J. FIN. 1015, 1016-1017 (finding that highly leveraged firm lose market share in industry downturn, reflecting a reluctance by customers to do business with distressed firms).
bankruptcy petition are not negligible. Financial constraint forces debt-stricken companies to pass up otherwise efficient investment opportunities. The prolonged duration of the bankruptcy proceedings serves to dissipate the value of the firm. Furthermore, conflicts of interest between creditors and shareholders, and among multiple creditors, can be another significant source of costs from financial difficulties. Faced with financial stress, shareholders and managers may well favor suboptimal investment opportunities with abnormally high risks. Competing rushes by creditors to

17 See Gilson, supra note 2, at 312 (suggesting the findings that average legal and professional fees reported by Chapter 11 companies range from 2.8 percent to 7.5 percent of total assets, and noting that LTV Corporation has spent over $150 million on legal and other professional fees since its filing for Chapter 11).

18 See Gertner and Scharfstein, supra note 3, at 1191 (noting that because creditors claim part of the cash flows from new investment, distressed firms can have difficulty issuing equity or debt for new investment, which may lead them to pass up positive net present value investments.)

19 The Chapter 11 procedure normally takes two to three years in ordinary cases. See Roe, supra note 3, at 236.

20 See David M. Cuttler and Lawrence H. Summers, The Costs of Conflict Resolution and Financial Distress: Evidence from the Texaco-Pennzoil Litigation, 9 RAND J. ECON. 157, 158 (concluding that financial conflict can have substantial effects on productivity from the case of dispute and subsequent settlement between Texaco and Pennzoil).

21 See Lynn M. Lopucki & William C. Whitford, Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U. PA. L. REV. 669, 683-684 (1993) (observing that the holders of junior interests have reason to prefer high risk investments).
collect debt may undermine the total value as well. Therefore, one of the purposes of a
bankruptcy proceeding is to enable the owners of the firm’s assets (creditors as well as
shareholders in the context of bankruptcy) to act collectively.\textsuperscript{22}

Reorganization via workout is aimed to reduce such costs involving financial stress
and bankruptcy institution.\textsuperscript{23} Creditors voluntarily consent to a package of reorganization
arrangements such as stretch-out of maturity date, debt-for-equity exchange, forgiveness
of interest, and provision of additional debt on the belief that they stand to benefit from
such voluntary concession.\textsuperscript{24}

Law and economics academia, however, have long recognized that holdout by
individually small but collectively substantial creditors is a principal impediment to the
success of workouts.\textsuperscript{25} The enhancement of the financial capability of a corporate debtor
through workout enables the debtor to better service debt owed to non-participants.
Hence, numerous minor creditors rationally and opportunistically decline to participate in

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\textsuperscript{23} See Gilson, \textit{supra} note 2, at 319 (finding that the professional fees incurred in exchange offers
are about one-tenth those incurred in a typical chapter 11 case).

\textsuperscript{24} In this sense, workout can be viewed as an application of the Coase theorem. See Roe, \textit{supra}
ote 3, at 236 (stating that “Ronald Coase’s famous theorem suggests that, in the absence of
transaction costs, the incentives of those financially interested in the nearly bankrupt firm would
be to contract to the efficient solution.”)

\textsuperscript{25} See e.g., Gertner and Scharfstein, \textit{supra} note 3, at 1191; Gilson, \textit{supra} note 2, at 316.
workout. If these individually non-pivotal creditors, taken together, are substantial enough to dissuade other creditors from agreeing to workout arrangements, an otherwise efficient workout effort will fail.

B. A SOLUTION TO HOLDOUT: VOTING

1. ASSENT SCHEME AND VOTING SCHEME

Voting can be an effective way to resolve the holdout problem. With a voting scheme put in place, a reorganization arrangement, passed by creditors’ vote, binds the entire creditors subject to the voting scheme (“voting group”) notwithstanding individual dissents to the arrangement, thereby preventing minor creditors from disproportionately benefiting from holdout. Therefore, the thrust of voting is the ‘binding force’ of the vote-passed workout arrangements on the entire voting group. The voting scheme helps wipe out opportunistic incentives by virtue of such binding force, and thereby align the interest of individual creditors with the interests of the entire voting group.26

I label the workout reorganization that is undertaken without any voting mechanism in place “the Assent Scheme”, noting that the reorganization is effective only to the

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26 See Gertner & Scharfstein, supra note 3, at 1211 (positing that the voting procedure does not allow public creditors to be treated differently depending on their vote, whereas tendering and non-tendering public creditors are treated differently).
assenting creditors. By contrast, I label the workout reorganization with a binding vote in place (irrespective of the ground of the binding force) “the Voting Scheme.”

2. CLASSIFYING THE VOTING SCHEME

We may distinguish the types of the Voting Scheme using two different criteria, (a) the ground of the binding force, and (b) the scope of the voting group.

a. Ground of Binding Force: Contractual or Statutory

In essence, a voting requires a ground of its binding force on the voting group including the dissenting creditors. The ground can be either contractual or statutory. A contractual ground refers to a voluntary submission by creditors to a voting scheme through any form of consent. Such voting contract can be entered into before or after a financial difficulty arises. In contrast, a statutory ground refers to a law that provides for the binding force of voting and thereby mandates a voting-based workout. A statutory ground inside of bankruptcy can be found from Chapter 11 of the Bankruptcy Code, which sets a Voting Scheme for reorganization via bankruptcy.27

27 11 U.S.C. § 1126(c) (2005). See Lopucki & Whitford, supra note 21, at 676 (pointing out as one of advantages of bankruptcy reorganization the fact that majorities of creditors can bind dissenting minorities through voting).
b. Scope of Voting Group: Homogeneous v. Heterogeneous

Debts in a voting group can be either homogeneous or heterogeneous to each other with respect to their terms such as priority, maturity date and interest rate. A homogeneous voting group\(^{28}\) consists of debts having identical terms, and a heterogeneous voting group is comprised of debts having diverse terms. For example, a voting group that consists of secured long-term bank loans and unsecured short-term commercial papers is clearly heterogeneous.

The distinction between homogeneous and heterogeneous voting groups is of great importance because there can be a clear discrepancy between the two groups in terms of the existence and extent of conflicts of interest among creditors in a voting group. A homogeneous voting group embraces little, if any, conflicts among creditors thanks to the plausible convergence of interests resulting from the likeness of debts. In contrast, a heterogeneous voting group may well suffer from material conflicts of interest among creditors holding debts of differing terms. Examples of such conflicts can be easily imagined. When a company’s assets can barely service senior debts but fall well short of covering junior debts, creditors of junior debts have good reason to vote in favor of debt rescheduling whereas senior creditors will naturally oppose the reorganization. Such intra-heterogeneous group conflicts may cause the incentives of some creditors to diverge from the overall efficiency. Such divergence may result in an inefficient reorganization.

\(^{28}\) Where a voting rule applies to a group of debts that are homogeneous, the ground can be named a homogeneous voting group.
The analysis in Part IV shows the mechanisms by which major creditors’ incentives may deviate from the maximization of the total value because of such misalignment of interest.

C. Two Statutory Interventions to Voting: Prohibit or Mandate

In the absence a statutory intervention, parties may freely choose between the Voting Scheme and the Assent Scheme. However, we may observe two starkly contrasting forms of statutory interventions to voting in workout in two jurisdictions: the United States and Korea. One rule prohibits creditors’ voluntary submission to the Voting Scheme. The other rule sets up and mandates the Voting Scheme.

1. The Voting Prohibition Rule

The Voting Prohibition Rule (the “Prohibit-Rule”) mandates the Assent Scheme by blocking or invalidating parties’ voluntary submission to the Voting Scheme. Section 316(b) of the Trust Indenture Act bans a binding vote, based on a majority action clause in a bond indenture, by bondholders to change any core term (such as principal amount, interest rate, or maturity date) of a bond issue. The prohibition is meant to prevent the insider bondholders (who may hold a greater percentage of shares as well) and the
investments banks (who are driven by pursuit of business opportunities) from pursuing their own interests at the expense of the other bondholders.\(^{29}\)

The Prohibit-Rule stops a voting-based workout, a presumably effective way to solve the holdout problem. Although exchange offers conditioned on exit consent,\(^{30}\) which is intended to strip untendered debts of covenant protections, have been used as a substitute for voting,\(^{31}\) they may not necessarily eliminate the holdout problem.\(^{32}\) Professor Mark Roe proposed that the voting prohibition statute be repealed and replaced with a flexible standard prohibiting fraud and distortions in bond recapitalizations.\(^{33}\)

2. **THE VOTING MANDATING RULE**

The Voting Mandating Rule (the “Mandate-Rule”) sets up the Voting Scheme without requiring voluntary submission by creditors to voting, providing a statutory

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\(^{29}\) *See* Roe, *supra* note 3, at 251, 252.

\(^{30}\) The exit consent is based on the provision of the indenture specifying that covenants can be changed or eliminated by either a simple or super majority vote of the nominal amount of debt.

\(^{31}\) *See* Gertner and Scharfstein, *supra* note 3, at 1191 (noting that public debt restructurings almost always assume the form of offering a package of new securities and cash in exchange for the original public debt due to the prohibition of the Trust Indenture Act.)

\(^{32}\) *See* Roe, *supra* note 3, at 247 (maintaining that the exit consent is not assured of diminishing the buoying-up effect accompanying the holdout problem).

\(^{33}\) *See id.* at 232-235.
source of the binding force of voting. The Corporate Restructuring Promotion Law of Korea constitutes a unique example of the Mandate-Rule. Under the Law, a three-fourth majority vote in terms of debt amount is binding on all financial-institution creditors in Korea.\textsuperscript{34}

\textsuperscript{34} The Law applies to every conceivable form of domestic financial institutions including domestic branches of foreign banks. The Law sets up a heterogeneous voting group since financial institutions held debts are subject to the Voting Scheme, irrespective of debts.
III. VOTING MANDATING RULE OF KOREA

A. BACKGROUND

1. CRISIS OF CORPORATE INSOLVENCIES

The Korean economy abruptly underwent a severe hardship in late 1990’s. The well-known economic crisis began with a series of large-scale corporate insolvencies in 1997. The scope and scale of these insolvencies were tremendous and unprecedented. In 1997 alone, 8 of 30 largest business conglomerates (widely known as Chaebols) became insolvent, unable to repay their due debts. In the first half of the year, two major Chaebols, named Hanbo and Sammi, filed for Corporate Reorganization, Korean counterpart to Chapter 11 procedure. In the following second half, more Chaebols such as Jinro, Kia, New Core, Haitai, Halla, and Dainong became insolvent. High leverage,

35 Prior to 1997, bankruptcy of major Korean corporations was exceptional and anecdotal, due in part to preferential financial support from banks in the form of additional loan. For this reason, the importance of bankruptcy institutions had not been well recognized before.

36 See Kim, supra note 10, at 65 (reporting that some large Chaebols went into bankruptcy in 1997).

37 The average debt-to-equity ratio of Korean corporations was about five times higher than that of Taiwan and the United Kingdom. By the end of 1997, the average debt-to-equity ratio of the thirty largest Chaebol reached 519%. See Kim, id at 65.
intra-Chaebol cross guarantee, and imprudent over-investment were mainly blamed for the insolvencies.

Bigger insolvencies ensued. In 1999, Daewoo Group, the second largest Chaebol at the time became insolvent. In addition, two flagship companies of the then biggest Chaebol Hyundai – Hyundai Electronics, and Hyundai Engineering & Construction – fell into financial difficulties and had to renegotiate debt with lenders.

Banks and other lenders were exposed to, and seriously struck by, the huge wave of corporate insolvencies as loans to these insolvent Chaebols became non-performing.38 A number of lenders were themselves on the verge of falling into insolvency. Several of these were liquidated39 or bailed out through capital injection by the Korean

38 Non-performing assets are debts whose issuers have fallen into financial difficulties. See Kim, *id* at 65 (stating that Korean commercial banks and merchant banks were saddled with 28.52 trillion Won and 3.89 trillion Won, respectively, in non-performing loans by October 1997). The aggregate amount of non-performing assets held by Korean financial institutions is 82.5 trillion Won (some USD 69 billion) as of June 2000. See Sun-deok Chang, *Busil Chakwon Jeongrieu Pilyoseong Mit Hyanghu Gwaje* (The Necessity of Orderly Treatment of Non-performing Debts and Things to be Done).

39 Examples of such liquidated banks include Daedong Bank, Dongnam Bank, Dongwha Bank, Chungcheong Bank, and Kyungki Bank.
government. An effective mechanism was urgently needed to deal with the sweeping nationwide insolvency crisis.

2. INCOMPETENCE OF BANKRUPTCY INSTITUTIONS

Reorganization and liquidation were two major bankruptcy institutions that insolvent companies may choose from. As for reorganization, while Korea had a full-fledged reorganization apparatus (called “Corporate Reorganization”) similar to the Chapter 11 procedure in America, there also was a limited-scale reorganization procedure, named “Compulsory Composition.” It was a court-overseen procedure in which a renegotiation of “unsecured” debt had to be resolved by a majority vote of creditors, which was then confirmed by a court, thereby binding the entire “unsecured” debts. Secured claims were not subject to the Compulsory Composition. Until 1997, the Compulsory Composition had not been perceived as a procedure for corporate bankruptcies, and thus almost never been used by insolvent companies in the past.

A grand and immediate problem facing controlling shareholders and managers of such insolvent Chaebol companies were the fact that they could find no reason to seek

40 Examples of such banks include Korea First Bank (which later acquired by Standard Chartered Bank) and Seoul Bank.

41 In practice, secured debts were also renegotiated at the same time on an individual assent basis, although creditors’ resolution did not affect the entitlements of secured debts. Such individual secured debt renegotiation can be viewed as a workout arrangement concomitant to a bankruptcy institution.
the “Corporate Reorganization” because of rigid court practices on management and ownership of companies in the procedure. Courts had administered Corporate Reorganizations in a way that incumbent managers and controlling shareholders had been precluded from the management and ownership of the bankrupt company, even though the Corporate Reorganization Law did not invariably require it. In 1996, the Supreme Court of Korea had set a rule requiring that reorganization plans, to be approved by court, provide for cancellation of the shares held by controlling shareholders. This rule was made after some high profile scandals involving the Corporate Reorganization and in response to widespread criticisms that controllers can abuse the Corporate Reorganization to entrench their control and ownership at the expense of other constituencies including creditors. Lower-level courts in charge of bankruptcy cases had since strictly adhered to this rule. According to this rule, controlling shareholders would invariably lose ownership at the conclusion of the corporate reorganization.

42 Corporate Reorganization Law, art. 221(3), (4) provides that where the total liabilities exceed the total assets, not less than a half of the company’s issued stocks should be cancelled. The ratio of cancellation should be two thirds in the case of the stocks held by those controlling shareholders who are liable for the financial stress.

43 Korean Supreme Court Litigation Rule No. 487 (July 7, 1996). The Rule set a strict guideline to lower courts that the stocks held by dominant shareholders should be cancelled in the proceeding. The rigidity of the rule was relaxed by an amendment in 1998, which prescribed that more than two thirds of dominant stock will be cancelled only where it is objectively proved that dominant shareholders inflicted material damage to the company.
Furthermore, courts did not allow debtor-in-possession, unlike in the United States.\textsuperscript{44} Upon receipt of filing for Corporate Reorganization, the court appointed a trustee who will run the company during the procedure, and draw up and propose a reorganization plan for approval by creditors and court.\textsuperscript{45} In search of candidates for trustees, courts had rule out incumbent managers and controlling shareholders.\textsuperscript{46}

\textsuperscript{44} See Lopucki & Whitford, \textit{supra} note 21 at 679-680 (observing that upon filing of reorganization the debtor management continues in office, playing a central role in setting business plan and reorganization plan).

\textsuperscript{45} The court usually appointed trustees from a pre-arranged pool that consisted mainly of retired corporate executives and retired bank officers or employees. It usually took one to two years to have a reorganization plan resolved by creditors and confirmed by court. However, the bankrupt firm would still be managed by its trustee from the time after the reorganization plan was approved, through the termination of the reorganization proceeding. These trustees were likely to lack the requisite expertise in that particular industry as well as the appropriate incentives to maximize the firm’s value.

\textsuperscript{46} Due to the cancellation of control block and the exclusion of incumbent management from being appointed as trustees, the controllers of corporations were extremely reluctant to file for Corporate Reorganization. In 2002, there were only 10 filings with the Seoul District Court. Recently, in an effort to induce more filings, the Bankruptcy Division of Seoul District Court suggested the possibility of change in that practice, stating that it will positively contemplate to appoint a trustee from incumbent management or its nominee.
Moreover, shareholders were not entitled to vote on a reorganization plan where a bankrupt’s liabilities exceed its assets.47

Under the circumstances, controlling shareholders of Chaebols who usually hold less than a majority stake in Korea48 may exercise little, if any, bargaining power in a Corporate Reorganization procedure once it commences. The rigid practices on corporate

47 Corporate Reorganization Law, art. 129(3) (Korea). As to the rationale for this provision, see CHAE-HONG LIM & CHANG-HOON BAEK, CORPORATE REORGANIZATION LAW (HOISAGEONGRIEBEBOB) (2nd ed. 2002) 579 (noting that voting right is not permitted to shareholders since they will not be distributed at a potential liquidation).

48 Most of controlling shareholders in Korea can be characterized as “Minority Controlling Shareholder” whose control is maintained via complex pyramid or cross-holding ownership structure, in the word of Professors Bebchuk, Kraakman and Triantis. See Lucian Arye Bebchuk, Reinier Kraakman and George G. Triantis, Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights in CONCENTRATED CORPORATE OWNERSHIP 295, 296 (RANDALL K. MORCK ED., 2000) (showing that “the agency costs imposed by controlling shareholders who have a small minority of the cash-flow rights in their companies can be an order of magnitude larger than those imposed by controlling shareholders who hold a majority of the cash-flow rights”); see also Ok-rial Song, The Legacy of Controlling Minority Structure: A Kaleidoscope of Corporate Governance Reform In Korean Chaebol, 34 Law & POL’Y. INT’L. BUS. 183, 196 (2003) (positing that the controlling shareholders of Korean Chaebol do not have majority shareholders in each firm and very often less than 10% of total outstanding shares, and that Korean Chaebol have developed so-called circular-shareholdings to attain minority controlling structure).
governance in Corporate Reorganization strongly dissuaded controllers from initiating bankruptcy proceedings at all costs. This institutional feature may exacerbate the problem arising from the conflict of interests between shareholders and creditors, by deterring shareholders from initiating the Corporate Reorganization procedure. During the delayed period, controlling shareholders may possibly engage in abnormally high-risk and value-decreasing projects to the detriment of creditors, in order to grab dim upside potential.

Creditors were also reluctant to be active in seeking Corporate Reorganization. The accounting rule required financial institutions to render a greater inflexible write-down of debts against a firm under a bankruptcy proceeding, relative to the level prevailing under other types of debt renegotiation processes. In addition, the court system of Korea did not provide for a separate bankruptcy court scheme with specialized bankruptcy judges. Instead, two particular divisions of the Seoul District Court dealt with most of the major bankruptcy cases. Judges in charge of bankruptcy cases, usually remaining for a term of two years in accordance with periodic rotation practices, were likely to lack the necessary

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49 According to the then Bank Accounting Rule (Section 27), in the case where a debtor was under Corporate Reorganization proceeding, not less than 20% of the portion expected to be paid should be written down (classified as “substandard”), with the portion not expected to be repaid entirely written off. By contrast, in the case of workout procedure, the ratio of such write-down was reduced to between 2% and 20% (classified as “precautionary” or “substandard”).

50 The Seoul District Court has jurisdiction over corporations whose main office is in Seoul, which is the case for many major Chaebol companies in Korea. Similarly, other district courts have a specific division that deals with bankruptcy cases.
expertise and experience to deal effectively with business and finance complexities of the cases before them.

Faced with such unsatisfactory bankruptcy system in place, the controllers of insolvent Chaebols, with the help of their legal advisors, sought an alternative that would enable them to maintain control and ownership while restructuring debt. Their search resulted in the discovery of the Compulsory Composition. They found that although the Compulsory Composition had been a dormant apparatus until then, it could be an outlet from the impasse in that the procedure did not impact the control and ownership of a bankrupt company.\textsuperscript{51} Jinro Group was the first to file for the procedure, and succeeded in rescheduling debt by Compulsory Composition. Several Chaebols such as Kia, Haitai, Halla, and New Core sought the same solution to renegotiate debts with creditors while keeping control and ownership structures intact. In the earliest of these cases, courts permitted the use of the Compulsory Composition procedure. However, encountered with the criticism that the Compulsory Composition was being exploited to get around the obstacles preventing entrenchment via the Corporate Reorganization, courts refused to proceed with the Compulsory Composition in 1998.\textsuperscript{52} From that time, the Corporate

\textsuperscript{51} The Compulsory Composition involves only debt restructuring, leaving the ownership structure intact.

\textsuperscript{52} Decision on New Core case, Seoul District Court, Case No. 97Geo57 (1998). The court held that corporations that are members of 64 large Chaebols whose borrowings exceed certain amount were not eligible to file for Compulsory Composition by reasoning that the Compulsory Composition was designed for small companies.
Reorganization has been the sole bankruptcy institution available to large companies seeking to restructure debt.

3. CONTRACTUAL APPROACH TOWARDS VOTING IN WORKOUTS: THE ACCORD

Dissatisfied with bankruptcy institutions, lenders and insolvent companies sought out-of-bankruptcy reorganization (i.e., workout). In June 1998, major domestic financial institutions reached an agreement among themselves entitled the “Corporate Restructuring Accord” (the “Accord”), establishing a consensual voting scheme for workouts. The Accord can be characterized as a “master” agreement in that it can potentially apply to every financially distressed corporate debtor whose debt size exceeds a given threshold amount, thereby providing a general framework for voting-based workout.

According to the Accord, the principal lender of a subject debtor firm is entitled to initiate a workout procedure by convening a creditors’ meeting. The exercise of subject

53 The signatories of the Accord were 130 financial institutions, such as banks, insurance companies, investment trust companies (which managed unit trusts), and merchant banks. See Eun-Ki Kim, Major Contents and Feature of Corporate Restructuring Promotion Law, 375 Jurist 69, 70 (2001).

54 The Accord may be viewed in part as a “regulatory” effort to curb corporate bankruptcy crisis, given that regulatory agencies were said to have taken an informal role in recommending and encouraging financial firms to sign the Accord.
debts is suspended pending approval of a workout arrangement. A 3/4-majority vote in favor of a workout proposal binds all signatory financial creditors.\footnote{This indicates that each signatory firm is contractually obligated to sign and comply with a particular workout arrangement that is authorized by a workout resolution, irrespective of whether the signatory firm assents to that particular resolution.} The Accord applied to a number of insolvent Chaebols including Daewoo.\footnote{Since its inception through June 2001, the Accord had applied to workout proceedings for 104 corporate debtors. See Committee of Finance and Economy of Congress, Legislative Review Report on the Bill of the Corporate Restructuring Promotion Law (2001).}

However, the Accord did not completely eliminate the holdout problem. In particular, foreign lenders, none of which were signatories of the Accord,\footnote{Non-signatories of the Accord include foreign creditors, non-financial creditors, and even certain domestic financial creditors such as securities houses.} held substantial portions of debt against large insolvent companies, a factor that in reality caused significant holdout problems under the Accord. When a corporate debtor was subject to a workout procedure under the Accord, which meant that debts held by Accord-signatory creditors were suspended and renegotiated, foreign creditors benefited from such arrangements in recovering their debts.\footnote{Foreign creditors have resorted primarily to two methods in collecting their debts. One way was to present bank-clearable promissory notes issued by a debtor company. It was highly effective method since the failure to honor such notes will result in the suspension of financial transaction pursuant to clearing house rule, which constitutes an event of default under most of}
disproportionately from workouts. The higher the proportion of debt held by foreign creditors, the less likely domestic creditors would agree to workout.

B. LEGISLATIVE MANDATING FOR VOTING IN WORKOUTS

In 2001, the Accord was replaced with the Corporate Restructuring Promotion Law (the “CRPL”), which set up an alternate statutory reorganization scheme in the light of the drawbacks of the bankruptcy institutions and the Accord. When the CRPL was enacted, the most outstanding concern of debt recapitalization via workout in Korea was Hynix Electronics Co., Ltd, formerly known as Hyundai Electronics Co., Ltd. The CRPL supports voting in workout by providing grounds to make voting binding. The Accord is widely regarded as having laid a practical foundation for the CRPL.

To resolve this problem, the Seoul Clearinghouse Rule (article 78(1)) exempts such companies under the workout procedure from the suspension despite a dishonor of note. The other way was to reduce their debts to judgment and to levy on assets of the debtor firm.

59 See Roe, supra note 3, at 236 (indicating buoying-up effect as disproportionate benefit of the holdouts from staying out of debt recapitalization.)

60 The objective of the CRPL is prescribed as being facilitation of corporate restructuring by way of facilitating market function. See CRPL, art. 1 (Korea).

61 The legislator of the CRPL, recognizing the structural similarity with the Accord, sought to keep the continuity of workout proceedings under the Accord after the implementation of the
1. SCOPE OF APPLICATION

The Voting Scheme of the CRPL applies to debt claims held by stipulated financial institutions (the “subject financial creditors”), including, among other things, banks, insurance companies, securities houses, mutual funds, unit trust funds, asset-backed securitization funds, Korean Deposit Insurance Corporation, and Korea Asset Management Corporation. Particularly, in view of the holdout by foreign creditors under the Accord, the CRPL expands the scope of application to branches of foreign banks in Korea. As for the size of a borrower, the CRPL applies to corporate borrowers whose debts subject to the CRPL amount to KRW 50 billion (approximately US$ 50 million) or more. The CRPL furnishes a potentially powerful mechanism by which most of corporate debts, other than trade and tort claims, can be renegotiated.

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CRPL. That is, the CRPL provides that the resolutions and debt restructuring under the Accord are deemed to be rendered pursuant to the CRPL. See CRPL Addendum, art. 3.

62 The number of financial creditors that are subject to the CRPL is approximately as many as 420. In particular, securities houses, asset-backed securitization funds, KDIC and KAMCO were not the signatories of the Accord.

63 CRPL, art. 2(1)(a) (Korea).

64 CRPL, art. 2(4) (Korea).
2. WORKOUT PROCEDURE AND VOTING REQUIREMENT

The principal lender to a corporation is entitled to initiate a workout process when it deems the borrower company to have difficulty repaying debts as they become due without external financial assistance or an extraordinary borrowing.\textsuperscript{65} During the examination process that follows, which may take up to four months,\textsuperscript{66} the exercise of subject debts may be put on hold.\textsuperscript{67}

The CRPL does not separate creditors or debts into subsets of voting groups. Namely, all subject debts form a single voting group.\textsuperscript{68} However, an additional voting is required for a subgroup comprised solely of secured creditors.\textsuperscript{69} A workout proposal can be resolved by the affirmative votes of the holders of not less than three fourths in amount of the entire subject debt, and of the secured debt, respectively. Unlike voting in the Corporate Reorganization which sets dual requirements with respect to both amount of debt and number of creditors, the requirement for resolution under the CRPL is set in terms of debt amount only; hence the number of creditors is not considered in voting.

\textsuperscript{65} CRPL, art. 2(5) (Korea).

\textsuperscript{66} CRPL, art. 14(2) (Korea).

\textsuperscript{67} In principle, the stay of debt exercise is determined at the first creditors’ meeting. In exceptional cases, at the outset, the stay may tentatively be put in place by the request of the Financial Supervisory Service prior to such meeting. CRPL, art 14(1)(2) (Korea).

\textsuperscript{68} CRPL, art. 27(1) (Korea).

\textsuperscript{69} CRPL, art. 17(2) (Korea).
3. Impact on Corporate Ownership and Control

Unlike the aforementioned practices of Corporate Reorganization, a workout under the CRPL does not necessarily require change in control or ownership of the subject corporate debtor, a factor that leads managers and controlling shareholders to prefer the CRPL procedure to Corporate Reorganization. In many cases, however, contrary to their expectations, controlling shareholders ended up losing their control as a result of workout under the CRPL by way of cancellation of control block together with debt-equity conversion arrangement.

While incumbent managers usually continue running the companies, major operational goals, projections, and the asset sale plan should be approved by creditors. Additionally, creditors continuously monitor management of a debtor company by setting up an approval mechanism for day-to-day business matters such as cash in-and out-flows during the procedure and by reviewing the debtor’s compliance with the rehabilitation plan on a quarterly basis.

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70 CRPL, art. 15(1)(2) (Korea).

71 CRPL, art. 13(3) (Korea).

72 CRPL, art. 16(1)(2)(3) (Korea).
4. EXIT RIGHT OF DISSENTING CREDITORS

The CRPL provides creditors who oppose workout with an option to exit: appraisal right. Upon exercise of the option, the price and terms of the purchase shall be determined, if not agreed upon between the relevant parties, by an independent Coordination Committee based on an expert’s appraisal regarding the value of the debtor firm and the feasibility of workout. While the properly determined price, based on accurate appraisal, may minimize the possibility of distortion by large creditors, the Coordination Committee is likely to tilt in the direction of undervaluation given that the committee tends to favor successful workout.

73 Unless a creditor exercises such a put option, it will be deemed to have consented to the workout arrangement by operation of law. CRPL, art. 29(1) (Korea).

74 The Coordination Committee shall consider, in determining the purchase price and terms, an evaluation extended by a financial expert and the financial status of the debtor company. CRPL, art. 29(5). The CRPL does not further spell out the standards of appraisal.

75 Multiple values can be suggested as criteria for the calculation of such appraisal: liquidation value, reorganization value, and workout value. In February 2002, the Coordination Committee issued a decision on Hynix Semiconductor to the effect that the purchase price may be calculated on the basis of the “liquidation value” of debtor. I suspect that such liquidation value standard might not provide sufficient protection to dissenting creditors since the liquidation value might be far less than what could result from the Corporate Reorganization or the workout.
5. Linkage to Bankruptcy

The CRPL furnishes measures to facilitate the conversion of workout into bankruptcy procedure, if necessary. Under certain conditions, a workout plan may turn into a pre-packaged reorganization plan.\textsuperscript{76} New debts extended under a workout arrangement have priority over the existing unsecured debts held by the subject financial creditors.\textsuperscript{77} This statutory priority can help resolve the debt-overhang problem which a highly leveraged company encounters in seeking a profitable investment project.\textsuperscript{78}

\textsuperscript{76} CRPL, art. 20(2) (Korea).

\textsuperscript{77} CRPL, art. 18 (Korea).

\textsuperscript{78} The debt-overhang problem was initially noticed by Stewart Myers. See Stewart C. Myers, \textit{Determinants of Corporate} Borrowing, 5 J. FIN. ECON. 147, 155 (1977) (showing that how the existence of corporate debt can reduce the present value of the firm by weakening the corporation’s incentive to undertake good future investments.)
IV. ANALYSIS OF TWO RULES

A. FRAMEWORK OF ANALYSIS

1. TWO WEALTH EFFECTS OF WORKOUT

Workout may have effects on the total size of value that a subject company will be worth and the way such value will be divided among various parties. I label the former “the efficiency effect” and the latter “the value-diversion effect.” As compared to a possible outcome realizable under the bankruptcy procedure, the efficiency effect of workout may be either positive or negative. When a workout reorganization enhances the total value by saving financial distress costs, facilitating a profitable investment opportunity or otherwise, it has a positive efficiency effect. On the contrary, a workout reorganization might reduce the total value (i.e., negative efficiency effect), in particular when it leads to, or makes possible, a suboptimal (value-reducing) investment project.\(^7^9\)

\(^7^9\) A suboptimal investment can be related to the shareholders’ distorted incentives to engage in high-risk projects in the face of financial stress (which is referred to as “asset substitution”). Concession in a workout might make such high-risk investment possible. This can be viewed as an agency problem from conflict of interests between creditors and shareholders. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 334 (1976) (suggesting that the owner will have a
Turning to the value-diversion effect, a workout reorganization may result in a disproportionate allocation among creditors of the total value, and thereby making value shift among creditors. Interestingly, the Prohibit-Rule and the Mandate-Rule may cause the value-shifting to be in opposite directions. The holdout problem clearly characterizes the value-diversion effect under the Assent Scheme mandated by the Prohibit-Rule. Value flows from the workout-participating creditors to the nonparticipating creditors when a workout reorganization completes despite the holdouts. The concession by participants through the reorganization boosts the debtor’s financial capability, which enables the nonparticipating creditors to be fully or better repaid. As a result, the value of debts held by non-participants will be buoyed up by the completion of a workout.

Under the Mandate-Rule, a binding vote invariably empowers the majority to take control of important matters affecting all members, not only regarding debt restructuring but also about governance matters such as ownership of the post-workout entity. Such control power enables the controlling majority to disproportionately benefit from their control. In the context of corporate governance, controlling shareholders are generally thought to divert non-negligible private benefits from its control of corporate decision-making.80 Similarly, the major creditors who can dominate a binding vote in workout

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80 Empirical evidences suggest that there are substantial private benefits of control. See, e.g., Michael J. Barclay & Clifford G. Holderness, Private Benefits from Control of Public Corporations, 25 J. FIN. ECON. 371, 372 (1989) (suggesting the premise that “ premiums paid for
stand to disproportionately benefit from controlling such vote that is binding on all creditors subject to the Voting Scheme. I label such disproportionate benefits as “private benefits from control of workout.” For example, in exchange for yes-votes, they may receive from insiders (such as managers or shareholders) some form of side benefits such as early repayment, security interest, guarantee, or other business opportunities. They may also obtain, and benefit from, inside information in the course of the workout. More directly, the reorganization arrangement may favor major creditors over other creditors. These examples show that under the Mandate-Rule, the private benefits from control of workout amount to a disproportionate allocation of value (i.e., the value-shifting from the noncontrolling creditors to the controlling creditors).

The private benefits from control of workout may be material especially when the voting group consists of heterogeneous debts. Suppose that a firm owes only two debts (Debt 1 and Debt 2) having identical priority – the face amount and the maturity of Debt 1 and Debt 2 are ($40, T₁) and ($120, T₂), respectively. Suppose also that the firm is reasonably anticipated to generate (a) a sure cash flow of $40 at T₁, and (b) an uncertain cash flow of either $120 or $0, each with a probability of 50%, at T₂. Therefore, Debt 1 will be fully repaid with certainty at T₁ while Debt 2 will be repaid only with 50%
possibility, unless some kind of recapitalization via workout or bankruptcy institution is invoked.\textsuperscript{81} As a result, the holder of Debt 1, in anticipation of such cash flows, has no reason to consent to the pre-arrangement of a voting rule for workout given the potential conflict of interest between Debt 1 and Debt 2.\textsuperscript{82} By contrast, the holder of Debt 2 would benefit from a workout arrangement that stretches out the maturity of the two debts, thereby making the maturity of both equal, unless the contemplated workout would significantly diminish the cash flows of the firm.\textsuperscript{83} Therefore, the holder of Debt 2 has good reason to seek a workout recapitalization that would help increase its own payoffs despite the fact that it might potentially reduce the overall cash flow of the debtor firm,\textsuperscript{84} where there exists a compulsory voting scheme for the workout.\textsuperscript{85} This basic example shows that there is a potential conflict of interest between different creditors and that a

\textsuperscript{81} To cope with this kind of problem, the debt contract of Debt 2 may contain an acceleration clause that is triggered by an event of default. In this example, let us assume that such an acceleration clause does not exist or cannot be triggered for Debt 2. In this situation, the expected value of cash flows from Debt 2 will be 60.

\textsuperscript{82} By contrast, there will be no such conflict of interest among multiple holders of Debt 1.

\textsuperscript{83} In this case, the expected value of Debt 2 will increase by 15, which is shifted from Debt 1, assuming that the aggregate cash flow remains intact.

\textsuperscript{84} The possibility of such value reduction arises in part from the agency problem out of conflict of interests between debt and equity.

\textsuperscript{85} The threshold level of cash flow will be 80, given that at this point the payoff of Debt 2 under the workout is equal to that without a workout.
voting rule for a workout among heterogeneous debts may result in a reduction of the overall value, which constitutes the inefficiency cost of the Mandate-Rule.

2. VALUE-DIVERSION, DIVERGENCE, AND INEFFICIENT WORKOUTS

If there is no value-diversion effect among creditors, the interest of all creditors in a voting group will converge toward maximizing the total reorganization value. In such a case, none of the creditors will be in favor of a value-reducing workout. However, both the Prohibit-Rule and the Mandate-Rule are open to possibilities to create the value-diversion effects (in opposite directions though), which may cause the interest of some creditors who stand to disproportionately gain from such value-shift (i.e., non-pivotal creditors under the Assent Scheme, and controlling creditors under the Voting Scheme) to diverge from an efficient, optimal reorganization. Such divergence may be understood as a kind of agency problem in the context of workout reorganization.

The analysis in this Part explores the mechanisms by which the value-diversion effect hinders some efficient workouts under the Prohibit-Rule, while the value-diversion effect yields some inefficient workouts under the Mandate-Rule.

3. EXAMPLE, DENOTATION AND ASSUMPTIONS
For the analysis, we consider an imaginary Company $A$, which has just become insolvent and whose management is about to propose a workout reorganization. The timing of events is shown in Figure 1.

At time 0, the management of Company $A$ proposes a workout reorganization plan that includes debt restructuring, business restructuring, and new investment project.

At time 1, creditors of Company $A$ accept or reject the reorganization proposal under the Prohibit-Rule or the Mandate-Rule, as the case may be.

At time 2, the reorganization plan is implemented (if workout has been accepted at time 1), or the bankruptcy proceedings are undertaken (if workout has been rejected).

At time 3, the cash flows of Company $A$ will be distributed to creditors.

Let

\[ V_W = \text{total value of Company } A \text{ if the proposed workout plan is accepted and completed,} \]

\[ V_B = \text{total value of Company } A \text{ if the bankruptcy proceedings are undertaken following the failure of the workout proposal,} \]

\[ \Delta W = V_W - V_B \text{ (net efficiency gain, or loss, of the workout). } \Delta W \text{ reflects all of the benefits and costs of the workout. The workout is efficient if, and only if, } \Delta V > 0, \]
\( V_D = \) the aggregate face amount of debts owed by Company \( A \) (i.e., the minimum total value of Company \( A \) that is needed to service all debts), and

\( B = \) private benefit from control of workout (under the Mandate-Rule).
It is assumed for the analysis that

1. In the potential bankruptcy proceedings that would follow the failure of the workout proposal, creditors will receive value proportionate to the face amount of their debts, while the shareholders of Company A will receive nothing.\footnote{I make this assumption merely for the ease of illustration. However, the analysis can also explain the case of shareholders having the holdup value. The shareholders of even insolvent companies might secure some value by holdup in the bargaining process under the Chapter 11. See Lynn M. Lopucki and William C. Whitford, \textit{Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies}, 139 U. PA. L. REV. 125, 143 (1990) (finding that in twenty-one of thirty cases when companies were insolvent, creditors agreed to allow shareholder recoveries from $400,000 to $63 million). See also Lucian Arye Bebchuk, \textit{A New Approach to Corporate Reorganization}, 101 HARV. L. REV. 775, 780 (1988) (noting that shareholders often use their delaying power to extract value even in instances in which the creditors are entitle to all of the reorganization value).}

2. Creditors will make their decisions concerning the workout solely on the basis of the financial return (That is, non-pecuniary factors are not considered), and that

3. Major creditors have complete information on all the variables.
B. ANALYSIS

1. THE VOTING PROHIBITION RULE

Under the Prohibit-Rule, majority creditors may not force minority creditors to join in workout. Minority creditors are free to stay out of workout. If a workout takes place under the Prohibit-Rule, the holdout creditors may disproportionately benefit from the concession by creditors participating in the workout. Hence, value may shift from participating creditors to holdout creditors.

Under the Prohibit-Rule where the holdout problem is prevailing, creditors can be separated into two categories in terms of the incentives toward workout. One category of creditors are major creditors, each of whom is individually essential and pivotal to the completion of workout reorganization. Hence, these creditors cannot benefit by holding out because their individual holdout will inevitably result in the failure of the workout. The other group is comprised of atomic creditors whose participation, viewed individually, is non-pivotal to the completion of the workout. Note that such atomic creditors in workout, taken collectively, might be critical to the workout and thus their collective holdout might sometimes result in failure of a workout attempt.

Let $\alpha$ be the ratio of debts held by the group of major creditors. Suppose that the group of major creditors will decide their payoffs from the contemplated workout on the premise that all of the non-pivotal, minority creditors will hold out.
Under the Prohibit-Rule, workout reorganization takes place if and only if the major creditors find that their payoffs from workout are greater than those from a potential bankruptcy procedure. This will be true if and only if the expected efficiency gain of the proposed workout is at least as much as the value to be shifted to the holdout creditors.

PROPOSITION 1. Under the Prohibit-Rule, workout reorganization will occur if and only if the following inequality is true:

\[ V_W - (1 - \alpha)V_D > \alpha V_B. \]

The portion of \((1 - \alpha)V_D\) represents that the nonparticipants will be fully paid as a result of the workout. Hence, the left-hand side of the inequality (1) is the post-workout value of Company A, remaining after the full repayment to the holdouts. This remaining value will be further allocated among the participating creditors and the shareholders.\(^{87}\) The right-hand side of the inequality (1) is the value of debts held by the pivotal, major creditors in the potential bankruptcy proceedings, which constitutes the opportunity costs of these creditors in accepting workout. (Note that the shareholders are assumed to

\(^{87}\) Therefore, the inequality (1) can be a necessary condition for the creditors’ consent to the workout, rather than a sufficient condition. The sufficient condition for the creditors’ agreement to the workout will be (let \(S_W\) be the value received by the shareholders in the workout):

\[ V_W - (1 - \alpha)V_D - S_W > \alpha V_B. \]

In the text, I present the necessary condition instead of the sufficient condition in order to show more clearly the efficiency effect and the value-diversion effect.
receive nothing in the potential bankruptcy.) Equivalently, the inequality may be rearranged as follows to show noticeably the contrast of the efficiency effect with the value-diversion effect:

\[
(2) \quad V_W - V_B \,(= \Delta W) > (1 - \alpha)(V_D - V_B).
\]

The left-hand side of the inequality (2) is the efficiency effect of the proposed workout, and the right-hand side is the value-diversion effect to be gained by the holdout creditors. The inequality (2) clearly shows that under the Prohibit-Rule, a workout can complete only if the efficiency effect outweighs the value-diversion effect.

The analysis reveals both the advantages and disadvantages of the Prohibit-Rule. It is superior to the Mandate-Rule in stopping all inefficient workout attempts that take on negative efficiency effects (i.e., \(\Delta V < 0\)). In this regard, the value-diversion effect (flowing from participants to nonparticipants) serves to align the interest of major creditors with the overall efficiency because major creditors stand to benefit only from the portion of the efficiency gain exceeding the value-diversion effect. The inferiority of the Prohibit-Rule is that it may stymie some efficient workout efforts, whose expected efficiency gain falls short of the value-diversion effect.

In the analysis, the ratio of the participating creditors (\(\alpha\)) is given. By modifying the inequalities (1) and (2), we may come up with the minimum ratio of the participating creditors that is needed for the completion of workout with the level of the efficiency effect and value-diversion effect taken as given (Let \(\hat{\alpha}\) denote such minimum ratio):
\[ \hat{a} > \frac{V_D - V_W}{V_D - V_B} \]

The minimum-ratio condition shows that the minimum ratio is in inverse proportion to the size of the (positive) efficiency effect (i.e., the difference between \( V_W \) and \( V_B \)). The larger the efficiency gain, the lesser the minimum ratio of the participants.

2. The Voting Mandating Rule

Under the Mandate-Rule, minority creditors cannot hold out. Major creditors may dominate the workout procedure, and stand to disproportionately benefit from workout. It constitutes the shift of value from the noncontrolling creditors to the controlling creditors. In this regard, we may classify creditors into two different groups under the Mandate-Rule. One group is comprised of the controlling creditors, who can effectively dominate the outcome of the voting. The other group consists of the remaining, noncontrolling creditors. For the analysis, let \( \beta \) denote the ratio of debts held by the group of the controlling creditors, which can provide an effective control of the workout voting.\(^{88}\)

\(^{88}\) The Mandate-Rule should set the requisite ratio necessary for the passage of a reorganization proposal. The requisite ratio may be either simple-majority (50%) or super-majority (say, 66% or 75%). The CRPL sets 75% of the requisite ratio of voting. A question may arise: “Does \( \beta \) (the ratio of debts held by the controlling creditors) have to be at least the requisite ratio?” If \( \beta \) is greater than the requisite ratio, the control would be certain and stable. Nonetheless, the controlling creditors might exercise an effective control over voting even with \( \beta \) short of the
Under the Mandate-Rule, a workout may complete if and only if the payoffs to the controlling creditors from workout are greater than those from a potential bankruptcy. The payoffs to the controlling creditors from workout are comprised of two components: (i) the pro rata value in the workout reorganization and (ii) the private benefits from control of workout.

**Proposition 2.** Under the Mandate-Rule, a workout reorganization will occur if and only if the following inequality is true:\(^{89}\)

\[
\beta(V_W - B) + B > \beta V_B. 
\]

The left-hand side of the inequality (3) represents the controlling creditors’ payoffs from the proposed workout, which is the sum of the pro rata value and private benefits from control of workout. The right-hand side represents the value of their debts if the contractual or statutory requisite ratio. Similarly, controlling shareholders may exert effective control with ownership short of majority. The non-controlling creditors might lack information necessary to make a proper evaluation concerning the wealth effect of a proposed reorganization plan or find it unprofitable to seek to gather and assess such information. Furthermore, such minority creditors might defer such evaluation to the controlling creditors.

\(^{89}\) Viewed more precisely, the sufficient condition for the controlling creditors’ vote in favor of the workout will be (let \(S_W\) be the value to be received by the shareholders in the workout):

\[
\beta(V_W - B - S_W) + B > \beta V_B. 
\]

In the text, I present the necessary condition instead of the sufficient condition because the necessary condition helps show more clearly the efficiency effect and the value-diversion effect.
bankruptcy proceedings ensue after the failure of the workout. Rearranged, the following inequality (4) clearly contrasts the efficiency effect with the value-diversion effect:

\[
V_W - V_B (= \Delta V) > - \frac{(1 - \beta)B}{\beta}
\]

The left-hand side represents the efficiency effect of the workout, and the numerator of the right-hand side represents the value-diversion effect flowing from the noncontrolling creditors to the controllers under the Mandate-Rule (i.e., the pure portion of private benefits from control of workout voting).

The analysis shows both the advantage and disadvantage of the Mandate-Rule. It is superior to the Prohibit-Rule in facilitating all efficient workouts (i.e., \(\Delta V > 0\)). The controlling creditors can always benefit from the efficiency gain of such workout. By contrast, the inferiority of the Mandate-Rule is that it enables some inefficient workout. The controlling creditors will vote for an inefficient workout if it furnishes greater payoffs to them because of substantial private benefits that can arise from control of workout. Note that while all creditors incur the efficiency costs from an inefficient workout, the controlling creditors monopolize the private benefits from control of workout.

\[90\] Such workout reorganization may help enable the insolvent company to engage in a suboptimal and value-reducing project, especially in conjunction with shareholders’ distorted incentives in the face of financial stress.
workout. Such asymmetry might induce the controlling creditors to pursue an inefficient reorganization at the expense of the minority creditors.

3. COMPARING TWO RULES

The analysis demonstrates a clear trade-off existing between the facilitation of efficient workouts and the deterrence of inefficient workouts. The Prohibit-Rule stops every inefficient workout attempt but also hinders some efficient workout efforts. On the contrary, the Mandate-Rule makes possible every efficient workout but induces some inefficient workouts. As such, neither of the two rules may perform optimally under all circumstances.

The analysis enables us to identify certain conditions under which one of the two rules is better than the other. First, suppose that creditors of a near-insolvent company are mainly comprised of numerous atomic bondholders, who are not individually pivotal to the success of workout. In this case, the holdout problem may well substantially deter an otherwise efficient workout,91 while the concern of private benefits from control of voting is modest. Here, the Mandate-Rule that mandates the Voting Scheme may perform nicely by stopping the holdouts and aligning the interest of all creditors. Conversely, the Prohibit-Rule may exacerbate the holdout problem by blocking the introduction of the Voting Scheme.

91 See Gilson, supra note 2, at 317 (arguing that having more creditors increases the likelihood that any one creditor will hold out).
Next, suppose a different situation where a handful of financial institutions hold the majority of debt claims with minor bondholders. In this case, despite the fact that the bondholders are likely to hold out, the major financial institutional creditors alone may complete a viable workout even without a voting scheme in place. The absence of a voting scheme will cause the interest of the major creditors more likely to align with the overall efficiency. Here, the Prohibit-Rule that mandates the absence of a voting scheme may work better than the Mandate-Rule. Table 1 summarizes the contrasting features of the two opposite schemes.

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92 See id, at 317 (finding that private restructuring succeeds more often when there are fewer creditors).
Debtors, not creditors, incur *a priori* the efficiency effect of the two rules insofar as the price terms of debts properly reflect the efficiency effect.\(^9^3\) Therefore, absent a statutory intervention debtors may well have the right incentives to elect an efficient one between the Assent Scheme and the Voting Scheme *ex ante*. Both of the two rules can be seen as suboptimal in the sense that they restrict the freedom of choice by parties of a proper scheme.

\(^9^3\) *Cf.* See Jensen & Meckling, *supra* note 79, at 313 (observing that the price which minority shareholders will pay for shares will reflect the effect of the divergence between the manager’s interest and theirs).
C. Evaluating the Mandate-Rule

1. Aligning Controlling Creditors with Efficiency

Under the Mandate-Rule, an inefficient workout can be undertaken because of the private benefits from control which misaligns the interest of majority creditors from efficiency. The inequality (4) in Section B above clearly shows that the lesser the private benefits from control (i.e., \((1 - \beta)B\)) become, the less likely majority creditors accept a value-reducing workout. Reducing private benefits from control will cause the controllers’ incentives to align more closely with efficiency of workout.

Establishing legal standards for workout may help reduce opportunism by controlling creditors to divert private benefits to the detriment of the total value as good corporate law does in the context of corporate governance.\(^{94}\) The CRPL of Korea requires that debt restructuring be handled in a ‘fair and equitable’ manner, although it does not articulate what it specifically means.\(^{95}\) This abstract standard may be utilized by courts as a standard to restrict the machination of majority creditors. In making the case for repealing the Prohibit-Rule of the Trust Indenture Act, Professor Mark Roe proposed a simple and flexible standard prohibiting fraud and distortion in bond recapitalization to replace the voting prohibition of the Trust Indenture Act.


\(^{95}\) CRPL, art. 17(1) (Korea).
Increasing the requisite ratio of voting may also help reduce private benefits from controlling workout. The dual voting requirements, which set the threshold in terms of the number of creditors as well as of the debt amount, may be considered, as in Chapter 11 proceedings.96

Providing dissenting creditors with an adequate appraisal right may contribute to reduce private benefits. It serves to secure certain minimum value for minority creditors and effectively set the ceiling of private benefits from control of workout. A shortcoming of the appraisal right is that the time, costs, and uncertainty involving the appraisal might make workout reorganization more costly and less attractive. Also, there can be a great difficulty in setting a standard for valuation that would give all participants the right incentives.

2. TRADE-OFFS: FACILITATING WORKOUT AND REDUCING BANKRUPTCY COSTS

The Mandate-Rule under the CRPL shares some features with the voting regime in Chapter 11. Both institutions, without requiring a contractual ground, install a vote-based reorganization, outside or inside of bankruptcy.97 It is relatively evident that workout under the Mandate-Rule has a competitive edge over Chapter 11 in speed and flexibility.

96 11 U.S.C. § 1126(c).

97 See Lopucki & Whitford, supra note 21, at 676 (pointing out as one of advantages of bankruptcy reorganization that majorities of creditors can bind dissenting minorities through voting).
Still, Chapter 11 has its own advantages, especially in reducing the value-diversion effect (i.e., private benefits from control). The scrutiny of the court over Chapter 11 procedure may help restrain major creditors from taking private benefits, as compared to the vote-based workout procedure under the Mandate-Rule.

Here, we encounter a trade-off and dilemma involving the Mandate-Rule. On one hand, it greatly facilitates the success of an out-of-court workout by instituting a mandatory voting scheme. In doing so, however, it may not be effective in reducing bankruptcy costs because of the mandatory voting scheme. Given its powerful impact on reorganization, the workout procedure under the Mandate-Rule can be perceived as effectively alternative bankruptcy reorganization. Hence, various constituencies such as customers, suppliers, and employees would respond to the workout under the Mandate-Rule in a manner similar to the way they would respond in Chapter 11 proceedings. As a result, the Mandate-Rule might undermine the efficacy of workout in terms of saving bankruptcy costs. Ironically, while the Mandate-Rule is meant to establish an effective mechanism for facilitating reorganization outside of court, it may result in a less attractive type of workout reorganization.

The CRPL of Korea offers a powerful mechanism for facilitation of workout, but it ends up with an inferior workout that is stripped of certain useful attributes of workouts in terms of saving bankruptcy costs. The approach of the CRPL demonstrates a clear trade-off between facilitation of workouts via a statutory voting rule and some of the benefits of workouts in terms of reducing bankruptcy costs. The Mandate-Rule under the CRPL of Korea provides an opportunity for reflecting on the nature of workout. Workout
basically constitutes a contract, among various creditors and debtor, to recapitalize debt. The workout can be seen as a bargain among creditors on the belief that such bargain may bring gains to the entire group of creditors and such gains will be divided among them. A voting scheme can still be a part of the bargain so long as it is based on the consensus of participants. In this regard, there can be good reason to doubt that the CRPL procedure still takes on the nature of workout.

D. COMPARING WITH ANALYSIS ON CONTROL TRANSFER RULES

This Part’s analysis can be viewed as parallel to Professor Bebchuk’s analysis on rules governing corporate control block. With respect to the two contrary rules on the sales of control blocks (the Market Rule and the Equal Opportunity Rule), Professor Lucian Bebchuk has presented the renowned trade-offs between facilitating efficient sales of control block and stopping inefficient sales. The distinction between the paradigmatic rules is centered on whether each rule entitles minority shareholders to join the sale of a control block by a controlling shareholder. The Market Rule, widely adopted in the United States, allows controlling shareholders to sell their control blocks without letting minority shareholders share in the gains. On the contrary, the other rule, labeled as the Equal Opportunity Rule, entitles noncontrolling shareholders to participate in or otherwise benefit from the control transaction, thereby preventing the controlling

shareholder from monopolizing the gains. Professor Bebchuk observed that, from the
efficiency perspective, the Market Rule serves efficient sales but fails to deter inefficient
sales, whereas the Equal Opportunity Rule stops inefficient sales but also impedes some
efficient sales.99

A remarkable analogy can be found between the two sets of trade-offs shown by
Bebchuk and the analysis of this paper. Both sets of trade-offs result from the direction of
the value-diversion effect. When the value-diversion effect flows from minority to
controller or majority (as with the Mandate-Rule and the Market Rule), the Mandate-Rule
or the Market Rule facilitates all efficient transactions but induces some inefficient
transactions as well because of the controllers’ partial misalignment of interest with the
overall efficiency. To the contrary, when the value-diversion effect flows from controller
or majority to minority (as with the Prohibit-Rule and the Equal Opportunity Rule), the
rules stop all inefficient transactions but deter some efficient ones as well.

99 See id, at 957.
V. CONCLUSION

Workout is based on consensus among participants, while Chapter 11 procedure resorts to voting. Even in the world of workout, however, voting has been sought to facilitate the success of workout. A contribution of this paper is having identified two contrasting legal approaches to voting for workout by looking into two seemingly unrelated statutes in Korea and America. The American approach that bans voting in workouts serves to keep the consensual nature of workout intact, and thereby stops all opportunistic inefficient workout attempts but blocks some efficient workout efforts as well.

The Korean approach that mandates voting in workouts facilitates every efficient workout effort but also brings some opportunistic inefficient workout attempts. The Mandate-Rule in Korea provides an opportunity for reflecting on the nature of workout. Workout basically constitutes a bargain among various parties with differing interests, to recapitalize debt. A voting scheme can still be a part of the bargain so long as it is based on the consensus of participants. In this regard, there can be good reason to doubt that the Mandate-Rule still takes on the nature of workout. The Korea rule offers a powerful mechanism for facilitation of workout, but it may end up bringing about an inferior workout in terms of saving bankruptcy costs.