An Economic Analysis of the Effect of Korean Labor Unions on Corporate Bankruptcy Threat*

by

Joonmo Cho**

Abstract

Since the inauguration of the Roh Moo Hyun government, critics have been vocal in pointing out that industrial relations in Korea have impeded corporate restructuring, getting in the way of FDI and undermining national competitiveness. However, there has not been sufficient research into the economic effects caused by trade unions. This study aims first to analyze empirically the impact of Korean labor unions on worsening corporate performance to assess whether unions maintain rational behavior when faced with impending corporate insolvency given the hostile industrial relations in Korea. If labor unions are a significant factor in worsening corporate performance leading to insolvency and ultimately rising odds of bankruptcy, the unions in fact weakening company competitiveness and destroying jobs to the detriment of the labor movement. The policy implication would thus be that the overall function of the labor union should be enhanced. The second purpose of the paper is to define the improvements needed to the Korean labor legislation to minimize the negative impact of the unions on the resuscitation of ailing companies. Existing research on the rehabilitation of weak enterprises was limited to studying amendments to labor laws to ensure the comprehensive succession of union and member rights in the event of corporate change. The recommendations made in this paper depart from the current labor law-centered literature in three ways. First, it examines ways to improve labor legislation based on empirical analysis. Second, it aims to suggest amendments to the legal system to enhance economic efficiency through mutually beneficial industrial relations, not simply pursuing the protection of union or worker rights. Third, the paper approaches labor market flexibility by recognizing that restructuring of struggling companies via mergers, acquisitions and transfers must take place before easing the criteria for legal layoffs at healthy companies. The resuscitation of bankrupt companies is key in establishing industrial relations for the good of all parties and in achieving economic efficiency.

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I. Introduction

Do labor unions in fact heighten a company’s likelihood to show poor financial performance and weaken the chances of bankruptcy? Is the presence of a union a hindrance in the revitalization of an ailing company? Other factors being equal, if unionized firms are more likely to grow insolvent and less likely to recover than their non-unionized counterparts, does that indicate that unions ultimately aggravate unemployment in the labor market? Are the labor unions committing, as Samuel Gompers (1986) alleged, the worst economic crime by luring firms to produce at a loss in order to drive them to bankruptcy?

The above questions on trade unions and weakening corporate performance are being widely debated recently. Since the Asian financial crisis, Korean companies have cited hostile labor unions as an obstacle in restructuring. Enterprise-level unions affiliated with umbrella-industrial organizations, in particular, are said to channel the confrontational relations of total capital against total labor to their companies, resulting in long strikes that benefit neither party. The overall view is that the unions cause more lost workdays and losses to aggravate an ailing company’s symptoms and hurt its chances of recovery.

The negative aspects of labor unions have much to do with labor legislation. The Korean laws on layoffs offer an apt example. The laws are criticized for preventing companies from undertaking timely restructuring, with the result that insolvency is actually accelerated. Mandatory consultation with the trade union or employee representative is one of four criteria\(^1\) that a company must meet prior to conducting dismissals for business reasons; however, the inflexible attitude that labor then brings to the discussion table hinders layoffs, slowing down restructuring and nudging the company closer to bankruptcy. Even if an already faltering company attempts to strike an agreement with its labor union for its revival, the union often continues with a strike against its own wishes out of consideration of its umbrella organization. The Korean media has often cited the case of Doosan Engineering in the first half of 2003 where both labor and management wanted to put a quick end to their differences, but the dispute escalated into a stand-off between higher labor and business bodies, so that the strike was prolonged. Many other critics have pointed out that the Korean labor unions have hurt national competitiveness and disrupted the inflow of foreign investment by slowing down restructuring. While such criticism abounds, there has, however, been a dearth of studies dealing directly with the issue. Existing research on the economic effect of unions have pointed out that they lead to high wages and low profits, implying that unions may aggravate corporate insolvency. The

\(^1\) Article 31 of the Labor Standards Act permits dismissals for business reasons only if there is urgent business necessity, effort by the employer to avoid dismissal, good faith consultation with the union or labor representative and fair selection of those to be dismissed. In some large workplaces, the consultation requirement has been strengthened to one of agreement with the union or labor representative.
research by Karier (1985) is a case in point. Karier argues that the higher the economic concentration ratio in an industry, the more likely high wages and low profits are to be seen in an unionized workplace so that a general capital profitability analysis that does not factor in the union’s influence will underestimate the monopoly effect.

However, low profits do not always mean that a company’s bankruptcy threat is heightened. If the union is preventing the normal profit of a company that is in a state of long-term equilibrium in perfect competition market, then the union is clearly worsening the odds of it fading away into eventual bankruptcy. If, however, the wage premium garnered by labor takes the form of sharing of surplus profit, the union may not necessarily threaten the corporate lifespan. A rational union would carry out concession bargaining if its company’s survival were in peril and so would not affect its health (Freeman and Kleiner, 1999; Blanchflower and Oswald, 1989). Freeman and Kleiner (1999), who studied the weakening of performance at US companies and the function of the labor union, lay out empirical evidence that, in contrast to previous thought, the union does not aggravate a company’s ailments. They argue that in an already weak enterprise, the union would engage in concession bargaining by refraining from demanding excessive wages and emphasizing job stability; thus, a company with such a rational union would be at least as likely as a non-unionized firm to recover its financial soundness.

But the theory of the rational union proffered by foreign industrial relations scholars can be criticized on many fronts. For example, the union may not believe the management’s assertions that the company’s finances have been weakened if there has been a historic lack of corporate information disclosure, i.e., if the precondition for rational bargaining – symmetry of information – is not met. The asymmetry in corporate information is a particularly serious issue in Korea where there is inadequate consultation between labor and business. A second reason why the theory is problematic has to do with the myopic nature of unions. The trade union that, due to financial constraints or preference, has a high discount rate on future value is likely to press for immediate wage increases rather than wait to share future profits by making concessions to revive the company. The third reason is that the union may insist on protecting its own interests for the sake of securing wage claims although it would be more economically efficient to help maintain corporate value; by doing so, labor is faced with the prisoner’s dilemma, a situation which can bring the company to bankruptcy.

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2 According to the Korean Act on the Promotion of Workers’ Participation and Cooperation, Chapter 1 on the obligations of the Labor-Management Consultative Council, Article 21 on Matters to be Reported, the employer is required to report on its overall corporate business plan and performance; however, the reporting is often criticized for being no more than a formality (material submitted to the meeting of the Sub-Committee on Labor-Management Relations of the Tripartite Commission, www.lmg.go.kr ). Labor argues that employers falsely report poor performance to suppress wage hikes, while business criticizes labor for pressing for excessive wage increases when the performance is deteriorating.
The following potential reasons stem from the structural nature of Korean industrial relations. Without stable sub-sectoral or sectoral labor-management relations, the umbrella union’s leadership is not strong enough to pursue rational decision-making based on concessions, but is likely to rely on militancy, with weak companies being sacrificed. Under such a structure, companies whose unions are affiliated with umbrella organizations have higher odds of growing weak and lower chances of making a recovery. Also, the unions’ move to standardize wages within an industry increases the risk of bankruptcy for all businesses in the sector. If both unionized and non-unionized companies follow the wage negotiations conducted by the leading unionized enterprise, this pattern bargaining can create a common wage level so that firms with comparatively lower labor productivity would find it hard to survive. This phenomenon is especially likely to be pronounced in an industry with a sectoral union. Lastly, another contributing factor is the lack of labor laws in Korea on the revitalization of distressed companies. The Korean legislation on layoffs and collective agreements do not differentiate between sound and ailing businesses. As will be dealt with later, the rigidity of the system impedes the recovery of weak firms and stands in the way of private bargaining between unions and employers unlike those in Germany and the US where exceptions to labor laws are recognized for bankrupt companies. In effect, inflexible labor legislation amplifies the negative impact of the unions themselves.

Therefore, despite the previous literature on western industrial relations which highlights the empirical evidence for the rational union theory, there is the possibility that no such results would be found in Korea with its confrontational industrial relations and unestablished practice of rational bargaining at distressed companies.3

This study has two main objectives. The first is to examine empirically the impact that Korean unions have on corporate distress. There has been very little research in and out of Korea that analyzes the link between the insolvency of companies and industrial relations. The work of Freeman and Kleiner (1999) focuses on the role of the union in the US firm’s road to bankruptcy, but the results of the study cannot be applied to other countries with different practices governing industrial relations. Most research to date on unions and weak firms have been limited to the examination of labor laws and have yet to offer fact-based analysis.

This paper will examine the empirical basis for the effect of unions on corporate insolvency by two methods. First, by estimating through a Logit analysis the extent of the impact that unionization has on a company’s odds of becoming financially distressed. The method will show whether trade unions continue to act rationally in the process of insolvency and

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3 The IMD of Switzerland in 2003 rated the hostility inherent in Korean industrial relations as being 30th among thirty countries with a population over 20 million and Korea was 25th in terms of lost work days per year per 1,000 people with 30,695 days (IMD Global Competitiveness Report, 2003).
bankruptcy, as Freeman and Kleiner (1999) argue, in the Korean context where confrontation is prevalent in industrial relations. If labor unions are a significant factor in worsening corporate performance leading to financial distress and ultimately, rising odds of bankruptcy, the unions would be in effect creating a vicious cycle of weak corporate competitiveness, less jobs and ultimately a downsizing of union organizations. The policy implication would thus be that efforts must be made to revise laws or reform industrial relations to ensure that labor unions play a more positive role.

In addition, the second purpose of this study is to propose initiatives to improve the Korean labor legislation to minimize the negative impact of unions on corporate recovery. Existing literature is mostly limited in scope to the legal amendments needed to ensure the comprehensive succession of the rights of unions and individual workers in the event of corporate change. This paper takes an economics-based approach to offer recommendations on revising labor laws on corporate bankruptcy so that insolvent companies may recover and unions can leverage their positive role. The recommendations made in this paper depart from the current labor law-centered literature in three ways. First, it examines ways to improve labor legislation based on empirical analysis. Second, it aims to enhance economic efficiency with mutually beneficial industrial relations, not simply insisting on the protection of union or worker rights. Third, the paper approaches labor market flexibility by recognizing that restructuring of struggling companies via mergers, acquisitions and divestiture must take place before relaxing the requirements for legal layoffs at sound companies. The resuscitation of bankrupt companies is key in establishing industrial relations for the good of all parties and achieving economic efficiency.

Chapter 2 of the paper reviews the existing financial, economic and financial management research on corporate failure and Chapter 3 examines the labor economics literature on the effect of unions on profitability. Chapter 4 delineates the theoretical framework for analyzing the influence of unions on the revival of bankrupt companies while Chapter 5 contains an empirical examination of the role of unions on corporate insolvency using Korea Investors Service data and the status data on unions nationwide provided by the Ministry of Labor. The latter data source is particularly valuable in assessing the impact of Korean industrial relations on distressed companies as it indicates the affiliation status of each union. In Chapter 6, foreign labor legislation on bankruptcy is reviewed and recommendations are made, based on empirical analysis, on changes to Korean laws to promote the positive while minimizing the negative functions of unions. The final chapter contains the conclusion.
II. Existing Literature on the Causes of Corporate Bankruptcy

Bankruptcy refers to the overall trajectory of a company’s financial distress and failure to recover. Possible reasons for bankruptcy include poor management, low sales, diversification into unrelated businesses, excessive leverage, troubled industrial relations and a series of financial failures. To date, most research outside of Korea traces the roots of company failure to inept executives (Keiser, 1966; Argenti, 1976), as do domestic studies.

[Table 1] lists the factors that influence the weakening of an enterprise’s financial condition; this study will focus on the role of the labor unions in the context of overall industrial relations and labor legislation. [Table 1] shows that corporate collapse is more often due to internal rather than external factors and the ultimate responsibility lies with the management who are accountable for decisions on the company’s operations, investment and finances (Keiser, 1996; Argenti, 1976; Hwang, 1987; Roh, 1996; Lee and Jang, 1998; Kim, 1999).

<table>
<thead>
<tr>
<th>Cause</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management</td>
<td>Inadequate decision-making skills, nepotism, disputes over management succession, lack of specialized education/experience, misuse of corporate funds, top-heavy organization</td>
</tr>
<tr>
<td>Corporate Structure</td>
<td>Over investment and expansion, failed diversification and errors in site location, unsuccessful joint business projects</td>
</tr>
<tr>
<td>Purchasing and Production</td>
<td>Inadequate capital expenditure, weak inventory management, poor quality control, outdated facilities, overspending in R&amp;D, poor technology</td>
</tr>
<tr>
<td>Sales</td>
<td>Excessive reliance on few customers, weak sales organization, failed pricing policies, inappropriate sale channels, lack of market research, no diversity in product lines</td>
</tr>
<tr>
<td>Finance</td>
<td>Equity shortage, excessive capital expenditure, lack of finance planning, over-investment of working capital, use of black market funds/accommodation bills</td>
</tr>
<tr>
<td>Industrial Relations</td>
<td>Confrontational relations, militant unions, inflexible labor legislation</td>
</tr>
<tr>
<td>Organization and HRM</td>
<td>Lack of internal control, unclear accountability and authority, irrational HRM policies</td>
</tr>
<tr>
<td>Market</td>
<td>Excessive competition, decline/depletion of demand</td>
</tr>
<tr>
<td>Economy and Funding</td>
<td>Recession, cyclical downturn in industry</td>
</tr>
<tr>
<td>Politics and International</td>
<td>Hike in raw materials prices, global economic downturn, unfair policies</td>
</tr>
<tr>
<td>Other</td>
<td>Series of interlinked bankruptcies</td>
</tr>
</tbody>
</table>

The following chapters will examine the impact of industrial relations, in particular, the role of unions and related labor laws, in the process of a company’s financial weakening or recovery. Labor legislation can have great impact on minimizing the negative effects of unions on a company’s revival. The functions of unions as related to the right to organize, right to collective bargaining and right to collective action are protected by law and result in a collective bargaining agreement (hereafter CBA). Thus, the actions of the union at a failed company as translated in the CBA affect corporate recovery. In turn, the validity of the CBA is governed by the legislative system, thus the laws impact the functions of unions and ultimately, the likelihood of recovery.

III. Existing Research on the Effect of Labor Unions on Profit

There has been much research on whether unions diminish corporate profit (Freeman, 1983; Freeman and Medoff, 1984; Karier, 1985; Becker and Olson, 1992). For instance, Freeman (1983) and Karier (1985) concluded that unions cut profits in economically concentrated industries but do not in competition sectors. The profit-related indices used in their study were share prices, capital earnings rate, Tobin’s q and price-cost margin.

Only a few studies, however, have looked directly at the union’s impact on the bottom line. Most of the research has focused instead on the wage effect of unions. Park (1984) examined the issue in the 1980’s while Park and Park (1989), Kim and Sung (1990), and Kim (1991) concluded that post-1987, trade unions had a positive relative wage effect. The overall research indicates that prior to 1987, the relative wage effect was almost negligible or in certain cases negative, but positive values, albeit slight, have been seen since 1987.

Based on such studies, the negative impact of unions on corporate profit can be indirectly assessed. Chae (1993), one of the few scholars who have dealt directly with the issue, showed that non-unionized monopoly companies either pay higher wages than their unionized counterparts or match the union wage levels and even follow the wage distribution pattern of the unionized firms in order to avoid the creation of a union, but in so doing, they are in effect acknowledging the union’s wage premium. This conclusion runs counter to those of foreign studies such as Freeman (1983) and Karier (1985) that state that the threat of unionization for monopolies with no union negates the union’s wage premium effect.

These studies, however, cannot simply be used to support the theory that labor unions increase the bankruptcy threat because the reduction in profit caused by unions may not cut into the company’s normal bottom line but may take the form of sharing of surplus profit.
IV. Theoretical Analysis of Corporate Survival and Labor Behavior

To survive over the short-term, a company’s average variable cost (AVC) must exceed its average revenue (AR). Among other factors, AVC is influenced by labor productivity and compensation. AR is affected by industrial organization variables such as the ease of market entry/exit and market share of individual companies.

Many theories argue that labor unions push for wage hikes for the employed while sacrificing the possibility of new job creation (Lindbeck and Snower, 1986). Unions, however, do not aim to keep on increasing wages indefinitely. Instead, they want to reach wage levels that ensure job stability for employees and maintain wages at a sufficiently higher level than alternative wages (Freeman and Kleiner, 1999). A rational union should be willing to refrain from insisting on excessive wage hikes and, if the situation calls for, to engage in concession bargaining to prevent a shut down as the company’s AVC exceeds its AR.

Over the long-term, a company’s survival depends on whether its total revenue (TR) exceeds total cost (TC); if it does not, the company will be bankrupt. Labor unions can also affect the long-term conditions for survival. For instance, Hirsch (1992) suggests that unions may be threat en long-term survival by focusing only on press ing for increased wages so that companies cannot invest in technology R&D which can lead to future profit. However, the reverse can also be argued; unions lengthen the odds of survival as they maintain a wage premium so as to attract high-quality labor and discourage market entry by rivals so that the companies’ monopoly status is upheld.

The theoretical basis for arguing whether unions increase the odds of organization failure or not, in effect, comes down to whether the unions are capable of rational behavior. The empirical study by Freeman and Kleiner (1999) looked at US data for evidence of such behavior and concluded that unions are rational and do not engage in rash actions that precipitate corporate failure.

A similar empirical study, however, is unlikely to yield comparable results in Korea where industrial relations contrast sharply with those of the US. Without stable enterprise-level relations in place, the central, umbrella organizations lack the leadership to pursue concessions and rational action but instead focuses on confrontation so that ailing companies find it hard to prevent collapse; this indicates the possibility that companies with affiliated unions may be more likely to fail and less to recover. Certain aspects of Korea’s distinctive industrial relations have their roots in labor legislation. Unlike Germany or the US where legal exceptions are made for bankrupt companies, the Korean laws are less flexible and are criticized for hindering recovery and private negotiations between unions and employers. Thus, in certain cases, rigid regulations compound the problem of confrontational relations to make corporate revival all the more difficult.
Most of the existing theoretical studies are focused on finding the logical grounds for the indirect impact unions have on increased bankruptcy threat. To find a theory to explain the functions played by unions, a more politicized theory grounded in economics is called for. A few foreign scholars such as Lawrence and Lawrence (1985) have put forward the finitely repeated game model that sees unions demanding higher wage levels as corporate bankruptcy threat escalates. The model delivers the theory that although it may be more economically efficient for unions to maintain enterprise value if financial conditions are weakening, they instead push to protect their interests by securing wage claims, creating a prisoner’s dilemma that results in bankruptcy. However, the theory can be refuted on two fronts. First, the conclusions do not explain how unions precipitate financial collapse, but are instead an example of reverse causality where unions have changed their strategies in reaction to the financial distress that is already evident in the company. Second, the implications of the games theory run counter to the rent-sharing model upheld by traditional labor economists. According to the rent-sharing model, labor unions demand sharp wage hikes during a boom but turn to concession bargaining and make appropriate demands when signs of trouble appear; the implication is that unions do not hinder corporations from posting normal levels of profit.

V. Empirical Analysis
1. Data
To best analyze the effect of unions on financing distress and recovery, an experiment should be conducted to set up unions at randomly selected non-unionized firms; these companies would then be compared to non-unionized counterparts to study any differences in their bankruptcy trajectory. However, as in other empirical studies covering social sciences-related issues, such an experiment is not feasible.

The data used in this study was from randomly sampled companies; information from Korea Investors Service, Inc. (KIS), an affiliate of Moody’s, and the Ministry of Labor’s status data on nationwide trade unions was merged. KIS data captures the extent of the effect each factor has on financial distress, but it does not indicate whether a company is unionized nor if so, if the union is affiliated with an umbrella organization. The nationwide labor union status data provided by the Ministry of Labor, however, includes information on the affiliation of unions. This study merges the data from the two sources by matching the company name and location to build a time series data base with information on a company’s finances and industrial relations; the data base will capture the influence unions had on certain points over the time series when

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4 The national labor union status data has been published by the Ministry of Labor since 1980 and listed data (on unionization, affiliation, etc.) from 46 sectoral sites of employment and 5,698 chapters in 2000. This study merges the status data from 1998 to 2002 with KIS data from the same period.
the companies’ financial status deteriorated.

As of 2001, KIS supplies data on 690 companies listed on the Korea Stock Exchange and 721 KOSDAQ enterprises and includes financial statements from 1980 to 2001. As the Ministry of Labor’s data is from 1998 to 2001, however, the sampling was done on manufacturing companies listed or registered from 1998 through to 2001. KIS data includes both manufacturers and financial service companies, but only the former was included in the sample as there was a lot of lost data on key explanatory variables of the latter. The sample number was 464 KSE companies and 192 KOSDAQ firms; after pooling four year’s worth of panel data, the number totaled 2,624.

2. Method

Log revenue, fixed assets/revenue, unionization status, and dummies for year and industry were used as explanatory variables for the Logit analysis to determine financial distress. In addition, to estimate the effect of unions joining an umbrella union, an interaction term between a union dummy and an affiliation dummy was set up to determine the changes in the estimates according whether there was interaction.

In a model with dummies set for 10%, 30% and 60% unionization rates, the unionization rate only precipitated distress in the group of companies with over 60% unionization and actually decreased the bankruptcy threat in the remaining firms.

In the study by Freeman and Kleiner, coefficient estimates for key variables indicated the following: the unionization dummy coefficient was significantly negative on corporate distress at a 90% level while unionization rate showed a positive sign. Thus, the empirical study found that the existence or lack of a union by itself does not negatively impact financial distress, but it did find that the higher the unionization rate, the higher the likelihood of financial difficulties.

However, while Korean labor legislation is premised on enterprise-level unions, most Korean unions are sectoral, so that issues on the agenda of umbrella groups often encroach on and hinder the bargaining at the individual workplace. The hostile relations between capital and labor at an upper level affect relations at enterprise-level, so that disputes are often used to gain the ends of the umbrella group. In this respect, the dummy variable on the affiliation status of each workplace will be useful in capturing the full context of Korean industrial relations. The study will examine the changes in the unionization status dummy coefficient according to

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5 Freeman and Kleiner (1999) used Compusat data combining financial and industrial relations information from sampled companies dating from 1983-1990; the total sample number was 319 and only 67 were distressed firms. The sample size in this study, selected as stated above, is over 700 listed companies alone, indicating a larger sample size than that of Freeman and Kleiner.
whether or not the affiliation dummy is included to see how the coefficient estimate is misinterpreted if the affiliation dummy is not factored in.

The financial distress criterion used as the Logit analysis dependent variable is the interest coverage ratio (ICR); if the ratio is over 1, the dependent variable value is 0 and if it is below 1, the value is 1. The ICR is a company’s operating profit divided by interest expenses and indicates its ability to service debts. Companies with a ratio below 1 run the risk of default as its loan payments cannot be serviced from the profits from its operations. For example, if the estimated coefficient of the unionization dummy is positive, it indicates that unions increase the bankruptcy threat.

[Table 2] Average ICR and Number of Companies (1998-2001)

<table>
<thead>
<tr>
<th>Companies</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No.</td>
<td>656</td>
<td>655</td>
<td>656</td>
<td>656</td>
</tr>
<tr>
<td>Av. ICR</td>
<td>1.21</td>
<td>8.84</td>
<td>70.96</td>
<td>162.0</td>
</tr>
<tr>
<td>ICR ≥ 1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No.</td>
<td>297</td>
<td>357</td>
<td>386</td>
<td>353</td>
</tr>
<tr>
<td>Av.</td>
<td>2.95</td>
<td>16.50</td>
<td>120.19</td>
<td>279.83</td>
</tr>
<tr>
<td>ICR &lt;1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No.</td>
<td>359</td>
<td>298</td>
<td>270</td>
<td>303</td>
</tr>
<tr>
<td>Av.</td>
<td>-0.26</td>
<td>-0.46</td>
<td>-1.03</td>
<td>-4.35</td>
</tr>
</tbody>
</table>

Note) ICR is EBIT over interest expenses; for the purposes of this study, EBIT is earnings before interest, taxes, depreciation and amortization.

[Table 2] lists the average ICR of the companies studied and the number of companies with an ICR over or below 1. [Table 2] indicates that the percentage of normal companies with an ICR over 1 was 45.3% in 1998, 54.5% in 1999, 58.8% in 2000 and 53.8% in 2001. The economic crisis of 1998 accelerated corporate distress and recovery was seen in 1999 and 2000, only to be reversed in 2001. However, the average ratio of these companies was 2.95 in 1998, 16.5 in 1999, 120.19 in 2000 and 279.83 in 2001, indicating that restructuring was paying off. In case of the under-performing companies with a ratio below 1, however, the average was -0.26 in 1998, -0.46 in 1999, -1.03 in 2000 and -4.35 in 2001, showing that the financial standing of these companies was deteriorating. The figures show that since the economic crisis, the companies have been gravitating toward polar ends of the soundness spectrum.

[Table 3] indicates the unionization status of companies and the percentage of unions affiliated with higher-level labor unions. The unionization rate has clearly decreased since the financial crisis, with the downturn being especially marked in ailing companies with an ICR below 1. The affiliation rate of company unions exceeds 95% in all the years studied.
[Table 3] Unionization and the Affiliation Rate of Corporate Unions

<table>
<thead>
<tr>
<th>Companies</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unionized</td>
<td>203</td>
<td>198</td>
<td>94</td>
<td>99</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rate</td>
<td>30.95</td>
<td>30.23</td>
<td>14.33</td>
<td>15.09</td>
</tr>
<tr>
<td>Umbrella Union-Affiliation Rate</td>
<td>99.01</td>
<td>97.47</td>
<td>96.81</td>
<td>96.97</td>
</tr>
<tr>
<td>Unionized</td>
<td>80</td>
<td>98</td>
<td>58</td>
<td>57</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rate</td>
<td>26.94</td>
<td>27.45</td>
<td>15.03</td>
<td>16.15</td>
</tr>
</tbody>
</table>

ICR > 1

| Umbrella Union-Affiliation Rate | 98.75 | 97.96 | 94.83 | 94.74 |
| Unionized | 123  | 100  | 36   | 42   |
| Total     |      |      |      |      |
| Rate      | 34.26| 33.56| 13.33| 13.86|

ICR < 1

| Umbrella Union-Affiliation Rate | 99.19 | 97.00 | 100.00| 100.00|

Note 1) Unionization rate is the percentage of unionized companies out of the total; affiliation rate is the percentage of unionized companies with unions affiliated with umbrella labor groups.

2) ICR is EBIT over interest expenses; for the purposes of this study, EBIT is earnings before interest, taxes, depreciation and amortization.

[Table 4] Basic Characteristics of Sample Data

<table>
<thead>
<tr>
<th>Sample Variable</th>
<th>No. of Effective Samples</th>
<th>Average Value</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>ICR</td>
<td>2,554</td>
<td>59</td>
<td>1.576</td>
</tr>
<tr>
<td>Revenue</td>
<td>2,568</td>
<td>494,028</td>
<td>2,250,442</td>
</tr>
<tr>
<td>Fixed Assets/Revenue</td>
<td>2,568</td>
<td>1.00133</td>
<td>3.33349</td>
</tr>
<tr>
<td>Unionization Dummy</td>
<td>2,623</td>
<td>0.22645</td>
<td>0.41861</td>
</tr>
<tr>
<td>Affiliation Dummy</td>
<td>2,623</td>
<td>0.22150</td>
<td>0.41533</td>
</tr>
</tbody>
</table>

(Revenue in KRW 100 mil.)

[Table 4] lists the average values and standard deviation of the variables used in the Logit analysis. In the table, the dependent variable is 0 if ICR is over 1, and 1 if it is below 1. As mentioned above, a positive value for the estimated coefficient of the unionization dummy indicates that the union is adding to the bankruptcy threat.
**[Table 5] Bankruptcy Threat from Affiliated Unions**

<table>
<thead>
<tr>
<th>Variable</th>
<th>Model 1</th>
<th>Model 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>-6.1185 (6.16)*</td>
<td>-6.1092 (6.123)*</td>
</tr>
<tr>
<td>log Revenue</td>
<td>0.3942 (1.145)*</td>
<td>0.3939 (1.142)*</td>
</tr>
<tr>
<td>Fixed Assets/Revenue</td>
<td>-0.8911 (8.347)*</td>
<td>-0.8919 (8.349)*</td>
</tr>
<tr>
<td>Unionization Dummy (Union=1, No union=0)</td>
<td>0.1570 (1.076)*</td>
<td>-0.0747 (6.297)*</td>
</tr>
<tr>
<td>Unionization Dummy*Affiliation Dummy</td>
<td>0.2362 (6.212)*</td>
<td></td>
</tr>
<tr>
<td>1999 Dummy</td>
<td>-0.3818 (2.784)*</td>
<td>-0.3824 (1.885)*</td>
</tr>
<tr>
<td>2000 Dummy</td>
<td>-0.7032 (5.792)*</td>
<td>-0.7040 (5.797)*</td>
</tr>
<tr>
<td>2001 Dummy</td>
<td>-0.6766 (5.073)*</td>
<td>-0.6775 (5.078)*</td>
</tr>
<tr>
<td>2 digit Industry Dummy</td>
<td>Included</td>
<td>Included</td>
</tr>
<tr>
<td>Likelihood Ratio</td>
<td>1.49*</td>
<td>1.49*</td>
</tr>
<tr>
<td>Number of Samples</td>
<td>2,568</td>
<td>2,568</td>
</tr>
</tbody>
</table>

Note: Chi-square value shown in parentheses; * indicates significance within 5%.

[Table 5] shows the results of the Logit analysis. In Model 1, the analysis excludes the interaction term for the unionization and affiliation dummies, while Model 2 includes the term. In both models, the year and industry dummies were included to control the heterogeneity of year and industry. The results show that bankruptcy threat increases with the log revenue. In other words, excessive growth without consideration for profitability heightens the risk of collapse. The threat decreases, however, as the fixed assets/revenue increase, indicating that the bigger the investment in fixed assets for every won of revenue earned, the company’s financial soundness increases while the likelihood of distress declines.

The unionization dummy, the key variable in this study, showed a significant positive sign in Model 1. This leads to the conclusion that the existence of a union precipitates financial weakening in direct contrast to the findings of Freeman and Kleiner (1999). The two scholars found that the hypothesis that unions have this effect is not upheld in US companies. Their conclusions gave rise to the “rational union” theory where unions do push for rent-sharing in
companies enjoying surplus profit, but do not press for wage hikes that can hurt profits. The above results, however, do not support this theory.

To examine the reasons for the difference, Model 2 includes the interaction term for the unionization and affiliation dummies to see if affiliated unions tend to opt for irrational, hostile relations despite their own interests. If such unions set a standard income through centralized bargaining by the umbrella organization, high wages will be demanded at even companies with low labor productivity and may heighten the bankruptcy threat. If higher-level unions intervene in enterprise-level negotiations to engage in diagonal bargaining, rational negotiations may give way to a hostile battle, heightening the risk for eventual failure. In such cases, the umbrella unions may sacrifice certain workplaces to press forward with its own agenda.

Model 2 shows that the coefficient of the interaction term for the unionization dummy and the affiliation dummy is significantly positive, indicating that affiliated unions precipitate financial distress. The unionization dummy, which had a positive coefficient in Model 1, is negative in Model 2; thus, unions, when unaffiliated, have no impact on a company’s financial weakening but rather, significantly diminish the bankruptcy threat as the Freeman and Kleiner (1999) study showed. Affiliation with an umbrella group can hinder the union’s rational behavior based on its own cost-benefit analysis.

VI. Suggested Amendments to Labor Legislation to Support Recovery of Bankrupt Companies

1. The Bankruptcy Act and Labor Laws

While the stakeholders alone, in many instances, can handle corporate bankruptcies too many types of debt held by a large number of creditors lead to differences in stakeholder opinion. With stakeholders arguing to protect their rights and positions, the bankruptcy proceeding are delayed so that enterprises which could have recovered are liquidated, and stakeholders gain less from eventual liquidation. To prevent such phenomena, bankruptcy procedures must be governed by law to ensure economic efficiency. The courts or government play the role of referee by setting the rules for stakeholder negotiations and maintaining oversight. Bankruptcy laws are needed for the following specific reasons. First, if bankruptcies are not handled openly, parties with economic dependence on or business interests in the company may be affected and contractual obligations unfulfilled, leading to loss of economic efficiency.

Second, legal interpretation is needed for impartial settlement of disputes between creditors. In particular, the legal system should impose stringent penalties for unfair practices such as selling assets for the preferential service of debt held by special interest parties immediately before declaring bankruptcy.
Third, if the bankrupt entity’s asset value exceeds its liabilities, creditors can recover their loans through the bankruptcy or liquidation proceedings. But if the company had valuable intangible assets, the liquidation of a temporarily insolvent company solely for the purposes of debt collection would not be economically efficient. Thus, in such cases, the law should step in to suspend debt collection and maintain intangible assets to ultimately protect the property of the creditors and prevent social loss.

Labor laws were developed in tandem with the creation of a mature industrial society based on capitalism. They had their roots in the conviction that a system solely based laissez-faire and market principles could not ensure more tangible freedom for the individuals as social disparity grew as a result of industrialization. The laws are premised on the fact that workers, as they provide labor to their employers while under supervision and direction, are legally dependent on the company. This dependence is a part of enhancing the efficiency of the corporate organization.

However, the legal dependency, designed to achieve economic efficiency, can easily lead to economic inequality between labor and management; labor laws act to intervene in private contracts between the two parties to resolve the unfair treatment. The key issue that may arise from the nature of the labor laws is how to strike a balance between distributional justice and economic efficiency.

For bankrupt companies, the issue is narrowed down to how far the purpose of the labor legislation should be upheld given the companies’ financial circumstances. If economic efficiency were the sole criterion, any company with a value as a going concern higher than liquidation value should be helped on the way back to financial health. But if the labor legislation were to be applied to bankrupt companies, their going concern value would fall and lead to liquidation. Thus, labor laws should be applied differently to bankrupt companies to aid recovery not only for the sake of employers and workers, but also for purposes of ensuring efficiency. However, the question remains as to how much the differential application would hurt distributional justice. If economic dependence of the workers justified using the same regulations on ailing companies, employee rights may be protected during the bankruptcy proceedings but may in the long-term hurt the workers as their company collapses and jobs are lost.

2. “Workouts”, the Three Bankruptcy Laws and the Labor Issue

In Korea, bankruptcies are handled according to legal provisions or privately between the company and its creditors. Bankruptcy procedures initiated and supervised by the courts according to the three bankruptcy laws, the Company Reorganization Act, Composition Act and Bankruptcy Act, make use of legal methods, while the handling of company failures without
relying on the provisions of the three laws is termed private proceedings. Private methods include joint financing, signing of a Corporate Bankruptcy Postponement Accord and workouts and are usually initiated by financial institutions.

Of the private and public methods available, workouts and bankruptcies governed by the three laws involve direct control by the courts or a third party. Joint financing and the Accord involve renegotiation between the parties directly concerned and as such, cannot be considered an exception to the labor law provisions although the company involved is in financial trouble; if such exceptions were recognized, employers may use them to avoid fulfilling their responsibilities under the labor legislation. Thus, if the special circumstances of the bankrupt company are to be accounted for in the form of exceptions to law, only workouts and proceedings in accordance to the three laws should qualify.

Workouts are a more proactive means of dealing with bankruptcies than joint financing and the postponement accord, and companies under workout are required to submit a management control waiver as part of the penalty for poor management. The workout is aimed at giving creditor institutions the lead in normalizing companies with goods odds of recovery to prevent bankruptcy by replacing executives, retiring shares and reducing the headcount. Workouts are essentially private negotiations between the debtor and its creditors, but if the creditors fail to agree on an acceptable deal, they then come under public auspices and are referred to the Corporate Restructuring Committee.

Regardless of how bankruptcies are handled, proceedings aimed at recovery of companies in severe distress clearly lack a set of procedures to deal with labor issues. The absence of clear-cut procedures may combine with unstable industrial relations to severely undermine the chances of revival.

The following section examines the possibility of changing the terms of employment and allowing exceptions to existing provisions on employee dismissal for business reasons, two key labor-related issues for bankrupt companies.

1) Allowing Changes in Working Conditions at Bankrupt Companies

There appears to be no mandatory grounds for maintaining existing working conditions in the case of companies under extenuating circumstances such as bankruptcy. Helping businesses recover is the economically efficient solution and is also in the interests of the creditors, debtor and employees. Therefore, changes to the bankrupt firm’s terms of employment should be allowed to facilitate the transfer of business. Bankrupt companies have surplus labor coupled with working conditions that are harder than ever to meet. Given the company’s weak competitiveness, the conditions will hamper not only a recovery on its own but also a bankruptcy rescue by means of an acquisition. To incentivize the potential buyer, changes to the
terms to reflect the financial circumstances of the company should be made possible as a precondition to the business transfer.

Any changes to working conditions, however, must not be left to the decisions of employers alone. By the same token, such changes should not be made subject to agreement by the employee representative or labor union. If agreement was made mandatory, effective revisions of the rules of employment or CBA will be triggered and the resulting changes in the terms of employment cannot be said to efficiently reflect the special circumstances of the bankrupt company. Examples of special treatment made in labor legislation for bankrupt companies are found in both the US and Germany.

(i) The US Bankruptcy Act

According to Chapter 11 of the US Bankruptcy Act, the trustee of a company undertaking bankruptcy proceedings may reject an existing CBA if certain conditions are met. Chapter 11, Subchapter 1, Section 1113 states that in bankruptcy proceedings for corporate reorganization, the conditions are for the trustee to notify and negotiate with the authorized employee representative on the changes to the CBA; the Section also lists the provisions to be met for the Bankruptcy Court to reject the CBA. Section 1113 (b) stipulates that subsequent to filing a petition and prior to filing an application seeking rejection of a collective bargaining agreement, the appointed trustee must make a proposal to the authorized representative of the employees within an appropriate period of time on the required modifications in the employee working conditions. Upon receiving the proposal and relevant information, the employee representative must evaluate the proposal. The trustee also must meet, at reasonable times, with the representative to negotiate in good faith to agree on mutually satisfactory modifications of the CBA. If the trustee has made the proposal to and conferred with the authorized representative in good faith, and the representative has refused to accept such a proposal without good cause, and the grounds for rejecting the CBA are clear, then the court shall approve the application for rejection. Section 1113 (e) lists the conditions under which the procedural requirements in (b) may be waived: “If during a period when the collective bargaining agreement continues in effect, and if essential to the continuation of the debtor's business, or in order to avoid irreparable damage to the estate, the court, after notice and a hearing, may authorize the trustee to implement interim changes in the conditions provided by a CBA.”

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6 Sec. 1113(a) The debtor in possession, or the trustee if one has been appointed under the provisions of this chapter…may assume or reject a collective bargaining agreement only in accordance with the provision on this section.
ii) The German Insolvency Law

Exceptions that restrict the validity of labor-management agreements at bankrupt enterprises are also found in Germany. The German Insolvency Law entered into force in January 1999 to prevent inflexible labor legislation and industrial relations from precipitating corporate collapse. The Insolvency Statute adds a new “layer” (Schicht) to the existing legal relationship by allowing for exceptions to the existing labor law provision, causing partial changes in the normally applicable provisions. The Insolvency Law allows for the following exceptions. First, the existing plant agreement between the debtor and the works council may be terminated with a maximum three weeks’ notice and the insolvency administrator retains the right to terminate the agreement without a period of notice (§120 InsO). Second, plant modifications have been facilitated at bankrupt companies. The insolvency administrator can implement plant modifications before conciliatory proceedings under the Co-determination Act are completed. Clearly, in the case of insolvent companies, the transfer of work relations is not subject to joint decision-making by labor and management, but is governed by law. Third, termination of service is facilitated and procedures allow for a rapid conclusion to any disputes on the validity of dismissals (§113 InsO) (Lee, 1997).

iii) Improvement to the Terms of Employment Provisions in the Korean Bankruptcy Laws

Given the status of industrial relations in Korea today, many companies fail to make use of the limited window of opportunity to recover due to escalating conflicts between labor and management. The special economic conditions of a company in bankruptcy proceedings under public oversight by the courts or the Corporate Restructuring Committee (CRC) should therefore be taken into account. If the court-appointed trustee or the management deems the move necessary, the courts or the CRC (or the Ministry of Labor in case of workouts) should approve the amendment to the working conditions to aid the search for a suitable acquirer. The amendments made with the approval of the public bodies should also be accorded the same legal validity as the CBA or work rules that will be applied between the buyer, original employer and the employee representative after the business transfer.

These measures will contribute to creating a system of legal responses that a company can take to prevent inflexible labor relations from barring recovery and impacting economic efficiency.
2) Special Application of Redundancy Dismissal Provisions for Bankrupt Enterprises

The US and Germany both have provisions that allow for less stringent procedures for layoffs for managerial reasons at bankrupt companies.

i) The US Provisions on Redundancy Dismissal at Bankrupt Firms

The US WARN Act (Worker Adjustment and Retraining Notification Act) lays out the notification obligations of the employer in the process of changing the employment relationship for reasons such as plant closing and massive layoffs. The Act is applicable to all businesses that employ 100 or more employees, excluding part-time employees or 100 or more employees, including part-time employees, who work at least 4,000 hours per week in aggregate, exclusive of overtime.

Plant closing is defined under the WARN Act as the permanent or temporary shutdown of a “single site of employment”, or one or more “facilities or operating units” within a single site of employment, if the shutdown results in an employment loss during any 30-day period at the single site of employment for 50 or more employees, excluding any part-time employees. Mass layoffs mean a reduction in force which first, is not the result of a plant closing, and second, results in an employment loss at the single site of employment during any 30-day period for at least 33 percent of the active employees, excluding part-time employees, or at least 50 employees, excluding part-time employees. The employer must provide written notification to the exclusive employee representative or in the absence of a representative, the affected employees and relevant state government 60 days in advance to carry out a plant closing or mass layoff.

In the case of the sale of part or all of a business, according to Section 2102, the seller is responsible for providing notice of any plant closing or mass layoff which takes place up to and including the effective date of the sale, and the buyer is responsible for providing notice thereafter and is authorized to carry out plant closing or mass layoff provided that the buyer fulfills the notification obligations stipulated in the Act (Cho, 1998). The US WARN Act contributes to corporate recovery as it clearly states the employer’s obligation as being one of notification and clarifies how the obligation is to be shared by the seller and buyer.

ii) German Provisions on Redundancy Dismissals at Bankrupt Firms

Section 613(a) of the German Civil Code states that all rights and obligations regarding employees are transferred to the buyer if a business, or part of a business is transferred by agreement and prohibits the terminations at healthy companies solely based on the transfer of business. However, in case of bankrupt companies, the majority opinion is that the Code permits
the seller to carry out terminations if the buyer so wishes (BAG 26.5. 1983 AP BGB §613 a Nr.
34, etc.). The basis for the interpretation is that the purpose of Section 613(a) is not to delay
employee terminations until after the business transfer in the case of sites of employment where
employment continuity is clearly no longer feasible (Ha and Park, 2001).

To summarize, the German law appears to maintain a continuation of the employment
relationship in the course of business transfers of bankrupt firms. However, a closer study of the
provisions indicates that more relaxed requirements are applied to failed companies than sound
enterprises. Any agreements reached between the employee representative and the employer
during the bankruptcy proceedings will have precedence over the individual worker’s interests,
indicating that the buyer may determine prior to the acquisition the number of employees whose
terms of employment will be transferred.

iii) Towards Flexibility in Korean Redundancy Dismissal Laws
for Bankrupt Companies

Even before Article 31 of the Korean Labor Standards Act was enacted, the majority of legal
precedents and scholarly opinion indicated that layoffs for managerial reasons had to meet four
criteria to be valid. The Supreme Court decision on Case “87 Da 2132” on May 23, 1989,
formed the key precedent by setting out the four criteria. The criteria are upheld in Article 31 of
the current Labor Standards Act. For an employer to dismiss employees for business reasons,
there must be i) an urgent business necessity (Para. 1); ii) every effort made to avoid dismissal
(Para. 2); iii) reasonable and fair criteria for selection of employees to be dismissed (Para. 2);
and iv) notification to and good faith consultations with the employee representative at least 60
days before the intended dismissal date (Para. 3).

The legal grounds on which unions can affect corporate recovery are provided by Paragraph 3
of the Act that calls for prior consultations with the employee representative. The provision
states that “where there is an organized labor union which represents more than half of the
workers at a business or business location, the employer shall inform and consult in good faith
with the labor union (where there is no such organized labor union, a person who represents
more than half of the workers; the "labor representative") regarding the methods for avoiding
dismissals and the criteria for dismissal.” Any dismissal by an employer that has not met this
prior notification requirement is deemed invalid. Prior consultation, of course, does not mean
agreement. The majority of legal opinion is that Article 31 cannot be taken to mean that layoffs
should be subject to collective bargaining; also, in jurisprudence, consultation is clearly
different from agreement.

But as the consultation requirement has been changed to one of prior agreement at most
employment sites, a contentious debate in the labor law community is on-going about whether
consultations can be subject to collective bargaining and industrial action, and as the decisions of umbrella unions affect strikes at individual sites regardless of the interest of the workers, the possibility still remains that current regulations on consultation will in effect, suppress recovery and allow unions to exert a negative influence. Therefore, to aid recovery and ultimately maintain employment, companies under workout and those which are governed by the three bankruptcy laws should be allowed to carry out layoffs upon public approval on the rationale of such decisions by the courts, Corporate Restructuring Committee or as the case may be, the Ministry of Labor, as long as the employers have notified the labor representative in advance.

3) Re-defining Dispute Mediation to Aid Corporate Recovery

The current regulations allow third-parties such as the Labor Relations Commission to intervene to mediate disputes. Third-party mediation, however, is only permitted in interest disputes over issues such as terms of employment and not rights disputes over layoffs. In the event of a labor dispute at an insolvent company, the inflexible mediation system deals a crippling blow to the firm’s struggles to recover. The current regulations do not enable preventative dispute mediation to avoid strikes at ailing companies driving away potential buyers or merger partners. As timely, preemptive mediation is an especially valuable means to aid the recovery of threatened companies, the current mediation system should be improved upon to allow for more proactive private mediation as well as more flexible public mediation by the Labor Relations Commission.

VII. Conclusion

This study examined empirical data to assess the impact of Korean labor unions on worsening corporate performance to gauge whether unions maintain rational behavior in the process of insolvency and recovery in the context of the hostile industrial relations in Korea. If labor unions are a significant factor in worsening corporate performance leading to financial distress and ultimately, rising odds of bankruptcy, the unions are in fact weakening company competitiveness and destroying jobs to the detriment of the union organization as a whole. The policy implication would thus be that policies are needed to bring the positive functions of the unions into play.

The empirical study did not show evidence of the rational union behavior previously found by Freeman and Kleiner (1999) and suggested that affiliated unions may turn to confrontational relations despite the fact that such behavior may be detrimental to the interest of the individual enterprise-level union.

The paper also examined ways to improve Korean labor legislation to minimize the negative impact of the unions on the resuscitation of ailing companies. Existing research on the
rehabilitation of weak enterprises was limited to studying amendments to labor laws to ensure the comprehensive transfer of union and member rights in the event of corporate change. The recommendations made in this paper depart from the current labor law-centered literature in three ways. First, it examines ways to improve labor legislation based on empirical analysis. Second, it suggests amendments to the legal system to enhance economic efficiency through mutually beneficial industrial relations, not simply pursuing the protection of union or worker rights at bankrupt companies. Third, the paper approaches labor market flexibility by recognizing that restructuring of struggling companies via mergers, acquisitions and transfers must take place before easing the criteria for legal layoffs at healthy companies. The resuscitation of bankrupt companies is key in establishing industrial relations for the good of all parties and also in achieving economic efficiency.
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