Cornell International Law Journal

Volume 40
Issue 3 *Fall 2007*

Article 3

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

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Lee, Hyun Chul (2007) "Efficient and Inefficient Debt Restructuring: A Comparative Analysis of Voting Rules in Workouts," *Cornell International Law Journal*: Vol. 40: Iss. 3, Article 3.
Available at: http://scholarship.law.cornell.edu/cilj/vol40/iss3/3

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

Hyun Chul Lee†

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Introduction

The United States and South Korea have contrasting legal rules governing workouts, or voting in debt restructuring: the Voting Prohibition Rule of the United States[1] and the Mandatory Voting Rule of South Korea.[2] In the United States, the Trust Indenture Act has long prohibited voting in a bond workout.[3] In stark contrast, South Korea has a unique statute that mandates voting in workouts among financial institutions[4] in an effort to resolve the twin problems of corporate insolvency crises and incompetent bankruptcy institutions. A workout is a contract-based debt restructuring for insolvent companies that functions as an alternative to bankruptcy.[5] Workouts are designed to preserve the value of financially distressed but economically viable companies by avoiding bankruptcy procedures.[6] Otherwise efficient workout attempts often fail in large part because numerous creditors—individually non-pivotal actors—opportunistically (but rationally) opt to stay out of workout arrangements.[7] The voting procedure is thought to help resolve the holdout problem.[8]

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1. *See* Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 232-35 (1987). The phrase "Voting Prohibition Rule" is the author's own terminology for the U.S. system of bankruptcy and workout.

2. *See generally* Corporate Restructuring Promotion Act, Law No. 6504 (2001) (S. Korea). The phrase "Mandatory Voting Rule" is the author's own terminology for the CRPA.

3. *See* Corporate Restructuring Promotion Act, No. 6504 (2001), ch. III, art. 19, 21, 22 (S. Korea).

4. *See* Corporate Restructuring Promotion Act, ch. I, art. 1.

5. *See* John McConnell & Henri Servaes, *The Economics of Pre-Packaged Bankruptcy*, *in* CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES 322, 322 (Jagdeep S. Bhandary & Lawrence A. Weiss eds., 1996). Arrangements for debt restructuring in workouts include, among other things, extending a maturity date, exchanging debt for equity, forgiving interest, and providing additional debt. For a list of similar workout debt restructuring arrangements, see *id.*

6. *See* Stuart C. Gilson, *Managing Default: Some Evidence on How Firms Choose Between Workouts and Chapter 11*, *in* CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES, *supra* note 5, at 308, 319 (observing that "[d]istressed firms can preserve more of their value by restructuring their debt privately, when possible, and thus avoi[d] chapter 11").

7. *See* Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189, 1191 (1991) (noting that creditors "with small stakes have an incentive to hold out"); Roe, *supra* note 1, at 236 (noting that the buoy-up effect for the holdouts causes workout attempts to fail).

8. *See* Gertner & Scharfstein, *supra* note 7, at 1211 (arguing that "the voting procedure can be used to internalize the effects" of reorganization and "get around the holdout . . . problem").

Encountering unprecedented large-scale corporate insolvencies in the late 1990s, South Korea enacted the Corporate Restructuring Promotion Act,[9] mandating a binding vote in workouts. This law established a vote-based workout mechanism, binding financial institutional lenders to a workout arrangement if favored by a three-fourths majority.[10] In contrast, the U.S. method laid out in the Trust Indenture Act[11] prohibits the use of a binding vote in a bond workout to change core terms of a bond issue.[12] This provision, aimed at protecting the interests of individual minority bondholders from insiders' machinations, has stopped workout reorganization via voting in cases where bond issues are the major form of corporate debt.[13] U.S. scholars and academics have challenged this U.S. voting prohibition.[14] For example, Professor Mark Roe asserts that the voting prohibition could contribute to unnecessary bankruptcies and, thus, should be repealed.[15]

The dramatic divergence between the United States and South Korean legislative solutions offers an intriguing opportunity to examine the implications that the two approaches may have for the efficiency of workout reorganization. This article develops a framework for analyzing and comparing the contrasting legal rules in these two jurisdictions.

Part I explains the two contrasting legal rules in the United States and South Korea that govern voting in workout restructuring. In the absence of statutory intervention, parties may elect whether to remain in an assent-based voluntary workout (which may be labeled the "Assent Scheme")[16] or to contract for a voting procedure (which may be labeled the "Voting Scheme").[17] Legislators may intervene, however, in two distinct ways. The United States' Voting Prohibition Rule mandates the Assent Scheme by blocking any contract for voting in workouts,[18] whereas South Korea's Mandatory Voting Rule makes the Voting Scheme compulsory, providing a statutory ground for the binding force of voting in workouts.[19]

Part II describes the corporate insolvency crisis that led South Korea to enact legislation that introduced the Mandatory Voting Rule as well as the major features of that legislation. In the late 1990s, the South Korean econ-

9. *See generally* Corporate Restructuring Promotion Act. South Korea promulgated this Act in response to serious financial emergencies.

10. *Id.* ch. III, art. 17(2).

11. Trust Indenture Act of 1939 § 316(b), 15 U.S.C. § 77 (2003).

12. The core terms subject to the voting prohibition include principal amount, interest rate, and maturity date. Roe, *supra* note 1, at 232.

13. *Id.* at 250-52.

14. *See, e.g.*, *id.*

15. *See id.* at 277-79 (asserting that the protection of individual investors through the voting prohibition needs to be reconsidered in light of the current situation where institutional investors hold most public debts).

16. In the absence of any basis of voting for a workout (contractual or statutory), a workout has to proceed on a consensual basis with dissenters being able to stay out of the debt restructuring. *See infra* Part I.B.1.

17. *See id.*

18. *See infra* Part I.C.1.

19. *See infra* Part I.C.2.

omy abruptly suffered a wave of corporate insolvency, unprecedented in its scope and scale, that eventually lead to an economic crisis in South Korea.[20] In 1997 alone, eight of the thirty largest business conglomerates in South Korea (widely known as *chaebol*)[21] became insolvent.[22] Although such *chaebol* badly needed rapid reorganization, they were very reluctant to file for corporate reorganization, South Korea's counterpart to the American chapter 11 bankruptcy, in large part because court practices did not permit incumbent managers and controlling shareholders to continue running companies during bankruptcy proceedings or to retain ownership in their companies after reorganization.[23] Also, lenders were not inclined to rely on bankruptcy institutions because they did not believe that these courts had the levels of expertise, experience, and flexibility necessary for handling complex business issues involving conflicts of interest.[24] Faced with rigid court practices, insolvent companies sought an alternate reorganization procedure through the Composition Act, a debt renegotiation procedure initially overseen by the courts, despite the fact that the procedure's legal effect is limited to unsecured debts.[25] Although the Composition Act very seldomly had been used before the South Korean economic crisis, the Composition Act instantly was favored by insolvent *chaebol* when they were informed that the procedure would leave control and ownership intact.[26] This attempt to circumvent the more traditional method was later rejected by the Seoul District Court.[27]

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20. Sandor E. Schnick, *Globalization, Bankruptcy and the Myth of the Broken Bench*, 80 AM. BANKR. L.J. 219 n.7 (2006).

21. A *chaebol* is a group of companies under common control of a controlling family or an individual, who usually holds less than majority ownership but exercises effective control by a complicated pyramid and cross ownership structure. It is a common form of corporate organization, governance, and ownership in South Korea. Pursuant to the Monopoly Regulation and Fair Trade Act, the Fair Trade Commission of South Korea announces the list of the thirty largest *chaebol* in terms of asset size every April. *See* Hwa-Jin Kim, *Living with the IMF: A New Approach to Corporate Governance and Regulation of Financial Institutions in Korea*, 17 BERKELEY J. INT'L L. 61, 63-64 (1999). Kim characterizes *chaebol* as "large groupings of related corporations under highly concentrated family or individual control and a unique pattern of unrelated diversification." *Id.* at 63.

22. *See id.* at 65 (listing the eight companies as Hanbo, Sammi, Jinro, Dainong, Kia, New Core, Haitai, and Halla). The author was personally involved in the bankruptcy and workout procedures of many of the insolvent *chaebol*, as a member of a South Korean law firm representing them. A substantial portion of the accounts regarding the South Korean bankruptcy crisis in this paper is based on the author's own experience as a lawyer for these companies.

23. Elinor Kim, *Corporate Insolvency Law and Practice in South Korea in the Aftermath of the Asian Financial* Crisis, CONN. J. INT'L. L. 155, 159-61 (2005).

24. *Id.* at 177.

25. *Id.* at 161.

26. *Id.* at 163.

27. In New Core, the Seoul District Court held that corporations who were members of the sixty-four largest *chaebol* whose borrowings exceeded twenty-five billion were not eligible to file for compulsory composition. *See* Sohn Sung-Tae, *Seoul District Court Rejects Composition Application for Corporations with Borrowings over 25 Billion Won*, KOREA ECON. DAILY, April 9, 1998, *available at* http://news.naver.com/news/read.php?mode=LSD&office_id=015&article_id=0000090365§ion_id=101&menu_id=101.

Dissatisfied with the existing bankruptcy institutions, corporate borrowers and financial lenders often engaged in workouts, establishing a voting-based workout mechanism by an agreement entitled the Corporate Restructuring Accord.[28] Corporate borrowers and financial lenders, however, encountered serious holdout problems with non-signatories, such as foreign creditors, as well as certain procedural defects.[29] Against this backdrop, the South Korean Legislature enacted the Corporate Restructuring Promotion Act. This new law required a statutory vote-based workout mechanism that would apply to debts held by all financial institutional creditors.[30] After Hynix Semiconductor Company (formerly known as Hyundai Electronics Company) utilized this mechanism,[31] a number of insolvent companies went through the vote-based workouts under the law.[32]

Part III of this paper analyzes the implications of the U.S. and South Korean legal rules for efficiency of debt restructuring. The analysis begins by identifying two effects that a workout may have on the parties' wealth. A workout may well have a significant impact on the total value of a corporate borrower (the efficiency effect). On the other hand, a workout may also affect the allocation of such value among creditors (the value-diversion effect). Each of the two voting rules has its own value-diversion effect which in turn influences the efficiency effect. Under the Voting Prohibition Rule, value may flow from the participating creditors to the non-participating creditors because the participants' concessions in a workout may boost the financial ability of corporate borrowers to repay the creditors who hold out.[33] In contrast, under the Mandatory Voting Rule, value may shift from minority creditors to majority creditors.[34] With debt restructur-

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The court reasoned that compulsory composition was designed for small companies. *Id.*

28. Kim, *supra* note 23, at 168.

29. *See id.* at 168 n. 135; *see generally* Corporate Restructuring Promotion Act.

30. *See* Kim, *supra* note 23, at 168-69.

31. *See* History of Hynix Semiconductor Co., http://www.hynix.com/eng/01_about/01_profile/profile_06.jsp (last visited Aug. 25, 2007). Hynix Semiconductor Company changed its name in March 2001 and emerged early from the CRPA in July 2005. *See id.*

32. From September 2001 to June 2007, seventy-one companies with three hundred or more employees underwent the CRPA restructuring procedures. Forty-nine of these companies successfully finished the CRPA process. *See* Lee Sun-Young, *Seventy Percent Success Rate for Big Firm Restructuring*, KOREA HERALD, July 18, 2007, *available at* http://www.kdb.co.kr/weblogic/Board?BID=25&NID=26663&ACTION=VIEW&NPAGE=16.

33. *See* Roe, *supra* note 1, at 236 (observing that a workout will leave a company to pay debt to the holdout bondholders in full).

34. Empirical evidence suggests 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). Barclay and Holderness suggest that "premiums paid for large-percentage blocks reflect the private benefits that accrue to the block owner." *Id.* at 373. They also found that "trades of large-percentage blocks of common stock are typically priced at substantial premiums to the exchange price," that the block-trade prices average twenty percent above the post-announcement exchange price, and that "[t]he average premium is $4 million (in GNP-price-deflated 1982 dollars), which represents 13% of the block-purchase price and 4% of the value of the firm's equity." *Id.* at 372.

ing 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."

This analysis also shows when efficient or inefficient workouts may take place under each rule. The Mandatory Voting Rule will facilitate any proposed efficient workout, 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 of a company, but because the workout procedure provides an opportunity to capture disproportionate benefits. The Voting Prohibition Rule, however, prevents any inefficient proposed workout, and in this regard, it is superior to the Mandatory Voting Rule. The disadvantage of the Voting Prohibition 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. Thus, there is a trade-off between the facilitation of efficient workouts and the deterrence of inefficient workouts. This article identifies certain circumstances under which one of the two rules is superior to the other. When creditors are numerous and not individually pivotal to the workout, the Mandatory Voting Rule may be more appropriate because the holdout problem may be acute. In contrast, when a handful of financial institutions hold the majority of debt claims with a few minor bondholders, the Voting Prohibition Rule is better suited because major creditors may successfully negotiate a workout with each other.

Under the Mandatory Voting Rule, reducing private benefits from control will align the majority creditors' incentives more closely with the overall efficiency of a workout. The workout procedure under the Mandatory Voting Rule can be perceived as, in effect, alternative bankruptcy reorganization because of the mandatory voting. Ironically, although the Mandatory Voting 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. A workout is a bargain to the parties, and a voting scheme can still be a part of the bargain as long as it is based on the consensus of the participants.[35] Therefore, there is good reason to suspect that the Mandatory Voting Rule in South Korea may not fall completely within the nature of a workout.

I. Two Rules on Voting in Workouts

A. Workouts: Reorganization Outside of Bankruptcy

Financial stress of an otherwise economically viable company requires an orderly reorganization of its capital (i.e., debt and equity).[36] Companies can undertake reorganization either within, or outside of, bankruptcy

35. *See* Corporate Restructuring Promotion Act, Law No. 6504, ch. III, art. 17(2) (2001) (S. Korea).

36. *See* Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 776 (1988).

procedures. Chapter 11 of the American Bankruptcy Code[37] sets the reorganization framework within bankruptcy, but reorganization outside of bankruptcy is referred to as a workout.[38]

When a company is financially stressed, both the underlying financial difficulty and the possibility of an ensuing bankruptcy procedure involve substantial costs.[39] Suppliers and consumers are reluctant to transact with a company in financial distress,[40] and skilled workers may leave the firm. Instead of concentrating solely on business operations, managers divert their time and attention to bankruptcy-related matters.[41] Furthermore, the direct costs associated with filing for a bankruptcy petition are not negligible.[42] Financial constraints force a debt-stricken company to pass up otherwise efficient investment opportunities.[43] The prolonged duration of the bankruptcy proceedings[44] serves to dissipate the value of the firm. Moreover, conflicts of interest between creditors and shareholders and between multiple creditors can be another source of significant costs arising from financial difficulties.[45] Faced with financial stress, shareholders and managers may well favor suboptimal investment opportunities with abnormally high risks.[46] The competing rush by creditors to collect debt may undermine the total value of the company as well.[47] Bankruptcy proceedings are intended to address some of these concerns by enabling the owners of the firm's assets (creditors as well as shareholders, in the context of bank-

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37. *See generally* Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 1101-1174 (2005).

38. *See* Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 677 (1993).

39. *See* Bebchuk, *supra* note 36, at 780 (observing that the inevitable delay in bankruptcy involves significant costs).

40. *See* Tim C. Opler & Sheridan Titman, *Financial Distress and Corporate Performance*, 49 J. FIN. 1015, 1016-17 (1994) (finding that highly leveraged firms lose market share in an industry downturn, reflecting a reluctance by customers to do business with distressed firms).

41. *See id.* at 1015.

42. *See* Gilson, *supra* note 6, at 311-12 (stating that "academic studies have found that average legal and professional fees reported by chapter 11 companies range from 2.8 percent to 7.5 percent of total assets"); *cf. id.* at 308 (noting that "LTV Corporation, for example, has spent over $150 million on legal and other professional fees since it filed for chapter 11 in 1986").

43. *See* Gertner & Scharfstein, *supra* note 7, 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").

44. Chapter 11 procedures normally take two to three years. *See* Roe, *supra* note 1, at 236.

45. *See* David M. Cutler & Lawrence H. Summers, *The Costs of Conflict Resolution and Financial Distress: Evidence from the Texaco-Pennzoil Litigation*, 19 RAND J. ECON. 157, 158 (1988) (concluding that, based on the dispute and subsequent settlement between Texaco and Pennzoil, "financial conflict can have substantial effects on productivity").

46. *See* LoPucki & Whitford, *supra* note 38, at 683-84 (observing that the holders of junior interests have reason to prefer high risk investments).

47. *See* Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 133 (1986).

ruptcy) to act collectively.[48]

Comparatively, reorganization via workout aims to reduce the costs that arise from financial stress and bankruptcy.[49] Creditors voluntarily consent to a package of reorganization arrangements, such as maturity date extension, debt-for-equity exchange, forgiveness of interest, and provision of additional debt, based on the belief that they stand to benefit from such voluntary concessions.[50]

Law and economic scholars have long recognized that holdouts by individually small, but collectively substantial, creditors are a principal impediment to the success of workouts.[51] The enhancement of the financial capability of a corporate debtor through a workout enables the debtor to better service debt owed to non-participants. Hence, numerous minor creditors rationally and opportunistically decline to participate in a 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.[52]

B. Voting: A Solution to Holdouts

1. *The Assent Scheme and the Voting Scheme*

Voting can be an effective way to resolve the holdout problem in a workout. With a voting scheme in place, a reorganization arrangement, passed by a vote of the creditors, binds the entire group of creditors subject to the voting scheme (voting group), notwithstanding individual dissents to the arrangement, thereby preventing minor creditors from disproportionately benefiting from a holdout.[53] The purpose of voting is that, once voted on, workout arrangements have binding force on the entire voting group. The voting scheme helps remove opportunistic incentives by virtue of such binding force and thereby aligns the interest of individual creditors with the interests of the aggregate voting group.[54]

I label the workout reorganization scheme that lacks a voting mechanism the "assent scheme," because the reorganization is effective only to the assenting creditors. In contrast, I label the workout reorganization scheme with a binding vote, irrespective of the ground of the binding force, the "voting scheme."

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48. *Id.* at 135.

49. *See* Gilson, *supra* note 6, at 319 (finding that "the professional fees incurred in exchange offers are about one-tenth of those incurred in a typical chapter 11 case").

50. In this sense, a workout can be viewed as an application of the Coase theorem. *See* Roe, *supra* note 1, 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").

51. *See, e.g.*, Gertner & Scharfstein, *supra* note 7, at 1191; Gilson, *supra* note 6, at 316.

52. *See* Gertner & Scharfstein, *supra* note 7, at 1190-191.

53. *Id.* at 1211.

54. *See id.* (positing that "the voting procedure does not allow public debtholders to be treated differently depending on their vote, whereas tendering and non-tendering public debtholders are treated differently").

2. Classifying the Voting Scheme

We may distinguish different types of voting schemes by using two different criteria: (a) the ground of the binding force and (b) the scope of the voting group. With regard to the first criterion, the ground of the binding force, a voting scheme requires a basis, either contractual or statutory, for its binding force on the voting group, which includes dissenting creditors.[55] A contractual basis exists where creditors voluntarily submit to a voting scheme through any form of consent.[56] Creditors may enter into such a voting contract before or after a financial difficulty arises. In contrast, a statutory basis arises from a law that gives voting binding force and thereby mandates a voting-based workout.[57] A statutory ground within bankruptcy can be found in chapter 11 of the Bankruptcy Code, which uses a voting scheme for reorganization via bankruptcy.[58] With regard to the second criterion, scope of the voting group, debts can be either homogeneous or heterogeneous among the group with respect to their terms, such as priority, maturity date, and interest rate. A homogeneous voting group consists of debts having identical terms; a heterogeneous voting group is comprised of debts having different terms.[59] For example, a voting group that consists of both secured long-term bank loans and unsecured short-term commercial papers is 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 encompasses few, 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 just 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 creditor group in the aggregate. This type of divergence may result in an inefficient reorganization.[60]

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55. *See, e.g.*, Patrick Bolton & David S. Scharfstein, *Optimal Debt Structure and the Number of Creditors*, 104 J. Pol. Econ. 1, 17 (1996) (providing an example of indentures in credit agreements).

56. *See, e.g.*, *id.*

57. *See, e.g.*, Bankruptcy Reorganization Act, 11 U.S.C. § 1126(c)-(d) (2005).

58. *Id.*; *see also* LoPucki & Whitford, *supra* note 38, at 677 (pointing out that one of the advantages of bankruptcy reorganization is that "specified majorities of creditors can bind dissenting minorities of the same class through voting").

59. *See, e.g.*, Baird, *supra* note 47, at 131.

60. *See, e.g.*, *id.* at 132-33. See *infra* Part III for a discussion of the mechanisms by which major creditors' incentives may deviate from the total value maximization because of such misalignment of interest.

C. Two Statutory Interventions with Voting: Prohibition and Mandate

In the absence of statutory intervention, parties may freely choose between a voting scheme and an assent scheme. However, the United States and South Korea have two starkly contrasting forms of statutory interventions. The United States' rule prohibits creditors from voluntarily submitting to a voting scheme,[61] whereas the South Korean rule sets up and mandates such a scheme.[62]

1. *The United States: The Voting Prohibition Rule*

The American rule, the Voting Prohibition Rule, mandates the assent scheme by blocking or invalidating parties' voluntary submission to a voting scheme.[63] Section 316(b) of the Trust Indenture Act bans any binding vote by bondholders, based on a majority action clause in a bond indenture, to change any core term, such as principal amount, interest rate, or maturity date of a bond issue.[64] The prohibition is meant to prevent insider bondholders (who may hold a greater percentage of shares as well) and the investment banks (who are driven by pursuit of business opportunities) from pursuing their own interests at the expense of the other bondholders.[65]

The Voting Prohibition Rule stops a voting-based workout, a presumably effective way to solve the holdout problem.[66] Although exchange offers conditioned on exit consent,[67] which is intended to strip untendered debts of covenant protections, have been used as a substitute for voting,[68] they may not necessarily eliminate the holdout problem.[69] Professor Mark Roe proposed that the Voting Prohibition Rule be repealed and replaced with a flexible standard prohibiting fraud and distortions in bond recapitalizations.[70]

2. *South Korea: The Mandatory Voting Rule*

The Mandatory Voting Rule, by providing a statutory source for the binding force of voting, sets up a voting scheme without requiring creditors

61. *See* Trust Indenture Act of 1939 § 316(b); 15 U.S.C. § 77 (2003).

62. Corporate Restructuring Promotion Act, Law No. 6504, ch. III, art. 17 (2001) (S. Korea).

63. *See* Roe, *supra* note 1, at 232.

64. *Id.*

65. *See id.* at 251-52.

66. *Id.* at 239-40.

67. The exit consent is based on the Trust Indenture Act's failure to prohibit a simple- or super-majority vote to change or eliminate covenants of a nominal debt amount. *Id.* at 248.

68. *See* Gertner & Scharfstein, *supra* note 7, at 1191 (noting that, due to the Trust Indenture Act, public debt restructurings almost always involve an exchange of new securities and cash for the original debt).

69. *See* Roe, *supra* note 1, at 247 (maintaining that an exit consent is not assured of diminishing the buoying-up effect accompanying the holdout problem); *see also* Gertner & Scharfstein, *supra* note 7, at 1191.

70. *See* Roe, *supra* note 1, at 232-35.

to voluntarily submit to such a scheme.[71] The Corporate Restructuring Promotion Act of South Korea constitutes a unique example of the mandatory voting rule.[72] Under this law, a three-fourths majority vote (in terms of debt amount held) is binding on all financial institution creditors in South Korea.[73]

II. The Mandatory Voting Rule of South Korea

A. Background

1. *Crisis of Corporate Insolvencies*

The South Korean economy abruptly suffered severe hardship in the late 1990s.[74] The well-known economic crisis began with a series of large-scale corporate insolvencies in 1997[75] whose scope and scale were tremendous and unprecedented.[76] In 1997 alone, eight of the thirty largest business conglomerates, or *chaebol*, became insolvent and were unable to repay their overdue debts.[77] In the first half of the year, two major *chaebol*, Hanbo and Sammi, filed for corporate reorganization, the South Korean counterpart to chapter 11 bankruptcy.[78] In the latter half of the year, more *chaebol* such as Jinro, Kia, New Core, Haitai, Halla, and Dainong became insolvent.[79] The insolvencies were mainly blamed on high leverage,[80]

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71. *See* Corporate Restructuring Promotion Act, Law No. 6504, ch. III, art. 17 (2001) (S. Korea).

72. *See, e.g., id. See generally* Sandy Shandro, *U.K.'s Chapter 11 Plan: Schemes of Arrangement*, 25 AM. BANKR. INST. L. REV. 30 (2006) (explaining that the United Kingdom's regime on restructuring and voting schemes resembles that of the United States more than that of South Korea).

73. Corporate Restructuring Promotion Act, ch. III, art. 17. The Act applies to every conceivable form of domestic financial institution, including domestic branches of foreign banks. The Act sets up a heterogeneous voting group because financial institutions' held debts are subject to the voting scheme irrespective of their terms. Kim, *supra* note 23, at 168.

74. *See* ORG. FOR ECON. COOPERATION & DEV., OECD REVIEWS OF REGULATORY REFORM: REGULATORY REFORM IN KOREA 11 (2000).

75. *See* NAM-KEE LEE, TOWARD A MATURE MARKET ECONOMY: COMPETITION LAW & POLICY IN KOREA 3-10 (2002) (describing the practices that led to the corporate insolvencies in the late 1990s).

76. Prior to 1997, the bankruptcy of major South Korean corporations was exceptional and anecdotal, due in part to preferential financial support from banks in the form of additional loans. For this reason, the importance of bankruptcy institutions had not been previously well-recognized. *See* ORG. FOR ECON. COOPERATION & DEV., *supra* note 74, at 23, 37.

77. *See* Kim, *supra* note 21, at 65 (reporting that some large *chaebol* went into bankruptcy in 1997, including Hanbo, Sammi, Jinro, Dainong, Kia, New Core, Haitai, and Halla).

78. YOUNGJAE LIM, KOREA DEVELOPMENT INSTITUTE, RESTRUCTURING OF CORPORATE SECTOR AND CONGLOMERATES IN POST-CRISIS KOREA (2003).

79. *Id.*

80. The average debt-to-equity ratio of South Korean corporations was about five times higher than that of Taiwan and the United Kingdom. *See* 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, 191 (2003). By the end of 1997, the average debt-to-equity ratio of the thirty largest chaebol reached 519 percent of shareholder equity. *See* Kim, *supra* note 21, at 64.

intra-*chaebol* cross guarantees, and imprudent over-investment.[81]

Bigger insolvencies ensued. In 1999, Daewoo Group—the second largest *chaebol* at the time—became insolvent.[82] In addition, Hyundai Electronics and Hyundai Engineering & Construction, two flagship members of the then-largest *chaebol*, Hyundai, fell into financial difficulties and had to renegotiate debt with lenders.[83]

Banks and other lenders were exposed to, and seriously struck by, the huge wave of corporate insolvencies as loans to these insolvent *chaebol* became non-performing.[84] A number of lenders verged on insolvency themselves.[85] Several of these lenders were liquidated[86] or bailed out through capital injections from the South Korean government.[87] An effective mechanism was urgently needed to deal with the sweeping nationwide insolvency crisis.

2. *Incompetence of Bankruptcy Institutions*

Reorganization and liquidation are the two major bankruptcy institutions between which insolvent companies may choose. As for reorganization, while South Korea had a full-fledged reorganization apparatus, the Corporate Reorganization Act, which is similar to the chapter 11 procedure in the United States,[88] there also was a limited-scale reorganization procedure, the Composition Act.[89] The latter was a court-overseen procedure in which a majority vote of creditors had to resolve a renegotiation of unsecured debt, which was later confirmed by a court, thereby binding the entirety of unsecured debts.[90] Secured claims were not subject to the Com-

81. *See* ORG. FOR ECON. COOPERATION & DEV., *supra* note 74, at 37-38 (describing inadequacies in pre-1997 insolvency procedures as well as the reforms of reorganization procedures in 1998 and 1999).

82. Don Kirk, *For Daewoo's Founder, Pride Before the Fall*, N.Y. TIMES, Feb. 23, 2001, at W1.

83. *See* Tong Whan Park, *South Korea in 1998: Swallowing the Bitter Pills of Restructuring*, 39 ASIAN SURVEY 133, 138 (1999). For more information on the *Hyundai chaebol*, see Peter M. Beck, *Revitalizing Korea's Chaebol*, 38 ASIAN SURVEY 1018, 1024-30 (1998).

84. Non-performing assets are debts whose issuers have fallen into financial difficulties. *See* KOREA ASSET MANAGEMENT CORP. (KAMCO), REPORT ON NON-PERFORMING ASSET MANAGEMENT FUND 23 (2001); *see also* Kim, *supra* note 21, at 65 (stating that by October 1997, South Korean commercial banks and merchant banks were saddled with 28.52 trillion won and 3.89 trillion won, respectively, in non-performing loans). South Korean financial institutions' non-performing loans amounted to 100 trillion won by October, 2001. *See id.* at 154-59.

85. *See* Kim, *supra* note 21, at 65.

86. Examples of such liquidated banks include Daedong Bank, Dongnam Bank, Dongwha Bank, Chungcheong Bank, and Kyungki Bank. *See* John Burton, *South Korean Banks Forced Into Mergers*, FIN. TIMES, June 29, 1998, at 4.

87. Examples of such banks include Korea First Bank (which was later acquired by Standard Chartered Bank) and Seoul Bank. *See* Sheryl WuDunn, *Bankruptcy the Asian Way: No Sinking, No Swimming, Just Floating Face Down*, N.Y. TIMES, Sept. 8, 1998, at C1.

88. *See* Kim, *supra* note 23, at 164.

89. *See id.* at 163.

90. *See id.*

position Act.[91] Until 1997, the Composition Act had not been perceived as a procedure for corporate bankruptcies and, thus, had almost never been used by insolvent companies in the past.[92]

Controlling shareholders and managers of such insolvent *chaebol* companies immediately faced the problem that they could find no reason to seek corporate reorganization because of rigid court practices on management and ownership of companies in the procedure.[93] Courts had administered corporate reorganizations in such a way that incumbent managers and controlling shareholders had been precluded from managing or owning the bankrupt company,[94] even though the Corporate Reorganization Act did not necessarily require this.[95] In 1996, the Supreme Court of South Korea had set a rule requiring that reorganization plans seeking court approval provide for cancellation of the shares held by controlling shareholders.[96] This rule was made after high profile scandals involving corporate reorganization and in response to widespread criticisms that controllers could abuse corporate reorganization to entrench themselves at the expense of other constituents, including creditors. Lower-level courts in charge of bankruptcy cases after the ruling have since strictly adhered to this requirement. According to this rule, controlling shareholders would invariably lose ownership at the conclusion of corporate reorganization.[97]

Furthermore, in contrast to practices in the United States, South Korean courts did not allow for debtors-in-possession.[98] Upon receipt of a filing for corporate reorganization, the court would appoint a trustee to run the company during the procedure and draw up and propose a reorganization plan for approval by creditors and the court.[99] In search of candidates

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91. In practice, secured debts were renegotiated at the same time on an individual assent basis, although creditors' resolutions 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. *See id.*

92. *See id.*

93. *See id.* at 164.

94. *See id.*

95. Corporate Reorganization Act, Law No. 172, art. 221(3)-(4) (1952) (S. Korea), provides that where total liabilities exceed total assets, not less than half of a company's issued stock shall be cancelled and two-thirds of the stock held by controlling shareholders who are liable for the financial stress shall be cancelled.

96. *See* CHOI DU-YUL, PROBLEMS AND WAYS TO IMPROVE THE CURRENT SYSTEM OF CORPORATE RESTRUCTURING 20 (2001), *available at* http://www.fki.or.kr/Common/Download.aspx?id=0b18c92f-4757-4441-8daf-b57ba5e3771f. The Supreme Court Litigation Rule No. 487 stated that the stocks held by dominant shareholders should be cancelled in the proceeding. 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 on the company. *See* Kim, *supra* note 23, at 164.

97. *See* Kim, *supra* note 23, at 164.

98. *See* LoPucki & Whitford, *supra* note 38, at 679-80 (observing that upon filing for reorganization, the debtor's management continued in office and played a central role in setting the business and reorganization plan).

99. *See* Kim, *supra* note 23, at 165-67, 175. The court usually appointed trustees from a pre-arranged pool that consisted mainly of retired corporate executives and retired bank officers and employees. It usually took one to two years to have a reorganization plan resolved by creditors and confirmed by the court. However, the bankrupt

for trustees, courts had ruled out incumbent managers and controlling shareholders.[100] Furthermore, shareholders were not entitled to vote on a reorganization plan where a bankrupt company's liabilities exceeded its assets.[101]

Under these circumstances, controlling shareholders of *chaebol*—who usually hold less than a majority stake[102]—could exercise little, if any, bargaining power in a corporate reorganization procedure once it commenced.[103] The rigid practices on corporate governance in corporate reorganization strongly dissuaded controllers from initiating bankruptcy proceedings at all costs. This institutional feature could exacerbate the problem arising from the conflicting interests of shareholders and creditors by deterring shareholders from initiating the corporate reorganization procedure. During the delayed period, controlling shareholders could engage in abnormally high-risk and value-decreasing projects to the detriment of creditors in order to make a grab for dim upside potential.

Creditors were also reluctant to actively seek corporate reorganization. The Accounting Rule required financial institutions to render, relative to the level prevailing under other types of debt renegotiation processes, a more inflexible write-down of debts against a firm under a bankruptcy pro-

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firm still would be managed by its trustee from the time the reorganization plan was approved through the termination of the reorganization proceeding. Trustees were likely to lack the requisite expertise in the particular industry as well as the appropriate incentives to maximize the firm's value.

100. Due to the cancellation of the control block and because incumbent managers were excluded 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 the Seoul District Court suggested the possibility of change in that practice, stating that it will positively contemplate appointing a trustee from incumbent management or its nominee. *See* JAEWAN PARK, THE WORLD BANK, GLOBAL INSOLVENCY LAW DATABASE: SOUTH KOREA §§ 1.4, 3.6, 3.8, 4.4, 4.6, 4.9, 7.4.2, 8.1 (2003); *see also* Kim, *supra* note 23, at 164.

101. The voting right was not extended to shareholders because they did not stand to receive any distributions upon liquidation. Corporate Reorganization Act, Law No. 172, art. 129(3) (1952) (S. Korea). As to the rationale for this provision, see CHAE-HONG LIM & CHANG-HOON BAEK, CORPORATE REORGANIZATION LAW (HOISAJEONGRIBEOB) 579 (2d ed. 2002).

102. Most controlling shareholders in Korea can be characterized as "minority controlling shareholders," whose control is maintained via a complex pyramid or cross-holding ownership structure. *See* Lucian Arye et al., *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* Song, *supra* note 80, at 196 (positing that "the controlling shareholders of a Korean chaebol do not have majority shares in each firm, and very often less than 10% of total outstanding shares are sufficient to effectively gain control over the group companies" and that Korean *chaebol* have developed so-called circular shareholdings to attain minority controlling structure).

103. *See id.*

ceeding.[104] In addition, the South Korean court system did not provide for a separate bankruptcy court with specialized bankruptcy judges.[105] Instead, two particular divisions of the Seoul District Court dealt with most of the major bankruptcy cases.[106] Judges in charge of bankruptcy cases, usually remaining for a two-year term in accordance with periodic rotation practices, were likely to lack the necessary expertise and experience to deal effectively with the business and financial complexities of the cases before them.

Faced with such an unsatisfactory bankruptcy system, the controllers of insolvent *chaebol*, 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 compulsory composition.[107] They found that although compulsory composition had been a dormant apparatus until then, it could be a way out from the impasse in that the procedure did not impact the control and ownership of a bankrupt company.[108] Jinro Group was the first to file for the procedure and succeeded in rescheduling debt via the Composition Act.[109] Several *chaebol* such as Kia, Haitai, Halla, and New Core sought the same solution to renegotiate debts with creditors while keeping control and ownership structures intact.[110] In the earliest of these cases, courts permitted the use of the Composition Act procedure.[111] However, encountering criticism that the Composition Act was being exploited to get around the obstacles preventing entrenchment via corporate reorganization, courts refused to proceed with the Composition Act in 1998.[112] From that time, corporate reorganization has been the sole bankruptcy institution available to large companies seeking to restructure debt.

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104. According to § 27 of the version of the South Korean Bank Accounting Rule then in effect, if a debtor was under corporate reorganization proceedings, then not less than 20% of the portion expected to be paid could be written down (classified as "substandard"), with the portion expected not to be repaid written off. In contrast, in the case of a workout procedure, the ratio of such a write-down was between 2% and 20% (classified as "precautionary" or "substandard").

105. A separate bankruptcy court is characteristic of the U.S. legal system. Administrative Office of the U.S. Courts, United States Bankruptcy Courts, http://www.uscourts.gov/bankruptcycourts.html (last visited Aug. 25, 2007).

106. The Seoul District Court has jurisdiction over corporations whose main office is in Seoul, which is true for many major *chaebol* companies in South Korea. Other district courts also have a specific division that deals with bankruptcy cases.

107. *See* Composition Act, Law No. 997, ch. I, art. I (1998) (S. Korea).

108. The Composition Act involves only debt restructuring, leaving the ownership structure intact. *See* Kim, *supra* note 23, at 163.

109. John A. Mathews, *Fashioning a New Korean Model Out of the Crisis* (Japan Policy Research Inst., Working Paper No. 46, 1998), *available at* http://www.jpri.org/publications/workingpapers/wp46.html.

110. *See id.*

111. *See* Kim, *supra* note 23, at 163.

112. Kim, *supra* note 23, at 167. For a discussion of the Seoul District Court's holding, see *supra* note 27 and accompanying text.

3. Contractual Approach Towards Voting in Workouts: The Accord

Dissatisfied with bankruptcy institutions, lenders and insolvent companies sought reorganizations outside of bankruptcy, or workouts. In June 1998, major South Korean financial institutions reached an agreement among themselves, entitled the Corporate Restructuring Accord (Accord),[113] establishing a consensual voting scheme for workouts.[114] 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 workouts.

Under the Accord, the principal lender of a subject debtor firm is entitled to initiate a workout procedure by convening a creditors' meeting.[115] The exercise of subject debts is suspended pending approval of a workout arrangement.[116] A three-fourths majority vote in favor of a workout proposal binds all signatory financial creditors.[117] The Accord applied to a number of insolvent *chaebol*, including Daewoo Group.[118]

The Accord did not completely eliminate the holdout problem. Foreign lenders—none of which were signatories to the Accord[119]—held substantial portions of the debts of large insolvent companies, a factor that caused significant holdout problems under the Accord. When a corporate debtor was subject to a workout procedure under the Accord, resulting in the suspension and renegotiation of debts held by Accord-signatory creditors, foreign creditors benefited from such arrangements in recovering their debts.[120] Foreign creditors thus stood to gain disproportionately from

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113. The signatories of the Accord were 130 financial institutions, such as banks, insurance companies, investment trust companies (which manage unit trusts), and merchant banks. *See* National Assembly Member Un-Tae Kang, Report on Bill for the Corporate Restructuring Act 7 (2001), *available at* http://likms.assembly.go.kr/bill/jsp/BillDetail.jsp?bill_id=016943.

114. The Accord may be viewed in part as a "regulatory" effort to curb the 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.

115. *See* CHAN-HYUN SOHN, KOREA'S FIRST CORPORATE RESTRUCTURING SINCE THE FINANCIAL CRISIS 45 (2002), *available at* http://www.kiep.go.kr/publication/std_rept_view.asp?num=131689&sCate=013001&lTp=r&nowPage=7&listCnt=15#.

116. *See id.*

117. Such a vote contractually obliges each signatory firm to sign and comply with any workout arrangement that is authorized by a workout resolution irrespective of whether the signatory firm assents to that particular resolution.

118. From its inception until June 2001, the Accord was applied to workout proceedings for 104 corporate debtors. *See* COMM. OF FIN. & ECON. OF CONG., LEGISLATIVE REVIEW REPORT ON THE BILL OF THE CORPORATE RESTRUCTURING PROMOTION ACT (2001).

119. Non-signatories of the Accord include foreign creditors, non-financial creditors, and even certain domestic financial creditors such as securities houses.

120. In collecting their debts, foreign creditors primarily resorted to two methods. One was to present bank-clearable promissory notes issued by a debtor company. This was highly effective because the failure to honor such notes would result in the suspension of financial transactions pursuant to the Seoul Clearinghouse Rule, which constitutes an event of default under most debt covenants. To resolve this problem, the Seoul Clearinghouse Rule, art. 78(1), now exempts such companies from suspension despite

workouts.[121] The higher the proportion of debt held by foreign creditors, the less likely domestic creditors would agree to a workout.[122]

B. Legislative Requirements for Voting in Workouts

In 2001, the Corporate Restructuring Promotion Act (CRPA), which set up an alternate statutory reorganization scheme in light of the drawbacks of the bankruptcy institutions and the Accord, replaced the Accord.[123] When the CRPA was enacted, the most outstanding concern with debt recapitalization via workout in South Korea was Hynix Electronics Company, formerly known as Hyundai Electronics Company. The CRPA supports voting in workout by providing the basis for making a vote binding.[124] The Accord is widely regarded as having laid a practical foundation for the CRPA.[125]

1. *Scope of Application*

The voting scheme of the CRPA applies to debt claims held by stipulated financial institutions (subject financial creditors), including, among others, banks, insurance companies, securities houses, mutual funds, unit trust funds, asset-backed securitization funds, the Korean Deposit Insurance Corporation, and the Korea Asset Management Corporation.[126] Particularly, in view of the holdout by foreign creditors under the Accord, the CRPA expands the scope of its application to branches of foreign banks located in South Korea.[127] With regard to the size of borrowers, the CRPA applies to corporate borrowers whose debts subject to the CRPA are greater than or equal to 50 billion South Korean won (KRW), which is approximately $50 million U.S. dollars.[128] The CRPA furnishes a potentially powerful mechanism by which most corporate debts, other than trade and tort claims, can be renegotiated.

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failing to honor a note. The other method was to receive judgment on debts and then obtain levies on the assets of the debtor.

121. *See* Roe, *supra* note 1, at 236 (characterizing the buoying-up effect as a disproportionate benefit for the holdouts from staying out of debt recapitalization).

122. *Id.*

123. The objective of the CRPA is to facilitate corporate restructuring by facilitating market function. *See* Corporate Restructuring Promotion Act, Law No. 6504, ch. I, art. 1 (2001) (S. Korea); *see also* Kim, *supra* note 23, at 168-69.

124. *See* Corporate Restructuring Promotion Act, ch. III, art. 17.

125. The drafters of the CRPA, recognizing the structural similarity to the Accord, provided that resolutions and debt restructuring under the Accord are deemed to be rendered pursuant to the CRPA. *See* Corporate Restructuring Promotion Act, Addenda, art. 3; *see also* Kim, *supra* note 23, at 169.

126. Corporate Restructuring Promotion Act, ch. I, art. 2(1). As of September 2001, approximately 420 financial creditors were subject to the CRPA. *See* Park Hyun-dong, *Minimizing Bank Management for Faltering Enterprises*, KUKMIN ILBO, Sept. 27, 2001 (S. Korea), *available at* http://news.naver.com/news/read.php?mode=LSD&office_id=005&article_id=0000071324§ion_id=101&menu_id=101.

127. Corporate Restructuring Promotion Act, ch. I, art. 2(1)(a).

128. *Id.* ch. 1, art. 2(4).

2. *Workout Procedure and Voting Requirement*

The principal lender to a corporation is entitled to initiate a workout process when the lender deems the borrower company to have difficulty repaying debts as they become due without external financial assistance or an extraordinary borrowing.[129] During the examination process that follows, which may take up to four months,[130] the exercise of subject debts may be put on hold.[131]

The CRPA does not separate creditors or debts into subsets of voting groups. Instead, all subject debts form a single voting group.[132] However, an additional vote is required for a subgroup comprised solely of secured creditors.[133] A workout proposal can be approved by the affirmative votes of the holders of three-fourths of the entire subject debt and the secured debt.[134] Unlike voting in corporate reorganization, which has requirements with respect to both amount of debt and number of creditors,[135] the requirement for approval under the CRPA is set in terms of debt amount only.[136] Therefore, the number of creditors is not considered in voting.

3. *Impact on Corporate Ownership and Control*

Unlike a corporate reorganization, a workout under the CRPA does not necessarily require a change in control or ownership of the subject corporate debtor, a factor that leads managers and controlling shareholders to prefer the CRPA procedure to corporate reorganization. In many cases, however, contrary to their expectations, controlling shareholders have lost control as a result of workouts under the CRPA by way of cancellation of a control block, together with debt-equity conversion arrangements.

While incumbent managers usually continue running the companies after the CRPA procedure, creditors should approve major operational goals, projections, and an asset sale plan.[137] 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-flows and out-flows,[138] and by reviewing the debtor's compliance with the rehabilitation plan on a quarterly basis.[139]

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129. *Id.* ch. I, art. 2(5).

130. *Id.* ch. III, art. 14(2).

131. In principle, the stay of debt exercise is determined at the first creditors' meeting. In exceptional cases, the stay may tentatively be put in place by the request of the Financial Supervisory Service prior to such a meeting. *Id.* ch. III, art. 14(1).

132. *Id.* ch. IV, art. 27(1).

133. *Id.* ch. III, art. 17(2).

134. *Id.* ch. III, art. 17(2).

135. David Arthur Skeel Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461 (1992).

136. Corporate Restructuring Promotion Act, ch. I, art. 2(4).

137. *Id.* ch. III, art. 15(1)-(2).

138. *Id.* ch. III, art. 13(3).

139. *Id.* ch. III, art. 16(1).

4. *Exit Right of Dissenting Creditors*

The CRPA provides creditors who oppose a workout with an exit option via an appraisal right.[140] Upon exercise of the option, if the relevant parties do not agree to the price and terms of the purchase, an independent Coordination Committee shall determine them based on an expert's appraisal regarding the value of the debtor firm and the feasibility of a workout.[141] Although a properly determined price, based on accurate appraisal,[142] 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 a successful workout.[143]

5. *Linkage to Bankruptcy*

The CRPA provides measures to facilitate the conversion of a workout into a bankruptcy procedure if necessary.[144] Under certain conditions, a workout plan may turn into a pre-packaged reorganization plan.[145] New debts extended under a workout arrangement have priority over the existing unsecured debts held by the subject financial creditors.[146] This statutory priority can help resolve the debt-overhang problem that a highly leveraged company encounters in seeking a profitable investment project.[147]

III. Analysis of the Two Rules

A. Framework of the Analysis

1. *Two Wealth Effects of a Workout*

A workout may have effects on the total value of a subject company 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

140. Unless a creditor exercises such an appraisal right, it will be deemed to have consented to the workout arrangement by operation of law. *Id.* ch. IV, art. 29(1).

141. In determining the purchase price and terms, the Coordination Committee is to consider an evaluation extended by a financial expert and the financial status of the debtor company. *Id.* ch. IV, art. 29(5). The CRPA does not further spell out the standards of appraisal.

142. 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 a debtor. Such a liquidation value standard might not provide sufficient protection to dissenting creditors because the liquidation value might be far less than what could result from the Corporate Reorganization or the workout.

143. Corporate Restructuring Promotion Act, ch. IV, art. 29(5).

144. *See generally id.* The Act stimulated the South Korean economy partly because of its flexibility.

145. *Id.* ch. III, art. 20(2); *see also id.* ch. III, art. 20(1).

146. *Id.* ch. III, art. 18.

147. Stewart Myers initially noticed the debt-overhang problem. *See* Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147, 155 (1977) (demonstrating 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").

compared to a possible outcome realizable under the bankruptcy procedure, the efficiency effect of a workout may be either positive or negative. When workout reorganization enhances the total value by saving financial distress costs, facilitating a profitable investment opportunity, or otherwise, it has a positive efficiency effect. In contrast, workout reorganization might reduce the total value and, thus, have a negative efficiency effect when it leads to, or makes possible, a suboptimal, or value-reducing, investment project.[148]

Turning to the value-diversion effect, workout reorganization may result in a disproportionate allocation among creditors of the total value, thereby making a value shift among creditors. Interestingly, the Voting Prohibition Rule and the Mandatory Voting Rule may shift value in opposite directions. Under the assent scheme that the Voting Prohibition Rule mandates, the holdout problem gives rise to the value-diversion effect. Whenever a workout reorganization is completed despite the holdouts, value flows from those creditors participating in the workout to the nonparticipating creditors. Participants' concessions in the reorganization boost 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 nonparticipants is buoyed by the completion of a workout.

Under the Mandatory Voting Rule, a binding vote invariably empowers the majority to take control of important matters affecting all members, including debt restructuring and governance matters such as ownership of the post-workout entity. Such control power enables the majority to disproportionately benefit from their control. In the context of corporate governance, controlling shareholders are generally thought to divert non-negligible private benefits via control of corporate decision-making.[149] Similarly, the major creditors who can dominate a binding vote in a workout stand to disproportionately benefit from controlling such a vote, which is binding on all creditors subject to the voting scheme. I label such disproportionate benefits "private benefits from control of workout." For example, in exchange for "yes" votes, majority creditors may receive side benefits from managers or major shareholders, such as early repayment, security interest, guarantee, or other business opportunities. They may also obtain and benefit from inside information over the course of the workout. More directly, the reorganization arrangement may favor major creditors over other creditors. These examples show that under the

148. A suboptimal investment can result from shareholders' distorted incentives to engage in high-risk projects in the face of financial stress, which is referred to as "asset substitution." Concessions in a workout might make such high-risk investment possible. This can be viewed as an agency problem from conflicts 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 strong incentive to engage in activities which promise very high payoffs if successful even if they have a very low probability of success").

149. Empirical evidence suggests that there are substantial private benefits of control. *See supra* note 34.

Mandatory Voting Rule, the private benefits from control of workout amount to a disproportionate allocation of value (i.e., value-shifting from non-controlling creditors to controlling creditors).

The private benefits from control of a workout may be material, especially when the voting group holds heterogeneous debts. Suppose, for example, that a firm owes only two debts (*Debt 1* and *Debt 2*), having identical priority. The face amount of *Debt 1* is $40 and its maturity is T_1, whereas *Debt 2* has a face amount of $120 and a maturity of T_2. Suppose also that the firm is reasonably anticipated to generate: (a) a sure cash flow of $40 at T_1 and (b) an uncertain cash flow of either $120 or $0, each with a probability of 50%, at T_2. Therefore, *Debt 1* will be fully repaid with certainty at T_1, but *Debt 2* has only a 50% chance of being repaid, unless some kind of recapitalization via workout or bankruptcy is invoked.[150] As a result, the holder of *Debt 1* has no reason to consent to a voting rule for a workout given the potential conflict of interest between *Debt 1* and *Debt 2*.[151] In contrast, the holder of *Debt 2* would benefit from a workout arrangement that extends the debts' maturity, making the maturity of both equal, unless the contemplated workout would significantly diminish the firm's cash flows.[152] 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,[153] so long as there is a compulsory voting scheme for the workout.[154] This basic example shows that there is a potential conflict of interest between different creditors and that a voting rule for a workout among heterogeneous debts may result in a reduction of overall value, which constitutes the inefficiency cost of the Mandatory Voting 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 Voting Prohibition Rule and the Mandatory Voting Rule leave open the possibility of value-diversion effects (though in opposite directions), which may cause the interests of creditors who stand to disproportionately gain from such a value shift (i.e., non-pivotal creditors under an assent scheme and controlling creditors

150. 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. For the purposes of 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.

151. By contrast, there will be no such conflict of interest among multiple holders of *Debt 1*.

152. In this case, the expected value of *Debt 2* will increase by 15, which shifts from *Debt 1*, assuming that the aggregate cash flow remains intact.

153. The possibility of this value reduction arises, in part, from the agency problem caused by the conflict of interest between debt and equity holders.

154. The threshold level of cash flow will be 80. At this point, the payoff of *Debt 2* under the workout is equal to that without a workout.

under a 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.

3. *Example, Denotation, and Assumptions*

The analysis in this Part of the paper explores the mechanisms by which the value-diversion effect hinders some efficient workouts under the Voting Prohibition Rule but yields some inefficient workouts under the Mandatory Voting Rule.

For this 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 below:

At T_0, the management of Company *A* proposes a workout reorganization plan that includes debt restructuring, business restructuring, and new investment projects

At T_1, creditors of Company *A* accept or reject the reorganization proposal under the Voting Prohibition Rule or the Mandatory Voting Rule, as the case may be

At T_2, the reorganization plan is implemented (if the creditors accepted the workout at T_1), or bankruptcy proceedings are started (if the creditors rejected the workout)

At T_3, the cash flows of Company *A* are distributed to creditors

Let:

V_W = total value of Company *A* if the proposed workout plan is accepted and completed

V_B = total value of Company *A* if the workout proposal fails and the company goes through bankruptcy proceedings instead

ΔV = $V_W - V_B$ (net efficiency gain or loss of the workout) ΔV reflects all of the benefits and costs of the workout. The workout is efficient if and only if $\Delta V > 0$.

V_D = aggregate face amount of debts that Company *A* owes (i.e., the minimum total value of Company *A* that is needed to service all debts)

B = private benefit from control of workout (under the Mandatory Voting Rule)

It is assumed for the purposes of this analysis that:

(1) In the bankruptcy proceedings following the failure of the workout proposal, creditors will receive value proportionate to the face amount of their debts, but the shareholders of Company A will receive nothing;[155]

155. I make this assumption merely for ease of illustration. However, the analysis can also explain a case in which shareholders receive the holdup value. Even the shareholders of insolvent companies might secure some value from holdup in the bargaining process under chapter 11. *See* Lynn M. LoPucki & William C. Whitford, *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 ranging from $400,000

(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
(3) Major creditors have complete information on all of the variables.

B. The Analysis

1. *The Voting Prohibition Rule*

Under the Voting Prohibition Rule, majority creditors may not force minority creditors to join a workout;[156] minority creditors are free to stay out of a workout. If a workout takes place under the Voting Prohibition Rule, the holdout creditors may disproportionately benefit from the concessions given by creditors participating in the workout.[157] Hence, value may shift from participating creditors to holdout creditors.

Thus, under the Voting Prohibition Rule, creditors can be separated into two categories in terms of their incentives regarding workout. One category of creditors is major creditors, each of whom is individually essential and pivotal to the completion of the workout reorganization. These creditors cannot benefit by holding out because doing so will result in the failure of the entire workout. The other group is comprised of creditors whose participation, viewed individually, is not pivotal to the completion of the workout. Nevertheless, such creditors, taken *collectively*, might be critical to the workout and, thus, their collective holdout might result in the failure of a workout attempt.

For this analysis, suppose that the major creditors will operate on the premise that all of the non-pivotal minority creditors will hold out. Further, let α be the ratio of debt held by major creditors to that held by all creditors.

Workout reorganization takes place if and only if the major creditors find that their payoffs from a workout are greater than those from a potential bankruptcy procedure. Their payoffs from a workout are greater if and only if the expected efficiency gain of the proposed workout is at least as great as the value to be shifted to the holdout creditors.

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

INEQUALITY (1) $$V_W - (1 - \alpha)V_D > \alpha V_B.$$

The portion $(1 - \alpha)V_D$ represents that the non-participants will be fully paid as a result of the workout. Hence, the left-hand side of Inequality (1) is the post-workout value of Company *A* remaining after full repayment to the holdouts. This remaining value will be further allocated among the

to $63 million"); *see also* Bebchuk, *supra* note 36, at 780 (noting that shareholders "often use their delaying power to extract a substantial value even in instances in which the creditors are entitled to all of the reorganization value").

156. Roe, *supra* note 1, at 250-51, 253.

157. *Id.* at 233.

participating creditors and the shareholders.[158] The right-hand side of Inequality (1) is the value of debts held by the pivotal, major creditors in the potential bankruptcy proceedings, which constitutes the opportunity cost to these creditors of accepting a workout. Recall that the shareholders are assumed to receive nothing in a potential bankruptcy. Likewise, the inequality may be rearranged as follows, noticeably showing the contrast of the efficiency effect with the value-diversion effect:

INEQUALITY (2) $$V_W - V_B \ (= \Delta W) > (1 - \alpha)(V_D - V_B).$$

The left side of Inequality (2) is the efficiency effect of the proposed workout, and the right side is the value-diversion effect to be gained by the holdout creditors. Inequality (2) shows that under the Voting Prohibition Rule, a workout can be completed only if the efficiency effect outweighs the value-diversion effect.

The analysis reveals both the advantages and disadvantages of the Voting Prohibition Rule. It is superior to the Mandatory Voting Rule in preventing inefficient workout attempts that take on negative efficiency effects (i.e., where $\Delta V < 0$). In this regard, the value-diversion effect (by which value would flow from participants to non-participants) serves to align the interests of major creditors with overall efficiency, because major creditors stand to benefit only from the portion of the efficiency gain exceeding the value-diversion effect. The downside of the Voting Prohibition Rule is that it may stymie some efficient workout efforts where expected efficiency gain falls short of the value-diversion effect.

In the analysis, the ratio of participating creditors to total creditors (α) is given. By modifying Inequalities (1) and (2), we may come up with the minimum ratio of participating creditors that is needed to complete the workout with the level of the efficiency effect and value-diversion effect taken as given (let $\acute{\alpha}$ denote such minimum ratio):

$$\acute{\alpha} > \frac{V_D - V_W}{V_D - V_B}$$

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 Mandatory Voting Rule*

Under the Mandatory Voting Rule, minority creditors cannot hold out; major creditors may dominate the workout procedure and stand to dispro-

158. Therefore, 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 represent 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.

portionately benefit from the workout.[159] Thus, value shifts from the non-controlling creditors to the controlling creditors. In this regard, we may classify creditors into two different groups under the Mandatory Voting Rule. One group is comprised of controlling creditors who can effectively dominate the outcome of the vote. The other group consists of the remaining non-controlling creditors. For purposes of the analysis, let â denote the ratio of debts held by the group of controlling creditors to the total debt.[160]

A workout will be completed if and only if the payoffs to the controlling creditors from a workout are greater than those from a potential bankruptcy. The payoffs to controlling creditors from a workout are comprised of two components: (i) the pro rata value in the workout reorganization and (ii) the private benefits from control of the workout.

PROPOSITION 2. Under the Mandatory Voting Rule, a workout reorganization will occur if and only if the following inequality is true:[161]

INEQUALITY (3) $$\beta(V_W - B) + B > \beta V_B.$$

The left side of 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 side represents the value of their debts if bankruptcy proceedings ensue after the workout fails. Rearranged as Inequality (4), the following expression contrasts the efficiency effect with the value-diversion effect:

INEQUALITY (4) $$V_W - V_B = (\Delta V) > -\frac{(1 - \beta)B}{\beta}$$

The left side represents the efficiency effect of the workout. The numerator of the right side represents the value-diversion effect flowing

159. *See* Corporate Restructuring Promotion Act, Law No. 6504, ch. III, art. 17 (2001) (S. Korea).

160. The Mandatory Voting 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 (greater than 50%). The CRPA sets 75% as the requisite ratio of voting. Corporate Restructuring Promotion Act, ch. IV, art. 27. A question may arise: "Does β, the ratio of debts held by the controlling creditors, have to be at least the requisite ratio?" If β is greater than the requisite ratio, then control would be certain and stable. Nonetheless, the controlling creditors might exercise an effective control over voting even with β short of 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 attempt to gather and assess such information. Furthermore, such minority creditors might defer such evaluation to the controlling creditors.

161. Viewed more precisely, the sufficient condition for the controlling creditors' vote in favor of the workout will be (let S_W represent the value received by the shareholders in the workout):

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

Again, 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.

from the non-controlling creditors to the controllers under the Mandatory Voting Rule (i.e., private benefits from control of workout voting).

This analysis shows both the advantages and disadvantages of the Mandatory Voting Rule. It is superior to the Voting Prohibition Rule in that it will facilitate any proposed efficient workout (i.e., where $\Delta V > 0$). The controlling creditors can always benefit from the efficiency gain of such a workout. By contrast, the downside of the Mandatory Voting Rule is that it enables some inefficient workouts. The controlling creditors will vote for an inefficient workout if it furnishes greater payoffs to them because of the private benefits of controlling a workout.[162] Although all creditors pay the costs of an inefficient workout, the controlling creditors monopolize the private benefits from control of workout. Such asymmetry might induce the controlling creditors to pursue an inefficient reorganization at the expense of the minority creditors.

3. *Comparing the Two Rules*

The analysis demonstrates a clear trade-off between facilitating efficient workouts and deterring inefficient workouts. The Voting Prohibition Rule stops every inefficient workout attempt but also hinders some efficient workout efforts. In contrast, the Mandatory Voting Rule makes every efficient workout possible but induces some inefficient workouts. As such, neither of the two rules perform optimally under all circumstances.

The following examples enable us to identify certain conditions under which one of the two rules is better than the other. First, suppose a near-insolvent company has numerous bondholders, none of whom are individually pivotal to the success of the workout. In this case, the holdout problem may well substantially deter an otherwise efficient workout[163] but concern about private benefits from control is modest. Here, the Mandatory Voting Rule that requires a voting scheme may perform nicely by stopping the holdouts and aligning the interests of all creditors. Conversely, the Voting Prohibition Rule may exacerbate the holdout problem by blocking the introduction of a voting scheme. Next, suppose a different situation where a handful of financial institutions hold the majority of debt claims with only a few other minor bondholders. In this case, even though the bondholders are likely to hold out, the major financial institutional creditors may be able to complete a viable workout even without a voting scheme in place.[164] The absence of a voting scheme will most likely cause the interests of the major creditors to align with overall efficiency. Here, the Voting Prohibition Rule may work better than the Mandatory Voting

162. *See* Roe, *supra* note 1, at 263-67. Such workout reorganization may help cause 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.

163. *See* Gilson, *supra* note 6, at 317 (arguing that "having more creditors increases the likelihood that any one creditor will hold out").

164. *See id.* at 317 (finding that private restructuring succeeds more frequently when there are fewer creditors).

Rule. Table 1 summarizes the contrasting features of the two opposite schemes.

Table 1
Wealth Effects of the Two Rules

	Voting Prohibition Rule	Mandatory Voting Rule
Value-Shift Effect	• From workout-participants to non-participants • Holdout problem	• From minority to controlling creditors • Private benefits from workout control
Efficiency Effect	• Stops any proposed inefficient workouts • Stymies some efficient workouts	• Facilitates any proposed efficient workouts • Induces some inefficient workouts
Suitable Case	• Concentrated debt holding	• Dispersed debt holding

Debtors, not creditors, incur the efficiency effect of the two rules, insofar as the price terms of debts reflect the efficiency effect.[165] Therefore, absent a statutory intervention, debtors may well have the right incentives to make the most efficient choice between an assent scheme and a voting scheme *ex ante*. Both of the rules can be suboptimal in the sense that they restrict the parties' freedom to choose a proper scheme.

C. Evaluating the Mandatory Voting Rule

1. *Aligning Controlling Creditors with Efficiency*

Under the Mandatory Voting Rule, creditors might choose an inefficient workout because of the private benefits derived from control, an effect which causes the interests of majority creditors to diverge from efficiency. Inequality (4), in Part III.B.2, shows that as the private benefits from control (i.e., $(1 - \beta)B$) become minimized, the likelihood that majority creditors will accept a value-reducing workout is also minimized. Reducing private benefits from control will cause the controllers' incentives to align more closely with an efficient workout result.

Establishing legal standards for workout may help reduce opportunism by controlling creditors who may divert private benefits to the detriment of total value, as good corporate law reduces such opportunism in the context of corporate governance.[166] South Korea's CRPA requires that debt restructuring "be achieved fairly and with meeting the equity," although it

165. *See* Jensen & Meckling, *supra* note 148, at 313 (observing that the price that minority shareholders will pay for shares "will reflect the . . . effect of the divergence between the manager's interest and theirs").

166. *See* Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1114 (1998).

does not articulate what this phrase means.[167] Courts may utilize this abstract standard as a tool to restrict the machinations of majority creditors. In making the case for repealing the Prohibition Rule of the Trust Indenture Act, Professor Roe proposed a simple and flexible standard prohibiting fraud and distortion in bond recapitalization as a replacement for the voting prohibition of the Trust Indenture Act.[168]

Increasing the requisite ratio of voting may also help reduce private benefits from controlling a workout. The dual voting requirements, which set the threshold in terms of the number of creditors as well as of the debt amount,[169] may be considered, as they are in chapter 11 proceedings.[170]

Providing dissenting creditors with an adequate appraisal right may also reduce private benefits. This would serve to secure some minimum value for minority creditors and effectively set a ceiling for private benefits from controlling workout. A shortcoming of the appraisal right is that the time, cost, and uncertainty involved might make workout reorganization more costly and less attractive. Also, there can be 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 Mandatory Voting Rule under the CRPA shares some features with the voting regime in chapter 11. Both institutions, without requiring a contractual ground, install a vote-based reorganization[171] outside or inside of bankruptcy.[172] It is fairly evident that a workout under the Mandatory Voting Rule has a competitive edge over chapter 11 in speed and flexibility. Still, chapter 11 has its own advantages, especially in reducing the value-diversion effect (i.e., private benefits from control). Court scrutiny in chapter 11 procedures[173] may help restrain major creditors from taking private benefits, as compared to the vote-based workout procedure under the Mandatory Voting Rule.

Here, we encounter a trade-off and dilemma involving the Mandatory Voting Rule. On one hand, it facilitates successful out-of-court workouts by instituting a mandatory voting scheme.[174] In doing so, however, it may not be effective in reducing bankruptcy costs because of that same scheme. Given its powerful impact on reorganization, the workout procedure under the Mandatory Voting Rule might be perceived, in effect, as an alternative to bankruptcy reorganization. That is, various constituencies such as cus-

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167. Corporate Restructuring Promotion Act, Law No. 6504, ch. III, art. 17(1) (2001) (S. Korea).
168. Roe, *supra* note 1, at 269-72.
169. Corporate Restructuring Promotion Act, ch. IV, art 27.
170. 11 U.S.C. § 1126(c)-(d) (2006).
171. *Id.*; Corporate Restructuring Promotion Act, ch. IV, art. 27.
172. *See* LoPucki & Whitford, *supra* note 38, at 677 (pointing out as one of the advantages of bankruptcy reorganization that majorities of creditors can bind dissenting minorities through voting).
173. *See, e.g.*, *id.* at 681-83.
174. Corporate Restructuring Promotion Act, ch. IV, art. 27.

tomers, suppliers, and employees may respond to workout under the Mandatory Voting Rule similarly to the way that they would respond in chapter 11 proceedings. As a result, the Mandatory Voting Rule might undermine a workout's utility in saving bankruptcy costs. Ironically, although the Mandatory Voting 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 CRPA of South Korea offers a powerful mechanism for facilitating workouts, but it results in an inferior type of workout, stripped of certain useful attributes in terms of saving bankruptcy costs. The approach of the CRPA demonstrates a clear trade-off between facilitating workouts and reducing bankruptcy costs. The Mandatory Voting Rule under the CRPA provides an opportunity to reflect on the nature of workouts. A workout basically constitutes a contract between various creditors and the debtor to recapitalize debt. A workout can be seen as a bargain among creditors, based on the belief that such a bargain may bring gains to the entire group of creditors and that 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 is good reason to doubt that the CRPA procedure still takes on the nature of a workout.

D. Comparing with Analysis on Control Transfer Rules

This Part's analysis can be viewed as parallel to Professor Lucian Bebchuk's analysis on rules governing corporate control blocks.[175] With respect to the two contrary rules on the sale of control blocks, the Market Rule and the Equal Opportunity Rule,[176] Professor Bebchuk presents the well-known trade-offs between facilitating efficient sales of control blocks and stopping inefficient sales.[177] The distinction between these paradigmatic rules is centered on whether each rule entitles minority shareholders to join the sale of a control block by a controlling shareholder.[178] 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.[179] In comparison, the Equal Opportunity Rule entitles non-controlling shareholders to participate in, or otherwise benefit from, the control transaction, thereby preventing the controlling shareholder from monopolizing the gains.[180] 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.[181]

175. *See* Lucian Arye Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q. J. ECON. 957 (1994).
176. *Id.* at 964, 968.
177. *Id.* at 963.
178. *See id.* at 964, 968.
179. *See id.* at 964.
180. *See id.* at 965.
181. *See id.* at 957.

A remarkable analogy can be found between the two sets of trade-offs shown by Professor Bebchuk and those analyzed in 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 majority (as with the Mandatory Rule and the Market Rule), the rules facilitate any efficient proposed transaction but induce some inefficient transactions as well, because of the controllers' partial misalignment of interest with overall efficiency. When the value-diversion effect flows from majority to minority (as with the Prohibition Rule and the Equal Opportunity Rule), the rules stop any proposed inefficient transactions but deter some efficient ones as well.

Conclusion

Workouts are based on consensus among participants,[182] whereas chapter 11 procedures rely on voting.[183] Even in the world of workouts, however, voting has been utilized. This paper has identified two contrasting legal approaches to voting and workouts by looking at two seemingly unrelated statutes in South Korea and the United States. The American approach, which bans voting in workouts, serves to keep the consensual nature of workouts intact and thereby stops any opportunistic, inefficient workout attempts but blocks some efficient workout efforts as well. The South Korean approach, which mandates voting in workouts, will facilitate any efficient workout effort but also permits some opportunistic, inefficient workouts. The Mandatory Voting Rule in South Korea provides an opportunity to reflect on the nature of workouts. A workout basically constitutes a bargain to recapitalize debt among various parties with differing interests. A voting scheme may be part of the bargain so long as it is based on the participants' consensus. Thus, there is reason to doubt that the Mandatory Voting Rule falls solidly within the nature of a workout. The South Korean rule offers a powerful mechanism for facilitating workouts, but it may end up bringing about an inferior workout in terms of saving bankruptcy costs.

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182. *See* Gertner & Scharfstein, *supra* note 7, at 1191.
183. 11 U.S.C.§ 1126(c)-(d) (2006).