

# **Journal of Korean Law**

**Vol. 8, No. 2, June 2009**

Law Research Institute  
Seoul National University



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## INFORMATION ABOUT THE JOURNAL OF KOREAN LAW

The *Journal of Korean Law* is published twice annually, in June and December, by Law Research Institute of Seoul National University. Please address all correspondence to:

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# The Case for Market for Corporate Control in Korea\*

Hwa-Jin Kim\*\*

## Abstract

*This Article offers an assessment of the preliminary evidence that the market for corporate control functions as a disciplinary mechanism for poor corporate governance in Korea. It analyzes SK Corporation's fight against Sovereign Asset Management, contest for control over the Hyundai Group, KT&G's fight against Carl Icahn, and LG Group and Carlyle's proxy contest against Hanaro Telecom, together with relevant laws and regulations. These high-profile cases dramatically exemplified the role of takeovers in the improvement of the corporate governance of Korean companies, and brought about active policy discussions in respect of the market for corporate control and takeover defenses. This Article will also provide a quick overview over the provisions in draft new Korean Commercial Code related to the market for corporate control and takeover defenses, including squeeze-out, poison pills, and dual-class commons. This Article argues that as the increasing exposure of control to the market could eliminate the inefficient controlling shareholder system in Korea, the new Korean Commercial Code should strike a balance between the active market for corporate control and effective takeover defensive tactics for the benefit of all shareholders and the value of the company.*

## I. Introduction

Korea may be qualified as one of the “inefficient controlling shareholder systems” under the taxonomy proposed by Professor Ronald Gilson.<sup>1)</sup> Recent

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\* Published simultaneously in 2009 OXFORD UNIVERSITY COMPARATIVE LAW FORUM, an Oxford University Faculty of Law official faculty publication.

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1) See Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641 (2006); Ronald J. Gilson, *Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange*, 60 STAN. L. REV. 633 (2007).

research shows that the average of controlling family ownership for public firms in Korea was 29.51%, compared with controlling families' cash-flow rights of 8.42%. In the case of Samsung Group, the largest Korean conglomerate, those numbers were 13.52% and 1.14%, respectively, for public firms in the group.<sup>2)</sup> The private benefit of control is also relatively high in Korea. The value of corporate control amounts to about 34% of firm market value in Korea, as compared to about 29% in Italy, 1% in Denmark, 9% in Germany, and 2% in the United States.<sup>3)</sup> The poor corporate governance practices of some large Korean firms are responsible for the still-continuing discussions on how to abolish the "Korea discount,"<sup>4)</sup> i.e., how to eliminate or reduce agency costs in the inefficient controlling shareholder system.

One of the solutions to the problem may be the increasing exposure of corporate control to the (global) market.<sup>5)</sup> This requires Korea to facilitate corporate takeovers and promote the market for corporate control. As a

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2) James Jinho Chang & Hyun-Han Shin, *Family Ownership and Performance in Korean Conglomerates*, 15 PACIFIC-BASIN FIN. J. 329 (2007) (also reporting that the average ownership of the controlling shareholders of non-public member firms of Samsung Group was 78.43%, whereas their cash-flow rights were as low as 19.43%). See also Kee-Hong Bae et al., *Tunneling or Value Added? Evidence from Mergers by Korean Business Groups*, 57 J. FIN. 2695 (2002); E. Han Kim & Woochan Kim, *Changes in Korean Corporate Governance: A Response to Crisis*, J. APP. CORP. FIN. 47 (Winter 2008).

3) See Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J. FIN. ECON. 325 (2003).

4) The origin of this concept traces back to the 1997 financial crisis. See Sang Yong Park, *Value of Governance of Korean Companies: International Investors Survey* (April 1999) (on file with the author).

5) Cf. Gilson, *supra* note 1, at 1676-1677. Other strategies suggested by Professor Gilson are improving the legal system and improved access to global capital markets. See *id* at 1673-1678. For cross-listing of Korean companies on foreign exchanges, see Hwa-Jin Kim, *Cross-Listing of Korean Companies on Foreign Exchanges: Law and Policy*, 3 J. KOREAN L. 1 (2003). As of March 2009, eight Korean companies have listed their ADRs on the New York Stock Exchange: KB Financial Group, Korea Electric Power Corporation, KT Corporation, LG Display, POSCO, Shinhan Financial Group, SK Telecom, and Woori Finance Holdings. Thus far, no study has been made on the effect of the Sarbanes-Oxley Act of 2002 on cross-listed Korean firms. See generally, Kate Litvak, *Sarbanes-Oxley and the Cross-Listing Premium*, 105 MICH. L. REV. 1857 (2007); John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757 (2002); Amir Licht, *Cross-Listing and Corporate Governance: Bonding or Avoiding?*, 4 CHI. J. INT'L L. 141 (2003); Darius P. Miller, *The Market Reaction to International Cross-listings: Evidence from Depository Receipts*, 51 J. FIN. ECON. 103 (1999).



matter of fact, contested mergers and acquisitions emerged in the business world of Korea in the mid-1990's and have since served as a popular topic for the media. The surprising takeover of Hannong Corporation by Dongbu Group in 1994 opened the gate for such transactions in Korea. This was followed by the abolition of the statutory protection of control as of April 1, 1997. In recent years, two or three hostile takeover attempts have taken place every year, even targeting member companies of the largest corporate groups like Hyundai and SK. The largest company in Korea, Samsung Electronics, is also said to be vulnerable to potential takeover threat by foreign competitors and/or hedge funds. KT&G's fight against Carl Icahn and Steel Partners in early 2006 provoked public discussions on the market for corporate control and hedge fund activism in Korea.

This article describes and analyzes the current status of corporate control in Korea by summarizing four recent cases together with relevant laws and regulations: SK Corporation's (SK's) fight against Sovereign Asset Management, contest for control over the Hyundai Group (Hyundai), KT&G's fight against Carl Icahn and his allies, and LG Group and Carlyle's proxy contest against Hanaro Telecom. This article, in particular, focuses on the role of takeovers in the improvement of the corporate governance of Korean companies as dramatically exemplified by the cases. Active policy discussions in respect of the market for corporate control and takeover defenses and the reshaping of large corporate groups are all on-going in Korea and should lead to new legislation. This article will provide readers with a quick overview over the provisions in draft new Korean Commercial Code related to the market for corporate control. The draft bill includes some important institutions such as squeeze-out, poison pills, and dual-class commons. As it was the case in the United States and other jurisdictions, many of the important developments in Korean corporate law are emerging out of judicial decisions in the context of corporate control contest. The new institutions, once finally adopted, may lead to significant number of litigations, and Korean corporate law will open a new era in its dynamic evolutionary process.

## II. The Setting

### 1. Corporate Governance and Takeovers

It is well known through numerous reports and scholarly works that many efforts to improve the corporate governance system of Korean companies have been undertaken since the 1997 Asian financial crisis.<sup>6)</sup> The Korean Securities and Exchange Act (KSEA) which stipulated rules governing public companies regarding their corporate governance went through 16 revisions since 1997, and the Korean Banking Act 11 revisions. The Korean Commercial Code (KCC) has also been subject to five revisions and is currently being scrutinized again for another major amendment.<sup>7)</sup> It is also noteworthy that various sectors have continuously engaged in endeavors to improve the corporate accounting practice and capital market structure as evidenced by the enacting of the Securities Class Action Act, *inter alia*.<sup>8)</sup> Legislators have also integrated the seven individual acts covering the capital market and are working on developing a new infrastructure for developing investment banks in the Korean capital markets.<sup>9)</sup> On February 4, 2009, the new Korean Financial Investment Services and Capital Market Act (KFISCMA) went into effect, which also substitutes the KSEA. The KSEA rules governing corporate governance of public companies, however, have moved

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6) Hwa-Jin Kim, *Toward the "Best Practice" Model in a Globalizing Market: Recent Developments in Korean Corporate Governance*, 2 J. CORP. L. STUD. 345 (2002); Bernard Black et al., *Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness*, 26 J. CORP. L. 537 (2001); 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 (1999); Jeong Seo, *Who Will Control Frankenstein? The Korean Chaebol's Corporate Governance*, 14 CARDOZO J. INT'L & COMP. L. 21 (2006); Bernard S. Black, Hasung Jang & Wochan Kim, *Does Corporate Governance Predict Firms' Market Values? Evidence from Korea*, 22 J. L., ECON., & ORG. 366 (2006).

7) See Korean Ministry of Justice Press Release, October 4, 2006.

8) Stephen Choi, *Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465 (2004) (discussing the impact of class actions and whether securities class actions would be beneficial in Korea). See also, Dae Hwan Chung, *Introduction to South Korea's New Securities-Related Class Action*, 30 J. CORP. L. 165 (2004); Ok-Rial Song, *Improving Corporate Governance Through Litigation: Derivative Suits and Class Actions in Korea*, in TRANSFORMING CORPORATE GOVERNANCE IN EAST ASIA, *supra* note \*\*, at 91.

9) See Korean Ministry of Finance and Economy Press Release, June 29, 2006.

into the KCC.<sup>10)</sup>

Contested mergers and acquisitions are no longer viewed with unfavorable judgment in Korea. In fact, as mentioned above, a number of corporate control contests and hostile takeover attempts have since taken place. Especially following the critical period in 1997, contested mergers and acquisitions have been playing a valuable function in improving corporate governance, and this led the way to amending many laws to facilitate and promote hostile takeovers.<sup>11)</sup> As a result, advocates for having takeover defensive tactics in place to protect incumbent management face objections.<sup>12)</sup> Additional restrictions are being imposed on member companies of large corporate groups instead, and the government is also considering implementing a number of regulations for the ownership structure of conglomerates in an effort to make them subject to the market discipline. Two of the most noted devices are investigation of the discrepancy between the control right and cash flow right within the large conglomerates and making the ownership structures known to the public.<sup>13)</sup>

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10) Articles 542-2 through 542-12 went into effect on February 4, 2009. This article cites the KSEA provisions depending upon the context.

11) For the current situation in Japan, see Curtis J. Milhaupt, *In the Shadow of Delaware? The Rise of Hostile Takeovers in Japan*, 105 COLUM. L. REV. 2171 (2005).

12) For discussions in the United States, see Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POLITICAL ECON. 110 (1965). See also Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Ronald J. Gilson, *Unocal Fifteen Years Later (and What We Can Do About It)*, 26 DEL. J. CORP. L. 491 (2001); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Ronald Gilson & Reinier Kraakman, *Takeovers in the Boardroom: Burke versus Schumpeter*, 60 BUS. LAW. 1419 (2005). Cf. Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979); Lipton, Martin, *Twenty-Five Years After Takeover Bids in the Target's Boardroom: Old Battles, New Attacks and the Continuing War*, 60 BUS. LAW. 1369 (2005); Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037 (2002). For recent developments in the European Union, see BARCA FABRIZIO & MARCO BECHT, *THE CONTROL OF CORPORATE EUROPE* (Oxford University Press, 2003); GUIDO FERRARINI ET AL. EDs., *REFORMING COMPANY LAW AND TAKEOVER LAW IN EUROPE* (Oxford University Press, 2004); Scott Mitnick, *Cross-Border Mergers and Acquisitions in Europe: Reforming Barriers to Takeovers*, 2001 COLUM. BUS. L. REV. 683. See also Ronald J. Gilson, *The Political Ecology of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment*, 61 FORDHAM L. REV. 161 (1992).

13) See, e.g., Korea Fair Trade Commission Press Release, July 13, 2005 (showing

The Korean government also thinks that the holding company structure might be a solution to the inefficient controlling shareholder system. The Korean government has been encouraging big company groups to restructure themselves to holding-dominated corporate groups. Interestingly, some large corporate groups in Korea responded positively to the government's initiative and transformed themselves to a holding structure. As of August 2007, 40 corporate groups completed such transformation. The market has responded positively to the experiment.<sup>14)</sup> Perhaps, the holding structure may be working as the compromise between outright improvements of corporate governance of such groups and controlling shareholders' pursuit of maintaining control. There may be new kind of inefficiencies involved in the process, however, because the holding structure would block new investments through the capital markets and become takeover-proof as long as the controlling shareholders desire to keep control over the firm.<sup>15)</sup>

## 2. *Foreigners at the Gate*

Following the 1997 crisis the growth of the Korean M&A market has been remarkable, and the door to the Korean market is now much more accessible for foreign investors and businesses.<sup>16)</sup> The proportion of foreign-owned shares of Korean companies has increased markedly. According to the data from Bloomberg, foreigners owned on average 55.7% of the 10 largest corporations in Korea as of June 22, 2006. As much as 83.4% of Kookmin Bank,

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improvements). For the current developments in and discussions on the law of corporate groups in Korea, see Hwa-Jin Kim, *Corporate Governance in Groups of Companies*, 362 KOREAN BAR ASSOCIATION JOURNAL 6 (2006); abbreviated version in 29 CORPORATE GOVERNANCE REVIEW 15 (Korea Corporate Governance Service, 2006) (Korean). For the reform in Italy, see Guido Ferrarini, Paolo Giudici & Mario Stella Richter, *Company Law Reform in Italy: Real Progress?*, 69 RABELS ZEITSCHRIFT FÜR AUSLÄNDISCHES UND INTERNATIONALS PRIVATRECHT 658 (2005).

14) See MONEY TODAY, May 2, 2007 (reporting the souring share price of some would-be holding companies). Cf. Giuseppe Alessi, *Holding Companies Discounts: Some Evidence from the Milan Stock Exchange* (Working Paper, 2000).

15) However, the average shareholding ratio of Korean holding companies in their listed subsidiaries is as low as 40.5%. Korea Fair Trade Commission Press Release, October 14, 2007. SK Telecom, a subsidiary of SK Holdings, is even listed on the New York Stock Exchange.

16) See Hwa-Jin Kim, *Taking International Soft Law Seriously: Its Implications for Global Convergence in Corporate Governance*, 1 J. KOREAN L. 1 (2001).

the largest financial institution in Korea, was owned by foreigners, and 51.8% of Samsung Electronics, the largest company in Korea. Those foreign investors have also firmly expressed their interest in corporate governance and control. The Korea Financial Supervisory Service reported that 406 foreign investors owned more than 5% of public companies based on the 5% Reporting (Large Holding Report) as of the end of 2007, and 116 of them reported that they obtained the stock in order to influence the management.<sup>17)</sup> The cases discussed below as well as the example of Norwegian Golar LNG's attempt to take over Korea Line Corporation in 2004 have certainly left Korean corporations on alert for the possibility of losing their control in the board room to foreign investors. Even mammoths like Samsung Electronics<sup>18)</sup> and POSCO<sup>19)</sup> are not exempted from the fear. The recent move of global private equity firms<sup>20)</sup> into the Korean market<sup>21)</sup> also makes Korean managers concerned as it is reported that the private equity firms can go hostile when they need to do so.<sup>22)</sup>

Recently, stressing the threat on their corporate control imposed by foreign funds, Korean companies are demanding the government to reform the existing systems; they want to have more secure means available to protect their corporate control, or to be free from the series of restrictions under the

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17) Korea Financial Supervisory Service Press Release, March 18, 2008.

18) Samsung Electronics, Study on the Restrictions on the Exercise of Voting Rights by Financial Affiliates (October 2004) (Korean) (on file with the author). In 2004, Samsung Electronics' expenditure in R&D amounted to 40.1 percent (3.5 trillion Korean won) of the total R&D expenditures made by Korean companies. That single company contributed 6 percent to the GDP and 14.8 percent to the export, respectively, in the same year. The corporate governance of and control over Samsung Electronics has become a national agenda.

19) See *POSCO Might Need to Steel Itself for Pressure by Activist Investors*, WALL STREET JOURNAL, March 6, 2006, at C10. POSCO is the third largest steelmaker of the world after Arcelor Mittal and Nippon Steel, see *Steel Deals France a Hard Lesson in Reality*, FINANCIAL TIMES, June 27, 2006, at 16.

20) See generally Brian Cheffins & John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1 (2008); Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth?: The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219 (2009); Ellis Ferran, *Regulation of Private Equity-Backed Leveraged Buyout Activity in Europe* (ECGI Working Paper, 2007).

21) See MAEIL KYUNGJE, February 2, 2009.

22) *Private Equity Firms Losing Their Manners*, INTERNATIONAL HERALD TRIBUNE, September 25, 2006; *Even by Another Name, Takeovers Remain Hostile*, INTERNATIONAL HERALD TRIBUNE, February 12, 2006.

Korean Anti-Monopoly and Fair Trade Act (AFTA). Samsung Electronics, in particular, has taken it as far as to submit a constitutional petition to the Constitutional Court of Korea in 2005 reasoning that the restrictions under the AFTA has rendered the entire body of Samsung conglomerate vulnerable to takeover attempts and the instability of laws and regulations has made it nearly impossible to set forth their long-term corporate strategies.<sup>23)</sup> But unfortunately, the unveiling of serious problems of its corporate governance put Samsung under the heavy pressure from the press before the petition could make its way to the justices. Samsung in the end pledged a large-scale corporate responsibility and made a huge donation to charity.

The attitude of the Korean government has been true to the principles, at least until recently. In other words, the government and grassroots organizations, including PSPD (People's Solidarity for Participatory Democracy, one of the largest grassroots organizations in Korea, which is enjoying increased power since the 1997 Asian financial crisis<sup>24)</sup>), seem to think that currently, there is no logic to dampen the expectation on contested mergers and acquisitions to function as improving corporate governance. Although foreign funds and investors involved in hostile takeover attempts are regarded with suspicion in general, they are finding advocates in the Korean market, some of whom even claim that there is no particular reason to bar foreign takeover attempts in the national key industries. It has been known that the United States in the recent FTA negotiations expressed its interest in abolishing the 49% limitation imposed on foreign ownership of the key-industry companies such as Korea Electric Power Corporation and KT Corporation. Some members of the Korean National Assembly worked on a bill modeled after the US Exon-Florio Act.<sup>25)</sup>

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23) A financial or insurance company belonging to a business conglomerate with at least two trillion Korean won in assets may not exercise the voting rights it holds in a domestic affiliate. Exceptionally, it may exercise the voting rights up to 30 percent in corporate control-related matters. AFTA, Article 11.

24) See Jooyoung Kim & Joongi Kim, *Shareholder Activism in Korea: A Review of How PSPD Has Used Legal Measures to Strengthen Korean Corporate Governance*, 1 J. KOREAN L. 51 (2001).

25) Patrick L. Schmidt, *The Exon-Florio Statute: How It Affects Foreign Investors and Lenders in the United States*, 27 INT'L LAW. 795 (1993).

### 3. *Tender Offer Rules*<sup>26)</sup>

No tender offers have been attempted in Korea prior to 1994. However, beginning with Hansol Paper's attempt to acquire shares of Daesang without the consent of the company's management in October 1994, the number of hostile tender offer has since increased in Korea. As of the end of 2007, 55 tender offers were reported since 2003.<sup>27)</sup> Competing tender offers are not unusual. Tender offers have grown in number, but, more notably, the types of and purposes for tender offers have also become more diversified. For instance, among 18 tender offers launched in 2007, 8 tender offers were made in the process of transforming a corporate group to the holding structure.<sup>28)</sup>

The Korean rules for tender offer has been evolving to facilitate corporate takeovers through tender offers and promote the market for corporate control. The Korean law basically allocates decision-making role in relation to takeover bid to the shareholders. It is made after the U.S. rules in that directors cannot control access to the shareholders.<sup>29)</sup> The KSEA had mandatory tender offer provision that required the acquirer to offer for at least 50% plus one shares

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26) Articles 133 through 146 of the KFISCA.

27) Korea Financial Supervisory Service Press Releases, January 31, 2007 and February 12, 2008.

28) *Tender Offer by LGCI in 2001*: LGCI Ltd. (LGCI) was a holding company established for the purpose of holding shares of certain LG Group companies, namely, LG Chem Ltd., LG Household and Health Care Ltd. and LG Home Shopping Inc. In order to satisfy the requirements of a holding company under the AFTA, LGCI needed to hold at least 30% of shares of each of its subsidiaries, and it chose to meet such condition through a tender offer for the shares of its three subsidiaries. Although LGCI could have acquired all of the required shares from other major shareholders, it has chosen to take this approach in order to provide the minority shareholders with the chance to tender the subject shares. This tender offer was also notable in that the consideration for the tender offer was not cash, as was the usual case, but, for the first time in Korea, newly issued shares of LGCI. See Korea Financial Supervisory Service Press Release, December 17, 2001.

29) However, as Korea is introducing the poison pills, it moves toward the UK model which allocates a decision-making role to target management in addition to the shareholders. For two models of regulation, see Paul Davies & Klaus Hopt, *Control Transactions*, in: Reinier Kraakman et al. eds., *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 157, 163-173 (Oxford University Press, 2004); STEPHEN KENYON-SLADE, *MERGERS AND TAKEOVERS IN THE US AND UK: LAW AND PRACTICE* (Oxford University Press, 2004). Cf. Lucian Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002).

when the acquirer crossed 25% threshold.<sup>30)</sup> The rule, however, has been taken out of the statute during the 1997 financial crisis as it blocked acquisitions of financially distressed firms by foreign investors.

The offeror must give the public notice in at least two regular or economic daily newspapers. The offeror then files the tender offer report with the Korea Financial Supervisory Commission (KFSC), and, on the same day, serves copies of the report on the target company and the Korea Exchange. Starting from the day immediately after the public notice is given, the offeror must place prospectus for public inspection at the KFSC, Korea Exchange, and the main and branch offices of the tender offer agent. Notice to individual shareholders is not required. The tender offer period may be between twenty and sixty days. This period may, however, be extended if there is any competing tender offer until the expiration of competing tender offer's offer period. A shareholder may withdraw its acceptance at any time during the offer period. During the offer period the offeror may not acquire target shares except by way of the tender offer process. In the rare event that the offeror fails to effect tender offer in accordance with his/her disclosure, he/she will be in violation of the disclosure obligation and may also face lawsuits from the other investors for damages.

The offeror must disclose, *inter alia*, his/her identity with that of specially interested persons, the purpose of the tender offer, and the target securities,<sup>31)</sup> including the number of shares to be acquired through the tender offer. The tender offer may be conditional upon acceptance of a minimum number of shares and may state that the offeror will not purchase above a certain maximum number. The offer period, date of purchase, price, the method of payment and other mechanical detail must also be disclosed. Availability of

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30) For the mandatory bid rule, see generally Davies & Hopt, *supra* note 29, at 178-181; Clas Bergstrom et al., *The Optimality of the Mandatory Bid*, 13 J. L., ECON., & ORG. 433 (1997); Scott Mitnick, *Cross-Border Mergers and Acquisitions in Europe: Reforming Barriers to Takeovers*, 2001 COLUM. BUS. L. REV. 683, 707-713.

31) There is no Korean requirement for compliance with the tender offer rules of any foreign exchange where the shares are listed or of any foreign jurisdiction in which there are shareholders, although the foreign rules themselves may require compliance. The depository receipts themselves are not one of the instruments that can be subject to a tender offer. However, any holder of the depository receipts can respond to a tender offer after exchanging the receipts for the shares.



the funds to pay the purchase price, including the statement that money or other consideration in excess of the amount required for the purchase has been deposited in a financial institution or otherwise reserved and description of such arrangements, and the source of the consideration must be disclosed. The funds to pay the purchased shares must be available in advance and described in the tender offer report filed with the KFSC. Further, future plans for the target company subsequent to the successful conclusion of the tender offer must be disclosed. Although the tender offer report is not a matter for approval by law, the KFSC may, in practice, direct the offeror to amend or withdraw the report. The target company is not obligated to respond to a tender offer. However, the target company can express its view on the tender offer, accept the tender offer or come up with a counter tender offer.

#### 4. *Takeover Defensive Tactics*<sup>32)</sup>

Now that the business environment in Korea is no longer so favorable to the current owners/directors, they are urging new means of takeover defense such as the poison pill and dual-class common shares and at the same time, are keeping themselves busy searching for other legitimate ways to protect their management control.<sup>33)</sup> Amid the alert state, some yet to be legally proven tactics such as the golden parachute are quite popular for them. The court cases on the takeover defenses are not informative, and the available cases are limited to the most commonly used methods like rights offerings and selling treasury shares to friendly parties. In particular, sale of treasury shares has been the favorite tactic of Korean corporations in their attempt to protect their corporate control.

*Sale of Treasury Shares:*<sup>34)</sup> Disposal of treasury shares must, in principle,

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32) See generally HWA-JIN KIM & OK-RIAL SONG, *MERGERS AND ACQUISITIONS* (Pakyoungsa, 2007) (in Korean); Hwa-Jin Kim & Ok-Rial Song eds., *HOSTILE TAKEOVER AND DEFENSIVE TACTICS* (Seoul National University Center for Financial Law, 2007) (Korean).

33) For the situation in Europe, see Marco Becht, *Reciprocity in Takeovers* (European Corporate Governance Institute Working Paper, 2003); John C. Coats IV, *Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?* (European Corporate Governance Institute Working Paper, 2003). See also Tatiana Nenova, *Takeover Laws and Financial Development* (Working Paper, 2006) (studying takeover laws of fifty countries).

34) Jonathan R. Macey & Fred S. McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95

comply with the procedure laid out in KIFSCMA. Under the KIFSCMA, listed companies would first have to obtain approval from its board of directors for the disposal of its treasury shares and then file a report on the disposal of treasury shares with the KFSC. In case the company disposes of its shares through the Korea Exchange, the order for the shares must be placed in certain way and the asking price will have to be within certain range. In contrast, if the disposal of the shares takes place off-the-market, there are no restrictions on the asking price and method of the order. Therefore, sale of treasury shares to a friendly party based upon an elaborate contractual arrangement, including the fair price and other terms, might be an effective takeover defensive tactic. Although there was a lower court decision that outlawed the disposition of treasury shares to the controlling shareholder,<sup>35</sup> other courts keep validating the disposition of treasury shares to friendly parties.

*Issuance of New Shares:* Under the KCC shareholders of the stock companies have the preemptive rights.<sup>36</sup> However, the KCC provides that the board of directors has the authority to issue new shares to third parties and/or shareholders not in proportion to the current shareholding ratio when necessary to achieve the objective of the company's management, such as introduction of new technology and improvement of capital structures.<sup>37</sup> This also applies to the issuance of convertible bonds (CB) or bonds with warrant (BW) (equity-linked securities). The articles of incorporation for most listed companies in Korea provide that the board has the authority to issue new shares or equity-linked securities to third parties and/or shareholders not in proportion to the current shareholding ratio under certain circumstances. Thus, the issuance of new shares can be an effective tool that the incumbent management can use to fend off hostile bidders. However, there have been several cases where the validity of issuing new shares or equity-linked securities to defend against takeover has been put to test and several court

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YALE L. J. 13 (1985); Charles Nathan & Marilyn Sobel, *Corporate Stock Repurchases in the Context of Unsolicited Takeover Bids*, 35 BUS. LAW. 1545 (1981); Matthew T. Billett & Hui Frank Xue, *The Takeover Deterrent Effect of Open Market Share Repurchases* (Working Paper, 2007).

35) Seoul Western District Court, Decisions of March 24, 2006 and June 29, 2006, Case Nos. 2006-Kahap-393 and 2005-Gahap-8262, respectively.

36) KCC, Article 418, Paragraph 1.

37) KCC, Article 418, Paragraph 2.

cases have held that such issuance is invalid (and is subject to the preliminary injunction).

*Strategic Alliance:* Many Korean companies enter into an agreement with a potential “white knight” to mutually hold the other’s shares and come to the aid if there is a hostile takeover attempt. For instance, POSCO and KB Financial Group recently agreed to cross-hold shares in the amount of 300 billion Korean Won.<sup>38)</sup> Quite often, the strategic alliance partner is customer or business partner of the company. There are no laws in Korea that prohibit companies from entering into such alliance agreement where parties mutually agree to hold the other’s shares. However, Art. 369 Paragraph 3 of the KCC provides that in case a company owns 10% or more of shares of the other company, the other company cannot exercise the voting rights on the shares of the first company. Further, in mutually acting as a potential white knight to the other, companies sometimes enter into an agreement to exchange non-executive (or outside) directors. The KCC now contains regulations on the qualification of non-executive directors. Under these regulations, one ground for disqualifying a candidate from being a non-executive director is if the candidate serves as the current officer/employee or served, in the recent two years, as an officer or employee of the company that has important business relationship or is in competitive or cooperative relationship with the electing company.<sup>39)</sup>

*Restrictions on Qualification of Directors:* To defend against a hostile takeover certain restrictions on the qualification of directors can be placed in the articles of incorporation. For example, the company’s articles of incorporation could provide that to become a director, the candidate must have served at least a certain period as an officer or employee of the company. This may make it difficult for a person who attempts a hostile takeover to nominate his or her own director candidates. In fact, some of the listed companies’ articles of incorporation contain such provision. As long as requirement concerning the period of employment is not too advantageous for the current management, such provision in the articles of incorporation would be held valid. However, such arrangement may backfire the board. Recently, KT, the largest

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38) MAEIL KYUNGJE, December 22, 2008.

39) KCC, Article 382, Paragraph 3.

telecommunications company of Korea has experienced difficulties in recruiting the new CEO.<sup>40)</sup>

*Golden Parachute:* The so-called “golden parachute” provides directors or management with lucrative severance payments in case they are ousted by hostile takeover. It is intended to make the company less attractive to potential acquirer by placing a heavy financial burden on the acquirer who seeks to acquire the company. Although there is no reported court case, it is widely believed that the golden parachute is allowed under Korean law if the company’s articles of incorporation allows it and/or if the company’s internal severance pay regulations allows the granting of golden parachute and the company obtains approval from the shareholders concerning the maximum remuneration of directors at the shareholders’ meeting. In fact, some of the companies in Korea currently provide golden parachute to its directors/management. As of August 2008, 15 listed companies have adopted golden parachute.<sup>41)</sup> However, there is a substantial risk that directors who approve payment of severance pay, which is considered excessive, may be in breach of their fiduciary duty under the KCC or Korean Criminal Code, depending on the seriousness of their actions. Moreover, it seems that there is negative sentiment on the part of shareholders and general public in Korea regarding the granting of golden parachutes.

*Staggered Board:* When the term of a director under the company’s articles of incorporation is three years, a way to avert hostile bidders from acquiring control of the board is by adopting so-called “staggered” board in the articles of incorporation so that each year, for example, the term of only 1/3 of the board members expires. This way, it would take at least two additional years for the hostile bidders to acquire a complete control over the board. It is understood that this device is, in the United States, one of the most popular<sup>42)</sup> and powerful anti-takeover arrangements when combined with the poison pill.<sup>43)</sup> However, in Korea, it is not clear how strongly the directors can resist

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40) MAEIL KYUNGJE, November 25, 2008.

41) HANKUK KYONGJE, September 2, 2008.

42) John C. Coates, *Explaining Variations in Takeover Defences: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1353 (2001).

43) Lucian Bebchuk, John Coats IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002); Michael D. Frakes, *Classified Boards and Firm Value*, 32 DEL. J. CORP. L. 113 (2007).

the successful bidder and this approach would not be effective if the hostile bidders can obtain sufficient votes to pass a special resolution and terminate all of the directors. The KCC, different from the Delaware General Corporation Law, does not confer any legal effect to the articles of incorporation that formally adopts the staggered board. Therefore, the directors can be discharged without cause,<sup>44)</sup> and their seats will be filled by the shareholders, not the remaining directors.<sup>45)</sup> Also, as the KCC currently does not allow the companies to adopt the poison pills, the effectiveness of the staggered board is questionable, if at all. As of August 2008, 20 listed companies have adopted staggered board.<sup>46)</sup>

*Supermajority Voting:* Another defensive tactic would be to provide for a stronger requirement in the company's articles of incorporation than the special resolution for certain events such as merger or business transfer that the acquirer may try to effect after the acquisition.<sup>47)</sup> However, there is a view

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44) KCC Article 385 (Dismissal): (1) A director may be dismissed from office at any time by a resolution at a general shareholders' meeting in accordance with Article 434: Provided, that in case where the term of office of a director was fixed and he is dismissed without cause before the expiration of such term, he may claim for damages caused thereby. (2) If the dismissal of a director is rejected at a general shareholders' meeting notwithstanding the existence of dishonest acts or any grave fact in violation of the relevant acts, subordinate statutes or the articles of incorporation in connection with his duties, any shareholder who holds no less than 3/100 of the total outstanding shares may demand the court to dismiss the director, within one month from the date on which the above resolution of the general meeting was made.

45) For Anheuser-Busch's staggering defense in 2008, see *InBev Seeks to Oust Anheuser-Busch Board*, INTERNATIONAL HERALD TRIBUNE, July 7, 2008.

46) HANKUK KYONGJE, September 2, 2008.

47) The board of directors of a Korean corporation has broad power and wide discretion to manage all matters which are reasonably necessary to achieve the purposes of a corporation. Generally all the affairs and business of a corporation are considered and determined by the board of directors except for the matters required to be resolved at shareholders meetings under the KCC or by the articles of incorporation of the corporation. The following matters are basically within the authorities of the board, but may be reallocated to the shareholders' meeting if the articles of incorporation so provide: (i) appointment of a representative director (Article 389(1)); (ii) issuance of new shares (Article 416); (iii) conversion of reserves into capital (Article 461(1)); (iv) issuance of convertible bonds (Article 513(2)); and (v) issuance of bonds with warrants (Article 516-2(2)). The Commercial Code also lists matters which require resolution at a shareholder meeting, i.e., matters which cannot be removed from shareholder authority even via the articles of incorporation. Certain important matters of a corporation can be adopted only by the affirmative vote of shareholders holding at least two-thirds (2/3) of the shares represented in person or by proxy at a general meeting of shareholders which represents

that articles of incorporation that provides for stricter requirement than special resolution under the KCC is void. There was a lower court decision that outlawed the supermajority requirement for removal of directors without cause.<sup>48)</sup> Thus, if the company provides for stronger requirement than the special resolution in relation to a hostile takeover in its articles of incorporation, it is possible that such requirement will be held void. Notwithstanding such a view, there are some listed companies in Korea that provide for stricter requirement than the special resolution in their articles of incorporation. As of August 2008, 38 listed companies have adopted supermajority voting.<sup>49)</sup> It should also be noted that even if setting forth such stricter requirement in the articles of incorporation is held to be valid, this would result, in effect, in minority shareholders having a veto right, which could place a burden on the management.

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the affirmative vote of the holders of at least one-third (1/3) of the total issued and outstanding shares. Article 434. This is called a "special resolution." This special voting requirement cannot be softened even by the articles of incorporation. It is required, *inter alia*, for (i) amendment of the articles of incorporation (Article 434); (ii) issuance of shares at a price less than par value after two (2) years of incorporation (Article 417); (iii) transfer of the entire business of the corporation or an important part thereof (Article 374(1)); (iv) take-over of the entire business of another company (Article 374 (3)), or take-over of a part of another company's business which will have important effect on the corporation's business (Article 374(4)); (v) issuance of convertible debentures to persons other than shareholders, and determination of the terms of conversion, etc. unless such matters are provided for in the articles of incorporation (Article 513(3)); (vi) removal, with or without cause, of a director or a statutory auditor from office prior to expiration of his term of office (Articles 385(1) and 415); (vii) a merger with another company (Article 522(3)), division or merger through division (Article 530-3(2)); (viii) reduction of stated capital (Article 438(1)); and (ix) dissolution of the corporation (Article 518). All other matters, including the election of directors (Article 382(1)) can be resolved by a simple majority vote of the shareholders present or represented at a general meeting of shareholders which represents the affirmative vote of the holders of at least one-fourth (1/4) of the total issued and outstanding shares.

48) Seoul Central District Court, Decision of June 2, 2008, Case No. 2008-Gahap-1167.

49) HANKUK KYONGJE, September 2, 2008.

### III. SK<sup>50)</sup>

#### 1. Background

The SK case uniquely provides empirical data and resources to show that first its problem-ridden corporate governance triggered a hostile takeover attempt, and then the takeover threat brought about major improvement in its corporate governance. Furthermore, it raised fierce political and economic controversies because (1) the hostile takeover threat came from a foreign investment fund, (2) energy was the core business of SK Group, and (3) SK Group's most important member company was the key telecommunication provider, SK Telecom, which was the 450<sup>th</sup> largest company based on its total market capitalization as of March 31, 2005.<sup>51)</sup>

The development of "SK Saga" arose during the period of the 1997 Asian financial crisis. SK Securities incurred a huge loss from the financial derivatives deals with JP Morgan prior to 1997, and it led to lawsuits both in Korea and the U.S. In an effort to bring reconciliation between the two parties, SK Global involved its overseas subsidiary, but PSPD deemed it illegal and

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50) HWA-JIN KIM, *THE LAW AND PRACTICE OF THE BOARD OF DIRECTORS* 42-45 (2nd ed., Pakyoungsa, 2007) (in Korean).

51) At the center of SK Group is SK Corporation which is controlled by SKC&C, which in turn is controlled by the current Chairman and CEO Chey Tae-won, the eldest son of the late head of SK Group Chey Jong-Hyun. Under the control of SK Corporation lies a number of affiliate companies including SK Telecom, SKC, SK Networks (former SK Global), and SK Shipping. The beginning of SK Group traces back to half a century ago, when Chey Jong-Hyun's brother Chey Jong-kun founded Sun Kyoung Textiles, the mother company of SK Networks, in 1953. About a decade later came the birth of Sun Kyoung Synthetic Fiber in 1967, and it later became SKC. Following the death of Chey Jong-kun in 1973, Chey Jong-Hyun succeeded his brother in 1978 and spurred the dramatic growth of SK Group in the 1980's and 1990's. Before his death in 1998, he entered into the mobile telecommunication industry and acquired the oil refining business, Yukong, both of which are remembered as his greatest achievements. Since the death of Chey Jong-Hyun, SK Group was led by the group Chairman Chey Tae-won and SK Telecom CEO Son Kil-seung, who is known as the most successful professional manager in Korean business history, until 2003. While taking the office of CEO at SK Telecom, Son Kil-seung also served as the president of the Federation of Korean Industries (FKI). But in the wake of the following event, Son Kil-seung claimed to be responsible and resigned from both SK Telecom and FKI at the same time. See <http://eng.skcorp.com>.

filed a complaint against the SK management with the Public Prosecutor's Office. Furthermore, fearing the loss of his corporate control due to the reinstatement of the legal limitation on total investment,<sup>52)</sup> Chey Tae-won exchanged his Walker Hill stocks with SK Corporation's and unexpectedly fell subject to the judicial restraint. To make matters worse, SK Global was found to have committed a large scale accounting fraud, and the stock prices of all the SK Group companies plummeted. When SK Corporation's stock price fell to 6,100 Korean won, Sovereign Asset Management suddenly emerged as the largest shareholder.<sup>53)</sup>

When Sovereign came into play, the public viewed it as a mysterious entity and scorned it as an ill-intended speculator. But Sovereign claimed to be a serious corporate governance fund. It is believed that Sovereign's actions taken in Korea not only were unpredictable and lacking consistency, but the Fund also seemed to be without any fundamental strategies. Sovereign persistently assailed SK Group's flaws in its corporate governance and eventually demanded the removal of Chey Tae-won, doubting his leadership qualifications as the head of SK Group. Sovereign further attempted to gain control of the board of SK Corporation by nominating outside director candidates. Notwithstanding the suspicion that Sovereign intended to take over SK Corporation, Sovereign kept its public announcement on the issue of corporate governance alone and expressed no plan to engage in the management and business. But the press cast doubt on Sovereign's true intentions.

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52) The so-called limitation on total investment amount was one of the means employed by the AFTA to curb undue concentration of economic power in a few hands; the other such means being (chiefly) the prohibition of cross (or reciprocal) equity investment, the prohibition of debt guarantees for an affiliate, and the limitation on voting rights of financial and insurance companies. While these latter prohibitions and limitation applied to companies belonging to any business group with at least two trillion Korean won in assets, the threshold for applying the limitation on total investment amount was five trillion Korean won in assets. A company then, belonging to a business group with at least five trillion Korean won and thus subject to the limitation on total investment amount, may not acquire or hold stock of other domestic companies in excess of 25% of its net asset amount. *See generally* Youngjin Jung & Seung Wha Chang, *Korea's Competition Law and Policies in Perspective*, 26 NW. J. INT'L L. & BUS. 687 (2006). The limitation on total investment amount has been abolished in March 2009. *See* Money Today, March 3, 2009 (brief historical account).

53) *See* Ok-Rial Song, *Legal Issues of the SK Case*, 3 BUSINESS FINANCE LAW 23 (2004) (Korean).



## 2. *Struggle*

Sovereign vied for the control of SK at two annual shareholder meetings. At the March 2004 meeting, it tried to remove the opt-out clause on cumulative voting from the articles of incorporation of the company and elect outside directors of their choice, but both attempts failed. With strong support from National Pension Service and minority shareholders, the 51.5% to 39.5% vote was in favor of the company.<sup>54)</sup>

Prior to the March 2004 shareholder meeting, SK tried to increase the share of its allies by disposing of its treasury shares to friendly parties. It decided to sell 13,208,860 treasury shares (accounting for approximately 10.41 percent of the issued and outstanding shares) to certain financial institutions friendly to the existing management. Sovereign sought a preliminary injunction of the directors' decision. It claimed that the board's decision to sell its treasury shares to friendly parties would cause the dilution of Sovereign's voting rights and, therefore, it was being prevented from fairly exercising its voting rights in the 2004 general meeting of shareholders. The Seoul District Court, however, refused to grant the preliminary injunction in its decision of December 23, 2003.<sup>55)</sup> The court opined that the disposal of any treasury shares should not be prevented even in the midst of a dispute for control of the company; provided, however, that the shares have not originally been acquired to perpetuate the existing management and the controlling shareholder(s). The decision to sell the treasury shares in the court's view was justified as business judgment. The March 2004 shareholder meeting was prevailed by the management.

Around October 2004, Sovereign demanded that SK hold an extraordinary general meeting of the shareholders to amend SK's charter to disqualify anyone with a criminal conviction from being a director of the company, and to elect certain persons designated by Sovereign as outside directors of SK. SK refused Sovereign's request to hold the meeting, stating that the proposal to amend the SK's charter was, in substance, identical to the proposal that was

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54) HANKUK KYONGJE, March 13, 2004, at 13.

55) Seoul Central District Court, Decision of December 23, 2003, Case No. 2003-Kahap-4154.

rejected in 2004 annual meeting, and that since the 2005 annual meeting was at close hand, there was no reason to urgently hold an extraordinary meeting to elect outside directors. In response, Sovereign filed a petition with the court seeking court's permission to hold an extraordinary meeting. The court rejected Sovereign's petition.<sup>56)</sup> Sovereign then made a shareholder proposal to include amendment of SK's charter and election of outside directors in the agenda of 2005 annual meeting, SK and Sovereign carried out a proxy contest in relation to the issue.<sup>57)</sup> The March 2005 shareholder meeting began in a highly tense setting; while Sovereign had demanded Chey Tae-won's removal from the board, the meeting agenda included renewal of Chey's term as director. But again, the result of the shareholder voting by a wide margin allowed the company to defend its corporate control and reelected Chey Tae-won to the board. The Seoul High Court convicted Chey Tae-won in June 2005 but he was saved from imprisonment and granted to stay on probation.

Sovereign, in July 2005, disposed of its entire stakes in SK and gained about 1 trillion Korean won in profit, which can seem as an outstanding performance by a corporate governance fund. The Fund thereafter invested in LG Group putting the market on alert again, but sold its stocks after six months and left the Korean market altogether.<sup>58)</sup> Sovereign's ambiguous moves in the process of ownership disclosure and reporting of foreign investment created confusion in the market and resulted in major changes in the 5% Rule. The change required a description of investment objective in great detail to be made public.<sup>59)</sup> Also, in order to prevent an investor from

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56) Seoul Central District Court Decision, December 15, 2004, Case No. 2004-Bihap-347. However, the court viewed Sovereign's petition not abusive.

57) Sovereign had a tough fight. SK demanded that Sovereign provide certificates of registered seal impression of the shareholders who issued proxy to Sovereign. Surprisingly, Sovereign complied with the company's demand. Therefore, the issue of the means and standards for confirming the veracity of a proxy did not arise at the shareholders meeting of SK.

58) See MAEIL KYUNGJE, August 24, 2005, at A1.

59) The KFISCA explicitly makes it obligatory to file a report of the "Purpose of Ownership" (that is, the purpose of influencing the management control of the issuer) in addition to the "Status of Shareholding." KFISCA, Article 147, Paragraph 1. The KFISCA also states that persons who have reported the purpose of their ownership as "for the purpose of influencing the management control of the issuer" will be, from the time of the filing of the report until the expiration of the fifth day, prohibited from acquiring additional equity securities of the issuer or exercising the voting rights on the shares that the persons own (as filed in the

acquiring a controlling stake in a Korean corporation for a very short period of time without due disclosure of his/her intention, the regulatory authorities have introduced a system similar to the cooling-off period system adopted in the United States. Under the new system, in case an investor whose investment purpose is portfolio investment comes to acquire 20% or more shares in a listed corporation, such investor would be prohibited from acquiring additional shares in the company or exercising voting rights during a certain cooling-off period, while for an investor with the purpose of participating in management, the threshold for triggering the cooling-off period would be 5%. In addition, under the new system, the cooling-off period would be also applicable to an investor who changes his/her investment purpose from portfolio investment to participation in management.

### 3. Evaluation

Sovereign's withdrawal from the Korean market evoked wild speculation but Professor Sang Yong Park of Yonsei University rendered an evaluation of Sovereign's strategies from an academic perspective.<sup>60</sup> According to Park, unlike undervaluation due to the 'Korea discount' which results from a multitude of factors, undervaluation that is triggered by a discount of subsidiary shares due to matters relating to poor corporate governance creates

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report). KFISMA, Article 150, Paragraph 2. Any one of the following acts falls under the definition of "an act to influence the management control": (1) the appointment or removal or suspension of office of a director or auditor, (2) amendment of the articles of incorporation in relation to the company's corporate bodies such as the director and board of directors, (3) change in the company's capitalization, (4) influence regarding the dividends policies, (5) merger (including short-form merger and small-scale merger) or division of the company, (6) stock swap or transfer of stock, (7) acquisition or transfer of all or a material part of the business, (8) the disposition or transfer of all or a material part of the assets, (9) lease of all or material part of the business, delegation of management, or entering into or amending or terminating a contract whereby the company will be sharing all the profit and loss of the business with another company, or entering into other contracts of a similar nature, (10) exercising *de facto* influence on the company or its officers or minority shareholders' rights or delegating such influence for the purpose of dissolving the company. Presidential Decree to the KFISMA, Article 154, Paragraph 1.

60) Sang Yong Park, *The Political Economy of Corporate Governance: Hostile Takeover and Labor's Participation in Management*, 34-2 KOREAN MANAGEMENT REVIEW 569 (2005) (Korean).

unique opportunities for arbitrage, and the SK case exemplifies the latter. The aggregate value of SK Corporation's listed stock fell under 40% of the equity (20.85%) value of SK Telecom owned by SK Corporation at the time when Sovereign's hostile takeover attempt was in the initial stage. During the period subject to the analysis, while the rate of increase of share price of other oil refining corporations did not even reach the rate of increase at composite stock price index, SK's rate far exceeded it. Such phenomenon cannot be explained by anything other than hostile takeover threats.

While under the threat of Sovereign's hostile takeover, SK Group assiduously worked on improving its corporate governance. It should be noted that there are several apparent reasons for such effort. First, it was not a surprise that they saw the need to fix their corporate governance, since it triggered their public criticism and disgrace. Second, Chey Tae-won was imprisoned and was going through trials. SK needed to make public that they were striving to improve its corporate governance system in order to render the situation favorable to the convicted chairman. Lastly, Sovereign assailed the corporate governance of SK, which was lagging behind global standards.

SK Corporation's effort to restructure its board by appointing a majority of outside directors was not a nominal political move. SK Group even went as far as to reform the boards of its private member companies into outside-director dominated boards, which was not required by law. Regardless of the motive for such drastic change, the result was building a well functioning board and earning a name as the pacesetter for high standard corporate boards in the Korean market. Professor Hasung Jang's widely quoted comment well summarizes the overall impact: "Sovereign achieved in one year what the Korean government could not in many years." SK Group also tried to transform itself as a loosely integrated entity within which the member companies share its brand. When the current market is infested with problems caused by the complicated relationships amongst member companies of large conglomerates, SK's move was praised as a prudent strategy. Finally, in April 2007, SK Group has ended up announcing its plan to transform itself to a holding company structure. The market applauded the move.

## IV. Hyundai

### 1. Background

Similarly, the Hyundai case reflects a corporate governance issue resulting in a hostile takeover attempt, but it is much more complicated than the SK case in terms of its historical background and high level of politics involved.<sup>61)</sup> Both the bidder and defender in the Hyundai case vied for support from the shareholders on a platform of improving corporation governance. This case demonstrates that corporate governance issues can lead to hostile take over attempt or dispute over corporate control.

The history of the Hyundai Group<sup>62)</sup> takes up an integral chapter of that of the Korean national economy. The now deceased founder and honorary chairman of Hyundai, Chung Ju-yung, founded Hyundai Engineering & Construction in 1947, which was the foundational entity of Hyundai and later became Hyundai Construction in 1950. Chung Ju-yung's professional career included holding the office of the president of FKI for 10 years; and once he even assembled a political party and ran for President of Korea. Founded in 1972, Hyundai Heavy Industries left a legend that it once obtained funds from Barclays Bank of England solely based on its plan for ship building business and the pictures of the site. The extraordinary history of Hyundai reached its peak in the late 1990's. Honorary Chairman Chung Ju-yung herded 1,001 cows to North Korea in June 1998, which certainly created a drama, and met with the ruler of North Korea, Kim Jong Il, in the following October. The historical event resulted in founding of Hyundai Asan in 1999 putting business with North Korea into force.

Hyundai Group, however, faced crisis in 1999. With Hyundai Construction being close to insolvency and the North Korea business getting out of hand, the Group had severe liquidity problems and was forced to restructure its affiliated companies by its creditors. As a result, Hyundai Group disposed of or separated 23 of its 49 affiliated companies and

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61) "Shakespeare could hardly have written a more convoluted tale of sibling rivalry, palace intrigue and thirst for power." FINANCIAL TIMES, May 5, 2006, at 28 (on Hyundai saga).

62) <http://www.hyundaigroup.com>

categorized the remaining 26 companies into the five key industries of heavy engineering, automobiles, electronics, construction and finance. Each of the five categories was turned into a form of small groups, which was reorganized as an independent business entity. Not included in the five key industries, Hyundai Department Store was given to the chairman's third eldest son, Chung Mong-keun, Hyundai Development Company to his third younger brother, Chung Se-young, and Kumgang Korea Chemical (Kumgang) to his fourth younger brother Chung Sang-young for independent management.

In 2000 an event dubbed "The Feud of the Princes" occurred. The conflict was a power struggle over the succession of Hyundai corporate control amongst Chung Ju-yung's sons, Mong-hun, Mong-koo, and their respective aids. Following the conflict, Mong-hun was selected as the successor to take over Hyundai Group, Mong-koo Hyundai Motor and Mong-joon Hyundai Heavy Industries. After the death of Chung Ju-yung in March 2001, Hyundai continued its North Korea business with the Kim Dae-jung Administration in honor of Chung Ju-yung's will. As Hynix Semiconductor and Hyundai Construction faced critical liquidity issues, Mong-hun gave up on the two companies and focused on running Hyundai Asan, the North Korea business. Mong-hun was investigated for accounting fraud in Hyundai Merchant Marine, which was connected to the allegation that he passed money to North Korea illegally. He committed suicide in August 2003.

## 2. Contest

After his death, his widow, Hyun Jeong-eun, succeeded him, and a foreign fund began to actively purchase the stocks of Hyundai Elevator, the flagship of Hyundai Group. In November 2003, alleging to salvage Hyundai Group from foreigners, the brothers' uncle and the president of Kumgang, Chung Sang-yung, who disliked the officers of late Mong-hun and was displeased with Hyun taking over Hyundai Group, contended for a hostile takeover acquiring, directly and indirectly, approximately 44.39 percent of the issued and outstanding shares of Hyundai Elevator.<sup>63)</sup> Amid the family conflict,

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63) See HANKUK KYONGJE, November 5, 2003, at 1. See also HANKUK KYONGJE, December 8, 2003, at A14 (Chung Sang-yung's half-page open position letter).

Mong-koo and Mong-joon remained neutral. Hyundai Group tried first to increase its capital by public offering in a large scale but was enjoined by the court. The board of directors of Hyundai Elevator, in an attempt to defend against Kungang's hostile takeover attempt, resolved to issue 10 million new shares, which was 178 percent of the then outstanding shares, at a 30 percent discount, with a condition that the number of the newly-issued shares to which any one person may subscribe cannot be more than 300 shares. Kungang sought a preliminary injunction of the proposed issuance of new shares by Hyundai Elevator, arguing that the proposed issuance is improper as it infringes on the preemptive rights of the existing shareholders and is an attempt only to perpetuate the current management. The court viewed that Hyundai's public offering did infringe the preemptive right of the shareholders.<sup>64)</sup>

The Suwon District Court found that the proposed issuance of new shares infringed on the preemptive rights of the existing shareholders, including Kungang, and it granted the preliminary injunction. The court reasoned that, considering that any attempt to defend a takeover bid should be made within the scope allowed under the laws and regulations and the articles of incorporation of the company concerned, Hyundai Elevator's proposed issuance of new shares, which is allowed only to the extent necessary to raise funds for the business of the company under the KCC and the articles of incorporation of the company, apparently for the purpose of perpetuation of the existing controlling shareholder(s) or the management, was not proper. However, the court did not completely rule out the possibility of issuing new shares as a means of takeover defense. Specifically, the court stated that the following event may be an exception to the general rule where the company concerned may issue new shares in an attempt to avert a hostile takeover: (1) if preserving the existing controlling shareholder(s) and/or the existing management of the target company is beneficial to the company itself or the shareholders in general or there are any other specific public reasons; and (2) if the target company has taken all reasonable steps in making the decision to issue new shares, such as soliciting the opinions of the disinterested

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64) Suwon District Court Yeosu Branch, Decision of December 12, 2003, Case No. 2003-Hap-369. See HANKUK KYONGJE, November 18, 2003, at 3.

shareholders or independent experts. According to the court, if these requirements are met, the issuance of new shares may not be invalidated because it was done for the proper business purposes as stipulated in the company's articles of incorporation and the KCC.

During the course of the legal battle, Hyundai emphasized that the 5% Rule should not be understood just as an "early warning system."<sup>65</sup> The purpose of the Rule was rather to protect minority shareholders who do not have the necessary resources to collect information on other (large) shareholders' intent. Certain empirical studies done by U.S. scholars<sup>66</sup> were heavily cited in the brief of Hyundai's counsel. The court accepted the argument and sanctioned Kumgang's violation of the 5% Rule severely.<sup>67</sup> The ruling of the court was perceived as extraordinary by the Korean bar partly because the Korea Financial Supervisory Service did not accept Hyundai's argument that the entire filing for over 5 percent made by Kumgang should be treated invalid.<sup>68</sup>

Hyundai Group's attempt to avert the hostile takeover attempt by Kumgang succeeded in the end, because Kumgang was found to be in violation of the 5% Rule for material omission in reporting,<sup>69</sup> although

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65) See generally WILLIAM J. CARNEY, *MERGERS AND ACQUISITIONS: CASES AND MATERIALS* ch.10 (Foundation Press, 2000). For the British 3% Rule, see PAUL L. DAVIES & L. C. B. GOWER, *PRINCIPLES OF MODERN COMPANY LAW* 922-932 (8<sup>th</sup> ed., Sweet & Maxwell, 2008). For the rule in Germany, see Klaus Peter Berger, "Acting in Concert" nach §30 Abs. 2 WpÜG, 49 *DIE AKTIENGESELLSCHAFT* 592 (2004).

66) See RONALD GILSON & BERNARD BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 903 (2<sup>nd</sup> ed., Foundation Press, 1995) (citing a study that shows higher abnormal rate of return in the case of compliance of the 5% Rule).

67) Seoul Central District Court, Decision of March 26, 2004, Case No. 2004-Kahap-809. The petition for the preliminary injunction was filed by Hyundai Securities.

68) See HANKUK KYONGJE, March 30, 2004, at 3.

69) See Korea Financial Supervisory Service Press Release, February 11, 2004; Suwon District Court Yeosu Branch, Decision of March 23, 2004, Case No. 2004-Kahap-51. Grounds for sanctions such as restraint on voting rights include not only defective reporting, but also false reporting and omission in reporting. More specifically, the KSEA had the following penal provisions: (i) a person who, in intentional violation of the obligation to file a Large Holding Report, did not report the status of shareholding, purpose of ownership and the details of the change, or has falsely reported or omitted to state material matters, will be restricted from voting on the shares that are in violation of the reporting requirement, as mentioned above, among the portion that exceeds 5% of the issued and outstanding voting shares for a period of six months; and (ii) a person who has delayed the above reporting or corrective reporting by



Hyundai went through the pierce proxy fight.<sup>70)</sup> No efforts were made for reconciliation. Chung Sang-yung had mentioned during the dispute period that he would stop the business with North Korea once he took over Hyundai Group, but the new chairman, Mrs. Hyun, successfully defended her management control and visited North Korea with one of her daughters to meet Kim Jong Il.<sup>71)</sup> Hyundai's business with North Korea continues to this date.

Before the crucial shareholders meeting of March 30, 2004, Kumgang announced that it would withdraw from the contest if it would lose the proxy contest. Indeed, Kumgang sold its shares of Hyundai Group to Schindler Holding of Switzerland and withdrew from the scene in early 2006. However, in May 2006, Hyundai Heavy Industries unexpectedly took over the shares of Hyundai Merchant Marine<sup>72)</sup> from Golar LNG and became Merchant Marine's largest shareholder. Heavy claimed that its takeover of the shares was an act of its support for the corporate control, but Hyundai Group did not accept the claim. Hyundai Merchant Marine is the key corporation of Hyundai Group and owns a large portion of Hyundai Construction shares.<sup>73)</sup> In fact, Hyundai Group has been preparing a bid for Hyundai Construction. Speculations were made that it was a strategic move for Mong-joon's succession of Hyundai Group, whilst Mong-koo of Hyundai Motor was put in

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mistake shall be subject to the same restraint from the date of the acquisition (or change) until the date that the correction report is made. In both cases, for the respective periods of time, the Korea Financial Supervisory Commission may order disposition of the shares that are in violation of the law. KSEA, Article 200-3, Paragraph 1; Presidential Decree to the KSEA, Article 86-8. Also, the New KFISCOMA adds a penal provision stipulating that a person who fails to file a Large Holding Report may be subjected to up to three years of imprisonment with labor or up to 100 million Korean won fine. KFISCOMA, Article 445, No. 20. See KOREA FINANCIAL SUPERVISORY SERVICE, UNDERSTANDING KOREA'S "5% RULE" (December 2005). For recent regulatory move against manipulation of reporting through derivatives, see Korea Financial Supervisory Service Press Release, March 14, 2006. See generally, Frank H. Easterbrook, *Derivative Securities and Corporate Governance*, 69 U. CHI. L. REV. 733 (2002); Anish Monga, *Using Derivatives to Manipulate the Market for Corporate Control*, 12 STAN. J. L., BUS. & FIN. 186 (2006).

70) At the shareholders meeting held on March 30, 2004, duplicative proxies representing about 300,000 shares (5.4 percent of issued and outstanding shares of the company) were presented and treated as invalid.

71) See MAEIL KYONGJE, August 6, 2005, at A7.

72) <http://www.hmm21.com/hmm/jsp/eng/index.jsp>

73) HANKUK KYONGJE, May 3, 2006, at A26.

prison for a large corporate scandal, and it was once again keenly reminded that Mong-hun and Mong-joon did not share a friendly brotherhood. This dispute is currently dormant, but may become active again.<sup>74)</sup>

### 3. *Viewpoint*

It is interesting to note that the incident that directly triggered Kumgang's attempt for a hostile takeover was a foreign fund's large-scale purchase of Hyundai shares. Heavy also made an equally interesting remark that the purchase of Merchant Marine shares was motivated by its concern over a potential hostile takeover by a foreign entity. Furthermore, the data and materials on the disputes over corporate control between Hyundai Group and Kumgang reveal that the main issues were not so much about creating synergies through mergers and acquisitions but calling attention to the problems affecting the corporate governance system and promise to correct the flaws therein. After the successful takeover defense, Hyundai Group's leadership did promise investors that it would focus further on the "responsibility, transparency and ethics" in managing the member companies.<sup>75)</sup>

It is also noteworthy that whereas the growths of Hyundai Group in the last decades took place in the most patriarchal setting in Korea, the outgrowth of patriarchal management assailed Kumgang for basing its hostile takeover attempt on what the accuser exemplified. That Hyundai Group entertained relying on the citizens (and netizens), employees and small investors as a means to protect its corporate control also was quite uncharacteristic. Lastly, an extraordinary situation emerged that the spotlight was put on the female gender of the current Hyundai chairman under attack and elicited solid support from female executives of Korea.

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74) See MONEY TODAY, May 2, 2006, at 3; JungAng Ilbo, May 1, 2006, at 3.

75) See HANKUK KYONGJE, April 2, 2004, at A15 (full page advertisement).

## V. KT&G<sup>76)</sup>

### 1. Background

KT&G<sup>77)</sup> is an outgrowth of the Monopoly Bureau founded in 1952 and Korea Tobacco and Ginseng Corporation founded in 1989. In 1999, the Corporation spun off its red ginseng business division and was listed in the same year. Issuing GDRs and disposing of stock owned by the government in 2002, it was entirely privatized and renamed KT&G. As of September 30, 2005, Kiup Bank was the largest domestic shareholder with 5.75%. KT&G listed its GDRs in the Luxembourg Stock Exchange and its management is run by professional managers and an independent board of directors.

KT&G implemented the cumulative voting system, a method the company allows that lets a group consolidate all its proxies behind one of the candidates it puts up for a seat or set of seats, increasing his or her chances of election.<sup>78)</sup> Since 2004, KT&G has been selected as the company with the best corporate governance practice every year by the Korea Corporate Governance Service.<sup>79)</sup> According to the sources from the Korea Exchange, the rate of return to shareholders of KT&G during the period between 2003 and 2005 was 96.09%, a record rate in Korea.

Carl Icahn's attack on KT&G in early 2006<sup>80)</sup> caught Korea by surprise.<sup>81)</sup> It was quite shocking to see KT&G fall subject to hedge fund, belittling its past glorious records of dispersed ownership and professional management, and recognition for the excellent corporate governance. This incident raised an alert for the soundness of the Korean criteria for evaluating corporate governance. Actually, during the dispute many flaws in KT&G management

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76) Kim, *supra* note 50, at 45 - 47.

77) <http://www.ktng.com/eng/index.jsp>

78) This is the default rule under the KCC. See KCC Article 382-2. See generally Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124 (1994).

79) [http://www.cgs.or.kr/eng/biz/b\\_model.asp](http://www.cgs.or.kr/eng/biz/b_model.asp)

80) *Icahn in South Korea Move*, FINANCIAL TIMES, January 18, 2006, at 1.

81) *See Icahn's Push in Korea Shows Rise of Raiders in Roiling New Markets*, WALL STREET JOURNAL, March 2, 2006, at A1.

and corporate governance were revealed.

Carl Icahn went about his usual way in the KT&G case,<sup>82)</sup> and in his doing so, the Korean capital market was able to draw lessons on the strategies and techniques of international hedge funds. His key suggestions included, *inter alia*: (1) selling down non-core assets, (2) spin-off and listing of Korean Ginseng Corporation, (3) restructuring KT&G's vast real estate portfolio, (4) increasing dividends so that the company's dividend yield would be in line with other world class tobacco companies, and (5) buying back shares, through tender offer, if necessary, and cancel shares to the extent legally permissible.<sup>83)</sup> On February 23, 2006, immediately after sending the "proposals for enhancing stakeholder value", the Icahn group proposed KT&G to acquire additional KT&G shares at 60,000 Korean won (with 13 to 33 percent premium). They were prepared to commit an aggregate of approximately two trillion Korean won (two billion US Dollars) of their own equity capital towards the consummation of the transaction and were sure about the possibility of additional debt financing. The proposal was rejected by KT&G in a letter dated February 28, 2006.

## 2. Showdown

Despite winning the favorable stance in the proxy contest with support from Institutional Shareholder Services and Glass Lewis, due to a material blunder by one of his local counsels, who failed to file a proper shareholder proposal, Icahn had to settle for appointing one outside director of his choice to the board at the March 2006 shareholders' meeting.

There were six directorships up for election at the meeting, consisting of two slots for outside directors and four slots for outside directors who would also serve on the audit committee. While the Icahn group's three candidates

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82) See Ken Auletta, *The Raid: How Carl Icahn Came Up Short*, NEW YORKER, March 20, 2006, at 132-143.

83) Icahn group's letter to KT&G dated February 23, 2006 (on file with the author). Icahn's suggestions look similar to those he made before to TimeWarner and other raiders made to various targets. See, e.g., *Boardrooms Tremble as the Grumpy Old Raiders Get Back to Business*, GUARDIAN, March 19, 2007; *Cadbury Schweppes to Separate Businesses*, INTERNATIONAL HERALD TRIBUNE, March 15, 2007; *Climax Nears in the Messy Battle for Heinz*, INTERNATIONAL HERALD TRIBUNE, July 28, 2006; *Now the Rebellion*, ECONOMIST, May 16, 2008 (Carl Icahn and Yahoo).

appeared on the agenda as candidates for election to the board, they would be only be available to compete for the two non-audit committee directorships. By reserving four of the six directorships for directors who would also serve on the audit committee, KT&G had strategically ensured that all of its nominees would fill these positions as candidates for such positions may only be selected by the board. The Icahn group claimed that such an approach infringed their right to submit the shareholder proposals in violation of the law.<sup>84)</sup>

However, on March 14, 2006, the Daejeon District Court rejected the petition by Carl Icahn and his allies, allowing their three nominees to vie for only two seats of KT&G's outside directorship. The Court overruled Icahn's claim, saying, "We do not find that KT&G's separate voting system for regular and audit directors encroaches upon the minority shareholders' right to a choice of directors like Carl Icahn and his partners claim.... Both separate and collective voting for directors are consistent with the current Commercial Code and Securities Exchange Act. Which to choose between the two depends on the board as long as there is no special proposal from shareholders during a shareholder proposal period.... The Carl Icahn consortium did not make issue with the voting method itself during a shareholder proposal period, although they argued that it was not in line with the law. All they wanted was to include three nominees they recommended as candidates for directors."<sup>85)</sup>

The four audit committee member positions on the 12-member board were assured to go to KT&G's candidates, but one of the two outside director positions is almost certain to go to an Icahn candidate because neither side will win the 66.7 per cent support needed to take both seats. Carl Icahn and his partners succeeded in getting their candidate on the board through cumulative voting. The remaining three candidates for the two seats for which the Icahn candidates were eligible received far fewer votes. In August 2006

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84) See Icahn group's letter to KT&G dated February 15, 2006 (on file with the author). For comment, see Ok-Rial Song, *Takeover Defense Through Composition of the Audit Committee*, 20 BUSINESS FINANCE AND LAW 93 (2006) (Korean).

85) Case No. 2006-Kahap-242. For discussions on shareholder proposals in the United States, see generally Lucian A. Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003); Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67 (2003); Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

KT&G accepted practically all of the suggestions made by Icahn.<sup>86)</sup> Carl Icahn, in December 2006, disposed of its entire stakes in KT&G and gained about 100 billion Korean won in profit (44.22% net return).<sup>87)</sup>

### 3. *New Issues*

At the time of dispute, one commentator went as far to say, "If Sovereign was a grade school kid, Icahn is a college student. Now a group of graduate students like KKR will flock to the Korean market. Are the Korean companies ready to defend its corporate control?"<sup>88)</sup> As peculiar as it may sound, the statement turned out to be quite convincing. The international nature that represented the mix of the shareholders elicited participation by many international players during the KT&G and Icahn dispute. KT&G was advised by Goldman Sachs and Lehman Brothers, and Georgeson Shareholder Communications acted in the proxy solicitation at the shareholder's meeting.

KT&G triggered an explosion of debates on the merits of leaving Korean companies exposed to the possibility of hostile takeover attempts.<sup>89)</sup> Many economists have proved the disciplinary function of a hostile takeover attempt; a hostile takeover attempt puts a rein on directors, thereby serving as an effective external controlling mechanism. In light of the positive effect, some argue for no limitation on allowing hostile takeover attempts. According to the liberal advocates, the need for securing takeover defensive tactics as demanded by companies lacks sound judgment. Numerous companies that belong to corporate groups are already free from any hostile takeover attempts because the recourse is available for them through the means of cross and circular shareholdings and complicated ownership structure. Therefore, the government should focus more on untangling ownership structures of Korean corporations and allow hostile takeover attempts to function

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86) *KT&G Bows to Icahn Demand to Return Cash to Shareholders*, FINANCIAL TIMES, August 10, 2006, at 1.

87) See MAEIL KYUNGJE, December 6, 2006, at A2.

88) See MONEY TODAY, April 13, 2006: <http://www.moneytoday.co.kr/view/mtview.php?type=1&no=2006040914422600450>

89) See, e.g., Korea Corporate Governance Service, Report on the Experts Discussions held on February 23, 2006 (Korean): [http://www.cgs.or.kr/review/0605/report\\_05.asp](http://www.cgs.or.kr/review/0605/report_05.asp)

effectively. They further argue that KT&G could not avoid being the target of the hedge fund because its dispersed ownership was characteristic of Western corporations and because it did not belong to a conglomerate. The threat imposed on KT&G by the hedge fund in the end benefited the shareholders and other interest parties and increased the value of the company.

The KT&G case also opened the new era in the discussion of (outside) directors' obligations and liabilities<sup>90</sup> in control contests and takeovers. In the course of the defense against Carl Icahn and his allies, KT&G considered selling treasury shares to friendly local banks. KT&G had 15,558,565 treasury shares representing about 9.76% of total issued and outstanding shares. While KT&G cannot exercise voting rights on its treasury shares, if the shares are sold to a third party, the third party would be able to exercise the voting rights attached to the shares. Thus, KT&G considered selling its treasury shares to a party friendly to the KT&G management and thereby increase the percentage of shares held by shareholders who would support the current management. On March 13, 2006, Industrial Bank of Korea, KT&G's third-largest shareholder with a 5.96 percent stake, and Woori Bank asked KT&G to allow due diligence for a possible purchase of KT&G's treasury shares. It was reported that Icahn and his allies would take legal actions against the board of directors of KT&G if they were to have pushed ahead with such a sale. According to Icahn, a sale of treasury shares to the banks "would constitute a breach of the board's fiduciary duties to the shareholders."<sup>91</sup> It is not known whether such a warning did in fact influence the decision of the KT&G's board, but one of the most popular takeover defensive tactics in Korea was not used by KT&G against Carl Icahn.

The issue of directors' liabilities arose again when Korea Securities Depository (KSD) decided not to accept the KT&G foreign shareholders' votes

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90) For recent studies in general, see Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006); Brian Cheffins & Bernard Black, *Outside Director Liability Across Countries*, 84 TEX. L. REV. 1385 (2006); Bernard Black et al., *Legal Liability of Directors and Company Officials Part 2: Court Procedures, Indemnification and Insurance, and Administrative and Criminal Liability*, 2008 COLUM. BUS. L. REV. 1; Bernard Black et al., *Legal Liability of Directors and Company Officials Part 1: Substantive Grounds for Liability*, 2007 COLUM. BUS. L. REV. 614.

91) *Icahn Threatens to Sue KT&G Board*, FINANCIAL TIMES, March 15, 2006, at 22.

electronically from local custodians from March 9, 2006.<sup>92)</sup> The Icahn group demanded that KT&G take actions to rectify the situation, and reminded that “[E]ach member of the board of directors is responsible and liable as fiduciaries to protect the integrity of a fair election process. In that capacity, it is incumbent on the board of directors to use all available means to force the KSD to exercise its authority to continue the electronic voting process and not cut off any shareholder’s voting rights. [We] intend to hold each director personally responsible for any failure to satisfy his duties to shareholders... and will take any and all legally available means against those that are responsible for such actions.”<sup>93)</sup> As the decision of the KSD was regarded as not depriving voting rights of the foreigners, no legal action was taken by the Icahn group. However, their course of action clearly showed a different approach, i.e., holding the directors personally liable for possible misconduct, not legally challenging the corporate act itself.

## VI. Hanaro

This was not a classical takeover case. However, the Hanaro Telecom case involved the first-ever full-scale proxy fight in Korea.<sup>94)</sup> The case also indicated that the legal dispute on the deal protection devices may arise in Korea in the future.

### 1. Proxy Contest

In 2003, a proxy contest over a shareholders’ meeting of Hanaro Telecom between LG Corporation supported by Carlyle Group on the one hand and

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92) This was a surprise to many local custodians who had expected that the deadline would be March 10th which is four business days before KT&G’s annual general meeting of shareholders to be held on March 17, 2006 which has been the normal practice with KSD and the local custodians.

93) Icahn group’s letter to KT&G dated March 12, 2006 (on file with the author).

94) The number of proxy contests has been arising recent years. Alone in 2007, 34 proxy contests took place, and dissident shareholders won 4 of them. See Korea Financial Supervisory Service Press Release, February 12, 2008.



Hanaro supported by Newbridge/AIG consortium and Hanaro's labor union on the other took place. Hanaro's board decided to receive new investment from Newbridge/AIG consortium and to achieve this purpose, approved several agenda on the shareholders' meeting which LG opposed, including determination of the minimum price for the issuance of new shares. Eventually, Newbridge/AIG won the contest with the desperate support from the labor union.

The KFISMA,<sup>95)</sup> its Enforcement Decree,<sup>96)</sup> and the Regulation on Securities Issuance and Disclosure promulgated by the KFSC apply to a proxy contest in Korea. With certain exceptions,<sup>97)</sup> in order to solicit votes from other shareholders, the solicitor must send to shareholders a proxy statement complying with the relevant rules. The solicitor who violates the rules may be subject to imprisonment of three years or less or a penalty of 100 million Korean Won or less.<sup>98)</sup> Both sides utilized diverse means of solicitation including posting advertisements in newspaper, mail, phone calls, opening of home page, etc. They also paid physical visit to the target shareholders. Newbridge/AIG consortium considered placing promotional materials and Hanaro's employee in major branch offices of Korea First Bank,<sup>99)</sup> but this was not implemented due to Korea First Bank's opposition. The piece proxy

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95) Articles 152 through 158.

96) Articles 160 through 166.

97) KFISMA's Enforcement Decree, Article 161.

98) KFISMA, Article 445, No. 21. It would be very difficult to carry out wide solicitation of proxy without the shareholders' register. Thus, the issues such as whether to permit the soliciting shareholder's request for review/copying of the shareholders' register and if so, when should the company allow the soliciting shareholder to review/copy shareholders' register became important issues in the proxy contest. According to LG, a shareholder can, under the KCC, request review/copying of the company's shareholders' register at any time during the company's business hours; however, Hanaro did not allow LG to review the shareholders' register for one week or more. LG sought to copy the CD that contained Hanaro's shareholders' register. Hanaro refused the request, however, citing concerns over leakage of private information of individuals such as resident registration number. The same issue came up in Hyundai case. When Hyundai refused Kumgang's request for review/copy of the shareholders' register on the ground that there would be leakage of shareholders' private information, Kumgang sought injunctive relief to allow it to review and copy Hyundai's shareholders' register. The court accepted Kumgang's petition for injunction and Kumgang was allowed to copy Hyundai's shareholders' register.

99) At the time, Newbridge was Korea First Bank's controlling shareholder.

solicitations by both sides produced an odd result. With Hanaro soliciting proxy first followed by LG's solicitation, there were shareholders who granted proxy to Hanaro and then later, also granted proxy to LG. Thus, the effect of duplicative proxy cards and how to deal with duplicative proxy cards became an issue. In the case of duplicative proxy cards, the majority view is the later proxy card is effective, because it is possible for a shareholder to revoke granting of proxy. If the validity of a given proxy could not be determined based on the date of its execution, then unless the intention of the shareholder who has given proxy is shown to be consistent, all of the duplicative proxies were viewed as invalid.<sup>100)</sup> In verifying the veracity of the proxy card, lawyers for Hanaro and LG all participated. In the case of written vote, an issue arose over whether Hanaro would allow a supervisor appointed by LG to supervise counting of the votes. Regarding the agenda on issuance of new shares which was a point of dispute, Hanaro allowed LG's supervisor to supervise counting of the votes.

## 2. Deal Protection

The case attracted public attention again in 2006 when Newbridge decided to liquidate its interest in Hanaro to SK Telecom. After the deal was agreed between both parties, Hanaro disclosed to the Korea Exchange that there was no deal concluded. This took place about ten hours after SK Telecom's disclosure to the exchange that the deal was concluded. It later turned out that LG Telecom approached to Newbridge with a higher offer that made Newbridge reconsider the deal with SK Telecom. SK Telecom referred to the deal protection clauses in the agreement and also strongly warned that it would definitely block the deal between Newbridge and LG Telecom if Newbridge changes mind after all. At the end of the day, Hanaro disclosed that it was sold to SK Telecom and received penalty from the Korea Exchange. The incidence was not followed by any shareholder lawsuits. However, the case showed that the U.S.-style deal protection<sup>101)</sup> would be needed for any

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100) At Hyundai's shareholders' meeting, duplicative proxies representing about 300,000 shares were treated as invalid.

101) Cf. Leo Strine, *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 BUS. LAW. 919 (2001); Gregory V. Varallo & Srinivas M. Raju, *A Fresh Look at*

merger talks in Korea. Discussion on the corporate directors' fiduciary duties in such cases<sup>102)</sup> will also become active.

## VII. The New Commercial Code

The KCC currently is undergoing a comprehensive revision. The Korean General Assembly has been discussing the government's proposal and other draft bills submitted by individual lawmakers since 2005. Although it is not expected that the bill will pass the legislative body anytime soon, the revision, once realized, should overhaul the KCC almost beyond recognition as the draft bill contains new institutions for corporate governance and finance of Korean firms.<sup>103)</sup> This part of the article comments on the provisions in respect

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*Deal Protection Devices: Out from the Shadow of the Omnipresent Specter*, 26 DEL. J. CORP. L. 975 (2001); Gregory V. Varallo & Srinivas M. Raju, *A Process-Based Model for Analyzing Deal-Protection Measures*, 55 BUS. LAW. 1609 (2000); Karl F. Balz, *No-Shop Clauses*, 28 DEL. J. CORP. L. 513 (2003); Guhan Subramanian, *Go-Shops vs. No-Shops in Private Equity Deals: Evidence and Implications*, 63 BUS. LAW. 729 (2008); J. Russel Denton, *Stacked Deck: Go-Shops and Auction Theory*, 60 STAN. L. REV. 1529 (2008).

102) Cf. R. Franklin Balotti & A. Gilchrist Sparks III, *Deal-Protection Measures and the Merger Recommendation*, 96 NW. U. L. REV. 467 (2002); Jennifer J. Johnson & Mary Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PENN. L. REV. 315 (1987); Mark Lebovitch & Peter B. Morrison, *Calling a Duck a Duck: Determining the Validity of Deal Protection Provisions in Merger of Equals Transactions*, 2001 COLUM. BUS. L. REV. 1; Comment, *Is Merger Agreement Ever Certain? The Impact of the Omnicare Decision on Deal Protection Devices*, 29 DEL. J. CORP. L. 805 (2004).

103) The draft bill introduces the corporate opportunity doctrine into the statute. Article 398 (Transaction between a Director and the Company) stipulates: (1) The person who falls under any one item below may transact with the company through his or third person's account only when the board of directors makes a prior approval of the transaction above. 1. Director 2. The spouse of a director, and the lineal descendant and ascendants of a director or its spouse 3. A company, in which the person(s) falling under item 1 or 2 above individually or in aggregate possess 50% or more of the issued and outstanding shares with the voting rights, or the subsidiary of such company 4. A company, in which the person(s) and company under the Section 1 through 3 above under this Article in aggregate possess 50% or more of the issued and outstanding shares with the voting rights. (3) In case when a director causes a third party to transact with the company using the corporate opportunity listed under any item below, which may benefit the company contemporaneously or in the future, the approval under Section 1 is required. 1. A business opportunity, which he or she came to know during the performance of his or her duty or using the information of the company 2. A business opportunity having a

of corporate control.

### 1. Squeeze-out

The draft bill includes the mechanism for acquisition of dissenting minorities. The compulsory buy-out threshold is set at 95% level. The proposed provisions below<sup>104)</sup> are general ones that allow a controlling shareholder to purchase compulsorily the shares owned by a minority, no matter whether the majority was acquired in a takeover bid or not. The minorities have the right to be bought out at the same 95%, i.e., 5%, level.<sup>105)</sup> However, there is no more sophisticated mechanism for determination of a fair price than the current one applicable to the shareholders' appraisal claims, which has been very controversial.<sup>106)</sup> Also, it should be pointed out that the Korean law does neither know the concept of the "entire fairness" as developed in *Singer v. Magnavox Co.*<sup>107)</sup> nor the fiduciary duty of majority shareholders to minority shareholders as it is the case in the United States<sup>108)</sup> and Germany.<sup>109)</sup> I have argued elsewhere that the new squeezeout institution

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close connection with a business that the company currently conducts or plans to conduct. For the U.S. law, see Eric Talley, *Turning Servile Opportunities to Gold: A Strategic Analysis of the Corporate Opportunities Doctrine*, 108 YALE L. J. 277 (1998).

104) Translation by Lee & Ko, Korea, and the author.

105) For a brief comparative account, see Paul Davies & Klaus Hopt, *Control Transactions*, in: Reinier Kraakman et al. eds., *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 157, 183-184 (Oxford University Press, 2004). For German law, see Holger Fleischer, *Das neue Recht des Squeeze out*, 31 ZEITSCHRIFT FÜR UNTERNEHMENS-UND GESELLSCHAFTSRECHT 757 (2002); Eberhard Vetter, *Squeeze-out – Der Ausschluss der Minderheitsaktionäre aus der Aktiengesellschaft nach den §§327a-327f AktG*, 47 DIE AKTIENGESELLSCHAFT 176 (2002). For Austrian law, see Franz Althuber & Astrid Krüger, *Squeeze-out in Österreich*, 52 DIE AKTIENGESELLSCHAFT 194 (2007).

106) See Hwa-Jin Kim, *The Appraisal Remedy Revisited*, 393 KOREAN BAR ASSOCIATION JOURNAL 8 (2009) (in Korean). For U.S. law, see, e.g., Lawrence A. Hamermesh & Michael L. Wachter, *The Fair Value of Cornfields in Delaware Appraisal Law*, 31 DEL. J. CORP. L. 119 (2005); Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L. J. 613 (1998).

107) 380 A.2d 969 (Del. 1977).

108) *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971). See J. A. C. Hetherington, *Defining the Scope of Controlling Shareholders' Fiduciary Responsibilities*, 22 WAKE FOREST L. REV. 9 (1987).

109) See Hwa-Jin Kim, *Markets, Financial Institutions, and Corporate Governance: Perspectives*

may work properly if and only if the Korean courts contemporaneously develop the fairness standard applicable to valuation as well as procedure and introduce the fiduciary duty of major shareholders to minority shareholders.<sup>110)</sup> This is more so because the draft bill also allows the U.S.-style cash-out merger transaction.<sup>111)</sup>

Article 360-24 (Controlling Shareholder's Right to Request for Sale)<sup>112)</sup>

- (1) The shareholder who possesses 95% or more of the total issued and outstanding shares of a company under his own account (hereinafter, "Controlling Shareholder") may request the other shareholder the sale of the shares possessed by such other shareholder (hereinafter, "Minority Shareholder") if the purchase is necessary to achieve the business purpose of the company ("Request for Sale")
- (2) For the calculation of the shares possessed by the Controlling Shareholder stipulated under Section 1 above, the shares in the same company owned by the parent company and its subsidiary shall be combined. For calculation, the shares of the company, in which a shareholder, who is not a

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from Germany, 26 GEO. J. INT'L L. 371, 392-394 (1995); John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J. CORP. L. 1, 29 (1999); J. Bautz Bonnano, *The Protection of Minority Shareholders in a Konzern Under German and United States Law*, 18 HARV. INT'L L. J. 151 (1977); Ulrich Wackerbarth, *Investorvertrauen und Corporate Governance*, 34 ZEITSCHRIFT FÜR UNTERNEHMENS-UND GESELLSCHAFTSRECHT 686 (2005); SUSANNE WIMMER-LEONHARDT, KONZERNHAFTUNGSRECHT 157-453 (Mohr Siebeck, 2004).

110) Hwa-Jin Kim, *Freeze-out of Minority Shareholders under the Draft New Commercial Code*, 50-1 SEOUL L. J. 321 (2009) (in Korean).

111) Article 523, No. 4.

112) The Korea Exchange Listing Rules provides that a listed company may apply for a voluntary delisting with the shareholders' resolution by a simple majority vote. However, the Korea Exchange may reject such application, unless the company meets the compulsory delisting requirements under the rules. The shares of a listed company will be designated as surveillance shares in any of the following cases, and such shares will become subject to compulsory delisting if the cause for such designation is not cured as appears in the next annual report filed after such designation: (1) The number of small shareholders (holding one percent or less) is less than 200 in the annual report for the most recent fiscal year; (2) The total number of shares held by small shareholders is less than 10 percent of liquid shares in the annual report for the most recent fiscal year; (3) The largest shareholder (including the shares held by affiliates and specially related persons) holds at least 80 percent of the total issued shares in the annual report for the most recent fiscal year; or (4) The monthly average trading volume is less than one percent of the total issued shares during any quarter. The Listing Rules expressly provides that the Korea Exchange may not reject the application for delisting if the compulsory delisting requirement is met. Listing Rules, Articles 77, 79 and 80.

- company, owns more than 50% of shares, shall be combined with the shares owned by such shareholder.
- (3) The Request for Sale under Section 1 must be approved by the shareholders' meeting in advance.
  - (4) When notifying the convening of a shareholder's meeting for the Section 3 above, the following items must be included in the notice thereof, and they must be explained by the Controlling Shareholder at such meeting.
    1. The shareholding status of the company by the Controlling Shareholder
    2. The purpose for the Request for Sale
    3. The basis of the calculation on the share price and the appraisal report by the certified appraiser on the appropriateness on the share price
    4. Payment guarantee on the share price
  - (5) The Controlling Shareholder shall make a public notice on the following items one month prior to the date when the Request for Sale is made and shall notify the shareholder and the pledgee, who are listed on the shareholder registry, separately.
    1. The Minority Shareholder shall deliver the share certificate simultaneously upon the receipt of the share price
    2. If the share certificate is not delivered, the share certificate will be null and void on the date when the Minority Shareholder accepts the share price or when the Controlling Shareholder deposits the share price in the public account
  - (6) The Minority Shareholder, who has received the Request for Sale under Section 1 above, must sell its shares to the Controlling Shareholder within 2 months from the date when the Minority Shareholder received the notice for the Request for Sale.
  - (7) In case of Section 6 above, the share price shall be determined by the agreement by and between the Controlling Shareholder requesting the sale and the Minority Shareholder whom such request was made to.
  - (8) In case when the Minority Shareholder and the Controlling Shareholder could not agree on the share price under Section 7 above within 30 days from the date when the Request for Sale was received by the Minority Shareholder pursuant to Section 1 above, the Minority Shareholder or the Controlling Shareholder individually may request the court to determine the share price.
  - (9) In case when the court determines the share price pursuant to the Section 8 above, the court shall determine the share price at fair value considering the financial condition of the company and other relevant factors.

Article 360-25 (Minority Shareholder's Right to Request for Purchase)

- (1) The Minority Shareholder of a company, where a Controlling Shareholder exists, may request the Controlling Shareholder to purchase its shares at any time ("Request for Purchase")
- (2) The Controlling Shareholder, who received the Request for Purchase under the Section 1, must purchase the shares of the Minority Shareholder within 2 months from the date when such Request for Purchase was made.
- (3) In case of the Section 2 above, the share price shall be determined by the agreement between the Controlling Shareholder and Minority Shareholder.
- (4) In case when the Minority Shareholder and the Controlling Shareholder could not agree on the share price under Section 2 above within 30 days from the date when the Request for Purchase was made, the Minority Shareholder or the Controlling Shareholder individually may request the court to determine the share price.
- (5) In case when the court determines the share price pursuant to the Section 4 above, the court shall determine the share price at fair value considering the financial condition of the company and other relevant factors.

Article 360-26 (Share Transfer, etc.)

- (1) The share shall be deemed to be transferred to the Controlling Shareholder on the date when the Controlling Shareholder makes the payment to the Minority Shareholder pursuant to Article 360-24 and 360-25.
- (2) In case when the Controlling Shareholder is unable to know whom the share price should be paid to or when the Minority Shareholder refuses to accept the share price, then the Controlling Shareholder may deposit the share price in the public account. In this case, the share shall be deemed to be transferred on the date of such deposit.

## 2. *Poison Pill*

The poison pill has been the single most controversial issue in discussions on takeover defenses in Korea over the years. This is more so because Japan has introduced the poison pill in 2005<sup>113)</sup> and its practical function has recently

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113) Satoshi Kawai, *Poison Pill in Japan*, 2004 COLUM. BUS. L. REV. 11; Ronald J. Gilson, *The Poison Pill in Japan: The Missing Infrastructure*, 2004 COLUM. BUS. L. REV. 21; William B. Chandler III, *Hostile M&A and the Poison Pill in Japan: A Judicial Perspective*, 2004 COLUM. BUS. L. REV. 45; Hideki Kanda, *Does Corporate Law Really Matter in Hostile Takeovers?: Commenting on Professor Gilson and Chancellor Chandler*, 2004 COLUM. BUS. L. REV. 67.

been contested before the courts in Japan.<sup>114)</sup> According to the widely-accepted definition, “the essence of the poison pill is that the crossing by an acquirer of a relatively low threshold of ownership triggers rights for target shareholders in relation to the shares of either the target or the acquirer, from which the acquirer itself is excluded and which render the acquisition of further shares in the target fruitless or impossibly expensive.”<sup>115)</sup> Under the current laws of Korea, poison pill that is commonly used in the United States<sup>116)</sup> is not allowed. There are various rules and regulations that limit the company’s ability to create the poison pill. Among others, as it is also the case in many European countries,<sup>117)</sup> under the KCC, resolution concerning dividend payout is subject to the resolution by the shareholders, not by the board of directors. Also, distribution of profit can only be made by cash or stocks, not contingent rights to purchase company’s new shares. The KFISCOMA also regulates the issuance price of new shares of listed companies.<sup>118)</sup>

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114) See Kenichi Osugi, *Transplanting Poison Pills in Foreign Soil: Japan’s Experiment*, in *TRANSFORMING CORPORATE GOVERNANCE IN EAST ASIA* 36, 43-51 (Hideki Kanda et al. eds., Routledge, 2008) (reviewing the Nippon Broadcasting Systems, Nireco and JEC cases); Osugi, Kenichi, *What is Converging?: Rules on Hostile Takeovers in Japan and the Convergence Debate*, 9 *ASIAN-PACIFIC L. & POLICY J.* 143, 157-159 (2007) (Bulldog case). It remains to be seen if the Japanese case law would evolve after the U.S. law. Cf. Mark D. West, *The Puzzling Divergence of Corporate Law: Evidence and Explanations from Japan and the United States*, 150 *U. PENN. L. REV.* 527 (2001).

115) Davies & Hopt, *supra* note 29, at 169. This definition is from Lucian Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 *COLUM. L. REV.* 1168 (1999); Lucian Bebchuk & Allen Ferrell, *On Takeover Law and Regulatory Competition*, 57 *BUS. LAW.* 1047 (2002).

116) *Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. 1985); RONALD GILSON & BERNARD BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 740-748 (2<sup>nd</sup> ed. Foundation Press, 1995); Martin Lipton, *Pills, Polls, and Professors Redux*, 69 *U. CHI. L. REV.* 1037 (2002); David A. Katz & Laura A. McIntosh, *Corporate Governance Update: Poison Pills – Maintain Flexibility in Takeover Defense* (Wachtell, Lipton, Rosen & Katz Memorandum, January 26, 2006); Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 *YALE L. J.* 621 (2003); Guhan Subramanian, *Bargaining in the Shadow of PeopleSoft’s (Defective) Poison Pill*, 12 *HARV. NEGOTIATION L. REV.* 41 (2007); Jonathan M. Karpoff & Morris G. Danielson, *Do Pills Poison Operating Performance?* (Working Paper, 2002); Jeffrey Gordon, *“Just Say Never” Poison Pills, Dead Hand Pills and Shareholder Adopted By-Laws: An Essay for Warren Buffet*, 19 *CARDOZO L. REV.* 511 (1997); Marcel Kahan & Edward B. Rock, *How I Learned To Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 *U. CHI. L. REV.* 871 (2002).

117) Davies & Hopt, *supra* note 29, at 169.

118) Articles 118 through 132.



The poison pill, if introduced in Korea, should be used to support a better deal for the shareholders. However, as Professor Gilson did warn Japan before,<sup>119)</sup> it may be used to simply block a bid in favor of the controlling minority, if institutions like independent directors, courts and active institutional investors do not police the uses to which the poison pill is actually put. It can also be expected that poison pills in Korea will generate lawsuits and Korean corporate law will evolve along the line developed by the Delaware takeover law as it was already evidenced in Hyundai case.<sup>120)</sup> Large Korean law firms have been educating their young lawyers in U.S. law schools since decades ago, and so has the Korean judiciary.<sup>121)</sup> Furthermore, large Korean firms may feel safer if they retain reputable U.S. law firms when confronted with a control contest. The expert group commissioned by the Korean Ministry of Justice has been working on another draft bill to amend the KCC since early 2008. In November 2008, the expert group came up with tentative draft provisions to introduce the poison pill into the KCC as follows:<sup>122)</sup>

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119) See Gilson, *supra* note 113, at 41-42.

120) But see Bernard S. Black, *The Core Fiduciary Duties of Outside Directors*, ASIA BUS. L. REV. 13, 27 (July 2001) (“[I] would not wish for another country to copy our confused case law.”) Comparative corporate law analysis is a very important methodology in academia as well as in corporate law practice in Korea. However, as far as takeover law is concerned U.S. law’s influence is dominant. For comparative corporate law in general, see John W. Cioffi, *State of the Art: A Review Essay on Comparative Corporate Governance: The State of the Art and Emerging Research*, 48 AM. J. COMP. L. 501 (2000); Katharina Pistor et al., *The Evolution of Corporate Law: A Cross-Country Comparison*, 23 U. PENN. J. INT’L ECON. L. 791 (2002); Edward B. Rock, *America’s Shifting Fascination with Comparative Corporate Governance*, 74 WASH. U. L. Q. 367 (1996). See also Roberta Romano, *A Cautionary Note on Drawing Lessons from Comparative Corporate Law*, 102 YALE L. J. 2021 (1993); William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference*, 38 COLUM. J. TRANSNAT’L L. 213 (1999). For a bibliography on international corporate governance, see Hwa-Jin Kim, *International Corporate Governance: A Select Bibliography*, 8 J. KOREAN L. 201 (2008).

121) For German corporate law’s experiences in adapting to the U.S. corporate law, see JAN VON HEIN, *DIE REZEPTION US-AMERIKANISCHEN GESELLSCHAFTSRECHTS IN DEUTSCHLAND* (Mohr Siebeck, 2008); MATHIAS M. SIEMS, *DIE KONVERGENZ DER RECHTSSYSTEME IM RECHT DER AKTIONÄRE* (Mohr Siebeck, 2005); ANDREA LOHSE, *UNTERNEHMERISCHES ERMESSEN* (Mohr Siebeck, 2005). For corporate control contests in Germany, see MARY O’SULLIVAN, *CONTESTS FOR CORPORATE CONTROL: CORPORATE GOVERNANCE AND ECONOMIC PERFORMANCE IN THE UNITED STATES AND GERMANY* (Oxford University Press 2000); JENNIFER PAYNE ED., *TAKEOVERS IN ENGLISH AND GERMAN LAW* (Hart Publishing, 2003).

122) Translation by Lee & Ko, Korea, and the author.

Article 432-2 (Subscription Option for New Shares)

- (1) A company may grant the right to the shareholders to request the company to issue the new shares within a specified period (“Exercise Period”), at the pre-determined price (“Exercise Price”) in proportion to the numbers and types of shares held by the shareholder (“Subscription Option”)
- (2) The company shall not receive any consideration in exchange for granting the Subscription Option.
- (3) The company intending to issue the Subscription Option must specify the following items in the Article of Incorporation
  1. The statement that the Subscription Option may be granted to the shareholders
  2. The limit on the number and types of new shares that could be issued pursuant to the exercise of Subscription Option
- (4) The Company may provide the following statements under its Article of Incorporation incorporating the terms described under the Section 3 above. In such case, the company may grant the Subscription Option pursuant to the terms under the Article of Incorporation only to maintain or increase the benefit of all shareholders and the value of the company.
  1. In certain cases, the Subscription Option may not be granted to some shareholders
  2. In certain cases, some shareholders may not be able to exercise the Subscription Option, or the terms of the Subscription Option may be different for some shareholders as compared to other shareholders
  3. In certain cases, the company may redeem all or part of the Subscription Options and in this case, the redemption terms may differ for some shareholders.
- (5) In case when the company grants the Subscription Option pursuant to the terms provided under the Article of Incorporation, which incorporated the terms described under Section 4 above, the exercise price may be the fair price on the date when the Subscription Option is granted or the exercise date or the price below the par value of a share.

Article 330 (Restriction on the Issuance of the Shares at a Price below the Par Value)

The shares shall not be issued at a price below the par value except the issuance pursuant to the Article 417 and Section 5 of Article 432-2.

Article 432-3 (Granting Subscription Option)

- (1) In case when a company grants the Subscription Option, the following items must be specified by the resolution of board of directors thereof.

1. The Subscription Option will be granted to the shareholders on a specified date.
  2. The number and type of shares to be newly issued pursuant to the exercise of Subscription Option or the method to calculate the number of shares thereon.
  3. Issues relating to the exercise price of the Subscription Option and the adjustment thereon.
  4. Exercise period and conditions on exercise of the Subscription Option.
  5. In case when the company decided not to grant Subscription Option to some shareholders, the scope of shareholders who will not be granted with the Subscription Option.
  6. In case when the exercise of the Subscription Option is restricted or the terms of the Subscription Option are different for some shareholder, the detailed information and the scope of shareholders who will be granted with the restricted Subscription Option or different terms thereon.
- (2) The company must publicly notify the resolutions of the board of directors within 7 days from the resolution date, approving the items under the Section 1 above
- (3) The Exercise Period under Item 4 of Section 1 shall begin after two weeks from the public notice under Section 2 above

#### Article 432-4 (Redemption of the Subscription Option)

- (1) In case when the company decides to redeem the Subscription Option pursuant to the terms provided in the Articles of Incorporation for the purpose under item 3 of Section 4 of Article 432-2, the board of directors must decide the following items. In this case, the company must make a public notice thereon immediately.
1. The scope of the Subscription Options that will be redeemed
  2. If the Subscription Option will be effective under the certain circumstances, the reasons thereof
  3. The effective date of the redemption
  4. The specifics regarding the money, asset or new shares to be paid or issued for redemption
  5. In case when some shareholders will have different terms for the redemption as compared to other shareholders, then the specifics of the different terms and the scope of those shareholders
- (2) With respect to the Subscription Option, which is redeemed pursuant to Section 1, the effectiveness of Subscription Option will be extinguished on the date of the effective redemption date.

Article 432-5 (Accompaniment of Subscription Option and Retirement without Consideration)

- (1) The Subscription Option cannot be transferred separately from the shares.
- (2) In case when the share is transferred after the Subscription Option is granted, it shall be deemed that the Subscription Option was transferred with such transfer.
- (3) The Company may retire all of the Subscription Option without a consideration through the resolution of board of directors or of the shareholders' meeting prior to the first date of the Exercise Period.

Article 432-6 (The Exercise of the Subscription Option)

- (1) A person, who intends to exercise the Subscription Option, must submit two (2) copies of applications to the Company within the Exercise Period and must fully pay the Exercise Price.
- (2) For the shareholders who have exercised the Subscription Option under Section 1, Article 516-9 shall apply, *mutatis mutandis*.

### 3. *Dual-class Commons*

The shareholders holding shares with multiple voting rights have management control over the company and, moreover, unless these shareholders decide to hand over the company to a third party, a takeover would simply be impossible. The dual-class commons are widespread in Europe<sup>123)</sup> but it is actually most prevalently utilized by the companies in the United States, including Berkshire and Ford Motors.<sup>124)</sup> According to recent data, roughly 200 or more listed companies including large companies such as Viacom and approximately 5-6 percent of the venture companies undergoing IPOs have issued the dual-class common shares.<sup>125)</sup>

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123) Report on the Proportionality Principle in the European Union (18 May 2007).

124) Jeffrey N. Gordon, *Ties That Bind: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1 (1988); Paul Gompers et al., *Incentives vs. Control: An Analysis of U.S. Dual-Class Companies* (Working Paper, January 2004).

125) Laura Field & Jonathan Karpoff, *Takeover Defenses of IPO Firms*, 57 J. FIN. 1857 (2002). For antitakeover arrangements of IPO firms, see generally Lucian A. Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PENN. L. REV. 713 (2003); Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J. L., ECON. & ORG. 83 (2001).

The KCC, however, Article 369, Paragraph 1, adopts the one share one vote system.<sup>126)</sup> It is a mandatory rule and as such understood to be a rule which a company cannot overturn by its articles of incorporation. However, restrictions on voting rights are not only stipulated under the KCC but in numerous other laws and regulations in Korea.<sup>127)</sup> A primary example is the requirement that a shareholder may exercise only up to 3% of the total number of issued and outstanding shares in the appointment of a statutory auditor.<sup>128)</sup> Although studies find that the one share one vote regime has value,<sup>129)</sup> it should be noted that the dual class share system should not be perceived simply as a means to retain incumbents' control of management. The dual class share system is relatively more transparent compared to cross-shareholdings or pyramid type structures. If the dual class share system is abolished, the relevant companies will attempt to either adopt cross-shareholding or create a pyramid type corporate structure to protect its management's interests.<sup>130)</sup> The Korean Ministry of Justice's expert group has

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126) Cf. Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEORGE WASH. L. REV. 687 (1986); Guido Ferrarini, *One Share - One Vote: A European Rule?* (European Corporate Governance Institute Working Paper, 2006); Sanford Grossman & Oliver Hart, *One Share - One Vote and the Market for Corporate Control*, 20 J. FIN. ECON. 175 (1988); Andrei Shleifer & Robert Vishny, *Large Shareholders and Corporate Control*, 94 J. POLITICAL ECON. 461 (1986); Dale A. Oesterle & Alan R. Palmiter, *Judicial Schizophrenia in Shareholder Voting Cases*, 79 IOWA L. REV. 485 (1994); Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775.

127) However, a ceiling on voting rights through charter provisions would be held invalid as it violates the one share one vote rule in KCC Article 369, Paragraph 1. Cf. *Providence & Worcester Co. v. Baker*, 378 A. 2d 121 (Del. 1977) (holding that a ceiling does not constitute discrimination against certain shareholders); Alberto Toffoleto & Paolo Montironi, *Italy Reforms Company Law*, INT'L FIN. L. REV. MERGERS AND ACQUISITIONS 137 (2004) (ceiling allowed in the new company law). For discussions in Germany involving Volkswagen, see *In VW Takeover Saga, German Court Rules Against Porsche*, INTERNATIONAL HERALD TRIBUNE, November 27, 2008; *As Tension with Volkswagen Mounts, Porsche Doesn't Rush into Takeover*, INTERNATIONAL HERALD TRIBUNE, November 27, 2007.

128) KCC, Article 409, Paragraph 2.

129) See, e.g., Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1945-1946 (1996).

130) See Lucian Bebchuk & Oliver Hart, *A Threat to Dual-Class Shares*, FINANCIAL TIMES, May 31, 2002 (warning that if the dual class share system was abolished in Europe, the relevant companies would attempt to either adopt cross-shareholding or create a pyramid type corporate structure to protect its management's interests). But see Ronald Masulis et al., *Agency Problems at Dual-Class Companies*, 64 J. FIN. (2009) (finding evidence supporting the hypothesis that

drafted a new provision for the KCC to introduce the dual-class commons in Korea as the following.<sup>131)</sup>

Article 344-7 (Shares with Multiple Votes)

- (1) A company may issue shares with multiple voting rights (“Shares with Multiple Votes”), provided that the company, which issued the type of a shares described under Article 344-3, shall not issue the Shares with Multiple Votes. Also, the company that issued the Shares with Multiple Votes shall not issue the type of shares specified under Article 344-3.
- (2) Shares with Multiple Votes shall be issued pursuant to the Article of Incorporation at the time of incorporation or its amendment adopted by unanimous consent of all shareholders.
- (3) In case when a company issues Shares with Multiple Votes, the Article of Incorporation must include the following items.
  1. The number of votes on each Share with Multiple Votes
  2. The method for allocating the Shares with Multiple Votes
  3. The statement that, in case of a certain circumstances, the shareholders may request the redemption of the Shares with Multiple Votes or the Company may redeem the Shares with Multiple Votes
- (4) The number of votes for each Share with Multiple Votes shall not exceed three (3).
- (5) The listed companies Article 542-2 shall not issue the Shares with Multiple Votes other than the Shares with Multiple Votes that were issued prior to the listing.

## VIII. Conclusion

The cases discussed above show that a company’s corporate governance bears a close link to hostile takeover attempts. Problems rooted in corporate governance of a company can ignite hostile takeover attempts. In the case of SK, the consequence reveals tangible numbers that manifest the improvement on corporate governance. The Hyundai case demonstrates that the takeover issues befallen a traditional Korean family business, as it was growing to

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managers with greater control rights in excess of cash-flow rights are more likely to pursue private benefits at the expense of outside shareholders).

131) Translation by Lee & Ko, Korea, and the author.

become a mega corporation and going through generational changes, unfold with a close link to a hostile takeover attempt from outside. Although no empirical evidence is provided on this case, it can be drawn that the mergers and acquisitions market is exerting positive influence on corporate governance. The KT&G case attests that Korean companies are not exempt from the international current of hedge fund activism<sup>132)</sup> and must promptly learn the survival and adaptation skills necessary in the market with a corporate governance paradigm shift. The Hanaro case showed that employees can influence the outcome of a takeover battle and corporate governance of the company.

The four cases were entangled in legal disputes. As a result, they all added great value to improving legal principles on mergers and acquisitions in the Korean market. The value is quite significant since the relatively short history of Korean market leaves a paucity of rich M&A resources. In particular, the SK and Hyundai cases called for developing various defensive tactics against takeover attempts, and a battle over the legitimacy of the new tactics unfolded at the courtrooms. All the major Korean law firms were mobilized in these cases and some U.S. law firms with long experience in the areas took part indirectly. Milbank Tweed Hadley & McCloy played a major role in the SK case. So did Simpson Thacher & Bartlett in the KT&G case. And yet, there is not enough resources providing guidelines for directors in control contest and hostile takeovers,<sup>133)</sup> because in Korea, a dispute hardly develops around directors' liabilities but the legality and legitimacy of a certain defensive tactic. Putting more weight on director liabilities is necessary for advancing the board system, and thus it needs to be addressed.

Another interesting point is that an occurrence of disputes in the Korean M&A market, which arise from the matters such as foreign ownership of

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132) For discussions on hedge fund activism, see *How to Handle Hedge Fund Activism*, deallawyers.com Webcast, May 9, 2006; Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PENN. L. REV. 1021 (2007); Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681 (2007). Cf. Henry Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006).

133) Hwa-Jin Kim, *Directors' Duties and Liabilities in Corporate Control and Restructuring Transactions: Recent Developments in Korea*, 7 OXFORD U. COMP. L. FORUM 2 (2006): <http://ouclf.iuscomp.org/articles/kim.shtml>.

stocks and listing on foreign exchanges, almost always calls for the involvement of Western investment banks, law firms, and consulting firms. Goldman Sachs, Lehman Brothers, Citigroup, and other investment bankers were regularly involved in the takeover and restructuring cases in Korea. When they are in the play, the Western institutions bring in a multitude of advanced financial techniques and takeover defensive tactics and thereby help raise the competency of professionals and professional services companies of Korea. Given the impact of such professionals' roles and performance on developing an efficient M&A market and corporate governance,<sup>134)</sup> the importation of the Western skills is commendable.

Finally, in view of the foregoing discussions, we may quite safely conclude that Henry Manne<sup>135)</sup> was right after all. He was right also in an Asian civil law country under the Confucian culture such as Korea some forty years after he presented the thesis that the market for corporate control functions as a disciplinary mechanism for poor corporate governance. The cases described in this article show, even empirically in the SK case, that the validity of his thesis may transcend national jurisdictions and cultural differences. The Korean case, in particular the SK case, also shows that the increasing exposure of control to the market could eliminate the inefficient controlling shareholder system. Hostile takeovers cannot solve all corporate governance problems of large Korean companies with controlling shareholders. However, promoting contestable control is a way forward. The new Korean Commercial Code should maintain a sophisticated balance between the active market for corporate control and effective takeover defensive tactics for the benefit of shareholders. Last, but not least, the usual emphasis on the role of judicial review in the controlling shareholder system should apply to the Korean case.<sup>136)</sup>

KEY WORDS: corporate governance, takeover, market for corporate control, proxy contest, controlling shareholder, Commercial Code, tender offer

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134) JOHN COFFEE, *GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE* (Oxford University Press, 2006); Stephen Choi & Jill Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 *YALE L. J.* 269 (2003).

135) Manne, *supra* note 12.

136) Cf. Bernard Black, *The Core Institutions that Support Strong Securities Markets*, 55 *BUS. LAW.* 1565, 1607 (2000).



# Analysis of Freeze-outs in Korea: Quest for Legal Framework Synchronizing Transactional Efficiency and Protection of Minority Shareholders

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## Abstract

*Although the outcome of freeze-out transactions conducted by controlling shareholders may benefit the corporation and controlling shareholders, such freeze-out transactions are often conducted at the expense of minority shareholders. To ensure minority shareholders are adequately protected in freeze-outs, it is important to have a detailed set of laws which assures fairness and, at the same time, sets forth procedures for efficiently conducting freeze-out transactions.*

*Under the current legal regime of Korea, the most commonly used freeze-out mechanism is a two-step process involving a tender offer and delisting of shares. However, a tender offer is not a sufficient freeze-out tool because, practically, the controlling shareholder cannot purchase all the shares of minority shareholders. On the other hand, such two-step process for freeze-out lacks effective remedial measures for minority shareholders and fails to satisfy the standard of fairness from the perspective of minority shareholders. Thus, the current freeze-out mechanism most commonly used in Korea neither provides for transactional efficiency in freeze-outs, nor afford adequate protection to minority shareholders. Accordingly, in an attempt to attain these two competing policy goals, this Article proposes certain changes to existing laws such as: (i) (to promote efficiency of freeze-out transactions) providing detailed guidelines for determining the tender offer price and reflecting actual market practice in regulations governing the delisting*

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process and (ii) (to ensure adequate minority protection) mandating fair disclosure and expression of opinions by the management of the corporation, requiring establishment of a special committee consisting of independent directors, and calling for a heightened judicial review.

In October of 2008, partly in response to the lack of efficient freeze-out mechanisms, the Korean government proposed a legislative bill (the "Bill"), which introduces, among others, some new freeze-out mechanisms: (i) cash-out merger and (ii) compulsory buy-out. While the Bill intends to facilitate the transactional efficiency of freeze-outs, it seems to overlook how the new freeze-out techniques will interplay with the existing laws, for the purpose of adequately protecting minority shareholders. With regards to the proposal of cash-out merger, this Article recommends (i) abolition of compulsory statutory formula in determining merger ratio and appraisal value and (ii) inclusion of rescissory damage as a remedy for the aggrieved minority shareholders. With regards to the proposal of compulsory buy-out, this Article argues for the removal of the burdensome requirement of shareholder approval and then, proposes a simplified procedure for assessing the value of minority shares by abolishing the mandatory negotiation period between shareholders.

In this Article, we first discuss the most commonly used freeze-out mechanisms (tender offer followed by delisting) and, then, analyze the merits and demerits of the new freeze-out mechanisms proposed under the Bill from the perspective of (i) promotion of transactional efficiency in freeze-outs and (ii) protection of minority shareholders.

## I. Introduction

On January 12, 2009, HK Bank filed for a voluntary delisting from the KOSDAQ market after its controlling shareholder had purchased shares from the minority shareholders through a tender offer, increasing the majority shareholding ratio to about 80%.<sup>1)</sup> On the next day, Irevo, another KOSDAQ-listed company, filed for a voluntary delisting after its controlling shareholder had increased its shareholding ratio to over 80% through a tender offer.<sup>2)</sup> The number of listed companies which opted for a voluntary delisting has significantly increased in 2008 compared to 2007.<sup>3)</sup>

This trend is likely to continue in 2009. In the wake of the global financial

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1) See Min-Cheol Park, *A Domino Flood of Delisting by Korean Companies*, MUNHWA DAILY NEWS, January 13, 2009, available at <http://www.munhwa.com/news/view.html?no=20090113010318242430020> (last visited May 9, 2009). See also Suk Kim, *Increase in Numbers of Tender Offer due to Low Stock Prices*, MUNHWA DAILY NEWS, December 5, 2009, available at <http://www.munhwa.com/news/view.html?no=20081205010318240330040> (last visited on May 9, 2009).

2) *Id.*

3) *Id.*

crisis erupting from September 2008, the Korean stock market has shown signs of a bear market. Meanwhile, the Korean government has been attempting to strengthen the regulatory monitoring and supervision over listed companies. Under such economic and regulatory environment, controlling shareholders have plenty of incentive to seize the moment and implement, the so called “going-private transactions” or “freeze-outs.”<sup>4)</sup>

Generally, a company and its shareholders may benefit from a freeze-out as follows: *first*, freeze-outs can reduce disclosure filings and other administrative costs associated with a listed company and also eliminate the opportunity cost of disclosing valuable information to its competitors;<sup>5)</sup> *second*, the management can run the company in a more flexible and efficient way without being exposed to the risk of challenges by minority shareholders; and *third*, freeze-outs can allow minority shareholders to cash out its otherwise illiquid investment.<sup>6)</sup>

On the other hand, a freeze-out is one of the methods which enables a controlling shareholder to extract its private benefit of control, sometimes even at the expense of minority shareholders. Controlling shareholders may also extract their private benefit of control by (i) taking disproportionately larger share from the company’s income, or (ii) selling control block at a premium.<sup>7)</sup> These classical types of abusive behavior of a controlling shareholder are generally subject to limitations imposed by the fiduciary rules under corporate laws. However, in Korea, controlling shareholders’ fiduciary duty owed to minority shareholders is rarely discussed, especially in the

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4) In general, a ‘going-private transaction’ refers to a transaction in which a controlling shareholder of a company buys out the remaining shares owned by minority shareholders and, accordingly, eliminates minority interest. As a result, the controlling shareholder acquires 100% control over the company and, consequently, privatizes the company. Therefore, a going-private transaction usually has the effect of forcing out the minority shareholders. Going-private transactions are often referred to as freeze-outs, squeeze-outs, minority buy-outs or take-outs, depending on the context. In this Article, we will use the term ‘going-private transaction’ or ‘freeze-out’.

5) See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 134 (Harvard University Press, 1st ed. 1991).

6) See REINIER R. KRAAKMAN ET AL., *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 142 (Oxford University Press, 1st ed. 2004).

7) See Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 786 (2003).

context of a freeze-out.

Like many other jurisdictions, Korean law does not prohibit a controlling shareholder from implementing a freeze-out.<sup>8)</sup> In a freeze-out, a controlling shareholder may take advantage of the asymmetry of information available to it and the minority shareholder, and behave opportunistically to maximize its private benefit, even at the cost of the company and minority shareholders.<sup>9)</sup> For example, a controlling shareholder may manipulate the timing of the freeze-out transaction so that the transaction takes place when the trading price of a share in the stock market falls below its intrinsic value.<sup>10)</sup> In addition, a controlling shareholder may influence the stock price of the company so that it can reduce the cost of freezing out minority shareholders.<sup>11)</sup>

So far, the Korean legal community has paid very little attention to such inherent tension between a controlling shareholder and dispersed minority shareholders.<sup>12)</sup> Accordingly, as a matter of policy, the legal framework governing freeze-outs should provide measures for adequate protection of minority shareholders interests, and such measures should be based on principles of fairness. To establish a standard of fairness, we refer herein to the fairness standard established by the Delaware court in a decision regarding a conflict-of-interest transaction.<sup>13)</sup> In this decision, the Delaware court held that a freeze-out transaction involving self-dealing issues should be structured to warrant fair dealing and fair price for minority shareholders, and that if the conflict-of-interest transaction fails the fairness test, then minority shareholders should be entitled to challenge the transaction or receive fair value of their shares through exercise of appraisal rights or a rescissory damage suit.

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8) As for further discussion of modern corporate law jurisdictions' approach, please refer to KRAAKMAN ET AL., *supra* note 6.

9) See Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L. J. 2, 31-38 (2005).

10) See *Id.* at 32.

11) See *Id.*

12) Korean scholars have recently begun to address this issue. For more reference, please refer to Hyeok-Joon Rho, *Imminent Adoption of Squeeze-out Devices in Korea: What Should be Considered for Balancing Majorities and Minorities?*, JOURNAL OF STUDY ON COMMERCIAL CODE, Vol. 26-4, 231 (2008).

13) See Gilson & Gordon, *supra* note 7, at 797-803, for more reference to Delaware court's review standard.

Freeze-outs can be implemented through various procedural mechanisms, including, *inter alia*, statutory merger, tender offer, reverse stock split, transfer of a whole business followed by outright liquidation of the company and exchange of shares. Under the current legal regime of Korea, a freeze-out is most commonly structured as a combination of a tender offer by a controlling shareholder and a subsequent voluntary delisting of the company. As you may perceive, a tender offer, by itself, is not a self-fulfilling freeze-out tool because it does not guarantee that a controlling shareholder can purchase all remaining shares from minority shareholders. In this sense, the current legal regime of Korea does not sufficiently facilitate transactional efficiency when conducting freeze-outs since a controlling shareholder cannot even force out abusive minority shareholders who hold out and hamper the operation of the company.

On the other hand, the current legal regime also fails to provide meaningful guidelines for establishing fairness such as fair dealing and fair price, nor state effective remedial measures that are available to minority shareholders. In past freeze-out transactions, the intricate issue of how to reasonably evaluate minority shareholders' interest has not been sufficiently discussed or judicially reviewed. As such, the current rules and practices of tender offer and voluntary delisting need to be reviewed and significantly upgraded to meet the policy goals of promoting transactional efficiency in conducting freeze-out transactions and providing adequate protection to minority shareholders. Partly due to this legislative loophole, when a freeze-out transaction occurs, civil activist groups tend to form a coalition with aggrieved minority shareholders seeking injunctive relief or staging a public protest against the freeze-out. This is not only costly but also entails a risk that the corporate dispute will be resolved by a political compromise or by yielding to the activist group's influence.<sup>14)</sup>

In October 2008, the Korean government proposed a legislative bill to amend the Korean Commercial Code (the "Bill") which provides for an extensive overhaul of rules governing corporate matters. Among the

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14) In 2003 and 2004 when Auction, a KOSDAQ listed company, attempted to voluntarily delist after its controlling shareholder Ebay made a tender offer to minority shareholders, civil activist lawyers led a protest against the company and legally challenged the freeze-out.

proposed items, the Bill introduces the concept of cash-out merger and compulsory buy-out, which will have a profound effect on the way (i) freeze-out transactions are structured and (ii) conflicting interests among shareholders are addressed, if adopted in its present form. In a cash-out merger, the surviving company will pay out cash consideration to shareholders of the extinguished company, which will allow the controlling shareholder to effectively remove the minority shareholders. In other words, as long as a controlling shareholder successfully accumulates enough number of shares to pass a resolution at the shareholders' meeting, it can effectively force out minority shareholders. Furthermore, the compulsory buy-out will enable a controlling shareholder who owns 95% of shares or more to compel remaining shareholders to sell their shares.

On its face, the Bill intends to facilitate freeze-out transactions by introducing new freeze-out methods available to a controlling shareholder. But upon closer review, the Bill overlooks how a cash-out merger and a compulsory buy-out will interplay with the existing laws governing mergers and appraisal rights of minority shareholders and mandates certain cumbersome procedures that are unnecessary in terms of transactional efficiency and protection of minority shareholders.

After identifying the merits and demerits of the Bill, this Article proposes certain changes to the Bill, in order to attain the two main policy goals in the context of freeze-outs: (1) the promotion of transactional efficiency in freeze-outs and (2) protection of minority shareholders. First, with regard to cash-out mergers, we recommend that the Bill eliminate the rigid formula determining the merger ratio and the appraisal value in a freeze-out of a listed company, and that the Bill explicitly state that shareholders will be entitled to rescissory damages if the merger ratio is significantly unfair in a cash-out merger. Second, with regard to compulsory buy-outs, we recommend that the valuation procedure for minority shares should be simplified by relying on a court-administered valuation in order to reduce the transactional cost of freeze-outs. In addition, we highlight that the protective measures proposed in the Bill for compulsory buy-outs (such as requirements for shareholders' resolution and disclosure of the purpose of freeze-out) would not help much in protection of minority shareholders.

This Article proceeds in two major parts. In Part II, we review and evaluate the current freeze-out mechanism: a combination of tender offer and

voluntary delisting, and propose certain changes to the existing laws. In Part III, we explain and analyze the cash-out merger and the compulsory buy-out set forth in the Bill and recommend amendments of the Bill in order to attain the two major policy goals of promoting transactional efficiency in freeze-outs and providing adequate protection to minority shareholders.

## II. Current Freeze-Out Mechanism

In many modern foreign jurisdictions, a controlling shareholder may freeze out minority shareholders without obtaining the consent of minority shareholders and, thereby taking a company private. Unlike these jurisdictions,<sup>15)</sup> the current Korean laws and market practices do not provide a controlling shareholder with an effective freeze-out mechanism.

Since the Korean statutory laws do not provide a controlling shareholder with measures to compelling minority shareholders to sell their shares, in practice, a less effective alternative has been used: the combination of (i) a tender offer by a controlling shareholder and (ii) a subsequent voluntary delisting by a listed company. A controlling shareholder of a listed company may achieve an effect similar to freeze-outs by engaging in these two steps, despite its uncertainty on the successful completion of the freeze-out and possible risk of the minority shareholders' refusal to sell shares for any reason or with no particular reason. While noting the economic need for an efficient freeze-out mechanism, we review and assess the two step freeze-out practices in the below and then propose certain regulatory changes to enhance the efficiency and fairness of the current freeze-out practices.

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15) In the U.S., there are several mechanisms of freeze-out, including a statutory merger, a reverse stock split, or asset acquisition, but a reverse stock split and asset acquisition are rarely used in practice. See Subramanian, *supra* note 9, at 17. Some freeze-out mechanisms of other jurisdictions may be utilized in Korea on a theoretical level, but in practice they are not a viable option due to the operation of law of fiduciary duty or difficulty in complying with technical/procedural requirements.

## 1. Freeze-out Tender Offer

### 1) Conflict of interest in a freeze-out tender offer

A tender offer, by itself, is not a self-fulfilling tool for a freeze-out in that a controlling shareholder may not acquire all remaining shares from minority shareholders and, therefore, cannot squeeze out the minority. However, if a controlling shareholder undertakes a tender offer by stating that its main purpose of the bid is delisting the company after a successful bid, minority shareholders will then be pressured to accept the tender offer, fearing that their shares may become illiquid investments.

A controlling shareholder may engage in a tender offer by utilizing its information advantage over minority shareholders.<sup>16)</sup> Also, in anticipation of the privatization of the target company, the incumbent management may act in favor of a controlling shareholder by affirmatively supporting or remaining silent on even unfair or value-decreasing freeze-out. Notwithstanding the potential conflict of interest between a controlling shareholder and minority shareholders in a freeze-out tender offer, Korean law and court precedent neither provide an explicit fairness review standard, nor afford minority shareholders adequate protection. The only resort for aggrieved minority shareholders in a freeze-out tender offer is just refusing to sell their shares.

This apparent indifference of regulatory authorities and judicial bodies results partly from the widely-held recognition that a tender offer is a private deal between a controlling shareholder and minority shareholders and, thus, it is not a corporate action requiring the interference of the corporate law of fiduciary duty. As we have seen in recent court cases in Korea, the court has begun to acknowledge the management's fiduciary duty when the incumbent management takes defensive measures against hostile take-over attempts by a bidder.<sup>17)</sup> Given that the board's role in a hostile takeover is subject to judicial review, we do not find any plausible reason for a different standard of judicial

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16) See Subramanian, *supra* note 9, at 30; Gilson & Gordon, *supra* note 7, at 785.

17) See Young-Cheol K. Jeong, *Hostile Takeovers in Korea: Turning Point or Sticking Point For Policy Directions* 19-20 (2008), available at [http://works.bepress.com/young\\_cheol\\_jeong/1](http://works.bepress.com/young_cheol_jeong/1) (last visited May 16, 2009).



review on the board's duties in responding to a freeze-out tender offer.<sup>18)</sup> The risk of opportunistic behavior by a controlling shareholder or the management of a target company in a freeze-out is greater than that in a sale-of-control transaction.<sup>19)</sup> Thus, minority shareholders in a freeze-out tender offer need as much protection as in a third party's hostile takeover since there is no market control over the controlling shareholder's action.<sup>20)</sup>

As mentioned above, there is no clear judicial review standard established in a freeze-out tender offer since the Korean legal community has not taken this issue seriously so far. In our view, the fairness standard which has been developed by the Delaware courts may apply to conflict-of-interest transactions, such as a freeze-out tender offer, even in the Korean context. The Delaware courts tend to apply the "entire fairness" standard to a transaction involved with a conflict of interest in which a controlling shareholder bears a burden of proof that the concerned transaction is made through fair dealing and at a fair price.<sup>21)</sup> In the following section, we explore how such fairness standard can be applied to a freeze-out tender offer in Korea. We also explain that the deficiency in detailed rules and established practices may increase unnecessary costs and risks in a freeze-out.

## 2) Assessment of Current Tender Offer Rules in the Context of Freeze-out

The Financial Investment Services and Capital Market Act of Korea (the "FSCMA"), which is the primary legislation that governs tender offer procedures, does not discriminate between a tender offer by a controlling shareholder and that by a third party bidder. When a bidder makes a public tender offer, the FSCMA mandates the uniform price rule (the "Uniform Price Rule"). The Uniform Price Rule of the FSCMA is comparable to the so-called "best price rule" in the U.S. and is adopted to ensure equal treatment of shareholders. The Uniform Price Rule does not by itself guarantee the fairness of a tender offer. Accordingly, a freeze-out tender offer should be

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18) See Gilson & Gordon, *supra* note 7, at 841.

19) See *id.* at 786.

20) This issue was explicitly reviewed in Delaware court. See *e.g.*, *In re Pure Resources, Inc. Shareholders Litigation*, 808 A.2d 421 (Del. Ch. 2002).

21) See Subramanian, *supra* note 7, at 11-12; Clark W. Furlow, *Back to Basics: Harmonizing Delaware's Law Governing Going Private Transactions*, 40 AKRON L. REV. 85, 97-98 (2007).

accompanied by measures ensuring fair disclosure of the bid terms, shareholders' informed decision-making and arm's length negotiation over the bid terms. Korean law, however, is not clear on the fairness standard in a tender offer except that FSCMA imposes certain disclosure requirements on the bidder. Set forth below is our discussion on the Uniform Price Rule and the disclosure requirements.

#### (1) Uniform Price Rule

Under the Uniform Price Rule of the FSCMA, a bidder should make a tender offer<sup>22)</sup> to all shareholders of a target company and the offered price should be uniform to all offerees. The basic tenor of this Uniform-Price Rule is to assure that all shareholders are treated equally in the tender offer process.

The Uniform Price Rule, on its face, may seem neutral or fair to the offeree shareholders. In practice, so long as a bidder complies with certain procedural or technical requirements prescribed in the FSCMA, it is deemed to satisfy the Uniform Price Rule and rarely becomes subject to shareholders' challenges or judicial scrutiny. If there is no arm's length negotiation by independent, disinterested directors, or any other measures to increase the fairness and appropriateness of the tender offer price, the Uniform Price Rule, alone, does not help much in protecting the interest of shareholders to whom the tender offer is made. In a freeze-out tender offer, even if a bidder puts pressure on

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22) 'Tender offer' refers to purchase of equity securities off-the-market through solicitation for an offer to sell (including exchanges with other securities) from or to an unspecified number of persons. Under the FSCMA, if a person who, together with any specially related persons (which comprise "affiliated persons" and "persons acting in concert") intends to acquire shares for consideration (or purchase or any other type of acquisition) from 10 or more persons during a six-month period, which will result in such person holding 5% or more of the total equity securities (which includes voting shares, certificates representing the right to subscribe for new voting shares, convertible bonds convertible into voting shares, bonds with warrants for new voting shares and exchangeable bonds which are exchangeable for any of the foregoing securities) of a listed company off-the-market, such person is required to make a public tender offer. This so-called 5% mandatory tender offer rule also applies to additional purchase of any number of equity securities by a person (including his specially related persons) holding 5% or more equity securities from 10 or more persons off-the-market during a six-month period. See the FSCMA, art. 133.

A person who intends to make a tender offer must publish a public notice (in at least 2 newspapers or an economic daily newspaper circulated nationwide) setting forth certain information and must file a tender offer statement with the Financial Services Commission of Korea and the Korea Exchange on the same day. See the FSCMA, art. 134.

minority shareholders to accept the bid in a coercive manner, the bidder may defend the legality of its bid under the convenient shield of the Uniform Price Rule. Accordingly, the Uniform Price Rule should be accompanied by measures ensuring fair dealing, if policy makers intend to provide any meaningful protection to shareholders.

Furthermore, the Korean laws and practices are not clear on what constitutes elements of uniform price. The Uniform Price Rule requires that a tender offer bidder should pay the uniform price for the shares tendered during a tender offer period without elaborating much on what forms the uniform price.<sup>23)</sup> Suppose a case where a certain economic consideration other than the purchase price is granted to the existing management or the controlling shareholder who as an executive director manages the target company. The Uniform-Price Rule does not provide detailed guidelines as to whether and to what extent such additional consideration will be regarded a part of the price paid to such shareholder. In practice, it is critical for a bidder to have the competent management remain at the company and continue managing the company.<sup>24)</sup> In this respect, a bidder of the tender offer has business rationale to grant certain economic incentive to the existing management. However, due to deficiency in relevant guidelines or established precedents, it is not clear whether granting any economic consideration other than the tender offer price to a certain group of shareholders or the management of the company outside the tender offer process results in a violation of the Uniform Price Rule.

Such uncertainty may limit the flexibility in structuring a tender offer from a bidder's perspective.<sup>25)</sup> In other words, the risk of violating the Uniform Price Rule may discourage a bidder from granting various means of economic incentives such as cash, stock option and future business commitment to competent management.<sup>26)</sup> Given the risk of uncertainty, the bidder may have

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23) See the FSCMA sec. 2 of art. 141.

24) See Michael A. Akiva, *During the Tender Offer" or Some Time Around It: Helping Courts Interpret the Best-Price Rule*, 7 *TRANSACTIONS* 353, 367 (2006).

25) To be mentioned below, similar concerns were raised in the U.S.

26) Similar concerns were also raised in the U.S. More specifically, from a practical point of view, "there is still uncertainty which makes bidders hesitant to use tender offers in that if a jury finds certain shareholders received additional consideration for their shares in breach of the best

to devise complex or sometimes costly scheme that otherwise would be simpler and cheaper in retaining efficient and competent management. Consequently, the absence of detailed guidelines under the Uniform Price Rule may even deter value-creating freeze-outs. Hence, the Korean legal community will need to exert efforts in devising foreseeable and balanced guidelines for the Uniform Price Rule.

## (2) Disclosure Requirement

In a freeze-out tender offer, while there is an inherent conflict of interest between a controlling shareholder and minority shareholders, the minority shareholders of the target company typically do not have sufficient information on the target company and the tender offer. Accordingly, the minority shareholders are unlikely to be in a position to make a fully informed decision on whether to accept the tender offer or not. Therefore, due to this inherent information asymmetry, there is a potential risk that the freeze-out tender offer will be structured in a manner unfairly preferential to the controlling shareholder at the expense of minority shareholders.<sup>27)</sup>

In general, the FSCMA requires a bidder of the tender offer to disclose certain information relevant to a target company and the tender offer.<sup>28)</sup> This disclosure requirement may help protect minority shareholders to some extent by informing them about the merits and demerits of the tender offer and help minority shareholders make an informed decision.<sup>29)</sup> However, the current level of the disclosure requirement under the FSCMA is insufficient

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price rule, a bidder could be required to pay damages on each of the other outstanding shares, calculated by dividing the total amount of excessive consideration received by those shareholders by the number of shares owned by them." See Victor Lewkow & Daniel Sternberg, *Return of the tender offer*, INTERNATIONAL FINANCIAL LAW REVIEW (January 2007), available at <http://www.iflr.com/Article/1977376/Return-of-the-tender-offer.html> (last visited May 16, 2009).

27) See Subramanian, *supra* note 9, at 7.

28) Under the FSCMA, certain information relating to any contracts or arrangements under which a tender offeror acquires the equity securities of the target company outside the tender offer (if any), any arrangements or agreements preceding the commencement of the tender offer between the tender offeror and directors (if any), officers or the largest shareholders of the target company, and future plan for the target company after the completion of the tender offer should be contained in a public notice and a tender offer statement. See the Enforcement Decree of the FSCMA sec. 4 of art. 145.

29) See Akiva, *supra* note 24, at 356.

for minority shareholders to make a fully informed decision in that (i) the scope of disclosed information is not comprehensive enough, (ii) the information does not give adequate description on the background of the tender offer, and, consequently, (iii) no shareholder can determine the adequacy of the tender offer price solely based upon the disclosed information.<sup>30)</sup> Thus, the disclosure requirements for a tender offer should be expanded to ensure minority shareholders are fairly dealt with.

### (3) Company's Opinion on Tender Offer

Under the FSCMA, the target company of a tender offer may, but is not mandatorily required to, express its view or opinion on the proposed tender offer in accordance with certain prescribed procedures. The target company's opinion as to the tender offer may serve as a reliable source of information for the minority shareholders when making a decision on whether to accept the tender offer. However, in reality, the target company rarely expresses its view or opinion on a tender offer. This reluctance or passiveness of the target company does not help address the information asymmetry problem between a controlling shareholder and minority shareholders and results in increase in the information investigation costs of the minority shareholders, hampering the ability of the minority shareholders to make an informed decision. As such, the current practice of management abstention needs to be altered by some form of regulatory intervention.

### 3) Proposal for Reform

As discussed above, due to the uncertainty in the Uniform Price Rule, a controlling shareholder may not efficiently undertake a freeze-out tender offer. Certainty and predictability of regulations are integral to maintaining an efficient market and, similarly, uncertainty may impede even a legitimate value-creating freeze-out.<sup>31)</sup> In this respect, the Uniform-Price Rule needs to be further supplemented in detail by legislation to provide a clear guideline on the scope of prohibited and/or permissive economic consideration to the

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30) For your information, U.S. securities regulation (i.e., SEC Rule 13e-3, 17 C.F.R.240.13e-3) also mandates that a public corporation that goes private make disclosures relating to the fairness of the transaction and to any discussions with third parties who may be interested in acquiring the company. See KRAAKMAN ET AL, *supra* note 6, at 143.

31) See Akiva, *supra* note 24, at 385.

controlling shareholder or the management of the company during the tender offer, and also to include safe harbor provisions.<sup>32)</sup> This would definitely help

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32) In the U.S., no one may make a tender offer unless the consideration paid to any security holder for securities tendered in the tender offer is the highest consideration paid to any other security holder for securities tendered in the tender offer under the Securities Exchange Act of 1934. This so-called Best Price Rule was introduced for the purpose of investor protection by requiring uniform treatment among investors. However, since the adoption of these rules, the Best Price Rule has been the basis for litigation brought in connection with tender offers in which it is claimed that the rule was violated as a result of the bidder entering into new agreements or arrangements, or adopting the subject company's pre-existing agreements or arrangements, with security holders of the target company. When ruling on these Best Price Rule claims, courts generally have employed either an "integral-part test" or a "bright-line test" to determine whether the arrangement violates the Best Price Rule. The integral-part test states that the Best Price Rule applies to all integral elements of a tender offer, including employment compensation, severance and other employee benefit arrangements or commercial arrangements that are deemed to be part of the tender offer, regardless of whether the arrangements are executed and performed outside of the time that the tender offer formally commences and expires. Courts following the integral-part test have ruled that agreements or arrangements made with security holders that constituted an "integral part" of the tender offer violate the Best Price Rule. The bright-line test, on the other hand, states that the Best Price Rule applies only to arrangements executed and performed between the time a tender offer formally commences and expires. Jurisdictions following the bright-line test have held that agreements or arrangements with security holders of the subject company do not violate the Best Price Rule if they are not executed and performed "during the tender offer." These differing interpretations of the Best Price Rule have made using a tender offer acquisition structure unattractive because of the potential liability of bidders for claims alleging that compensation payments violate the best-price rule. This potential liability is heightened by the possibility that claimants can choose to bring a claim in a jurisdiction that recognizes an interpretation of the Best Price Rule that suits the claimant's case. These differing interpretations do not best serve the interests of security holders and have resulted in a regulatory disincentive to structuring an acquisition of securities as a tender offer, as compared to a statutory merger, to which the Best Price Rule does not apply. See Amendments to The Tender Offer Best-Price Rules, SEC Final Rule Release No. 34-54684, at 5-9, available at <http://www.sec.gov/rules/final/2006/34-54684.pdf> (last visited May 16, 2009).

In this connection, the Securities and Exchange Commission of the U.S. has recently adopted amendments to the Best Price Rule, which clarify that the related provisions apply only with respect to the consideration offered and paid for securities tendered in a tender offer. This change to the rule is expected to allow the more frequent use of tender offers in takeover transactions where new commercial arrangements are entered into with a target company shareholder in relation to the takeover.

In addition, the Securities and Exchange Commission has adopted certain non-exclusive safe harbors in connection with compensation arrangements, which create an explicit exemption from the Best Price Rule for the negotiation, execution or amendment of, or payments made under, any employment compensation, severance or other employee benefit arrangement with

facilitate the transactional efficiency.

As we have discussed above, the protection mechanism for minority shareholders should be enhanced by (i) subjecting a bidder to more comprehensive disclosure requirements and (ii) mandating the management of the target company to express their opinion over the terms of the tender offer. The market would be better off if a legal framework, which requires a bidder to take proactive actions to ensure a fair price, adequate information disclosure and other measures of a fair dealing, is established.<sup>33)</sup> Also, many

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any target company shareholder, provided that the amounts payable under the arrangements are paid or granted as compensation for past services performed or future services to be performed or to be refrained from being performed and will not be calculated based on the number of shares tendered by the shareholder. For the safe harbor to be available, the compensation arrangements should have been approved by independent directors vested with fiduciary responsibilities for approving compensation arrangements who have knowledge of the specific arrangements with shareholders of the target company and the relevant tender offer when the approval is granted. The safe harbor merely requires approval of an arrangement by the compensation committee (or a committee performing a similar function) of the target company's board of directors. All of the members of any committee approving the arrangement must be independent directors, which for listed companies will be determined by reference to the independence requirements of the applicable listing standards and for foreign private issuers may be determined by reference to the laws or standards of their home country. See Lewkow & Sternberg, *supra* note 26.

33) Under the Securities Exchange Act of 1934 of the U.S., if a tender offer by a controlling shareholder of the target company falls under a going private transaction which has either a reasonable likelihood or a purpose of producing, either directly or indirectly an effect causing any class of equity securities of the target company which is either listed on a national securities exchange or authorized to be quoted in an inter-dealer quotation system of a registered national securities association to be neither listed on any national securities exchange nor authorized to be quoted on an inter-dealer quotation system of any registered national securities association, the tender offeror is required to disclose certain information about fairness of the tender offer and any report, opinion or appraisal relating to the consideration or the fairness of the consideration to be offered to security holders or the fairness of the tender offer. See 13e-3 of General Rules and Regulations promulgated under the Securities Exchange Act of 1934 (SEC Rule 13e-3, 17 C.F.R. 240.13e-3)

In Japan, to address conflict-of-interest issues and to promote the fairness of the offer price, the tender offer rules require that if the offeror is either (a) the management or is acting at the request of, and has common interests with, the management or (b) the parent of the target company, then the disclosure of the following matters must be made in registration statement: (i) measures designed to ensure the fairness of the offer price (if any); (ii) the process leading to the commencement of the tender offer; and (iii) measures intended to avoid a conflict of interest (if any). The tender offer regulations do not mandate that the offeror take such measures to ensure fairness of the offer price or avoid a conflict of interest, but if such measures are taken,

foreign jurisdictions such as U.S., U.K., and Japan, adopt rules mandating the expression of an opinion of the company in the tender.<sup>34)</sup> If compulsory rules regarding the expression of the opinion of management are adopted, the management will become subject to the disclosure regulations, violation of which will lead to civil and/or criminal liability. The target management will, accordingly, act more prudently and carefully in their delivery of opinion to the public for fear of being subject to legal liability arising from a disclosure violation. Under these circumstances, the monitoring cost of minority shareholders will be significantly lowered so that the overall welfare of the minority shareholders will be increased at the relatively smaller cost borne by the controlling shareholder or the company.

Meanwhile, in order to ensure that the tender offer price mirrors arm's length pricing, we may consider an approach that ensures arm's length negotiations between a controlling shareholder (i.e., a bidder) and minority shareholders in the freeze-out tender offer process. Such arm's length standard is consistent with the general principle of corporate law applicable to

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the offeror must describe such measures in the registration statement. In addition, if there is an evaluation report or opinion that the offeror has referred to in deciding on the offer price, the offeror will be required to file such report or opinion as an attachment to the registration statement. *See* the Financial Instruments and Exchange Law of Japan sec. 2 of art. 27-3.

34) Under the Securities Exchange Act of 1934 of the U.S., the target company, no later than 10 business days from the date the tender offer is first published or sent or given, shall publish, send or give to security holders a statement disclosing that it (i) recommends acceptance or rejection of the tender offer, (ii) expresses no opinion and is remaining neutral toward the tender offer or (iii) is unable to take a position with respect to the tender offer. Such statement shall also include the reason(s) for the position (including the inability to take a position) disclosed therein. *See* 14e-2 of General Rules and Regulations promulgated under the Securities Exchange Act of 1934 (SEC Rule 14e-2, 17 C.F.R. 240.14e-2).

In Japan, considering the importance any opinion of a target company may have for shareholders (especially, minority shareholders) and other investors to make informed investment decisions, a target company will be required to express its opinion whenever it is subject to a tender offer. *See* the Financial Instruments and Exchange Law of Japan art. 27-10.

Under Rule 25.1 of the U.K. City Code on Takeovers and Mergers, the board of the target company must circulate its views on the tender offer, including any alternative offers, and must, at the same time, make known to its shareholders the substance of the advice given to it by the independent advisers and should, insofar as relevant, comment upon the statements in the offer document regarding the tender offeror's intentions in respect of the target company and its employees.



a self-dealing transaction requiring approval from disinterested parties in conflict-of-interest transactions. Thus, in the freeze-out tender offer context, adopting rules requiring disinterested board approval may be considered.

The requirement of disinterested board approval will serve as an efficient and effective tool in furtherance of protecting the minority shareholders, because the corporate fiduciaries are in the best position to fully understand the company. For the purpose of forming a disinterested board, the target company may establish a special committee consisting of only independent directors and grant the special committee power to negotiate. Then, the tender offer price determined through such negotiation between a bidder (i.e., the controlling shareholder) and the special committee will likely be closer to an arm's length price.

Furthermore, judicial review will play a key part in developing and furthering a fairness standard in a freeze-out tender offer. If a controlling shareholder coerces the minority shareholders into accepting tender offers with substantially unfavorable terms by abusing information asymmetry and the power to structure the tender offer, such coercive act of the controlling shareholder must be scrutinized by the court.<sup>35)</sup>

## 2. *Voluntary Delisting*

### 1) *Delisting Process*

In order for a controlling shareholder to take a listed company private, a voluntary delisting procedure is required. Voluntary delisting is subject to the approval of the Korea Exchange that operates the two major stock markets in Korea, i.e., Stock Market and KOSDAQ Market. A voluntary delisting must be approved at the shareholders' meeting. In general, unless otherwise required by the articles of incorporation of the company, for a Stock Market listed

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<sup>35)</sup> *In re Pure Resources*, 808 A.2d at 445 (Del. Ch. 2002), the Delaware court held that in order for a tender offer to be non-coercive: (1) the offer must be subject to a non-waivable condition that the majority of the minority shareholders tender their shares; (2) the controlling shareholder must guarantee the consummation of a prompt short-form merger at the same price if it obtains 90% or more of the shares; and (3) the controlling shareholder must make no "retributive threats" in its negotiations with the special committee. See Subramanian, *supra* note 9, at 21-22.

company, an “ordinary resolution” of the company’s shareholders is required (which can be adopted by the affirmative vote of a majority of the shareholders present at the meeting, representing at least 1/4 of the total number of outstanding voting shares of the company) and for a KOSDAQ Market listed company, a “special resolution” of the company’s shareholders is required (which can be adopted by the affirmative vote of at least 2/3 of all voting shares present at the meeting, representing at least 1/3 of the total number of outstanding voting shares of the company). However, even if a listed company obtains its shareholders’ approval for voluntary delisting, unless certain events<sup>36)</sup> triggering the compulsory delisting by the Korea Exchange are reasonably expected to occur, the Korea Exchange may, at its own discretion, refuse to accept the listed company’s application for voluntary delisting for various reasons, including its failure to take steps to protect minority shareholders.

For the sake of minority shareholder protection, the Korea Exchange, in practice, has been requesting the controlling shareholder to take certain measures as a pre-condition to its approval of the delisting application. In most cases, such measures include the controlling shareholder’s purchase of shares held by minority shareholders through (i) a liquidation trading<sup>37)</sup> and (ii) a post-delisting offer.<sup>38)</sup> To ensure such measures will be taken, the

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36) In general, if a tender offer for shares in a listed company by a controlling shareholder of the company is successfully completed as planned, it is highly likely that the trading volume of the shares in the listed company will decrease considerably and the shares in the listed company will not be widely dispersed among a large number of shareholders. The relevant regulations of the Korea Exchange provide for certain compulsory delisting conditions relating to low trading volume and narrow dispersion of shares.

37) Usually, the Korea Exchange suspends trading of the shares in a listed company which satisfies delisting requirements and, accordingly, will be delisted soon. However, the Korea Exchange may allow the soon-to-be delisted shares to be traded on the Stock Market or the KOSDAQ Market through liquidation trading for a certain period of time (in most cases, 7 trading days are given for liquidation trading). The main purpose of liquidation trading is to provide minority shareholders with an opportunity to dispose of their shares before the delisting becomes effective. In general, a controlling shareholder of the company purchases the shares held by the minority shareholders before they lose their marketability as a result of delisting. However, because there may still be minority shareholders who do not want to sell their shares through the liquidation trading, a controlling shareholder may not be able to obtain all the shares of the minority shareholders.

38) In most cases, this type of offer by a controlling shareholder of a listed company has

controlling shareholder is requested to submit to the Korea Exchange its commitment letter for implementing such measures. Subsequently, such commitment is publicly disclosed to the minority shareholders.

As a result of delisting, the remaining shares owned by the minority shareholders (if any) lose liquidity in the market. Given that dissenting minority shareholders are provided with an opportunity to sell their shares under the series of tender offer, liquidation trading and post-delisting offer, the subsequent delisting alone does not prejudice the interest of minority shareholders. Nevertheless, since there is no clear guideline as to liquidation trading and post-delisting offer, this may result in making the delisting process less certain, to all relevant parties, including the company, the controlling shareholder, and remaining dissenting shareholders.

## *2) Proposal for Reform*

As a means of eliminating uncertainty, we propose the minority shareholder protection measures currently implemented in practice, under the supervision of the Korea Exchange, become statutory requirements. This will surely enhance the certainty and transparency of the delisting process so that parties involved in a freeze-out transaction through a delisting process will have a more clear picture on their status before, during or after the conclusion of the freeze-out transaction.

In furtherance of the above, the listing/delisting regulations of the Korea Exchange may adopt a provision requiring a controlling shareholder to engage in certain protective actions such as mandating a controlling shareholder to purchase shares from minority shareholders at a fair or appropriate price during a certain period after the company is delisted, as a condition to approval of delisting by the Korea Exchange. Further, the listing/delisting rules may add more provisions detailing comprehensive procedures and pricing mechanics for the post-delisting share purchase.

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lasted for six (6) months following the official delisting date. Also, the price of such offer has been the same amount as the price offered in the immediately preceding tender offer for the shares in the listed company.

### III. New Freeze-Out Mechanisms Proposed in the Bill

#### 1. *Proposed Amendment to the Korean Commercial Code*

The Bill proposes certain devices which are designed to give more flexibility to the controlling shareholder when buying out minority shares for the purpose of a freeze-out transaction. Such devices are cash-out mergers and compulsory buy-outs. The significance of these two proposed devices is that they allow the controlling shareholder to squeeze out minority shareholders, at the controlling shareholder's own will.

Generally, cash-out mergers provide more flexibility in the form of the merger consideration which is to be given to shareholders of the extinguished company in a merger. Under the current Korean Commercial Code, the form of merger consideration that can be given to the shareholders of the extinguished company is, in principle, limited to the shares of the surviving company. However, the Bill allows a cash-out merger, wherein a surviving company may pay cash as merger consideration to shareholders of the extinguished company and, accordingly, force out the minority shareholders.

The Bill also allows compulsory buy-out which entitles a controlling shareholder with 95% of shares or more to effectively squeeze out the minority shareholders as long as it satisfies certain procedural requirements (e.g., approval at the shareholders' meeting, mandatory negotiation between the shareholders and appraisal process administered by the court).

While the proposed cash-out merger and compulsory buy-out may provide a controlling shareholder with a powerful tool for freeze-outs, enhanced minority protection are also necessary, since the Bill allows a controlling shareholder to squeeze out minority shareholders even against their will.

In the following, we explain the main features, requirements and procedures of cash-out merger and compulsory buy-out, followed by an analysis on potential conflicts and practical difficulties in balancing the competing concerns of transactional efficiency in freeze-outs and protection of minority shareholders under these new freeze-out tools. Afterwards, we discuss our proposals for amendment to legislative bill to address this intricate issue.

## 2. Cash-out Merger

### 1) Overview

Under the current regime of Korean corporate law, the form of merger consideration for minority shareholders is in principle limited to the shares of the surviving company, with the exception of cash payment for fractional shares that cannot be exchanged with a share of the surviving company. A controlling shareholder cannot squeeze out minority shareholders since minority shareholders can only receive shares and remain as a shareholder of the surviving company. However, the Bill provides that the surviving company may pay cash to the minority shareholders of the extinguished company as merger consideration. Hence, under the Bill, a controlling shareholder may effectively freeze out minority shareholders by engaging in a cash-out merger.

The following example illustrates how cash-out merger works. A controlling shareholder of the target company which is to be extinguished through a merger sets up a wholly owned subsidiary. Then, the controlling shareholder causes the target company to merge into the subsidiary and pay cash to minority shareholders of the target company as merger consideration. As a result, the controlling shareholder becomes the sole shareholder of the surviving company and, consequently, the controlling shareholder effectively takes the company private.<sup>39)</sup>

As shown above, a controlling shareholder with sufficient voting shares to pass a resolution of a cash-out merger at the shareholders' meeting can effectively squeeze out minority shareholders and minority shares are deprived of a choice on remaining as a shareholder of the surviving company. Thus, there is a disparity in the position of minority shareholders in a cash-out merger compared to that in a stock-for-stock merger. While noting this fundamental difference, we discuss in the below (i) how a cash-out merger can be implemented in harmony with the existing laws governing merger, (ii)

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39) The proposed amendment also provides for a forward triangular merger, in which shareholders of the target company would receive shares of the parent of the acquiring company as merger consideration in exchange for their shares in the extinguished company. See the Bill art. 523 and art. 523-2.

whether the rational behavior of a controlling shareholder and minority shareholders in a cash-out merger may lead to a reasonable agreement on merger terms and, (iii) what measures should be taken *ex ante* and *ex post* in order to protect minority interest without hampering efficient procedures for freeze-outs.

## 2) *Interplay between Cash-Out Merger and Existing Rules: Merger Procedure and Minority Protection*

As discussed before, the Bill introduces the concept of cash-out merger, in which the surviving company pays cash to minority shareholders as merger consideration in exchange for minority shareholders' shares of the extinguished company. Apart from the fact that minority shareholders receive a new form of merger consideration (i.e., cash) instead of shares of the surviving company, the cash-out merger introduced in the Bill is to be performed in the same manner as a stock-for-stock merger pursuant to the procedures prescribed under the existing corporate laws. The following sections discuss how the cash-out merger will be implemented under the current merger rules.

### (1) Shareholders' Approval

Pursuant to the Korean Commercial Code, a fundamental corporate change, such as merger, business transfer or dissolution, mandates a special resolution of the shareholders, which requires the consent of at least 2/3 of voting shares present at the shareholders meeting and which must also represent at least 1/3 of the total outstanding voting shares (the "super-majority").<sup>40)</sup> Therefore, assuming that all shareholders are present at the shareholders' meeting, if minority shareholders have more than 1/3 of the total voting shares, minority shareholders can block the fundamental corporate change contemplated by the controlling shareholder.

By operation of statutory resolution requirements, if minority shareholders own more than 1/3 of all outstanding voting shares, a controlling shareholder may not implement the merger at its own will without obtaining consent from at least part of minority shareholders. Hence, a controlling shareholder has an

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40) See the Korean Commercial Code art. 434 and art. 522. Fundamental corporate changes also require the approval of the board of directors.

incentive to offer terms of merger that are, at least not obviously unfavorable to minority shareholders in order to induce their consent to the merger. On the contrary, if minority shareholders own less than 1/3 of all outstanding voting shares, minority shareholders are not in a position to block the merger. In such case, the controlling shareholder will not have much incentive to seriously negotiate with minority shareholders over the terms of merger, and may behave opportunistically to maximize its private gain in a merger.

#### (2) Dissenting Shareholders' Appraisal right

As mentioned in the above, the execution of merger requires a super-majority approval at the shareholders' meeting. Due to such super-majority requirement in certain cases, a controlling shareholder may have to offer merger terms that are attractive to minority shareholders. Otherwise, intransigence of minority shareholders may block or significantly delay the conclusion of the merger. On the other hand, such merger also entails a risk of majority opportunism such as squeezing out of minority shareholders at a lower price than the so-called intrinsic value. Like other modern corporate law jurisdictions, the Korean Commercial Code provides for an appraisal remedy<sup>41)</sup> for dissenting shareholders by which such shareholders can cash out their investment at fair value.

In the event that minority shareholders do not agree on and dissent to the contemplated merger, they can exercise appraisal rights within twenty (20) days of the shareholders meeting.<sup>42)</sup> In this case, appraisal of share value becomes a key issue and both the company and dissenting shareholders should first negotiate on the value of shares to be purchased by the company. If the company and dissenting shareholders fail to reach an agreement on the value of the shares within thirty (30) days of the dissenting shareholders' request, then the court may determine the value of the shares.

In addition, companies listed on the Korea Exchange must use the

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41) Appraisal rights in connection with merger are granted to the shareholders who (i) are listed on the shareholder registry as of the date of the close of shareholder registry, (ii) notify the relevant company of their objection in writing prior to the shareholders' meeting for approval of the merger, (iii) submit a written request to purchase their shares within 20 days following the date of such shareholders' meeting and (iv) hold the shares from the close of the shareholder registry to the exercise of such appraisal rights. *See* the Korean Commercial Code art. 360-5.

42) *See* the Korean Commercial Code art. 374-2.

valuation formula for appraisal of shares set forth in the FSCMA. When at least one of the parties to the merger is a listed company, the price of shares to be purchased by such listed company as a result of the exercise of the appraisal right by the dissenting shareholders should be, first, determined through negotiation between dissenting shareholders and the listed company. However, if they fail to agree on the purchase price, the purchase price should be computed pursuant to the formula prescribed under the FSCMA.<sup>43)</sup> The policy rationale for using the FSCMA formula in assessing the appraisal value seems to be based on the assumption that regulatory intervention is necessary to further the protection of shareholders of a listed company by providing a uniform appraisal method that regulators deem fair. If either party does not agree to the value calculated pursuant to FSCMA formula, then the court determines the value upon the request of either party.

In practice, virtually all listed companies make reference to the predetermined appraisal formula of the FSCMA when offering the appraisal value to dissenting shareholders, and shareholders seldom challenge such appraisal value calculated in accordance with the FSCMA formula.

Therefore, under the current framework for determining appraisal value, the appraisal value can be determined either pursuant to the FSCMA's formula or by the court if minority shareholders reject the value proposed by the company. Accordingly, with respect to the appraisal of shares in a listed company, the company and its controlling shareholder do not have much room to fiddle with the appraisal value, even though the FSCMA formula does not always guarantee that dissenting shareholders will get fair value for their shares.

### (3) Merger Ratio

The general rule of calculating merger ratio is that the surviving company and the extinguished company negotiate and determine the merger ratio subject to the approval of the board of directors of both companies. In a cash-out merger, it is likely that a controlling shareholder controls the board of

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43) Pursuant to the appraisal formula set forth in the FSCMA, appraisal value shall be calculated as follows: the arithmetic average of the weighted average of daily closing prices for (i) two-month period, (ii) one-month period and (iii) one-week period ending one day before the date of resolution of the board of directors. *See* the FSCMA art. 165-5; the Enforcement Decree of the FSCMA art. 176-7.



directors of both companies. Thus, the controlling shareholder has, in fact, power to determine the merger ratio and, consequently, determine the amount of cash to be paid as merger consideration to minority shareholders.

In a cash-out merger, the lower the price of cash consideration which the surviving company pays to minority shareholders, the better-off the surviving company and its controlling shareholder and, therefore, the controlling shareholder has an incentive to determine the merger ratio in a manner favorable to the surviving company. By doing so, the controlling shareholders will be able to extract private benefits at the expense of minority shareholders.

The merger rules under the FSCMA that require the use of the prescribed formula in determining a merger ratio when at least one party to the merger is a listed company may help prevent the controlling shareholder's opportunistic behavior, that a controlling shareholder would no longer manipulate or determine the merger ratio unfairly or unfavorable to minority shareholders.<sup>44)</sup>

Given the foregoing cash-out merger mechanism, it seems clear that the rational behavior of the shareholders will differ, depending upon (i) whether the controlling shareholder's shareholding ratio exceeds 2/3 of all voting shares and (ii) whether either party to a cash-out merger is a listed company. With these two key factors in mind, we analyze below the cash-out merger mechanism and its ramification to the minority shareholders. Then, we discuss the demerits of the compulsory use of the prescribed FSCMA's appraisal formula in determining the appraisal value as well as the merger ratio in attaining the policy goal of facilitating transactional efficiency in freeze-outs and protecting the interest of minority shareholders.

### 3) Economic Analysis: Rational Behavior of Minority Shareholders

#### (1) Case A: Shareholding Ratio of Controlling Shareholder is less than 66 2/3%

As discussed above, since the merger practically requires an approval of 2/3 of the outstanding voting shares in the target company, the controlling shareholder with less than 2/3 of the outstanding voting shares in the target

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44) See the Regulation on Securities Issuance and Disclosure art. 5-13; the Enforcement Regulation on Securities Issuance and Disclosure art. 4.7.

company will need to obtain consent from at least some of minority shareholders. Upon receipt of the terms of merger, the minority shareholders may consent or dissent to the merger and end up with different positions depending on whether the merger occurs. The following two scenarios are likely to occur for minority shareholders.

- ① If the minority shareholders consent to the merger:
  - (i) in the event the merger occurs, it will receive cash as merger consideration; and
  - (ii) in the event the merger does not occur, it will continue to hold shares.
- ② If the minority shareholders dissent to the merger:
  - (i) in the event the merger occurs, it will receive cash in the amount of the appraisal value; and
  - (ii) in the event the merger does not occur, it will continue to hold shares.

The following table demonstrates the expected return of a minority shareholder depending on whether they consent or dissent to the cash-out merger.

|  | Minority Shareholder's Decision                         |   |
|--|---|---|
|  | Consent to Merger                                       | Dissent to Merger                                       |
| Expected Return When Merger Occurs         | Cash as merger consideration (A)                        | Cash equivalent to the appraisal value (B)              |
| Expected Return When Merger Does Not Occur | Expected value of shares when merger does not occur (S) | Expected value of shares when merger does not occur (S) |

\*For the purpose of our discussion on the main topics in this Article, we have not taken into account information costs, appraisal costs, and time value of money in our analysis.

When a minority shareholder consents to a merger, the formula for expected return of a minority shareholder is as follows:

$$E(R)_{(\text{consent})} = (p \times A) + [(1 - p) \times S]$$

where,

$p$  = the probability of the success of the merger;

$1 - p$  = the probability of the failure of merger

When a minority shareholder dissents to a merger, the expected return for a minority shareholder is as follows:

$$E(R)_{(dissent)} = (q \times B) + [(1 - q) \times S]$$

where,

$q$  = the probability of the success of the merger;

$1 - q$  = the probability of the failure of merger

A rational minority shareholder shall consent to the merger if  $E(R)_{(consent)}$  is greater than  $E(R)_{(dissent)}$ , and *vice versa*. Therefore, a controlling shareholder eager to achieve a cash-out merger will have the incentive to increase the likelihood of success of the cash-out merger by increasing  $E(R)_{(consent)}$  over  $E(R)_{(dissent)}$ . Therefore, a controlling shareholder would structure a cash-out merger so that  $E(R)_{(consent)}$  is greater than  $E(R)_{(dissent)}$ .

$$E(R)_{(consent)} > E(R)_{(dissent)}$$

$$(p \times A) + [(1 - p) \times S] > (q \times B) + [(1 - q) \times S]$$

$$(p \times A) - (p \times S) > (q \times B) - (q \times S)$$

$$p \times (A - S) > q \times (B - S)$$

(such formula, "Formula 1")

In case when minority shareholders are well dispersed and, thus, an individual minority shareholder owns very minimal equity stake in a company, the decision of an individual minority shareholder would have little effect on the likelihood of success of the merger. If so, it is reasonable to assume that  $p$  equals  $q$ . In such case,

$$p \times (A - S) > p \times (B - S)$$

$$A - S > B - S$$

$$A > B$$

As the above formula shows, a rational minority shareholder with minimal equity stake in a company shall consent to the merger only when the amount of cash to be received as a merger consideration ( $A$ ) is greater than the appraisal value of shares ( $B$ ). Therefore, the controlling shareholder would have an incentive to provide minority shareholders with merger consideration in cash in the amount greater than the appraisal value.

If a single minority shareholder owns all remaining shares or dispersed minority shareholders act collectively in one direction, the minority shareholders' decision will be, in fact, a determining factor in the success of the merger. In such case, we can assume " $p$ " (the likelihood of success of the merger when a minority shareholder consents to the merger) will be 1, and " $q$ " (the likelihood of success of the merger when a minority shareholder dissents to the merger) will be 0. Under this assumption, if we substitute 1 and 0 for  $p$  and  $q$  in Formula 1, respectively,

$$1 \times (A - S) > 0 \times (B - S)$$

$$A - S > 0$$

$$A > S$$

As the above outcome indicates, minority shareholders, whose aggregate shareholding can determine the fate of the merger, would consent to the merger only when the amount of cash to be received as merger consideration ( $A$ ) is greater than the value of the shares when the merger does not occur ( $S$ ). On the other hand, a controlling shareholder eager to conclude the cash-out merger, will have an incentive to provide minority shareholders with cash as merger consideration in an amount greater than the value of the shares when the merger does not occur.

In sum, from the perspective of a controlling shareholder whose shareholding ratio is less than  $2/3$  of the outstanding voting shares, it can promote the cash-out merger only when the amount of cash to be given to a

minority shareholder as merger consideration is greater than either (i) the value of shares when the merger does not occur ( $S$ ) or (ii) the appraisal value of shares when appraisal rights are exercised ( $B$ ).

If the court determines  $B$  based on the value of the company before the merger and does not reflect the synergy effect arising from the merger, then  $B$  equals  $S$ . On the contrary, if such synergy is considered in determining the appraisal value,  $B$  exceeds  $S$ . Based upon such analysis,  $B$  is equal to or greater than  $S$ . Accordingly, in order for the controlling shareholder to successfully carry out the cash-out merger, the controlling shareholder should propose cash as a merger consideration ( $A$ ) greater than the appraisal value of shares ( $B$ ), which will be equal to or higher than the current share value ( $S$ ). In summary,  $A > B \geq S$ .

Under the above circumstances, it is difficult for a controlling shareholder to extract private benefit at the expense of minority shareholders because the minority shareholder will surely want to receive, at a minimum, an amount of cash not less than the current value of the shares.

In order to induce minority shareholders to consent to the merger, a controlling shareholder may lean towards determining the merger ratio which assures minority shareholders that they would receive merger consideration in cash in an amount equivalent to the fair value of shares. However, as discussed previously, when at least one party to the merger is a company listed on the Korea Exchange, the amount of cash to be given as merger consideration shall be determined based upon the merger ratio computed pursuant to the merger formula prescribed under the FSCMA. Further, the appraisal value shall also principally be determined pursuant to the appraisal formula set forth in the FSCMA. Therefore, a controlling shareholder may not be able to propose a more favorable merger ratio to minority shareholders beyond the merger ratio determined pursuant to the FSCMA formula even if it wants to do so. As a result, the FSCMA merger rules may have the effect of discouraging a controlling shareholder whose shareholding ratio is less than  $2/3$ , from conducting freeze-outs with more favorable terms to minority shareholders and, accordingly, deterring even a value-creating freeze-out.

The FSCMA formulas for merger ratio and appraisal value are, seemingly, designed as a device to protect minority shareholders from the controlling shareholder's opportunistic behavior. However, it is unclear whether the FSCMA formulas fully serve the intended purpose. There can be a variety of

different methods in evaluating the value of shares. We cannot find any justifiable reason to favor one statutory method over the other. The most appropriate valuation method may depend upon the circumstances surrounding the concerned company and its shareholding structure. Therefore, in some cases, the draconian requirement of mandating the use of the FSCMA formulas may result in an unintended harm to shareholders.

In light of the foregoing, we argue that, for the purpose of (i) facilitating a value-creating freeze-out and (ii) protecting the minority shareholders' interest, it would be better to abolish the statutory requirement mandating the use of the FSCMA formula in computing the merger ratio and the appraisal value. We believe that the rigid application of the predetermined formulas of the merger ratio and appraisal value under the FSCMA does not serve the policy goal of providing adequate protection to minority shareholders. Instead, other forms of protective measures should be further considered, such as enhancing the information disclosure requirements in a freeze-out merger and empowering minority shareholders with a statutory right to seek monetary damages on the grounds of inadequacy of merger consideration or unfairness of the merger ratio.

(2) Case B: Shareholding Ratio of Controlling Shareholder is not less than  $66\frac{2}{3}\%$

If the shareholding ratio of the controlling shareholder is not less than  $\frac{2}{3}$  of the outstanding voting shares, the minority shareholder's decision as to the merger would not affect the shareholders' resolution of the merger. In this case, the merger will be approved at the shareholders' meeting regardless of whether the minority shareholders vote against it. We illustrate in the below table the expected return of minority shareholders.

|                 | Minority Shareholder's Decision |   |
|-----------------|---------------------------------|---|
|                 | Consent to Merger               | Dissent to Merger                               |
| Expected Return | Cash as merger consideration    | Cash equivalent to appraisal value ( <i>B</i> ) |

\*For the purpose of our discussion on the main topics in this Article, we have not taken into account information costs, appraisal costs, and time value of money in our analysis.

The rational choice of minority shareholders will depend on whether  $A$  is greater than  $B$ . By contrast, from the controlling shareholder's standpoint, its main concern will be to minimize the amount of cash consideration paid to minority shareholders in order to reduce outflow of cash from the company. Thus, the controlling shareholder has an incentive to manipulate the merger ratio by undervaluing the shares of the extinguished company vis-à-vis the value of shares of the surviving company and to reduce cash consideration to be paid to minority shareholders.

If minority shareholders find the merger ratio proposed by a controlling shareholder, unfair or unsatisfactory they may dissent to the merger and exercise their appraisal rights. Then, the court will determine the fair value of the minority shares, unless the minority shareholders and a controlling shareholder agree to the value of the minority shares.<sup>45)</sup> Assuming that the court adequately and somehow correctly assesses the fair value of the minority shares, minority shareholders can be protected against the risk of the opportunistic behavior of the controlling shareholder.

As mentioned before, in the case of a listed company, the FSCMA sets forth the formula for determining the appraisal value for dissenting shareholders, based upon the market closing prices for a recent trading period. Assuming that the market trading price fairly reflects all relevant public information under the efficient capital market hypothesis and the controlling shareholder cannot manipulate the market trading price, the formula under the FSCMA seems to properly assess the fair value of the shares held by dissenting shareholders.

We note that the calculation of appraisal value is based on the market price, which fluctuates over periods. Because the controlling shareholder can determine the timing of the cash-out merger, the controlling shareholder may act opportunistically in order to reduce the appraisal value. For example, (i) the controlling shareholder may buy out shares of the minority shareholders when the market trading price of the target company is lower than its intrinsic value; and (ii) the controlling shareholder may try to drag down the trading price of shares or even take measures to lower the value of the target company

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45) It is not certain whether the fair value should include the expected synergy or be calculated based on the value of the company before the merger.

for the concerned period.<sup>46)</sup>

As we explain in this section, regardless of whether the shareholding ratio of the controlling shareholder is less or greater than 2/3 of outstanding voting shares, the rigid FSCMA appraisal formula based on the market price may not help protect the minority shareholders' interest and may even deter a value-creating freeze-out. Therefore, the appraisal formula under the FSCMA for calculating the appraisal value should be abolished.

### (3) Summary

As we have so far argued, in the case of a listed company, the inflexible formula under the FSCMA for determining the merger ratio as well as the appraisal value may not always effectively facilitate a value-creating freeze-out, and would not always adequately protect the interest of minority shareholders, as well. As a way to address this issue, we propose that the rigid requirement mandating the use of the one-size-fit-all like formula under the FSCMA should be eliminated and that, instead, we should rely on good faith negotiations and agreement between a controlling shareholder and minority shareholders in determining the merger ratio and appraisal value. Any failure to reach an agreement to bridge the gap between the parties will ultimately be subject to judicial review.

### 4) *Protecting the Interest of Minority Shareholders*

In the previous section, we have argued that it would be better to rely on private contracts based on the rational behaviors of the controlling shareholder and the minority shareholders when determining the pricing mechanism for cash-out mergers, rather than the interference of the authorities by fixing a rigid rule. For the purpose of warranting such rational behaviors, minority shareholders should, among others, be adequately informed. In this regard, corporate laws should require that (i) the minority shareholder be furnished with information to overcome the inherent information asymmetry between a controlling shareholder and minority

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<sup>46)</sup> See Subramanian, *supra* note 9, at 31- 32. The U.S. Supreme Court also expressed its fairness concerns in a squeeze-out transaction by stating that the fairness of such transaction would be affected by "when the transaction was timed, how its was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained." See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).



shareholders, and that (ii) minority shareholders be empowered with effective means to challenge the merger if their decision is tainted with incorrect information which is attributable to the fault of a controlling shareholder or the management of the company.

(1) *Ex Ante* Protections

In order to enable minority shareholders to make informed decisions, information on the two companies to be merged and the terms of merger should be fairly and timely provided to minority shareholders.<sup>47)</sup> Given that the scope of information accessible to minority shareholders is somewhat limited compared to a controlling shareholder, minority shareholders may not be able to make an informed decision without the cooperation of the management of the target company or the controlling shareholder. Thus, there should be some mandatory measures to ensure that the information and terms of the cash-out merger are fairly disclosed to minority shareholders.

Then, the next question is who owes the duty to disclose information to minority shareholders. Under Korean law, the directors have a fiduciary duty to negotiate, execute and perform the terms of merger in good faith. As such, it seems reasonable and imperative that the management of the two companies to be merged undertake to disclose information regarding the merger to the minority shareholders.

Under the Korean Commercial Code, directors of the two companies to be merged should keep the following materials in each of their main offices: (i) a copy of the merger agreement; (ii) documents describing the distribution of the surviving company's shares to the shareholders of the company to be extinguished and its basis thereof; and (iii) the balance sheet and income statement of both companies.<sup>48)</sup> Shareholders of the two companies to be merged may investigate and make copies of those materials.<sup>49)</sup>

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47) The SEC Rule 13e-3 requires that a controlling shareholder make extensive disclosures to the minority shareholders in conjunction with a freeze-out transaction—including the purpose of the transaction (and why alternative methods for achieving the same purpose were rejected), a summary of the investment banker's fairness opinion, and financial information such as current and historical market prices—for the purpose of facilitating an informed decision by minority shareholders. *See* Subramanian, *supra* note 9, at 10.

48) *See* the Korean Commercial Code art. 522-2(1).

49) *See* the Korean Commercial Code art. 522-2(2).

In spite of the above disclosure requirement, it is not evident whether the scope of disclosed information is sufficient for the shareholders to make a prudent and informed decision on the appropriateness of the merger consideration. In addition, it is not clear what kind of sanctions will be levied on directors in the event they fail to fully perform their obligations or make defective/misleading disclosures.<sup>50)</sup> Therefore, it would be better to clearly stipulate in the Korean Commercial Code what kind of civil and/or criminal sanctions may be imposed on directors in case they breach such obligations. This will surely induce the directors to actively engage in negotiation, execution and performance of the merger on behalf of the shareholders and fairly disclose the merger information to shareholders. Also, the scope of information disclosure in a freeze-out merger should be expanded to the level that applies to a statutory stock-for-stock merger of the listed companies.<sup>51)</sup>

We may consider some other *ex-ante* protections, which are designed to warrant a genuinely negotiated arm's length price under the cash-out merger. One probable method of protection is to require the board approval by disinterested directors in a cash-out merger, which is to replicate the element of an arm's length negotiation.<sup>52)</sup> This protection is the product of translating the arm's length standard to the area of freeze-out transactions.<sup>53)</sup> Therefore, if a special committee consisting of independent directors has real negotiation

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50) Under the Korean Commercial Code, if the director does not disclose materials as stated above, a fine of only up to Korean Won 5,000,000 (equivalent to approximately US \$ 4,000) will be levied (art. 635(1)21).

51) The FSCMA and the regulations thereunder require a company to file a registration statement when it issues or distributes its shares to not less than 50 shareholders of the target company as a result of the merger (art. 119 of the FSCMA). In the registration statement, information such as the merger conditions, the basis of calculation of merger ratio, general information on the companies, and financial statements of companies, among others, are included (art. 2-9 of the Regulation on Securities Issuance and Disclosure). Shareholders of the target company may then be provided with more information than stipulated in the Korean Commercial Code. However, this filing requirement of the registration statement may not apply to a company executing a cash-out merger, since the company does not issue or distribute shares to shareholders of the target company. As the need for disclosure in a cash-out merger is no less dire than in a stock-for-stock merger, there should be a certain form of a disclosure document that can deliver the equivalent level of information to affected shareholders, and this seems to be another legislative task when the cash-out merger is introduced in the Korean law.

52) See Subramanian, *supra* note 9, at 8.

53) *Id.*

and veto power over the cash-out merger then the terms of merger are more likely to reflect the arm's length price.<sup>54)</sup>

In line with furthering arm's length pricing, another method for protecting minority shareholders is to require an independent outside firm to evaluate the fairness of the merger ratio between the two merged companies under the cash-out merger regardless of whether the merged companies are listed on the Korea Exchange or not. Independent evaluation of the fairness of the merger ratio will help ensure that the merger ratio mirrors the arm's length transaction.

## (2) *Ex Post* Protections

In addition to the above *ex ante* protections, *ex post* remedies should be available to minority shareholders in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved.<sup>55)</sup> In this respect, the Korean Commercial Code provides for a rescissory lawsuit, challenging the legality of the merger which allows minority shareholders to challenge the cash-out merger itself if they believe that any illegal actions are involved in the *ex ante* requirements of the merger, such as disclosure of information.<sup>56)</sup> Statute of limitations for the rescissory lawsuit is 6 months after the date of registering the merger in the commercial registry.<sup>57)</sup>

A private cause of action for the rescissory lawsuit is not enumerated in detail under the Korean Commercial Code. According to some court precedents and scholarly commentaries, the following incidents are typically viewed as a cause of action for the rescissory lawsuit challenging the merger: procedural defect in resolution of the shareholders' meeting; non-disclosure of material information related to the merger; failure to grant appraisal rights to

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54) *Id.*

55) The U.S. Supreme Court further stated that "[u]nder such circumstances, the Chancellor's powers are complete to fashion any form of equitable and monetary relief as may be appropriate, including rescissory damages. Since it is apparent that this long completed transaction is too involved to undo, and in view of the Chancellor's discretion, the award, if any, should be in the form of monetary damages based upon entire fairness standards, i.e., fair dealing and fair price." See Weinberger, 457 A.2d at 714.

56) Standing to bring the rescissory lawsuit is granted to a shareholder, director, statutory auditor, liquidator, administrator, or a creditor who does not consent to the merger. See the Korean Commercial Code art. 529.

57) See the Korean Commercial Code art. 529.

minority shareholders; and a significantly unfair merger ratio. In the presence of any of the foregoing causes of action, the aggrieved minority shareholders may bring a rescissory lawsuit, seeking to void the merger.

However, under the current regime, minority shareholders cannot claim for monetary damages instead of seeking nullification of the merger itself. For example, if minority shareholders challenge the merger by referencing to a significantly unfair merger ratio, minority shareholders cannot claim monetary damages or demand for additional economic consideration, but may only seek rescission of the merger.

Relief available under the current rescissory lawsuit may not be appropriate for the aggrieved minority shareholders in that the primary concern of the aggrieved minority shareholders is to receive the fair value of their shares. Minority shareholders may prefer to receive additional compensation for damages rather than voiding the entire merger transaction. Further, rescinding and, subsequently, unwinding a merger (which has already been consummated) would cause a significant amount of social and economic loss. As such, the court may be reluctant to grant rescission.

When a cause of action for a rescissory lawsuit is based on a significantly unfair merger ratio, this rescissory remedy is particularly important to minority shareholders who consent to the merger, because no other legal remedy is available to such consenting shareholders other than rescissory lawsuit. By contrast, the dissenting minority shareholders may seek for monetary damages for “significantly unfair merger ratio” during the appraisal proceeding.

In the event that a cause of action for rescissory lawsuit occurs, under the current remedial framework, there would be no practical remedy available for the consenting minority shareholders, who seek additional monetary award. The Korean corporate laws have not yet clearly established rules and standards regarding whether a consenting shareholder can directly seek monetary damages against directors of the target company even in the event the defect of the concerned merger is attributable to a director’s breach of fiduciary duty.

A fraud action based upon the Civil Code may also be considered as an alternative option. For example, if the minority shareholders believe that the controlling shareholders has manipulated the merger ratio, the aggrieved minority shareholder may bring a fraud claim against the controlling

shareholder. However, it is not certain whether the court would accept a fraud claim based upon the cause of action for a rescissory suit, because (i) the requisite elements for fraud claim and rescissory claim are different and (ii) a fraud action requires a higher threshold (i.e., fraudulent intent) than a rescissory action. To date, there has been hardly any case law, acknowledging a fraud claim in the merger context.

The most effective solution to this problem seems to be a legislative amendment by adding “rescissory damages” in the Korean Commercial Code as a distinctive remedy in a rescissory lawsuit. In other words, an aggrieved party may seek either (i) rescission of the merger or (ii) the rescissory damages. If our proposal is adopted, minority shareholders may claim monetary damages when the merger ratio is significantly unfair without the need to nullify and void the merger itself. This kind of rescissory damage has been firmly recognized in the courts of U.S.<sup>58)</sup> as well as under German law.<sup>59)</sup>

Meanwhile, Article 529(1) of the Korean Commercial Code grants standing for a rescissory lawsuit to the shareholder, director, statutory auditor, liquidator, administrator or creditor who has opposed the merger.<sup>60)</sup> As a matter of law, the consenting minority shareholders will no longer be the shareholders of the target company once they receive cash as merger consideration in a cash-out merger. Therefore, the literal reading of Article 529(1) leads to the conclusion that consenting shareholders who are already freed out from the company do not have standing to bring a rescissory lawsuit. Therefore, if the cash-out merger is introduced as a freeze-out mechanism in Korea, the standing requirement should be revised to grant a standing to the consenting shareholders in the rescissory lawsuit.

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58) *See* Weinberger, 457 A.2d at 714.

59) *See* Umwandlungsgesetz art. 15.

60) Article 529 of the Korean Commercial Code (Action for Nullification of Merger)

(1) The nullification of a merger may be asserted only through an action which shall be filed by each company’s shareholder, director, auditor, liquidator or bankruptcy trustee or creditor who has opposed the merger.

(2) The action under paragraph (1) shall be brought within six months from the day on which the registration under Article 528 has become effective.

### 3. *Controlling Shareholder's Compulsory Buy-out Right*

#### 1) *Overview*

##### (1) *Compulsory Buy-out*

The Bill proposes to allow a controlling shareholder holding 95% or more of a company's shares to buy out the remaining shares owned by minority shareholders (the "compulsory buy-out right").<sup>61)</sup> Pursuant to the Bill, a controlling shareholder may exercise its compulsory buy-out right by undertaking the following: (i) the controlling shareholder notifies minority shareholders of its intention to exercise its compulsory buy-out rights; (ii) the company convenes a general shareholders' meeting, and the controlling shareholder explains to minority shareholders the purpose of the buy-out, its assessment and basis for the purchase price, and certain other statutorily prescribed items; (iii) shareholders approve the controlling shareholder's exercise of such compulsory buy-out right at the shareholders' meeting; (iv) the controlling shareholder requests minority shareholders to sell their shares, and minority shareholders become obliged to sell their shares within 2 months; (v) the controlling shareholder and minority shareholders negotiate on the purchase price; (vi) if the parties agree on the purchase price, the remaining shares are transferred to the controlling shareholder immediately when minority shareholders receive the purchase price; (vii) if the parties fail to reach an agreement within 30 days, either party may request the court to determine the purchase price. Remaining shares are transferred at the purchase price as determined by the court.<sup>62)</sup>

The compulsory buy-out right recommended under the Bill is analogous to those adopted in certain European countries such as France, Germany and

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61) See the Bill art. 360-24. In counting the 95% level, shares owned by the parent company (i.e., a company holding more than 50% of shares in the other company) and subsidiaries (i.e., a company in which more than 50% of shares are owned by the other company) of the acquiring company are aggregated (in case where the controlling shareholder is a company). Similarly, shares owned by a company in which more than 50% of shares are owned by the controlling shareholder are aggregated together (in case where the controlling shareholder is an individual). See the Bill art. 360-24(2).

62) See the Bill art. 360-24.

UK.<sup>63</sup> However, the requisite elements triggering buy-out rights differ from one jurisdiction to another. In France, the buy-out right is reserved only to listed companies,<sup>64</sup> whereas, in Germany, such right is expanded to both listed and non-listed companies.<sup>65</sup> Some countries allow the exercise of the buy-out right only when a controlling shareholder reaches a certain threshold level of shareholding by a tender offer; others do not impose such kind of restrictions.<sup>66</sup> The Bill neither limits the types of a company under which the compulsory buy-out right may be applicable, nor requires a tender offer procedure as a prerequisite to the exercise of the compulsory buy-out right.

A controlling shareholder may tend to prefer a cash-out merger to a compulsory buy-out due to the lower threshold of the requisite shareholding ratio: only 2/3 of shareholding is sufficient for the controlling shareholder to execute a cash-out merger whereas a 95% shareholding is required for a compulsory buy-out. However, the advantage of a compulsory buy-out over a cash-out merger is that it is a more direct and cost-efficient method for a controlling shareholder holding at least 95% of shares (e.g., a controlling shareholder does not have to establish a subsidiary for the sole purpose of eliminating minority shareholders). In that sense, compulsory buy-out, if adopted, will serve as a useful freeze-out method.

## (2) Compulsory Sell-out

The Bill also empowers minority shareholders to sell their shares to the controlling shareholder when the controlling shareholder holds 95% or more of the shares in the company (the “compulsory sell-out right”).<sup>67</sup> This

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63) See Code monétaire et financier §L433-4, Règlement général de l’AMF §§237-1~237-13 (France); Aktiengesetz §§327a~327f and Wertpapiererwerbs- und Übernahmegesetz §§39a, 39b (Germany); Companies Act §§979~982 (UK).

64) See PHILIPPE MERLE, *DROIT COMMERCIAL, SOCIÉTÉS COMMERCIALES* 812, 813 (Daloz, 1st ed. 2007); Code monétaire et financier §L.433-4; Règlement général de l’AMF §§237-1~237-13.

65) See Hwa-Jin Kim, *Freeze-out of Minority Shareholders under the Draft New Commercial Code*, *SEOUL LAW JOURNAL*, Vol. 50, No. 1, 336-338 (2009); Aktiengesetz §§327a~327f and Wertpapiererwerbs- und Übernahmegesetz §§39a, 39b.

66) In France, buy-out rights are allowed for shareholders who acquired 95% or more of issued shares in a listed company against minority shareholders who have not presented their shares in the tender offer procedures. Code monétaire et financier §L.433-4.; See PHILIPPE MERLE, *supra* note 64, at 813.

67) See the Bill art. 360-25; the Review Report on the Proposal of New Commercial Code (Corporation Part), the Legislation & Judiciary Committee of the Korean National Assembly,

compulsory sell-out right will contribute to securing the minority shareholders' exit right. Some European countries recognize similar rights for minority shareholders.<sup>68)</sup>

Pursuant to the compulsory sell-out right, if a minority shareholder exercises the compulsory sell-out right, the controlling shareholder must purchase such shares within 2 months. The purchase price should be negotiated by both parties, but, if such negotiation fails, either party may request the court to determine the purchase price.

As mentioned in Part II, the Korean financial authorities have set a policy that when a controlling shareholder acquires shares in a listed company through a tender offer and, thereafter, voluntarily applies for delisting, the controlling shareholder is obliged to make an offer to buy the remaining shares owned by minority shareholders at the same price as the tender offer price (the so-called "post-delisting offer"). The compulsory sell-out serves the same purpose as the post-delisting offer in a sense that the minority's exit right will be somehow secured.

## 2) *Balancing of Competing Interests*

The Bill provides a controlling shareholder with a compulsory buy-out right and also empowers minority shareholders with a compulsory sell-out right. However, the situations where a controlling shareholder exercises its buy-out right differ from those where the minority shareholders exercise their sell-out right. The controlling shareholder may want to exercise his/her compulsory buy-out right when he/she wants to buy all of the remaining shares of the company but the minority shareholders may be unwilling to sell their shares for certain reasons such as: (i) minority shareholders do not agree on the share price offered by the controlling shareholder or (ii) minority shareholders simply want to remain as a shareholder of the company. Meanwhile, minority shareholders may want to exercise their compulsory sell-out right when they want to exit from the company, but the controlling shareholder may not be interested in purchasing the minority shareholders'

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Oct. 2008, at 80-82.

68) Règlement général de l'AMF §§236-1~236-4 (France); Companies Act §§983~985 (UK). However, Germany has not adopted compulsory sell-out rights. See Hwa-Jin Kim, *supra* note 65, at 337.



shares and they cannot find other investors who want to purchase the minority shareholders' shares. Thus, the fact that each party possesses a device to force the other party to sell or purchase shares does not necessarily mean that the interests of the controlling shareholder and the minority shareholders will be fairly balanced.

### *3) Problems with the Controlling Shareholder's Compulsory Buy-out Right*

The compulsory buy-out procedure should be designed in a cost-efficient and time-saving manner in order to achieve its legislative purpose of transactional efficiency in a freeze-out.

On the other hand, in a compulsory buy-out minority shareholders will lose their ownership of shares at the discretion of a controlling shareholder. As minority shareholders do not have a choice on whether to sell their shares or not, the purchase price naturally becomes the most important factor in selling their shares. Thus, the best way to protect the minority shareholders in a compulsory buy-out is to assure that they receive a fair price for their shares. In this respect, it is important to establish an appropriate purchase price valuation method within the compulsory buy-out mechanism.

Thus, in determining whether the interests of a controlling shareholder and minority shareholders are balanced in a compulsory buy-out situation, both transactional efficiency of the buy-out right and fairness of the purchase price of the minority shareholders' shares should be simultaneously considered. However, the compulsory buy-out requirements proposed in the Bill pose problems in terms of both promoting transactional efficiency in freeze-outs and providing a fair price to minority shareholders. In the following section, we discuss practical issues in connection with the compulsory buy-out and propose our recommendations to address such issues.

#### (1) Shareholders Approval

According to the Bill, a controlling shareholder may exercise its compulsory buy-out right subject to the approval of the shareholders' meeting.<sup>69)</sup> With respect to the approval, Article 368(4) of the current Korean Commercial Code provides that a shareholder who has a special interest

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<sup>69)</sup> See the Korean Commercial Code art. 360-24(3).

related to an agenda of a shareholder's meeting cannot exercise its voting rights. Since the exercise of the compulsory buy-out right is subject to the approval of the shareholders' meeting, the controlling shareholder is more likely to be considered as having a special interest in the shareholders' resolution and, thus, will not be able to exercise its voting rights.<sup>70)</sup>

Therefore, only minority shareholders will be able to exercise voting rights for the approval and, practically, the consent from the majority of minority shareholders (the "MOM Shareholders") will be required for the controlling shareholder's exercise of the compulsory buy-out right. In other words, in exercising the compulsory buy-out right, the controlling shareholder should not only acquire at least 95% of the shares, but also procure the support of the MOM shareholders (e.g., more than 2.5% if the controlling shareholder holds 95% shares in the company). In order for the MOM Shareholders to approve the buy-out, the purchase price of shares in a compulsory buy-out should be at least at a level acceptable to the MOM shareholders. Ironically, in such situation, the exercise of compulsory buy-out rights would not be meaningful to MOM shareholders, since they would have anyhow accepted an offer from the controlling shareholder if they had been offered the purchase of shares at such price.

Even in such situation, the controlling shareholder will not acquire shares from the MOM Shareholders in advance before his exercise of the compulsory buy-out right, since such advance purchase does not help him at all to effectuate the freeze-out. For example, suppose shareholder A holds 95% of shares in T Company. Among the remaining minority shareholders, shareholder B who holds 2.6% of the shares, values his shares at \$10 per share and is ready to sell his shares to shareholder A. On the contrary, another shareholder C holding 2.4% of the shares evaluates his shares at \$12 per share

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70) If the court views that a transaction under the compulsory buy-out right also implicates the minority's interest, all shareholders of the company (including both the controlling shareholder and the minority) will be deemed as an interested shareholder. If that is the case, it is not certain who will be able to vote in the shareholders' meeting. By contrast, if the court views that all shareholders are disinterested, then a typical shareholders' meeting rule is applied and the controlling shareholder with 95% of shares will be able to pass the shareholders' meeting resolution, approving the exercise of compulsory buy-out right by the controlling shareholder. As a result, the requirement for shareholders' approval does not contribute to the protection of minority shareholders at all in this context.

and refuses to sell his shares below \$12 per share. Shareholder A acquires additional 2.6% of shares from shareholder B at \$10 per share and his holding has increased to 97.6%. Shareholder A then initiates a compulsory buy-out procedure by offering a purchase price of \$10 per share, but shareholder C is not satisfied with the offer price. In that case, shareholder A cannot squeeze out shareholder C, despite of his 97.6% of shareholdings in the company since he cannot procure approval from the shareholders' meeting.

On the other hand, in the same example, suppose shareholder A holds 95% of shares but chooses not to separately acquire an additional 2.6% of shares from shareholder B. Instead, the controlling shareholder offers a purchase price of \$10 per share when initiating a compulsory buy-out. In such case, shareholder B will support the buy-out and, thus, the buy-out will be approved at the shareholders' meeting. Shareholder A then can compulsorily acquire all of the remaining shares from minority shareholders, with the shareholding ratio of 95% (which is lower than the shareholding ratio of 97.6% in the above example).

The foregoing examples clearly show that dissenting minority shareholders will be differently treated in a compulsory buy-out, depending on the strategy of the controlling shareholder. The exercise of a compulsory buy-out right may be frustrated even if the controlling shareholder possesses a much higher shareholding over 95% when he is required to obtain the resolution of the MOM Shareholders. A controlling shareholder holding 97.6% of shares may even circumvent such MOM shareholder approval requirement by transferring its 2.6% of the shares to a friend and make him vote for the buy-out at the shareholders' meeting. The fate of minority shareholders will then be decided by such a 'fake majority of minority shareholder' but not by the bona fide 'majority of minority shareholders.' Thus, the interest of minority shareholders cannot be adequately protected by simply imposing the MOM shareholders approval requirement.<sup>71)</sup>

Thus, from the standpoint of dissenting minority shareholders, the requirement for the MOM Shareholders approval does not provide sufficient

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71) The Review Report on the Proposal of New Commercial Code added comment that minorities can be protected by the MOM requirement. See the Legislation & Judiciary Committee of the Korean National Assembly, *supra* note 67, at 81.

comfort. A dissenting shareholder, who values his shares at \$12 per share but ends up selling his shares at \$10 due to the MOM Shareholders approval of the value of remaining shares at \$10 per share, will still feel that he has not received a fair price. In other words, such dissenting minority shareholder will anyhow be squeezed-out from the company against his will if there is MOM shareholders' approval.

As we have explained, the requirement of approval of MOM Shareholders makes it difficult for a controlling shareholder to exercise its buy-out right, and increases the uncertainty on the likelihood of its success in closing the freeze-out. Furthermore, this MOM Shareholders requirement does not necessarily provide adequate protection for the minority shareholders. Thus, we view that the shareholders' approval requirement should be removed from the Bill.

#### (2) Purpose of Compulsory Buy-out

At the general shareholders' meeting, a controlling shareholder should explain or present to the minority shareholders the following items: (i) the ownership structure of the controlling shareholder in the target company; (ii) the purpose of the buy-out, (iii) the assessment and basis for the calculation of the purchase price and fairness opinion of a certified appraiser; and (iv) guarantee letter for payment of the purchase price.

Among those items, we are of the view that the requirement to disclose the purpose of the buy-out is unnecessary<sup>72)</sup> since the controlling shareholder can find a business reason for the buy-out without much difficulty. Further, the knowledge of such business purpose provides no meaningful protection for the minority, since the minority will have little interest in what will happen to the company after the buy-out.

#### (3) Process of Determining Share Price

The most important concern in a buy-out from the view of both a controlling shareholder and minority shareholders is "the purchase price" to be paid for the shares of minority shareholders. Since minority shareholders have no choice but to sell their shares and to receive the purchase price from the controlling shareholder, the protection of minority shareholders should be focused on determining the fair value of shares. In this section, we review and

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72) See Weinberger, 457 A.2d at 715.

analyze the process of determining share price, either through a negotiation between the parties or evaluation by an independent third party such as an expert nominated by the court.

The Bill stipulates that the controlling shareholder and minority shareholders should first negotiate the share price. If parties agree, the remaining shares are transferred to the controlling shareholder immediately upon receipt of the purchase price by the minority shareholders. If both parties fail to reach an agreement within 30 days from the exercise date of the buy-out right, either party may request the court to determine the purchase price. After the court's evaluation process, the controlling shareholder will acquire the remaining shares as soon as the minority shareholders receive the court-determined purchase price or as soon as the court-determined purchase price is deposited with the court, in the event the minority shareholders challenge the fairness of the court-determined purchase price. This price evaluation and decision mechanism is similar to those under the existing laws on appraisal rights of dissenting shareholders.<sup>73)</sup>

It is possible that individual negotiation between the shareholders may result in a different purchase price for each minority shareholder. Even when the court decides on the purchase price, upon request of either a controlling shareholder or any minority shareholder, the court-determined price applicable to such shareholders may be different from the price paid to other minority shareholders who reached agreement through a negotiation. Thus, it seems that the Bill acknowledges that there may be a discrepancy in the purchase prices among the minority shareholders.

This price determination mechanism, however, neither facilitates efficient freeze-out procedures for the controlling shareholder, nor provides adequate protection to minority shareholders. First, the 30 day mandatory negotiation period seems to be a somewhat redundant process which may delay the buy-out process without a fruitful result. A controlling shareholder would typically exercise its compulsory buy-out right when minority shareholders do not sell their shares at the price originally offered by the controlling shareholder. If the parties agree on the purchase price, the controlling shareholder would be able to purchase shares from the minority anyway,

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73) See the Korean Commercial Code art. 374-2.

without resorting to its compulsory buy-out right. Thus, had it been easy for the shareholders to agree on a purchase price, they would have agreed on a purchase price before the controlling shareholder exercises its compulsory buy-out right.

Second, minority shareholders usually have less information on the company compared to the controlling shareholder. In order to overcome such information asymmetry, minority shareholders need to conduct investigation and bear related costs. In terms of the cost-efficiency of the investigation, the investigation costs per share incurred by a minority shareholder will be larger than that of the controlling shareholder since he has less information on the company to begin with. Such burden of costs may deter minority shareholders from conducting independent investigation and does not prove to be a solution for the information asymmetry between a controlling shareholder and minority shareholders.

Third, it would be unfair for the minority shareholders to bear a substantial amount of the transaction costs (such as investigation costs as mentioned above) in a sale where they are forced to sell shares. Further, since each minority shareholder is to separately negotiate with the controlling shareholder, each shareholder needs to perform a separate investigation on the company—the aggregate transaction costs of all minority shareholders may end up being larger than that of the controlling shareholder. Needless to say, such increase in overall transactional costs does not seem to be appropriate in light of the fact that the compulsory buy-out was introduced to make the procedures of the freeze-out more efficient.

It may be helpful to refer to practices of other jurisdiction where a similar type of buy-out right has already been adopted. For example, in France the share price is decided by an independent appraiser without requiring negotiation between the parties, first. The financial supervising authority, *Autorité de Marché Financier*, as the supervisor of the process, has the power to reject the share price when it finds it inappropriate.<sup>74)</sup> As explained above, it is unlikely that the 30 day mandatory negotiation period will make the freeze-out procedures more efficient. Rather, it may work in the opposite direction and increase the overall transactional costs of the freeze-out. Thus, we propose

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74) Règlement général de l'AMF §237-1, al. 3.

the removal of the mandatory negotiation period from the compulsory buy-out procedures.

#### *4) Problems with Minority Shareholders' Compulsory Sell-out Right*

##### *(1) Requirement for Sell-out Right*

The Bill also proposes that minority shareholders be entitled to sell their shares to a controlling shareholder when the controlling shareholder holds 95% or more of the shares in the company.<sup>75)</sup> If the minority shareholder exercises such right, the controlling shareholder must purchase the shares from the minority shareholder. However, such obligation of the controlling shareholder can be easily circumvented by dispersing its shares. For example, a controlling shareholder holding 95% of shares can transfer 5% of shares to a friend. Then the controlling shareholder's shareholding ratio does not reach the 95% threshold and, thus, minority shareholders cannot exercise their put-option rights.

To prevent such circumvention, shares owned by the parties who have a special relationship with the controlling shareholder should be aggregated in calculating the 95% threshold. Such parties should include, among others, parties who have promised to exercise their voting rights in concert with the controlling shareholder, or parties actually participating in the management of the company along with the controlling shareholder.

##### *(2) Method of valuation*

In a compulsory sell-out, the method of determining the purchase price is quite similar to that under the compulsory buy-out. First, there will be a mandatory negotiation period of 30 days, and if negotiations are unsuccessful, the court will determine the purchase price, at the request of either party. However, as discussed in compulsory buy-outs, such negotiation may prove to be redundant and is likely to delay the freeze-out. Thus, it seems better to directly resort to a court-administered valuation process without mandating a 30-day individual negotiation period.<sup>76)</sup>

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<sup>75)</sup> See the Bill art. 360-25.

<sup>76)</sup> The related costs are likely to be borne by minority shareholders who initiate the sell-out. However, such burden of costs may discourage minority shareholders from exercising their sell-out right. This cost- issue needs to be further discussed by the legal community if the compulsory buy-out or compulsory sell-out is adopted and included in the corporate laws.

## IV. Conclusion

Korean corporate law has been focused on the classic issue of agency problems within the framework of the fiduciary duty of the management owed to the company. Until now, the Korean legal community has paid little attention to the potential conflict of interest between a controlling shareholder and minority shareholders. However, the recent increase in freeze-outs poses a difficult question to scholars and practitioners as to how corporate laws can promote transactional efficiency in freeze-outs while guaranteeing proper protection of minority shareholders.

In Part II of this Article, we have analyzed the current freeze-out mechanism used in Korea (i.e., tender offer followed by delisting) and proposed changes to each step of such freeze-out mechanism which will enable minority shareholders to make informed decisions, to be fairly dealt with, and to sell their shares at a fair value in the tender offer and subsequent delisting process.

In Part III of this Article, we have analyzed cash-out mergers and compulsory buy-outs which are the two new freeze-out mechanisms proposed in the legislative bill for amendment of the Korean Commercial Code. To address how these new freeze-out tools can interplay harmoniously with the existing laws regarding merger and minority shareholders' right, we recommend certain *ex-ante* and *ex-post* protective measures for minority shareholders and the abolition of cumbersome procedures (such as requirement for shareholder approval and mandatory negotiation period in compulsory buy-outs) to promote transactional efficiency of freeze-outs.

We hope that this Article provides new insight to the legal community in the rules and practices of freeze-out transactions, and elicit robust discussions among scholars and professionals on the issue of fiduciary duty owed by controlling shareholders to minority shareholders.

KEY WORDS: freeze-out, going-private transaction, tender-offer, delisting, cash-out merger, compulsory buy-out, minority shareholder, controlling shareholder



# Issuance of New Shares as a Takeover Defense and Countermeasures

Sang Gon Kim\*

## Abstract

*In the face of a hostile takeover bid, the best defense is to acquire more friendly shares than the bidder. The problem here is that once the takeover bid becomes known in the market, share prices may increase drastically so as to render it difficult to purchase shares in the market. A solution in this case is to issue new shares to a white knight, and there have been several attempts to do so.*

*Under the Commercial Code of Korea, the general rule with respect to the issuance of new shares is to offer them to existing shareholders in proportion to their existing shareholding. As an exception to these preemptive rights principle, the Commercial Code allows for third-party offerings, but this is limited to where it is necessary to achieve the managerial goals of a company such as the introduction of new technologies or improvement of the financial structure.*

*Much debate has centered on the question of whether a third-party offering as a defense to a hostile takeover bid falls under the above exception to preemptive rights under the Commercial Code. The courts have consistently held that it does not, and so in order to achieve the same result as a third-party offering, companies have used the method where they first issue a massive number of new shares and then allocate to third parties any new shares which were not subscribed by shareholders.*

*The courts have ruled that since the shareholders were given the opportunity to acquire the new shares, allocation of unsubscribed new shares to third party is lawful. However, critics have pointed out that if the original purpose of issuing new shares was to induce forfeited shares, in substance it is no different from a third-party offering and so it should be unlawful. The courts have yet to rule on this matter.*

## I. Introduction

In a hostile takeover situation, the most important issue for both the bidder and target is securing friendly shares. This is because, in order for a hostile takeover to succeed, the bidder's designees must be elected as the directors of the target and such election is decided by votes at the meeting of shareholders.

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Generally speaking, there are 3 ways of securing friendly shares in a hostile takeover situation: (i) proxy contest, (ii) sale of treasury shares to friendly shareholders and (iii) issuance of new shares to friendly shareholders.

Proxy contests in listed companies are regulated by the Financial Investment Services and Capital Markets Act (“FSCMA”).<sup>1)</sup> There are numerous legal problems regarding the methods for soliciting proxies and for validating power of attorneys at meetings of shareholders. Furthermore, there still remain concerns of proxy contests being handled in favor of existing shareholders who have the power to call meetings of shareholders.<sup>2)</sup>

Regarding the sale of treasury shares and issuance of new shares, since they are subject to approval of the target’s board, in practice they are used only as defensive measures by the controlling shareholder in contrast to proxy contests which can be used as offensive tools.

We discuss below the legality of the issuance of new shares as a takeover defense, which is one of the aforementioned ways to secure friendly shares, as well as countermeasures in response thereto. We also discuss briefly the similarities and differences between the sale of treasury shares and issuance of new shares.

## II. Legal Assessment of Takeover Defense Measures by Directors

The issuance of new shares is subject to board approval, thus as a general matter we first discuss whether directors’ takeover defense measures are lawful.

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1) The Securities and Exchange Act (“SEA”), which was the relevant law, was abolished with the promulgation of the FSCMA on February 4, 2009. The special provisions under the SEA relating to listed companies have been incorporated in the Commercial Code and the rest have been incorporated in the FSCMA. As such, certain provisions under the abolished SEA (as referred to herein) are equally applicable under the FSCMA.

2) Sang Gon Kim, *Issues Relating to Shareholders’ Meeting of Listed Companies involving Proxy Contests for a Hostile Takeover Bid*, 52 KOREA LISTED COMPANIES ASSOCIATION RESEARCH (2005) (in Korean).

### 1. *The Activist Thesis*

Under this view, directors must actively defend against hostile takeover efforts for a variety of reasons, including the following: Hostile takeovers do not increase the overall wealth of society; the target's share value increases during a takeover defense and so serves the interests of shareholders; directors have a duty to protect not only shareholders but the target's employees, customers, creditors, etc. Directors' defensive actions must be respected under the business judgment rule.

This line of argument has been set forth by Lipton of the US and Martens Wiedermann of Germany and is known to be the majority position of the public and the courts in the US and the minority position in Germany.<sup>3)</sup>

### 2. *The Passivity Thesis*

Under this view, directors must remain passive in the face of hostile takeovers for a variety of reasons: Hostile takeovers have the effect of increasing the overall wealth of society by transferring the target's assets to more competent management; although the target's share value may increase during the course of the takeover defense, such defense may in the long run harm shareholder interests by decreasing the motivation for the takeover bid; since directors owe a duty only to shareholders to maximize the target's interests, there is no need for directors to consider other parties' interests.

This line of argument is known to be the majority position in Germany and the minority position in the US courts.

### 3. *Compromise Thesis*

Under this view, directors in general are to remain passive in the face of hostile takeovers but may engage in defensive actions such as persuading shareholders or arranging for a public offering as long as they do not preclude

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3) Wook Rae Lee, *Legal Assessment of Defensive Action of Directors against a Hostile Takeover*, 12 BFL 12 (2005); Jong Joon Song, *Key Defense Measures against M&A*, 14-1 STUDY ON COMMERCIAL LAW 190 (1995) (in Korean).

or impede shareholders from making decisions.<sup>4)</sup>

#### 4. Conclusion

Where management engages in takeover defenses, there is the issue of shareholder discrimination in that they may act friendly towards the existing controlling shareholder while behaving antagonistically with respect to the bidder. Furthermore, considering that a takeover bid is essentially a dispute between shareholders, one may wonder if the reasonable thing for directors to do in a takeover situation is to keep neutral.

However, since a director, as an appointee of the target, owes fiduciary duties thereto, it seems reasonable to argue that a director may undertake takeover defenses if he reasonably determines that such actions are necessary to protect the target's interests.<sup>5)</sup> For example, assuming that a certain bidder's goal is to sell off the assets of the target and dissolve it, if the director reasonably determines that the long-term business outlook is good and that the target's business will improve if operations are maintained so as to increase shareholder wealth, then it would be reasonable to engage in takeover defenses. In light of a director's fiduciary duties, it may even be argued that such actions are required by law. In a lower-court case where the directors of a company undertook a large-scale capital increase with consideration to defend against a hostile takeover bid,<sup>6)</sup> the court ruled that "the question of whether such action is permissible must take into account the totality of circumstances, including the motivation or purpose behind the defense and the reasonableness of the defense tactics, and must also consider the interests of the target and the shareholders that are being protected by such actions as well as the adequacy of the procedures by which such actions are implemented." This ruling seems to be recognizing that the determination of whether takeover defenses undertaken by a director are permissible rests on how "fiduciary duty" is interpreted.

When considering the above, the issuance of new shares by a director as a takeover defense does not appear to be forbidden for the reason that it violates

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4) *Id.*

5) Wook Rae Lee, *supra* note 3, at 13.

6) 2003Kahap369 (Suwon District Court, Yeosu Branch Court, Dec. 12, 2003).

a director's duty to keep neutral or loyal. However, the determination of whether such issuance is permitted does appear to require a case-by-case assessment of whether applicable provisions under relevant laws such as the Commercial Code and FSCMA have been observed. We discuss in detail below.

### **III. Legality of Third-Party Allocation of New Shares as a Takeover Defense**

Allocating new shares to shareholders in proportion to their shareholdings is called a "shareholder offering" and any other method of allocating new shares is generally referred to as a "third-party allocation." This allocation can be divided into two types: private offering to designated third parties and public offering to non-designees undertaken pursuant to applicable provisions under the FSCMA. Each of these has a different legal basis for issuance and we discuss them in turn.

#### *1. Private offering*

##### *1) Interpretation of Article 418 Paragraph 2 of the Commercial Code*

Article 418 Paragraph 2 of the Commercial Code ("Clause") states that "a company may, notwithstanding Paragraph 1, allocate shares to persons other than shareholders in accordance with the articles of incorporation; provided, however, that such allocation shall be limited to situations where it is necessary to achieve the managerial goals of the company, including introduction of new technologies or improvement of financial structure." This provision was introduced when the Commercial Code was amended on July 24, 2001. Before such amendment, the Commercial Code simply read that "unless provided for otherwise in the articles of incorporation, a shareholder shall be entitled to receive new shares in proportion to its shareholding."

However, numerous legal commentaries had argued that even before the above amendment, in addition to applicable provisions under the articles of incorporation, requirements similar to those contained in the proviso of the Clause ("Proviso") had de facto been applicable to third-party allocations.<sup>7)</sup> It was in acceptance of such argument that the Clause was created at the time of

the Commercial Code's amendment on July 24, 2001.

Thus, if the strengthening of control in a takeover situation does not fall within the "managerial goals" provided under the Clause, then we would have to conclude that third-party allocation of new shares as a takeover defense is not permitted.

## 2) *Legal commentaries and court rulings*

Examples of "managerial goals" that legal commentaries have propounded (other than the introduction new technology and improvement of financial structure specified under the Commercial Code) have been limited to those necessary for the business operations of a company, including: expeditious capital raising,<sup>8)</sup> corporate restructuring, joint venture or strategic partnership with foreign companies,<sup>9)</sup> injection of foreign capital, securing of upstream/downstream markets and any other goals in furtherance of its development and which cannot be obtained through a shareholder offering.<sup>10)</sup> Therefore, it appears that legal commentaries do not find the "managerial goals" under the Proviso to include the defense and strengthening of control by controlling shareholders or the maintaining of existing management. In particular, some legal commentaries have expressly stated that, irrespective of "managerial goals," preemptive rights cannot be restricted for the purpose of expelling a particular shareholder or wresting control away from another party.<sup>11)</sup>

Courts in general appear to hold the same position as the above legal commentators. One Supreme Court ruling held that in the face of an imminent or actual battle for corporate control, the issuance of convertible bonds for the sole purpose of causing or impeding a change of control can

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7) JONG JOON SONG, KOREA COMMERCIAL LAW ADMINISTRATIVE SOCIETY, ANNOTATED COMMERCIAL CODE (CORPORATIONS III) 450-451 (Joo Chan Son & Dong Yoon Jung eds., 2003); KI SOO LEE, CORPORATE LAW 502 (Pakyoungsa, 1997); TAE RO LEE & CHUL SONG LEE, LECTURES ON CORPORATE LAW 632-634 (Pakyoungsa, 1992); Dong Seung Lee, Study on Preemptive Rights of Shareholders—Focus on Exclusion Factors 243-245 (Ph.D. Thesis, Korea University, 1998); Joon Sub Lee, *Exclusion of Preemptive Rights of Shareholders*, 13 STUDY ON COMMERCIAL LAW 228-230 (1994) (in Korean).

8) DONG YOON JEONG, CORPORATE LAW 504 (Bubmoonsa, 2003) (in Korean).

9) KI BUM KWON, MODERN THEORY ON CORPORATE LAW 801 (Samjiwon, 2005) (in Korean).

10) CHUL SONG LEE, LECTURES ON CORPORATE LAW 694 (Pakyoungsa, 2006) (in Korean).

11) JONG JOON SONG, *supra* note 7, at 451.

constitute a cause for nullification.<sup>12)</sup> In another case of dispute for corporate control, the court held that the third-party allocation of shares despite the absence of any real managerial need to deprive the shareholders of their preemptive rights (and whose main purpose was to serve as a takeover defense) was null and void.<sup>13)</sup> Another court dealing with a similar case stated that preemptive rights serve to help existing shareholders maintain their control over the company in a takeover situation, thus in order for the company to undertake a third-party allocation at the expense of preemptive rights, the purpose for raising capital thereby must coincide with the company's interests and the necessity to quickly and flexibly raise funds to meet such purpose at the exclusion of preemptive rights must be established. If a third-party allocation by a company were to result in the substantial weakening of the existing shareholders' control over it, then such allocation would be valid only if there existed a managerial need that rendered it imperative to preclude preemptive rights even before the conclusion of corporate control dispute. This last court decision<sup>14)</sup> appears to make it all the more clear what the general position of the courts is.

However, in the corporate control dispute case between KCC and Hyundai Group where Hyundai Elevator tried a public offering of "Kukmin" shares,<sup>15)</sup> the court held that where "maintaining the control of the existing shareholders or the management powers of the existing management serves the interests of the target and general shareholders or is warranted by a special social necessity, and where the opinion of general shareholders and neutral experts on the issuance of new shares has been heard," then such issuance may found to be necessary to meet a "managerial goal" under the Clause. This ruling is different from the conclusions reached by the aforesaid courts and it almost appears as if in certain circumstances defending against a takeover

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12) 2000Da37326 (Supreme Court, June 25, 2004). Although this decision is in regards to the issuance of convertible shares of Samsung Electronics, since Article 513 Paragraph 3 of the Commercial Code provides for the application of the Provision for the issuance of convertible bonds, it can be argued that the logic behind issuing convertible bonds applies equally to the issuance of new shares.

13) 2005Gahap71241 (Seoul Central District Court, Jul. 7, 2006).

14) 2005Kahap744 (Seoul Central District Court, May 13, 2005).

15) 2003Kahap369 (Suwon District Court, Yeosu Branch Court, Dec. 12, 2003).

may fall under “managerial goal” of the Clause. However, this judicial position is very uncommon, and considering that the Supreme Court ruling and lower court opinions in the above paragraph have all been issued after this rare decision, it seems safe to say that the court’s stance is that defending against takeover bids do not fall under “managerial goal” of the Clause.

### 3) *Subconclusion*

As seen above, it appears that legal commentators and the courts are in agreement that, in a hostile takeover situation, issuing new shares to the controlling shareholder or a white knight friendly thereto violates the Clause and is thus not permitted.

In particular, considering the ruling in case no. 2005 Kahap 744, Seoul Central District Court (May 13, 2005), which held that even where the managerial need to undertake a third-party allocation is recognized, such issuance is illegal unless it can be established that there existed circumstances that made it impossible to delay such issuance until after the conclusion of the dispute for corporate control, the position of the courts on this matter seems very clear. In practice, the courts seem to prohibit third-party allocation of shares in hostile takeover cases without exception.

## 2. *Public offering*

### 1) *Issue*

A public offering differs from a private offering in two major ways.

First, in contrast to a private offering, in a public offering it is not determined in advance who will participate in the capital increase to become a shareholder and so the issuance of new shares by itself does not immediately render to a particular third party the effect of a change in control.

Secondly, Article 165-6 of the FSCMA (Article 189-3 of the abolished SEA), which permits a listed company to undertake a public offering, does not provide for compliance with the Clause and so it is unclear whether the “managerial goal” requirement for third-party allocation as discussed above is applicable to a public offering.

Should a large-scale public offering take place, the equity of the existing shareholders would be substantially diluted, and although this would not lead to a particular third party’s acquiring control over the company, it would



have the effect of causing loss of control by the controlling shareholder. As such, in the case where the shares acquired by the bidders already exceed the equity interest of the controlling shareholder, the existing management would try for share dilution through a public offering instead of a private offering (which would most likely be forbidden), and if the public offering succeeds, then control over the company will ultimately be decided through a proxy contest. This renders a public offering a meaningful takeover defense.

## 2) *Legal commentaries and court rulings*

Legal commentators agree that the Proviso applies to public offerings<sup>16)</sup> and there do not appear to be any opposing views in this regard.

The basis for this position is that the nature of preemptive rights is such that they cannot be arbitrarily restricted by majority vote, and only where the interests of the company or all of the shareholders are served should they be limited.<sup>17)</sup>

The only case precedent on this issue seems to be the court decision in the aforesaid dispute between KCC and Hyundai Group (Suwon District Court, Yeosu Branch Court, case no. 2003 Kahap 369, Dec. 12, 2003). In this case, the court stated that the legislative history behind the FSCMA's providing for public offerings by listed companies indicated the goal to achieve the division of ownership and management by encouraging and inducing the widespread ownership of shares. Also, public offerings were made available to listed and registered companies to enable expeditious and efficient capital raising. Considering the above, the court held that it was difficult to find the Clause as being more than a standard by which to determine whether the issuance of new shares was abused and to find that it was directly applicable. Thus, the court ruled that the Clause does not apply to public offerings.<sup>18)</sup>

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16) Hyun Tae Kim & Yong Joon Yoon, *Study on Practical Issues Regarding Preliminary Injunctions against the Issuance of New Shares*, in *HOSTILE TAKEOVERS AND DEFENSES* 109-110 (Hwa-Jin Kim & Ok-Rial Song eds., 2007); Ki BUM KWON, *supra* note 9, at 800; Choong Myung Jeong, *Legal Study on Hostile Takeover Defenses – Focus on Third Party Allocation of Shares*, 25 *STUDY MATERIALS ON ADMINISTRATION OF JUSTICE* 433-434 (Supreme Court Library of Korea 1999); Eung Jin Kim, *Study on Restrictions on Shareholder Preemptive Rights* 42-43 (Masters Thesis, University of Seoul, 2004) (in Korean).

17) TAE RO LEE & CHUL SONG LEE, *supra* 7, at 633.

18) Article 9 Paragraph 2 of the articles of incorporation of Hyundai Elevator provided that

### 3) *Subconclusion*

Although the rationale behind the above ruling is unclear, it appears that the court took into account the fact that Article 84-5 Paragraph 1 of the Enforcement Decree of the SEA (currently Article 176-8 Paragraph 1 of the FSCMA) defines “public offerings” as excluding preemptive rights and as having unspecified masses subscribe to new shares and that the SEA (currently FSCMA) is considered a special law of the Commercial Code.

However, considering the factors listed below, the Proviso should apply to public offerings as legal commentaries argue.

First, public offerings were introduced on Jan. 13, 1997 when the SEA was amended (the same provisions are incorporated in the FSCMA) and the Clause was newly created when the Commercial Code was amended on July 24, 2001. As discussed in Section III.1.A above, most legal commentators recognized that even before such amendment of the Commercial Code certain requirements needed to be met in order to preclude preemptive rights, and such views were incorporate to create the Clause. To the extent that public offerings are a way of increasing capital at the exclusion of preemptive rights, considering the purpose of the Commercial Code amendment, it appears reasonable to conclude that public offerings should also meet the requirements under the Commercial Code.<sup>19)</sup>

Also, the reason that the FSCMA (now-abolished SEA) is generally seen as a special law of the Commercial Code is because it provides for special provisions regarding listed companies, and where restrictions in addition to those under the Commercial Code are to be applied to listed companies, such special provisions are then applicable. It is in this sense that the FSCMA (now-abolished SEA) takes on the form of a special law, and it is not the case that whenever a matter is addressed by both the FSCMA (now-abolished SEA)

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“new shares may be allocated to non-shareholders by a board resolution under the following subparagraphs where it is necessary to achieve the managerial goals of the company, including introduction of new technologies or improvement of financial structure,” and Subparagraph 2 of the same Paragraph specified “issuance of new shares through a public offering in accordance with the provisions of the SEA.” The court interpreted the above to mean that the necessity to achieve managerial such as the introduction of new technologies or improvement of financial structure applied to public offerings and prohibited the issuance of new shares.

19) Hyun Tae Kim & Yong Joon Yoon, *supra* note 16, at 112.

and the Commercial Code, the former prevails.<sup>20)</sup> Therefore, arguing that the FSCMA (now-abolished SEA), which provides for public offerings, is a special law and thus the Clause should not be applicable seems to be a logical leap.

Finally, the reasonable conclusion from a practical perspective also seems to be that the Proviso is applicable to public offerings. For public offerings, all that is prescribed by law is the minimum issuing price and the board is free to decide the issuance price, number of shares and disposal of forfeited stocks. Therefore, if the board sets a high issuing price and undertakes a massive public offering so as to induce a large number of forfeited shares, the board would be able to dispose of such shares at its discretion. The effect would be to allow the new shares to be allocated to specified third parties in circumvention of the Clause, which clearly contravenes the legislative purpose behind promulgating it.

As such, it seems reasonable to conclude that the Proviso is applicable to public offerings, thus they should be treated the same way as private offerings. Some legal commentaries argue that the Clause embodies requirements recognized under German law, i.e. principles of equal treatment of shareholders and benefit to the company, and that the former does not have any significant implications in a public offering which involves numerous unspecified persons. Similarly, with respect to the latter, in the absence of any special purpose of the public offering such as a change in or maintenance of control, its scale is not large and issuance is at near-market price, it is recognized not pose a problem.<sup>21)</sup> Based on this rationale, these legal commentaries argue the Proviso requirements are presumed to be met in public offerings.<sup>22)</sup>

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20) For example, with respect to the relationship between Article 366 of the Commercial Code, which requires minority shareholders to hold 3% or more shares in order to demand the convocation of a meeting of shareholders, and Article 191-13 Paragraph 5 of the SEA (currently Article 542-6 Paragraph 1 of the FSCMA), which requires a 3% or 1.5% shareholding (depending on the size of the company) for the same, the Supreme Court (2003Da41715, Dec. 10, 2004) has ruled that since the above SEA provision cannot be seen as a special law of the Commercial Code, a shareholder that meets either of the above requirements may demand the convocation of a meeting of shareholders.

21) Dong Seung Lee, *supra* note 7, at 222.

22) Yong Ho Hong, *Issuance of Securities for the Defense of Hostile Takeover* (Masters Degree Thesis, Seoul National University, 1998) (in Korean) at 52; Choong Myung Jeong, *supra* note 16, at 434.

However, as discussed earlier, the fact that there is a high risk of a public offering circumventing the Clause appears to render it dangerous to presume that the Proviso requirements are satisfied in public offerings. It seems that even in this case a strict assessment should be made as to whether the Proviso requirements are actually met.<sup>23)</sup>

### 3. *Third-party allocation through contribution in kind*

#### 1) *Legal commentaries and case rulings*

Two opposing views are held on this matter: One view argues that since a contribution in kind is a means of receiving a third-party allocation, there must be a basis therefor provided under the articles of incorporation in accordance with the Clause or a special shareholder resolution (which has the same effect).<sup>24)</sup> The other view argues that a contribution in kind is an exception to preemptive rights, thus it is permitted through a board resolution pursuant to Article 416 Paragraph 4 of the Commercial Code without any basis in the articles of incorporation.<sup>25)</sup> These two views are pitted against each other.

In a Supreme Court case, although the main issue was tax-related, the court held that preemptive rights are not applicable to contributions in kind, thus new shares for a contribution in kind can be issued solely based on a board resolution.<sup>26)</sup>

Logically speaking, it would be reasonable to state that those who view contributions in kind as a means of a third party allocation will argue that the Clause applies and those that say that contributions in kind are an exception to preemptive rights will argue that the Clause does not. In reality, it appears that contributions in kind are seen as an exception to preemptive rights but nonetheless are found to be subject to the Proviso requirements.<sup>27)</sup> This position seems reasonable when considering that the nature of preemptive

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23) Hyun Tae Kim & Yong Joon Yoon, *supra* note 16, at 114.

24) CHUL SONG LEE, *supra* note 10, at 690-692; Kon Sik Kim, *Contribution in kind and Preemptive Rights*, 31 JURISPRUDENCE (Seoul National University 1990) (in Korean).

25) GI WON CHOI, NEW PRINCIPLES OF CORPORATE LAW 730-73 (Pakyoungsa 2005) (in Korean); KI BUM KWON, *supra* note 9, at 798-799; DONG YOON JEONG, *supra* note 8, at 504-505.

26) 88Nu889 (Supreme Court, Mar. 14, 1989).

27) DONG YOON JEONG, *supra* note 8, at 504-505.

rights is such that they cannot be arbitrarily restricted even by majority vote.<sup>28)</sup>

## 2) *Restrictions on contributions in kind as a takeover defense*

As seen above, even where the Proviso requirements are recognized as being applicable to contributions in kind, since such contributions by nature would most likely be necessary for the company's business operations, it appears that the Proviso requirements would be easily met. If so, when defending against a takeover, would there any way for a controlling shareholder to prevent the bidder from increasing its equity stake by contributing assets necessary for the operations of the target?

The case that sheds light on this point is the aforementioned 2005 Kahap 744 case. Here, the court held that even if the issuance of new shares is in line with the managerial goals of the company, issuance thereof at the preclusion of preemptive rights before the conclusion of the corporate control dispute would be justified only if there existed managerial needs that made it compelling to do so. The court's point was that, even if the issuance met the Proviso requirements, considering that a corporate control dispute was ongoing, the main purpose of the issuance can be said to have been to defend against the takeover. Thus, unless there is no other justification for the timing of the issuance, then such issuance is unlawful. It appears that this reasoning can be equally applied to issuance of new shares for contributions in kind.<sup>29)</sup>

## 4. *Shareholder offerings*

### 1) *Issue*

Shareholder offerings grant preemptive rights to shareholders in proportion to their respective shareholdings, thus in principle they do not infringe upon their rights. Also, even if a shareholder waives its preemptive

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28) Hyun Tae Kim & Yong Joon Yoon, *supra* note 16, at 127.

29) A same decision was reached by the court in a Seoul Central District Court case (2005Gahap71241, Jul. 7, 2006). In this case, the court held that where a third party allocation is undertaken in the special situation of a corporate control dispute in order to bring about a change in control or to impede such change, then even if such issuance conforms in some way with the company's managerial goals, the need to attain such goals will need to be negated and ultimately such issuance of shares will need to be seen as invalid.

rights, such waiver is of a right already bestowed, thus it can be argued that the disposition thereof by the board is not problematic. However, in reality, in the context of a takeover situation, where a significant number of shareholders waive their preemptive rights and if the board allocates the forfeited shares to a particular third party, then the result would be the same as if a third party allocation occurred. Therefore, even with shareholder offerings, if the board has the power to dispose of forfeited shares and where no restriction is placed thereupon, then there is a risk that through the setting of certain prices and number of shares to be issued, the board will be able to induce forfeited shares and thus bring about the same result as a third party allocation. As such, the issue of whether a shareholder offering whose purpose is to bring about a large number of forfeited shares is unfair (and thus should be outlawed) is a very important issue for discussion.

## 2) *Legal commentaries and case rulings*

In cases involving shareholder offerings, those seeking a preliminary injunction to prevent such issuance have argued that (i) a large-scale capital increase with consideration is being undertaken in the absence of any dire and immediate need for funds, (ii) the issuing price<sup>30)</sup> is high as the discount rate<sup>31)</sup> is lower than usual and (iii) the share offering aims to induce a large number of forfeited shares by forbidding the transfer of preemptive rights and allowing the board to dispose of forfeited shares, the result being an infringement of shareholder rights.

In response, the courts have rejected most of the above claims, stating that (i) the need for a capital increase is a matter that requires a high degree of business judgment and (ii) since shareholders' preemptive rights are recognized, the board resolutions themselves cannot be seen as bringing about

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30) According to Article 5-18 of the Regulation on Securities Issuance and Disclosure, the base share price for the issuance of new shares is calculated using the higher of (i) the arithmetic average of 1-month average closing price, 1-week average closing price and base date closing price (the base date for third-party allocation being 3 days prior to the subscription date and for a public offering, 5 days prior to the subscription date. The issuing price for a shareholder offering can be freely determined) and (ii) the base date closing price.

31) Article 5-18 of the Regulation on Securities Issuance and Disclosure states that base price shall be discounted up to 30% for public offerings and up to 10% for third-party allocations to set the issuing price.

a change in shareholdings.<sup>32)</sup> In particular, in response to the argument that forfeited shares were induced, one ruling stated that “even if the exceedingly high issuance price rendered a large number of forfeited shares, and the disposal thereof was delegated to the board so as to give rise to the possibility that the current management of the debtor will increase the number of friendly shares, if such disposal and the discount rate are determined in accordance with the law and articles of incorporation, it cannot be found that such disposal method is materially unfair.”<sup>33)</sup> On the other hand, no cases were found in which the court forbid shareholder offerings in the contest of a takeover situation.

By contrast, although not a preliminary injunction case to prevent the issuance of new shares, one lower case court<sup>34)</sup> held that “an issuance of new shares found to be materially unfair by both legal commentators and the courts is ... where new shares are intentionally issued at high prices by the board in order to induce a large number of forfeited shares ... so as to discriminate among shareholders and harm the interests of certain shareholders.” This is in direct contrast to the above ruling.

There is also a view among legal commentaries that where share prices are below par value, if new shares are issued at par value or at a price substantially higher than market value so as to induce a large number of forfeited shares, such issuance is materially unfair.<sup>35)</sup> No views in opposition to the above were found.

Thus, it appears reasonable to conclude that “the issuance of new shares at exceedingly high prices so as to induce large numbers of forfeited shares” can become the target for a claim to prevent the issuance of new shares.

On the other hand, even if new shares are issued at an adequate price, what happens where too many shares are issued? In this regard, lower courts have held, without exception, that in a shareholder offering the timing and

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32) 2004Kahap2046 (Busan District Court, Oct. 5, 2004); 2005Kahap2904 (Seoul Central District Court, Aug. 25, 2005); 2007Kahap247 (Suwon District Court, Jun. 25, 2007); 2008Kahap138 (Seoul Central District Court, Jan. 24, 2008); 2005Gahap1588 (Cheju District Court, Feb. 16, 2006).

33) 2005Kahap823 (Suwon High Court, Nov. 17, 2005).

34) 2005Noh2371 (Seoul High Court, May 29, 2007). This is the case sometimes referred to as the “Everland Convertible Bond Issuance Case.”

35) CHUL SONG LEE, *supra* note 10, at 710.

scale of the capital increase requires a high degree of business judgment and so they have denied relief to the plaintiffs. In a case where a shareholder offering was undertaken in the course of a corporate control dispute, one lower court even held that “the argument that there is a problem with the capital procurement for the reason that the capital increase is on a massive scale and there is a short time interval between the disclosure date and record date cannot be a factor in the consideration of whether the issuance of new shares is materially unfair as long as the determination of the scale and timing of the capital increase is in compliance with the provisions of the Commercial Code and articles of incorporation.”<sup>36)</sup>

### 3) *Subconclusion*

As seen above, the position of the courts is to permit shareholder offerings in takeover situations, and they are reluctant to forbid them even in situations where a large number of forfeited shares are induced so as to have an effect similar to a private offering and thus render the result unfair.

However, in some of the aforesaid cases where a claim for preliminary injunction to prevent the issuance of new shares was denied, the court stated that “there was insufficient evidence to support a finding of inducement of large-scale forfeiture ...,” which also means that if sufficient support had been provided, the court may have granted the injunction.<sup>37)</sup> Also, in the aforementioned Everland convertible bond case, the Seoul High Court held that the issuance of new shares by directors with the aim of inducing large-scale forfeiture was materially unfair. Taking these into account, it would be reasonable to conclude that issuance new shares at a high price so as to induce forfeited shares and to allocate such shares to particular shareholders is unlawful.

In practice, it is very difficult to establish that shares were issued at a high price for the purpose of inducing forfeiture for the following reason: A listed company conducting a shareholder offering determines the issuing price pursuant to Article 57 of the Regulation on Securities Issuance and Disclosure (a subordinate law under the SEA prior to the promulgation of the FSCMA),

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36) 99Kahap1747 (Seoul District Court, Jul. 7, 1999).

37) 2004Kahap2046 (Busan District Court, Oct. 5, 2004).



whereby it uses the third trading day prior to the subscription date as the base date and takes the arithmetic average of (i) 1-month average closing price, (ii) 1-week average closing price and (iii) base date closing price. It then compares this calculated number against the base date closing price, takes the lower of the two and applies a 30% discount to determine the issuing price.<sup>38)</sup> The problem here is that the share price at this point in time is several times higher than usual as it has increased in a short interval due to the takeover bid, so acquiring new shares at the issuing price calculated using the increased share price is not easy for minority shareholders. This means that even if the issuing price was calculated in accordance with the law, it is likely that a large number of forfeited shares will result.<sup>39)</sup> Nonetheless, as discussed above, the courts have held that if the disposition of forfeited shares and discount rate are determined in accordance with the law and articles of incorporation, it is difficult to find that the share issuance is materially unfair.

In addition, in cases where shares are issued at a 30% market-price discount (i.e. at a low price) but issuance is on a massive scale so as to induce share forfeitures, the courts have even held that the fact that a massive issuance occurred cannot be considered in the determination of whether the issuance was materially unfair.

Therefore, where a shareholder offering is undertaken in the face of a share price bubble caused by a corporate control dispute, there is the problem that share forfeiture can be induced with relative ease and they can then be allocated to friendly shareholders.

Taking into account the position of the courts, the issuance of new shares as a takeover defense is generally thought to be difficult. However, this is due to the fact that the courts have almost completely forbidden the issuance of new shares to specified third parties, i.e. controlling shareholder or white

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38) Under the FSCMA, the Regulation on Securities Issuance and Disclosure has been amended to do away with the issuing price restrictions in a shareholder offering. This means that now a company undertaking a shareholder offering can set the issuing price at its discretion as long as it is at least equal to par value.

39) Even if there are no restrictions on the issuing price of shares in a shareholder offering, it appears that listed companies will continue to issue shares either at market price or with a certain percent discount in order to minimize the effect on share price. Therefore, the possibility of mass forfeited shares seems to continue to be significant and so this discussion appears to remain pertinent.

knight. In fact, with respect to the inducement of forfeited shares through a shareholder offering, the courts have almost always permitted this for the convenient reason that insufficient evidence has been provided. As such, the issuance of new shares as a takeover defense still seems to remain as a viable takeover defense. Personally, my hope is that further study will be conducted regarding the takeover defense of using forfeited shares arising out of a shareholder offering, and also that continuous challenges will be made to the court's prevailing attitude in this regard so as to bring about changes thereto.

#### **IV. Countermeasures against the Issuance of New Shares as a Takeover Defense**

##### *1. Overview*

As discussed in section III above, issuing new shares to defend against a takeover may be found illegal. So how would the bidder prevent such issuance?

The first countermeasure that can be considered is a preliminary injunction to prevent the issuance ("Preliminary Injunction"). However, if the subscription payment is made and the new shares are issued before filing for such injunction or before the court grants the injunction after the motion is filed, then this would no longer be a viable countermeasure. In this case, one would need to file a motion to provisionally suspend the validity of the issuance ("Provisional Suspension"). These measures are provisional in nature so ultimately the main action would need to be instituted to obtain a final resolution. However, in practice, considering that offensive and defensive measures are quickly instituted in these situations and that the party filing for the above provisional dispositions is usually satisfied with the result thereof, most of the time the main action is not instituted and the dispute typically ends at the provisional stage of litigation. This is the reason why most cases involving a battle for corporate control do not end up at the Supreme Court level and are mostly concluded at the lower courts. In consideration of the above, we limit our discussion below to the legal practice of filing for Preliminary Injunctions and Provisional Suspensions.

## 2. Preliminary Injunctions

The typical order granting a Preliminary Injunction reads “The issuance of [ ] common stock with par value of [ ], which the debtor is preparing to issue pursuant to the board resolution adopted on [ ], shall be prohibited.”<sup>40)</sup>

As can be seen above, a Preliminary Injunction case involves several issues.

### 1) Rights protected by a Preliminary Injunction

Article 424 of the Commercial Code states that where shares are issued (i) in violation of law or the articles of incorporation or (ii) in a severely unfair manner so as to harm shareholder interests, shareholders may demand the issuing company to desist from such issuance (“Share Injunctive Right”).

Therefore, generally speaking, the Share Injunctive Right is the right being protected by the Preliminary Injunction. Looking at each type of issuance of new shares discussed above, it could be argued that (i) a private offering infringes upon shareholders’ preemptive rights and is thus in violation of law and the articles of incorporation, (ii) a public offering and contribution in kind can either constitute an issuance in violation of law or a materially unfair issuance and (iii) a shareholder offering is a materially unfair issuance.

On the other hand, there is a question of whether, in addition to the Share Injunctive Right, the right of shareholders to demand a director to desist from engaging in unlawful acts (“Director Injunctive Right”) can constitute a right eligible for protection by a Preliminary Injunction.

The difference between the Director Injunctive Right and Share Injunctive Right is that (i) the former is available only for minority shareholders with an equity stake of 1% or more whereas the latter is available for all shareholders, (ii) the former deals only with acts in violation of law or the articles of incorporation whereas the latter can, in addition to such violations, be exercised where there is a material unfairness and (iii) the former is a public-interest right exercised in the face of irreparable damage to the company whereas the latter is exercised where a shareholder faces the threat of

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40) Court Practice Manual, Execution of Civil Affairs IV, at 359.

sustaining injury.

There is a view among legal commentaries that rights protected by Preliminary Injunctions include both of the above Injunctive Rights,<sup>41)</sup> and there do not appear to be any opinions that expressly oppose it. However, my personal view is that, to the extent that the issuance of new shares causes an increase of capital in a company, the issue concerned is the infringement of shareholder rights and it cannot be said that a company sustains irreparable damage. Therefore, I have doubts as to whether Director Injunctive Rights should be something that can be protected by a Preliminary Injunction.

## 2) *Timing of filing for the Preliminary Injunction and Duration of Prohibition*

Where payment for subscription of the new shares has occurred before a motion is filed for a Preliminary Injunction or before the court renders its decision in response thereto,<sup>42)</sup> then a subsequent grant of the Preliminary Injunction has no effect upon the share acquirer.<sup>43)</sup> Thus, it is common sense that the filing should be made prior to the issuance of new shares. The problem is that with unlisted companies oftentimes shareholders do not know whether a board meeting is convened. With listed companies, although the general rule for a third-party allocation is that the subscription payment can be made only after a securities notification is filed and the mandatory waiting period lapses, there is an exception where if the new shares are deposited with the Korea Securities Depository (“KSD”) for 1 year, then it is possible to make the subscription payment on the date of the board meeting. Thus, it is very difficult to file for the Preliminary Injunction and obtain a judgment before the new shares are issued.

The above problem would be solved if it is possible to obtain the Preliminary Injunction prior to the convocation of the board meeting, and this seems to be related to the issue of whether there is need for protection under a Preliminary Injunction and whether there exists a right that is eligible for

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41) See *e.g.*, GI WON CHOI, *supra* note 25, at 780; DONG YOON JEONG, *supra* note 8, at 528; JONG JOON SONG, *supra* note 7, at 503.

42) In the event a claim for Preliminary Injunction is filed, the FSC restrains the issuance of new shares by not giving effect to the securities report until the court issues its decision. Thus, in contrast to an immediate issuance of shares through deposit, where issuance is sought through the filing of a securities report, actual issuance is difficult while the claim is pending.

43) See *supra* note 40, at 358.

protection by a Preliminary Injunction, i.e. whether there is something against which a Share Injunctive Right can be exercised.

One lower court ruling denied a motion for Preliminary Injunction, holding that in the absence of a board resolution to issue new shares (which is what was being asked to be prohibited), there is nothing against which to exercise a Share Injunctive Right.<sup>44)</sup>

However, if theoretically there is a probability that an unlawful issuance of new shares will occur, then there should not be any reason not to prohibit it. Further, considering the practical need to ensure the actual efficacy of the Share Injunctive Right, the above ruling seems unfair.

In contrast to the above decision, there has been a lower court ruling prohibiting the issuance of new shares before a scheduled board meeting took place (at which a resolution was to be adopted to that effect)<sup>45)</sup> and another court prohibited such issuance for a set period of time even though there was no scheduled board meeting.<sup>46)</sup> This decision held that “Until the date that a decision is issued in case no. 2006 Kahap 685, Daejon District Court, Chunahn Branch, (i) debtor [ ] corporation shall not issue any new shares to a third party and (ii) debtors [ ] shall not engage in any acts in furtherance of the issuance of new shares, including voting at the board meeting of debtor [ ] corporation for the third-party offering of new shares.”

Considering that in a battle for corporate control, the target may continuously try to issue new shares without any managerial reason, and once new shares are issued it is difficult to deny their validity,<sup>47)</sup> it appears

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44) 2002Ra96 (Busan High Court, Jul. 21, 2003).

45) In a Daejon District Court case (Chunan Branch Court, 2006Kahap671, Oct. 31, 2006), the court ruled that “the issuance of new shares that the respondent is preparing to undertake through a resolution of the meeting of the board scheduled for Nov. 3, 2006 shall be prohibited.”

46) 2006Kahap696 (Daejon District Court, Chunan Branch Court, Dec. 4, 2006).

47) In a Seoul Central District Court case (2008Kahap2561, Aug. 11, 2008) involving a claim for Provisional Suspension, the court held that “in cases such as the present one where the provisional disposition affects the validity of shares already issued by the respondent, the plaintiff obtains relief tantamount to a final relief at the conclusion of the main action whereas the respondent, without having the opportunity to fight the main action, has its issuance of new shares invalidated and so may subsequently face difficulty raising capital. Thus, the Provisional Suspension will be allowed only if the reason to nullify the issuance and the need to suspend its validity without delay through a Provisional Suspension is established at a higher degree than in typical provisional disposition cases.”

reasonable to argue that the law should permit provisional rulings that prohibit the issuance of shares for a set period of time as above. In particular, considering that (i) both Share Injunctive Rights under Article 424 of the Commercial Code and Director Injunctive Rights under Article 402 of the same are generally recognized to be eligible for protection under a Preliminary Injunction, and (ii) it is typical for a court granting a preliminary injunction to prevent directors from engaging in unlawful acts to set the duration of the prohibition until the date the court ruling is handed down in the main action,<sup>48)</sup> it appears reasonable to argue that a similar period of prohibition should be set in a Preliminary Injunction case.<sup>49)</sup>

Before its amendment on Dec. 31, 2004, Article 23 Paragraph 4 of the FSCMA contained a provision forbidding a target to issue new shares during a tender offer. In one case, the bidder, in order to prevent the target from issuing new shares, made an offer for an insignificant amount of shares and set the offer period at 60 days, which was the legal maximum. However, this provision has now been removed from the FSCMA, and so it appears to be even more necessary to permit a provisional disposition to set a fixed period during which to prohibit the issuance of new shares.

### 3. *Provisional Suspension*

As seen above, once new shares are issued, a Preliminary Injunction is no longer an adequate defense. In such case, one must file for a Provisional Suspension.

Typically, a court decision granting a Provisional Suspension regard reads “The validity of the issuance of [ ] new shares with par value of [ ], which the respondent [ ] corporation issued to respondent [ ] pursuant to a resolution adopted at the board meeting on [ ], shall be suspended.” The court sometimes adds language prohibiting the exercise of voting rights.

The problem here is that Provisional Suspensions are hardly granted by the courts. In case no. 2008 Kahap 2561, Seoul Central District Court held as follows: “In cases such as the present one where the provisional disposition

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48) See *supra* note 41, at 349.

49) Hyun Tae Kim & Yong Joon Yoon, *supra* note 16, at 134.

affects the validity of shares already issued by the respondent, the plaintiff obtains relief tantamount to a final relief at the conclusion of the main action whereas the respondent, without having the opportunity to fight the main action, has its issuance of new shares invalidated and so may subsequently face difficulty raising capital. Thus, the Provisional Suspension will be allowed only if the reason to nullify the issuance and the need to suspend its validity without delay through a Provisional Suspension is established at a higher degree than in typical provisional disposition cases.” Also, this ruling seems to have been influenced by a Supreme Court decision<sup>50)</sup> that held that, once shares are issued, even if there is no board resolution or there is a defect therein, board resolutions are merely internal decision-making procedures and so do not affect the validity of the new shares.

This attitude of the courts seems to be taking into consideration the safety of share transactions as shares, once issued, may have passed through several hands. This is all the more so when considering one ruling by a lower court<sup>51)</sup> that granted a Provisional Suspension, which held that “shares issued to the respondent are currently deposited with the Korea Securities Depository, thus temporary invalidation thereof will not affect the safety of transactions.”

As mentioned above, in order for a listed company to issue new shares, it must either file a securities report with the Financial Services Commission and wait for a prescribed period to lapse or deposit the shares with the KSD for 1 year (which would enable immediate payment of the subscription price and hence the issuance of the shares). In case of subscribing for shares under the former method, an opponent may file for Preliminary Injunction during the waiting period for the securities report to become effective, and once such filing is made the FSC will not give effect to the securities report until the court’s ruling is handed down. Therefore, the opponent would be able to obtain a court judgment. In case of subscribing for shares under the latter method, it would be difficult to file for a Preliminary Injunction if the subscription payment is immediately made through the KSD-deposit method, but the likelihood of obtaining a Provisional Suspension in this case seems higher compared to where the same relief is sought with respect to new shares that are not deposited with the KSD.

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50) 2005Da77077 (Supreme Court, Feb. 22, 2007).

51) 2005Kahap744 (Seoul Central District Court, May 13, 2005).

## V. Conclusion

Previously, takeover defenses were undertaken in the form of issuing new shares (or convertible bonds) to the controlling shareholder or a white knight. In response, the courts prohibited such issuance almost without exception for the reason that it infringed upon shareholders' preemptive rights.

Attempts have been made to change the way the takeover defense of issuing new shares is used so it is not conspicuous as above but at least from the outside it appears not to infringe upon shareholder rights. The first of such attempts was the public offering of Hyundai Elevator in the takeover dispute between KCC and Hyundai Group. Although the court ultimately forbid this attempt, the reason therefor was not because of infringement upon shareholder rights but rather due to the interpretation of provisions in Hyundai Elevator's articles of incorporation regarding the requirements for a public offering. Considering that most listed companies, unlike the articles of incorporation of Hyundai Elevator, do not restrict public offerings to be conducted only to meet managerial goals, this issue continues to be open to interpretation.

Recently, more drastic attempts have been made in the form of shareholder offerings. In the situation where there is a share price bubble caused by the takeover dispute, the target issues a massive number of shares at a price calculated using the inflated share price as the base, the aim being to induce a large number of forfeited shares. In theory, legal commentators and the courts seem to agree to some extent that this type of issuance is materially unfair. In practice, however, if a motion is filed for a Preliminary Injunction, the courts have almost always denied it, stating that there was insufficient evidence to support a finding that the forfeited shares were induced.

This is currently a problem with the practice of the courts. Considering that there have been cases of abuse where shareholder offerings are used to induce forfeited shares so as to enable their allocation to specified shareholders, the hope is that further study will be conducted on this issue and that the courts' practice will change in this regard.

KEY WORDS: new shares, takeover, takeover defense, Hyundai Elevator, rights offering



# Stock Repurchase as a Defense against Hostile Takeovers

Hee Jeu Kang\*

## Abstract

*The board of directors has the authority to decide on the sale of the company's own stocks, and the board of directors' decision to duly dispose of the company's own stocks that have been legitimately acquired should, in principle, be deemed lawful. Even when the company sells its own shares for the defense of the management right, the legality of such sale should be determined considering the reasonable basis and proportionality of the defensive action. If the decision to sell the company's own shares to its shareholders or to third parties is subject to the business judgment of the board of directors, the legality of such sale should be determined in accordance with the same principle. The board of directors' decision to sell the company shares should thus be determined in accordance with the principle of reasonable basis and the principle of proportionality. However, if the purpose of the sale of the company shares is only for the benefit of the controlling shareholder having the management right, rather than for the benefit of the company and the shareholders as a whole, then it may be possible for such sale to be deemed illegal. The sale of the company's own shares per se should not be considered an automatic violation of the principle of shareholder equality. Nevertheless, if the company's own shares are sold to certain major shareholders at a price that is significantly lower than the market price, such sale may be in violation of the principle of shareholder equality or the directors' duty of care as the fiduciary of the shareholders.*

## I. Introduction: Defending against Hostile Takeovers

The term "mergers and acquisitions" (M&A) is generally understood as referring to a transaction that aims for control of management.<sup>1)</sup> Among different types of M&As, a hostile takeover presupposes an adverse relationship between the current board of directors of the target company and

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1) JAE-YEOL KWON, *DEFENSIVE TACTICS AGAINST HOSTILE TAKEOVERS* 5 (KOSDAQ Listed Companies Association, April 2005).

the hostile company trying to acquire the target company.

In the event of a hostile takeover attempt, the management of the target company can use defense strategies involving the acquisition of company shares or the amendment of articles of incorporation. Examples of defense strategies involving the purchase of the target company's shares include: (i) acquisition of shares for control; (ii) securing of a friendly shareholder for mutual cooperation; (iii) repurchase and sale of the company's own shares; (iv) paid-in capital increase through a designated third party; (v) issuance of convertible securities to friendly parties; (vi) issuance of bonds with warrant to friendly parties; (vii) use of a white knight; and (viii) large-scale paid-in capital increase. Defense strategies involving the amendment of articles of incorporation include: (i) amendment of provision relating to issuance of new shares to a third party; (ii) adoption of staggered board system; (iii) tightening of director qualifications; (iv) tightening of requirements for appointment of director; (v) adoption of a special majority rule; (vi) inclusion of a golden parachute; (vii) limitation on use of proxy votes; and (viii) exclusion of cumulative voting system. In addition to these two types of defense measures, the target company may use strategies involving operational management, other specific defense activities (e.g., sale of material assets and report or alerting to the regulatory authorities of the aggressor company's violation of disclosure duties, procedural regulations or any other such laws or regulations), and the prescription of poison pills.<sup>2)</sup>

A hostile takeover can have both positive and negative effects. On the positive side, a hostile takeover can reduce the agency problem, enhance efficiency in management, and increase social and economic wealth. On the negative side, a hostile takeover can transfer wealth from, or reduce the wealth of, shareholders and bring a myopic attitude to operational planning.<sup>3)</sup> Accordingly, whether or not a hostile takeover is justifiable depends on whether it produces more positive results than negative ones.

The target company's stock repurchase<sup>4)</sup> and the sale of the target

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2) *Id.* at 55; Hwa-Jin Kim, *Current Status of the M&A Market and Challenges in the Areas of Policy and Law*, 6 BUSINESS, FINANCE & LAW 31 (July 2004) (in Korean); DALE A. OSTERLE, MERGER AND ACQUISITIONS 231.

3) JAE-YEOL KWON, *supra* note 2, at 30.

4) Hwa-Jin Kim, *supra* note 3, at 44.

company's own stocks to a third party have generally been accepted as legally permissible ways of defending against hostile takeover attempts. However, the legality of these defense strategies came into question with a preliminary disposition and the subsequent final holding on a case before the Seoul Western District Court in 2006, involving a hostile takeover situation. In that case, the Court held that the target company's over-the-counter sale of stocks to the controlling shareholder, serving as the representative director of the company, and other persons in special relationship with the controlling shareholder were illegal because such sale violated other shareholders' rights under the principle of shareholder equality. In light of this new development, the following sections examine legal issue relating to defense strategies against hostile takeover attempts, including issues involving the sale of the target company's treasury shares.

## **II. Defense Strategies against Hostile Takeovers and Duties of Director**

### *1. Legal Principles on Director's Duties*

Under the Anglo-American legal system, a director of a company must act in compliance with the principles of duty of care and duty of loyalty. Under the principle of duty of care, the director must exercise the care that a reasonable person would use under similar circumstances, and the director may be held responsible for her action or inaction during the performance of her duties.

The duty of loyalty, on the other hand, requires the director to act in the best interest of the company,<sup>5)</sup> and in the event of a conflict between the interest of the director and the interest of the company, the director must put the company's interest ahead of her own. To determine whether a director has breached her duty of care, the Court applies the doctrine of business judgment, and for determination on the director's violation of duty of loyalty, the principle of fair dealing is applied.

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5) ARTHUR R. PINTO, UNDERSTANDING CORPORATE LAW § 8.01.

The Commercial Act of Korea characterizes the relationship between the company and its director as an agency relationship requiring the director to perform her duty as a fiduciary of the Company (Commercial Code, Art. 382(2); Civil Act, Art. 681) and in accordance with laws and regulations and the company's articles of incorporation (Commercial Act, Art. 382-3). Accordingly, if the director violates her duty as a fiduciary or the duty of loyalty, and the company suffers damages as a result, then the director may be held liable for the damages (Commercial Act, Art. 399(1)). Moreover, in the event the company incurs an irreparable damage as a result of directors' action in violation of law, regulations or the articles of incorporation, the shareholders may bring a derivative action against the directors (Commercial Act, Art. 402). One peculiar aspect of the Korean law that is that a director may be criminally charged with malfeasance under the Act on the Aggravated Punishment, Etc. of Specific Economic Crimes.

## 2. Duties of Director and Defense against Hostile Takeovers

No consensus has been reached in legal communities over whether directors of the target company may actively intervene to defend their management control against a hostile takeover attempt.<sup>6)</sup> Under the American legal system and Korea's majority view, directors are, in principle, permitted to defend their management, using their business judgment, and directors are held responsible for any abuse of their power committed in their defense efforts.<sup>7)</sup> To qualify as a legitimate business judgment in the Korean legal system, the following elements must be shown: (i) directors' judgment on a business matter; (ii) disinterestedness and independence of directors; (iii) a judgment based on sufficient information; (iv) good will; (v) absence of abuse of discretion; (vi) absence of fraud, illegality, abuse of authority, and waste of company assets.<sup>8)</sup> Directors must also consider all reasonably accessible

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6) Wook Rae Lee, *Legal Assessment of Director's Defense Tactics against Hostile Takeovers*, 12 BUSINESS, FINANCE & LAW 10 (July 2005).

7) Jong Joon Song, *Business Judgment Rule and Issues of Its Acceptance in Korea*, 364 HUMAN RIGHTS AND JUSTICE 23 (December 2006).

8) Seok-Bum Hong, *Application of Business Judgment Rule and its Limits*, 364 HUMAN RIGHTS AND JUSTICE 26 (December 2006).

material information before making any business judgment in relation to the sale of the company. Particularly, before deciding on a matter relating to an M&A transaction, directors have the duty of care as fiduciary of the company to collect all necessary information and to act with caution.<sup>9)</sup> Directors must not leave such decision to the shareholders without taking any position on the matter. In the event that directors have to approve a transaction between the company and a director, the directors must show that the transaction is fair to both parties.<sup>10)</sup> If the directors are given the authority to decide whether to sell the management control to a hostile company or to a white knight, the directors' role shifts from the protector of management control to a seller at an auctioneer who must sell the company to the highest bidder to maximize shareholders' profit.<sup>11)</sup>

In defending the target company, the following two conditions must be satisfied for the doctrine of business judgment to apply: (i) a reasonable belief that there was a risk to the policy and efficacy of the company (i.e., the "principle of reasonable basis"); and (ii) reasonableness of the defense measures taken in relation to the degree of risk posed (i.e., the "principle of proportionality").<sup>12)</sup> Once the above two conditions are shown to be satisfied, directors are protected under the doctrine of business judgment.

To satisfy the principle of reasonable basis, the board of directors must have in good faith decided, after examining the degree of threat, that it was necessary to use the defense measures the board decided to employ. If the Court recognizes that the use of the defense measures was appropriate, the directors' decision to use such measures will be deemed a valid business judgment. To hold the directors responsible, shareholders must prove that the directors violated their fiduciary duty by showing, among others, that (i) the directors' objective was to maintain their position in the company; (ii) the directors did not act in good faith or committed fraud; and (iii) the directors

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9) *Smith v. Van Gorkom*, 488 A.2d. 858 (Del. 1985).

10) *Weinberger v. UOP Inc.*, 457 A.2d. 701 (Del. 1983).

11) *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d. 173 (Del. 1985).

12) *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d. 946 (Del. 1985).

lacked adequate information on which they could base their decision.<sup>13)</sup> Even when the directors' decision is not protected under the doctrine of business judgment, it is sometimes justified under the principle of equity.<sup>14)</sup> In the event the directors have to choose between two potential acquirers, the directors' decision may be protected if it satisfies the principle of reasonable basis and the principle of proportionality.<sup>15)</sup> When there is change of management, the directors must in good faith take actions based on reasonably reliable information, actively engage in negotiations with the potential acquirers, and treat all potential acquirers on equal basis.<sup>16)</sup>

### III. Repurchase and Sale of Company's Own Shares for the Defense of Management Control

#### 1. Stock Repurchase for the Defense of Management Control

Prohibiting stock repurchase in principle, the Commercial Act permits a company to buy back its own shares only for certain purposes such as the cancellation of stocks (Commercial Act, Arts. 341, 341-2 and 342-2). On the other hand, the Financial Investment Services and Capital Markets Act ("FSCMA") permits stock repurchase if executed under certain circumstances for the stabilization of management control or stock price (FSCMA, Art 165-2(1)). A stock repurchase can serve as a particularly useful defense strategy when the controlling shareholder lacks the capacity to protect her management control, and it may be preferred by minor shareholders who benefit from the resulting increase in the stock price.<sup>17)</sup>

The defense through stock repurchase may be summarized as follows: 1) though treasury shares do not have voting rights, the voting rights can be revived if the shares are sold to friendly third parties; 2) the repurchase of stocks can raise the price of shares by decreasing their number in the market,

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13) *Unitrin, Inc. v. American General Corp.*, 651 A.2d. 1361 (Del. 1995).

14) DALE A. OESTERLE, *supra* note 3, at 263.

15) *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.3d. 173 (Del. 1986).

16) *Paramount Communications Inc. v. QVC Network, Inc.*, 637 A.2d. 34 (Del. 1994).

17) Hwa-Jin Kim, *supra* note 3, at 45.

and thereby increase the cost and risk for the acquiring company and reduce its potential gains from the acquisition; 3) because a stock repurchase would reduce the cash held by the target company, the target company will appear less attractive if the aggressor company's aim is to acquire the target company's liquid assets; 4) although the repurchase of shares would not increase the number of voting rights held by the company due to limitations on the number of voting rights that can be acquired through stock repurchase, the proportion of the company's voting rights will increase and thereby allow the company to indirectly defend the management control and; 5) as other kinds of defense strategies are more limited in their effectiveness, it is relatively more advantageous to use stock repurchase for defense of management control.<sup>18)</sup>

## *2. Discourse on Defense through Issuance of New Shares*

Although the target company's defense through the sale of treasury shares is different from defense through the issuance of new shares, these two defense strategies share structural similarities. A defense through issuance of new shares may be regulated under Article 418(2) of the Commercial Act which requires any issuance of new shares to have business purposes. Article 424 which allows shareholders to demand the company to stop any issuance in violation of laws, regulations or its articles of incorporation or in an obviously unfair manner by which shareholders may suffer disadvantages. Citing the above provision of the Commercial Act, the Court has decided in one case that even if the principle purpose of issuing new shares was to defend the current management and there was no sufficient basis for the need to quickly supply funds, the issuance of new shares may be interpreted as having an business purpose under Article 418(2) of the Commercial Act if it can be recognized that maintaining the current management and the controlling shareholder would serve the interest of the company and ordinary shareholder. In determining whether maintaining the current management and the controlling shareholder serves the interest of the company and the ordinary shareholder, the court took into consideration: (1) the purpose of the

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18) *Id.*

hostile takeover attempt and the source of the hostile company's funds, (2) operational strategies of the current management and the controlling shareholder, (3) the corporate culture of the target company, (4) the social and economic importance of the target company's business, and (5) the prospect on the continuation of the target company's current business.<sup>19)</sup>

### 3. *Sale of Treasury Shares*

The sale of treasury shares is distinguishable from the issue of new shares in several different ways. First, unlike the issuance of new shares, which is effected mainly to supply capital to the company, the sale of treasury shares, which the company acquired with various objectives including the increase of stock price, stability in management, payment of debt, and supply of security interest, is not undertaken for the primary purpose of capital increase. Second, while Article 418 of the Commercial Act regulates the preemptive right of new shares, there is no provision in the Commercial Act regulating the purchase right of treasury shares. Third, while the issuance of new shares increases the number of total issued shares, the sale of treasury shares does not change the number of total issued shares. Lastly, when new shares are issued to existing shareholders, they do not change the ratio of shareholding, but when they are issued to a third party, they may change the existing shareholders' ratio of shareholding. On the other hand, when treasury shares are sold to specific shareholders or a third party, the existing shareholders' ratio of shareholding may be affected significantly as voting rights that have been suspended are restored. Because of such characteristics of treasury shares, a target company must take into account the particularities of the sale of treasury shares.

### 4. *Case Precedents on Sale of Treasury Shares*

More recent cases involving the legality of the sale of treasury shares as a defense against hostile takeover include the following: 1) the decision for injunction against the exercise of the Seoul Western District Court on March 24, 2006 (2006*kahap*393); 2) the decision by the Seoul Western Court on June 29,

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19) 2003KaHap369 (Suwon District Court Yeosu Branch, Dec. 12, 2003).



2006, confirming that the over-the-counter sale of treasury shares was null and void (2005gahap8262) (the “*Daerim Tongsang Case*”); and 3) the decision by the Suwon District Court on January 30, 2007 (2007kahap30) (the “*Fine-digital Case*”).

### *1) Cases Holding the Sale of Treasury Shares Illegal*

The Court summarized the *Daerim Tongsang* case as follows: Neither the Commercial Act nor Securities Act (before the enactment of FSCMA) apply regulations for the issuance of new shares to the sale of treasury shares, and the effect of sale of treasury shares is in principle different from that of the issue of new shares because the former action changes neither the total asset of the company nor the existing shareholders’ ratio of shareholding. However, the sale of treasury shares can have the same effect as the issue of new shares if the treasury shares are sold only to specific shareholders and the other shareholders’ ratio of shareholding is consequently diminished. The sale of treasury shares should, therefore, be regulated like the issue of new shares, and the sale of treasury shares should be prohibited if it is used to avoid regulations. In *Daerim Tongsang*, the sale of treasury shares had a significant effect on the interest of the plaintiff who was a major shareholder and on the control of the company. Taking into account the motive for the execution of the share purchase agreement and the interests of the parties involved, this Court hold the sale of treasury shares null and void.

This decision is significant in that the Court deviated from case precedents by holding that the sale of treasury shares to specific shareholders violated the rights of other existing shareholders and was thus invalid. The reasons for holding the sale invalid was that: (1) the sale of treasury shares had significant effect on the interest of the existing shareholders and on the control of the company; (2) the other shareholders were not given the opportunity to buy the treasury shares; (3) the treasury shares were sold only to specific shareholders; and (4) taking into account the motive for the execution of the share purchase agreement and the interests of the parties involved, the Court could not overlook the sale. A target company’s defense tactics have been supported with the logic that a stock repurchase would have a deterring effect as it increases the cost of hostile takeover. Also, it is argued that if a hostile takeover attempt is already being made, the sale of treasury shares to the controlling shareholder or a friendly third party would increase the number of

friendly shares and thereby help defend the management control. However, with the above decision, it is possible that the sale of treasury shares to the controlling shareholder or a friendly party during a hostile takeover attempt will be held valid only if it was done in compliance with all applicable laws and regulations. Therefore, to use defense measures involving the purchase and sale of the target company's own shares, it is necessary for the target company to take greater caution to comply with all applicable laws and regulations.

## 2) Cases Holding the Sale of Treasury Shares Legal

In the case of *Fine Digital*, the sale of treasury shares was held legal. The holding of *Fine Digital* is as follows: (1) selling treasury shares is distinguishable from issuing new shares because the former neither affect the company's total assets nor the proportion the existing shareholders' voting rights; if these factors are considered, it is difficult to accept the claim for cancellation of sale of treasury shares, which is similar to a claim for cancellation of issuance of new shares; (2) because the sale of treasury shares involves a third party, the sale can be found invalid only when the third party knew or could have known that the purpose of the sale was to defend the management control; (3) even in situations where the sale of treasury shares can be made void due to the absence of resolution by the board of directors, the sale of treasury shares can be found invalid only if the third party either knew or could have known that the board resolution was never adopted.

The holding in this case outlined above is significant in two aspects. (1) This case was decided on the premise that even if the treasury shares were sold in order to defend the management control, because such sale essentially is selling of shares that have already been issued, there is no effect on the company's total assets or on the proportion of existing shareholders' voting rights. Therefore, in this case, it is difficult to apply the reasoning for holding the issuance of new shares invalid. This case is significant in that it decided that the sale of treasury shares cannot be held invalid only because it was undertaken for the purpose of defending the management control.<sup>20)</sup> (2) With

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20) For commentary on this decision, see Il-Bong Moon, *Preliminary Disposition Relating to the Sale of Treasury Shares*, 23 BUSINESS, FINANCE & LAW 89 (May 2007).

regard to the legality of a sale of treasury shares that requires the board of directors' resolution, this case was decided on the basis that even if the sale of treasury shares is deemed invalid due to procedural errors on the part of the seller, the sale can be voided only when the other party in the dealing knew or could have known that the seller did not have the board approval. This holding seems to reflect the rule that the company does not assume liability when the other party is unaware of the fact that there was no board resolution when such resolution is required.<sup>21)</sup> However, it can be inferred from this case that if the sale of treasury shares is for defending the management control and if the directors acted out of malice for the benefit of a major shareholder or for an illegal benefit of a director, thereby violating the public order and morals, such sale of treasury shares can be voided.<sup>22)</sup>

##### *5. Legality of the Sale of Treasury Shares to a Third Party*

There is no standard prescribed in FSCMA, the Commercial Act or related regulations for determining whether the sale of treasury shares to a third party during a hostile takeover attempt is legal. Because of the lack of standard, it appears that, in the past, such sale of treasury shares was deemed either legal or subject to the business decision of the directors. More recently, however, attempts are being made to apply Article 418 of the Commercial Act, dealing with preemptive right of new shares, or Article 424 of the same Act, dealing with issuance of new shares, to the sale of treasury shares discussed above, and the *Daerim Tongsang* case was an example of such attempts.

Unlike in Japan where regulations for the issuance of new shares are applied to the sale of treasury shares, it appears that in Korea it would be difficult to apply Articles 418 and 424 of the Commercial Act to a situation where new shares are not being issued. This is because whereas an issuance of new shares accompanies a capital increase, any increase from the sale of treasury shares may be deemed as the return of capital of capital to its original place. While the Commercial Act and FSCMA and the related regulations

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21) See e.g., 97Da34709 (Supreme Ct., Mar. 27, 1998).

22) Il-Bong Moon, *supra* note 21, at 100.

prescribe rules for the purchase of the company's own shares, the two Laws do not contain any provision on the sale of treasury shares, aside from some procedural rules in FSCMA relating to regulatory reporting. As the sale of treasury shares is considered a profit and loss transaction to which the principle of shareholder equality does not apply, and as such sale is a personal transaction between the transacting parties, any limitation on such transaction should be carefully considered. Moreover, the application of regulations for the issuance of new shares may result in diminished benefits of financial management due to strict procedural requirements.<sup>23)</sup> Therefore, it would be most reasonable to view the board of directors as having the authority to decide on the sale of treasury shares, whether such transaction takes place on exchange or over the counter, and whether the treasury shares are sold to existing shareholders or to a third party. In principle, if the board of directors decides to sell legitimately acquired treasury shares in compliance with relevant laws and regulation, the resulting sale should be treated as legal. The holding in *Fine Digital* discussed previously seems to be based on this principle. Those who view the repurchase of the company's own shares as a legitimate defense against a hostile takeover attempt presuppose that the sale of legitimately acquired treasury stocks to existing shareholders or a third party is also a legitimate transaction. Even if treasury shares are sold to defend the management from a hostile takeover attempt, it would be most appropriate to determine the legality of such sale by examining whether the defense was reasonable under the given circumstance.<sup>24)</sup>

If the board of directors has the authority to make a business decision on the sale of treasury shares, then the legality of the decision should be determined by applying the principle of business judgment, which is the standard applied for evaluating board actions. In evaluating the legality of the board decision, a determination on whether the treasury shares were initially acquired by the company in compliance with relevant laws and regulations would be an important step. Furthermore, the decision of the board can be evaluated using the 'principle of reasonable basis' and the 'principle of

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23) Jong Joon Song, *A Study on Regulating the Procedures in the Sale of Treasury Shares*, 3504 THE LAW TIMES (Nov. 8, 2006).

24) *Id.*

proportionality' discussed above. The directors can be protected under the principle of business judgment if there was reasonable basis for the belief that the hostile takeover attempt posed a risk to the company policy and the defensive measure taken was reasonable in relation to the degree of the threat posed against the company. However, if the sale of treasury shares is only for the interest of the controlling shareholder rather than for the interests of the company and its shareholders who are faced with a hostile takeover attempt, the decision of the board to sell treasury shares may be held illegal.

The sale of treasury shares to specific major shareholders per se may not violate the principle of shareholder equality. Nonetheless, it may be a violation of the principle of equality as well as the directors' duty of care as fiduciaries if the company sells the treasury shares to specific shareholders for a price that is significantly lower than the market price.<sup>25)</sup> Even under such circumstance, the determination on the reasonableness of the sale should be based on various factors including the reasonableness of the purchase price, the source of the purchase money, the cause of contest over management control, the long-term development plan of the company, how the hostile party came to acquire shares, and the major shareholders' long-term interests.

Determining the reasonableness of the purchase price should not be difficult if the shares of the company are listed on the Korea Stock Exchange or KOSDAQ and a market price is established. However, if the company shares are not listed and a market price is unavailable, determination of the reasonableness of the purchase price may require complex procedures. The 'market price' of an unlisted share can be determined using the following principles: (1) if there exists an objective exchange value that is established through a transaction conducted in a normal and ordinary manner, that objective exchange value should be the market price;<sup>26)</sup> (2) even if there is no such other transaction, if the purchase price can be deemed objective because

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25) In the U.S., there are case laws holding that it is a breach of fiduciary duty for directors to sell the company shares to a specific group of shareholders at a price below the best price for those shareholders to gain control over management without giving the same opportunity to the other shareholder. *See e.g., Schwartz v. Marien*, 43 App Div 2d 307, 351 NYS 2d 216.

26) 86Nu318 (Supreme Ct., Jan. 20, 1987); 86Nu408 (Supreme Ct., May 26, 1987); 88Nu4997 (Supreme Ct., Mar. 27, 1990); 90Nu4761 (Supreme Ct., Sep. 28, 1990); 92Nu1971 (Supreme Ct., Oct. 27, 1992).

the purchase was conducted in a normal and ordinary manner, then the purchase price may be treated as the market price;<sup>27)</sup> (3) if there exists no other transaction and if the purchase price cannot be treated as the market price, then the appraised value pursuant to the Inheritance Tax and Gift Tax Act shall be deemed the market price. If the company sells its shares at a price that is substantially lower than the market price, the sale of the shares may be held invalid, and the directors who approved the sale may be held liable both criminally and for damages. If the directors are shown to have placed their own interest ahead of the interest of the company, they may be held responsible for breach of the duty of loyalty.

#### 6. *The White Knight Strategy and the Sale of Treasury Shares*

The white knight strategy refers to a passive defense tactic in which the target company finds a third party purchaser who would buy the company under the condition that is more favorable to the current management of the target company. There is also what is called the white squire strategy in which the target company finds a third party purchaser who would buy only a minority of shares without gaining management control and take a position that is favorable to the current management. In Korea, the white squire strategy is understood to be a type of white knight strategy.<sup>28)</sup>

It appears that the use of the white squire strategy can be quite helpful. In addition to helping the company defend against a hostile takeover attempt, the white squire strategy can improve the financial condition of the company with the sale of treasury shares, and the funds acquired from the sale enables the company to repurchase its own shares in the future. If the white squire strategy is adopted, the legality of such strategy would be determined based on whether the treasury shares were sold at a reasonable price to an appropriate third party in a reasonable manner.

While the white squire strategy can be used as a defense strategy against a hostile takeover attempt that is already taking place, it may be more effective

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27) 86Nu408 (Supreme Ct., May 26, 1987); 92Nu1971 (Supreme Ct., Oct. 27, 1992); 93Nu22333 (Supreme Ct., Dec. 22, 1994); 2001Du5903 (Supreme Ct., May 27, 2003).

28) JAE-YEOL KWON, *supra* note 2, at 140.

as a preventive measure against a potential hostile attack. For example, financial plans that involve the transfer of treasury shares, such the issuance of exchangeable bonds and convertible bonds, may help prevent hostile takeover attempts. However, because it is possible for a white squire to betray the management and try to takeover the company, the company must use a trustworthy party as the white squire, cause the white squire to enter into a stand still agreement for mutual nonaggression,<sup>29)</sup> employ cross ownership of shares to the extent the voting rights are not limited due to mutual ownership,<sup>30)</sup> or employ a strategic cooperation arrangement that can hold each other in check.

KEY WORDS: takeover, stock repurchase, director's duties, treasury shares

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29) When using the white squire strategy, the company offers additional shares to the white squire with the condition that the white squire would enter into a stand still agreement requiring the white squire to side with the current management in the face of hostile takeover attempt. ARTHUR R. PINTO, UNDERSTANDING CORPORATE LAW, § 12.04.

30) In recent years, the Korean press has been reporting more frequently about the use of cross ownership as a defense strategy against a hostile takeover attempt. For example, Maeil Business Newspaper published an editorial on July 4, 2007 that described the cross ownership of shares between KT&G and Shinhan Holdings as a type of white knight strategy employed to defend the management control. The editorial praised the cross ownership of shares as the best defense strategy that is permitted by law.





# Mergers and Acquisitions Practice of Reorganizing Corporations in Korea and Its Ongoing Change

Sung Jun Hong\*

## Abstract

*One of the most outstanding legal phenomena in Korean reorganization practice has been the pursuit of Mergers and Acquisitions. In fact, in Korea, reorganization practice just begun one decade ago right after a number of conglomerates fell into bankrupt, when Korea faced nationwide economic disaster provoked by the lack of foreign key currency, and a number of conglomerates fallen into bankrupt rushed into court. M&A transaction in reorganization procedure emerged right after the rush of reorganization filings. Meanwhile, it has played significant role in rehabilitation of reorganizing company. Until now, almost every reorganizing company has succeeded in rehabilitating by being injected capital via M&A. Analysis of efficiency of M&A transaction of reorganizing company carried out last several years shows that the earlier debtor company initiates M&A, the more creditors are paid. This is the reason that all the reorganizing companies are urged to pursue successful M&A transaction. M&A of the reorganizing company has several features arising from the limitation to meet the needs of the debtor company; receiver-initiating, fast completion and strictness in negotiation between the debtor and buyer. In reorganization practice, most M&A transactions are carried out through issuing new shares to buyer and, business transfer or asset transfer is rarely pursued. In the M&A process, fairness to potential buyers is the most highlighted, for it induces better price due to their competency to acquire the reorganization company. Recently, a significant change in reorganization practice regarding the pursuit of M&A occurs due to the Debtor Rehabilitation and Bankruptcy Law effective as of April 1<sup>st</sup>, 2006. It introduced quasi-debtor in possession receivership, and then gives reorganization practice a significant influence for receivers not to have to pursue M&A in every reorganization case. Moreover, new reorganization practice allows and respects the result of M&A conducted in a fair manner under the consent between debtor and major creditors. Furthermore, M&A practice of reorganizing company is changing regarding how and when it is initiated, as global economic surroundings are on changing, and receivers of the reorganization*

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*company under the supervision of court is seeking efficient ways to M&A for rehabilitation of once financially distressed company.*

## **I. Introduction**

Lately, in Korea, it is very common to come across news, reports or articles on mergers and acquisitions (M&A) of various corporate entities, but the emergence of M&A as an attention-worthy private business activity among the Korean financial and business milieu is relatively a recent phenomenon; led by a number of conglomerates, Korean companies began utilizing M&A as an integral part of their restructuring procedures following the outbreak of the economic crisis in 1997.

It has merely been over a decade since the bankruptcy laws have been routinely put into practice in Korea, while substantial studies concerning legal principles of the bankruptcy laws and reorganization practices that materialize such principles are even more recent occurrences themselves. After all, it may as well be said that corporate reorganization practices are regarded as fairly new in Korean corporate settings, and M&A, which only began regularly appearing in restructuring practices since the new millennium, may arguably be one of the youngest areas of the practices.

One of the most salient differences in reorganization practices of Korea that separates it from similar practices of other countries has to be its substantial use of M&A transactions. Most companies with reorganization plan confirmed<sup>1)</sup> pursue M&A transactions, either on its own account or not. The old corporate reorganization practice under the Company Reorganization Law, which was abolished as the Debtor Rehabilitation & Bankruptcy Law is effective, identified M&A as an essential aspect of the reorganization procedure, and eliminating factors that might potentially impede M&A had been regarded as one of the most important tasks, while M&A had always been an important matter of concern for receivers in their execution of business after commencement of cases or confirmation of the plans. It would

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1) In reorganization practice in Korea, confirmation of plan does not mean the closing of the reorganization case. Court usually supervises debtor companies' carrying out the approved and confirmed plan of amortization style paying off.

not be an exaggeration to note that M&A has come forth as the sole device for a bankrupt company looking to rehabilitate through reorganization procedures. Nonetheless, M&A transactions carried out following the previous reorganization practice are not coherent in their contents or execution. The differences in nature of businesses and profits, as well as other situations the companies going through M&A transactions may face, could be the main reason for such discrepancy, and the piecemeal changes based on the results of M&A's implantation into the reorganization procedures, as well as the market's consistent transformation, may also have constituted the reasons for such inconsistency.

Recently, a significant factor has arisen that should bring changes to prospective M&A practices for bankrupt companies – the Debtor Rehabilitation & Bankruptcy Law (“DRBL”), which came into effect on April 1<sup>st</sup>, 2006 has introduced the “Quasi-Debtor in Possession Receiver System,” or former executives receivership system while substantially reinforcing the functions and authorities of the creditors’ committee in order to supervise and restrain the business activities of former executives.

In the newly-adopted reorganization procedures, receivers who are former executive managers at the time of filing of reorganization petition will have an inclination to take passive attitudes towards M&A as they will attempt to hold onto their rights to conduct business, as well as their controlling interests of the company once confirmation of the reorganization plans has been granted, and, thus, it may be difficult to commence M&A transactions in an opportune time. On the other hand, creditors have been criticizing about their lack of participation in such receiver-initiating M&A transactions, and that the control of such companies facing reorganization might be transferred at unreasonably low prices; in the new reorganization procedure, a more intricate conciliation of interests may be required due to the reinforced functions and authorities of the creditors’ committee that will likely attempt to reflect the interests of the creditors to a greater degree.

In this article, without explaining the general subject matter of M&A transactions and based on the author's understanding garnered through dealing with a series of companies' M&A transactions during their reorganization procedures and other cases that the author had come across, it will present the preexisting processes of an M&A transaction of such companies and the recurring commercial and legal issues, followed by an

explication of the rationale behind these matters. In addition, this article will further elaborate on the possible amendments and the elements of concern for the M&A practice that may be expected under the new DRBL. Moreover, since an M&A transaction is an inseparable constituent within reorganization procedure, explanations concerning bankruptcy-law-related matters will be provided, but restricted to an extent where basic understanding of an M&A transaction in such bankruptcy procedure is required.<sup>2)</sup>

## II. A Need for M&A Transactions in Reorganization Procedures

### 1. *A Need for M&A Transactions in Reorganization Procedures Operational Experiences*

① Reorganization procedure may be defined as a collective debt restructuring procedure to keep a financially troubled or bankrupt company viable through conciliation of various interests that surround debtors facing bankruptcy, including the creditors and the shareholders. It may possess number of social and economic functions, but its fundamental function is to equitably distribute the assets and profits to the company's creditors as a part of a collective debt restructuring procedure. Reorganization procedure may be distinguished from straight bankruptcy procedure, which presupposes that debtor dissolves and ceases to do business, in that it assumes that the debtor continues her own business, pays off her debt with the proceeds from that business, and carries out her reorganization plan. That means corporate reorganization procedures thereby seek to simultaneously accomplish two

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2) M&A transactions of a company facing reorganization is a legal phenomenon that demands an understanding of general laws, including commercial law and insolvency law, while simultaneously requiring an economic, managerial judgment that pursues resource-distribution efficiency. When engaging in actual M&A transactions of reorganizing companies, one often encounters problems that cross the legal and managerial boundaries. In course of solving such problems, conflicts between lawfulness and efficiency inevitably occur, indicating that M&A transactions do not solely depend on the logic of lawfulness or efficiency. Therefore, one must consider both the aspects of lawfulness and efficiency of a transaction in understanding M&A activities of a company facing reorganization.

objectives of “continuation of business” and “maximization of creditors’ satisfaction.”

Previous reorganization plans of most companies facing bankrupt took into consideration the fact that the companies are not likely to recover their earning powers early in the process, and accordingly devised restructuring plans that postponed debt payment for a specific period in the early stages of the plan, removing the debtors from the pressures of their debts for a set period to concentrate solely on the restoration of their businesses and earning powers, thereby establishing solid grounds of their restructuring plans as early as possible. Hence, if a company restores its earning powers fairly early and lays a foundation to continue on its business, it may simply execute the remaining stages of the confirmed plan to successfully complete its reorganization procedure and restructure itself on its own.

Regrettably, most companies facing reorganization fail to carry out these plans, leading them to severe difficulties in carrying out their reorganization plans beyond their debt postponement period even resulting in nullification of reorganization procedures. In the last few years, as attesting to this point, the author had not been able to locate successful cases where a company fully executed its reorganization plans at least from the corporate reorganization practice records of the Seoul Central District Court, Bankruptcy Division.<sup>3)</sup> The causes for such difficulties posed by reorganization plans vary; a company facing the verge of bankrupt may have made an exceedingly optimistic forecast of its business prospects, or it may have constructed a plan that exceeds the limits of its capabilities. Moreover, another reason for such lack of success would be that it requires much more than just the efforts of the debtors to reclaim the confidence of the market, and the fact that it would be nearly impossible to require a company to carry out a ten-year plan constructed prior to its confirmation, particularly in recent rapidly changing economic environment.

There will not be procedural problems in situations where a company fails to carry out its reorganization plan, as all that the court has to do is to annul

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3) The only exception, as far as the author knows, is the reorganization case of Medison Co. Ltd., a famous manufacturer of medical ultrasound devices. It was established in 1985, filed reorganization petition at Chuncheon District Court in 2002, and finally exited the court’s supervision in 2006 by successfully restoring its business.

**Chart 1.** Positive Analysis on Implementation Period of an M&A Transaction

| Time Required from Commencement to Termination |                     | Liquidation Value Analysis |                                      |   |
|--|---------------------|----------------------------|--------------------------------------|---|
| Length of Period, Commencement ~ Termination   | Number of Companies | Number of Companies        | Asset to Liquidation Value Ratio (%) | Liquidating Dividend Rate to M&A Credit Recovery Rate (%) |
| Less than 2yrs                                 | 5(8.8%)             | 4(11.4%)                   | 51%                                  | 290%  |
| 2 ~4yrs  | 20(35.1%)           | 2(34.3%)                   | 54%                                  | 311%  |
| 4 ~6yrs  | 18(31.6%)           | 13(37.1%)                  | 64%                                  | 170%  |
| 6~8yrs   | 11(19.3%)           | 5(14.3%)                   | 55%                                  | 217%  |
| More than 8yrs                                 | 3(5.2%)             | 1(2.9%)                    | 47%                                  | 147%  |
| Total  | 57(100%)            | 25(100%)                   | 54(Avg.)                             | 227(Avg.)   |

the company's reorganization procedure and order it to be converted into straight bankruptcy. However, reorganization procedure will inevitably draw criticisms that it is merely a costly way of delaying bankruptcy, especially when the fundamental functions of a reorganization plan are to satisfy the debt and restore the debtor, as mentioned above. Accordingly, a company must seek a way to avoid bankruptcy, protect the interests of the creditors, and plan for its rehabilitation at the same time, even if it requires a change in course of its reorganization plan, and M&A has been endorsed as a viable option.

Reorganization practice in Korea has always pursued M&A transactions under the objectives of "satisfaction of creditors" and "rehabilitation of debtors." For a "company" to recover, possessing a "responsible managing entity" has been deemed necessary.

Scrutinizing the instances of the companies that entered the procedures of reorganization, it has often been the case that the causes that led to their bankruptcy lied in imprudent management of their executives. Also, companies often seem to switch into more creditor-oriented governance structures through reorganization, but it is uncertain as of how responsible a creditor, usually a financial institution, will be in managing the companies. As it can be seen here, having a managerial entity that can soundly manage the company is certainly a pressing issue for the continued existence of a

reorganizing company.

② Seoul Central District Court Bankruptcy Division has been actively engaged in M&A activities since 2000.<sup>4)</sup> Instances where reorganization procedures have been completed through M&A transactions include 2 cases in 2000 (KIA Motors, Asia Motors), 14 cases in 2001 (Sammi Specialty Steel, You One Construction), 19 cases in 2002 (Pan Ocean Shipping, C& Merchant Marine, Ssangbangwool, Ssangbangwool Development, Midopa, Hanshin Engineering & Construction), 8 cases in 2003 (Tongil Heavy Industries, Kukdong Construction, Seahbesteel), 14 cases in 2004 (Koryo Industrial Development, Youngnam Textiles, New Core, Dong Seo Industry), 6 cases in 2005 (Ilhwa, Thrunet, Jinro), 6 cases in 2006 (SKM, JR Construction, Anam Construction, HanHap Industry), 8 cases in 2007 (Keonyoung, Saerom Sungwon, Hyundai LCD, Hantong Engineering, Nasan), and several cases in 2008 (BOE Hydix, Korea Express, Eitech). Instances of a company completing its reorganization procedures without accompanying an M&A transaction are yet to be found, at least in the case of Seoul Central District Court.

③ Chart 1<sup>5)</sup> above demonstrates an analysis concerning the implementation periods and related credit recovery and other rates of the data collected from the 57 companies that terminated their corporate reorganization procedures early through M&A activities. The chart indicates that an M&A transaction increases the creditors' benefits, regardless of the time of implementation. It can also be noted that the M&A transactions that terminated after 2 to 4 years since commencement recorded the highest credit recovery rates per liquidating dividend rate, attesting to the fact that it may be more effective to recover corporate value lost during the bankruptcy process prior to engaging in M&A.

④ It is interesting to note that the credit recovery rate of M&A transactions that occurred within 2 years of commencement recorded the second highest. This may be an indication that implementing prearranged M&A transactions before the company's corporate value depreciates due to bankruptcy may possibly be more efficient. Recently, creditor-initiated M&A transactions that

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4) Prior to 2000, the Koryo Development, the Keunhwa Pharmaceutical M&A deal in 1998, and the Mikang, the Byuksan Construction M&A deal in 1999.

5) SEUL CENTRAL DISTRICT COURT, BANKRUPTCY DIVISION, REORGANIZATION PRACTICE GUIDEBOOK II 175, (2<sup>nd</sup> ed. Pakyoungsa 2008).

are reflected within the restructuring procedures have appeared in a form of prearranged M&A transactions. Such forms of M&A transactions are expected to arise more often as Seoul Central District Court plans to give positive consideration to M&A transactions that the debtors initiated prior to filing for petition of reorganization procedure under agreement with their major creditors.

## *2. Characteristics of M&A Transactions in Corporate Reorganization Procedures*

In the author's opinion, M&A activities of a company facing reorganization have the following characteristics in comparison to general M&A transactions outside of court:

### *1) Seller(=Receiver)-Oriented M&A*

M&A transactions arising during the period of reorganization procedures pending in court are seller-oriented. The receivers, as financial advisors of an M&A transaction of a company facing reorganization, are quite limited in their decision-making capacity, as they have to mediate the convoluted entanglement of interests among the debtors, creditors and shareholders as their trustees. It is for this reason that the prospective buyers often feel that the receiver approaches numerous matters with unnecessary strictness and create difficulties that may have been able to be resolved through negotiation in conventional M&A practice.

In this perspective, M&A transaction of reorganizing company may be regarded as seller-oriented, imposing the buyers to comply with the subject matters required for debtors' rehabilitation and satisfaction of debt.

### *2) Pursuit of Rehabilitation and Resulting Limitations*

The main objective of a M&A transaction of a debtor company is to seek for its rehabilitation through "procuring funds for debt payoff" and "securing a responsible managing entity." In order to meet its ultimate objective in resuscitating the company, there will inevitably be a number of restrictions, including preference for an increase in the paid-in capital, requirements of managing abilities, compulsory lock up of acquired shares, and prior elimination of potential legal restrictions.



### 3) *Accelerated Procedures*

An M&A transaction of a company in its reorganization procedure is proceeded with speed after its public announcement. Prior to tender offer, receiver arranges for the bidders an agenda of events after the close of bid, including the deadline for signing a memorandum of understanding (MOU) after selecting the preferred bidders, the deadline for granting detailed due diligence for determining the acquisition price, the deadline for negotiation for adjusting the price of acquisition, and the deadline for signing the purchase agreement. In situations where an extension to any of the above deadlines is made under the requirement of the buyer, permission from a court will be required, and even the extended deadline will be subject to certain restrictions. The purpose of such promptness is to seek for an early stabilization of the debtors' business by quickly settling the string of negotiations required in an M&A transaction and prevent any delay in the process.

### 4) *Concomitance of Bankruptcy Law Procedures*

Most M&A transactions of reorganizing companies undergo procedures for amendments of reorganization plans, a procedure specific to bankruptcy law. Outside of the matters pertaining to an M&A transaction itself, therefore, a thorough preliminary examination of bankruptcy law matters, particularly the requirements of amendments in reorganization plans and the possibilities of closing of the reorganization case, are necessary.

### 5) *Emphasis on Fairness and Transparency*

One of the functions of an M&A transaction of company in need of reorganization is debt satisfaction, and it requires an inducement of a prospective buyer that is willing to offer high acquisition price. It may be said that the reorganizing company holds a neutral interest regarding this matter.

These days, the number of competing companies looking for an acquisition or selection as a financial advisor has been amassing, as well as the possibilities that companies that have fallen out of competition lodging objections to the selection process, which accentuates the need for maintaining transparency and fairness in the reorganization procedures. When selecting a preferred bidder or a legal entity that shall carry out due diligence on business and assets of the seller and debtors pertaining to transfer of business, the receiver shall proceed the procedure in a fair manner, soliciting opinions of

the creditors' committee (Debtor Rehabilitation and Bankruptcy Rule of Supreme Court §49). Also, the "Regulation Regarding M&A Transactions of a Reorganizing Company (Seoul Central District Court Regulation No. 11)" emphasize fairness in an M&A procedure by requiring the financial advisor to document a detailed evaluation standard that appraises categories including: the size of an increase in paid-in capital, viability of securing funds for acquisition; soundness of prospective buyers' financial structures; and the intention and ability of the buyer or preferred bidder to manage and develop the debtor prior to submission of a binding bid offer or a final service proposal preferred bidder.

An M&A transaction of a reorganizing company proceeds in a transparent and a fair manner under the supervision of the court. Since an M&A transaction of a reorganizing company will only have legal force through reorganization plan amendment procedures made by meeting of interested parties for a resolution of an amendment plan with the approval of creditors, even before such approval is made, the receivers will be under supervision of the court in exercising their authority throughout all stages of the M&A activity, including its implementation, designation of financial advisor, tendering offer, drafting invitation for bid (IFB) and memorandum of understanding (MOU), designation of preferred bidder, negotiation of MOU, arrangement of acquisition price, and negotiation of investment agreement. Another reason for the emphasis on fairness and transparency in M&A transactions is to maintain competition among participants in a fair and transparent manner and allow the competition to increase acquisition price, and, ultimately, promote satisfaction of the creditors.

In light of global economic crisis brought about by insolvency of some global financial conglomerates, court policy above mentioned seems to be changing lately. Reorganization corporations cannot easily find the potential buyers who afford huge amount of fund to take over the target company, mainly because the financial market is inactive. Therefore, if a potential buyer expresses the receiver its sincerity to inject adequate fund to the reorganization company, and the receiver accepts the proposal, and if creditors' committee, which composes of major creditors secured and unsecured within 5 to 10 members, consents the M&A proposal, the court is likely willing to approve the M&A transaction. In this case, the reorganization case would be processed quickly based on the M&A transaction.

### 3. *Reorganization Procedures and M&A*

Since April 1<sup>st</sup>, 2006, the reorganization procedure has been carried into effect by the DRBL, which gives significant impact on the old M&A practice of corporate reorganization. The new reorganization practice based on DRBL presented significant procedural changes, including the introduction of a list of secured and/or unsecured creditors and shareholders, reformation of the debt investigation procedures, the adoption of business transfer prior to confirmation of plan and the creation of cross-border insolvency procedure. The most significant change, however, was the reformation in the “receivership system,” and the corresponding “reinforcement of functions and authorities of creditors’ committee.” Furthermore, the tendencies for early graduation of reorganization procedure significantly reshape the landscape of prospective M&A practices, and the impact of DRBL appears.

#### 1) *The Receivership System*

In previous reorganization practices, the courts held the authority to designate a third party as a receiver and used this authority in almost every case, and it designated the former executive as a receiver only in extremely rare and exceptional instances. In the very beginning of old practice since 1997, such practice may have been established on the social sentiment that the managers of insolvent companies must be called to account for their failures by being excluded from participating in management. The practice, with almost no exception, has designated a third party as a receiver, and placed the mark of “gross mismanagement” on the former executive because she supposedly caused the bankruptcy of the debtor company, which constituted the grounds for excluding her from managerial candidacy, considering the fact that the former executive will be reluctant in initiating an M&A transaction to protect her managerial authority, which clashes with an efficient rehabilitation of a reorganizing company. The former managing shareholders were also strictly excluded from corporate governance and management in the old practice, and their shares were retired via punitive share cancellation.

As a general rule, however, under the reorganization practice based on the DRBL it may be noted that the executive at the time of filing for reorganization is designated as the receiver of debtor company. A third party may

exceptionally be designated as the receiver only in cases where substantial abuses and gross mismanagement actions of the former executive, such as concealment and misappropriation of debtor's properties, and then caused the debtor bankrupt, and in a few other cases where a third party designated is deemed necessary for rehabilitation of the debtors. The purpose of such adoption is to induce the former executives to file reorganization petition as early as possible by preventing the debtors' immediate exclusion from corporate governance, operation of business and the resulting delay in such engagements. However, proceeding M&A transactions immediately after designating the former executive as receiver is contradictory to this purpose. The former executives would hesitate to file the petition of the commencement of reorganization procedure if M&A transaction should be initiated in all the cases, for it means when they come to court, shareholders who elected them as executives lose all their interest.

Therefore, in the new reorganization practice after DRBL, opportunities shall be granted to the former executives to perform business activities and plan for rehabilitation based on execution of reorganization plans drafted based on the earning powers of the debtor's company. An M&A transaction shall be a subsequent method in case such attempt results in failure.

## 2) *Early Closing of Reorganization Cases*

There had been instances in the old reorganization practice where reorganization cases had been closed prior to the passage of the ten-year period, but such instances were limited to the cases where a company's assets significantly outweighed its liabilities, significant parts of its reorganization debts have been paid, and in cases where an execution of reorganization plan was assured. An M&A transaction was the specific means to actualize an early closing of a reorganization cases. In a sense, it can be told that an early closing had been granted only in cases where a company was expected to pay off a significant parts of its debts, or to secure resources to pay off its remaining debt, or was foreseen to consistently secure such resources after completion of an M&A transaction.

The new reorganization practice positively considers closing the cases early immediately after the company started paying off its debt, assuming there are no hindrances to carrying out the confirmed reorganization plan. Such reformation of practice reflects the fact that there are institutional and

social discriminations for a debtor pending her reorganization procedure, which may impede her resuscitating efforts.

At this state, in case the business providing the financial resources for debt payoff is stable, the prospects for such business are not discouraging, and there are no particular circumstances to further doubt the company's ability to pay off its debt's. The companies shall be able to engage in closing its reorganization case early, even if significant parts of the company's debts have not been paid off, or even if the company's liabilities outweigh its assets. In extreme circumstances, a debtor company may be able to graduate early immediately after it has started paying off its debts according to the plan without initiating an M&A transaction, in case the debtor's business and its earning powers are stable. Reorganization procedure may be ended prior to the completion of a company's debt payoff, and that means an M&A transaction will not necessarily be implemented during the period when the reorganization case is pending in the court. Creditors may seek a maximization of credit satisfaction by setting the particulars in the plan regarding execution of an M&A transaction. In such cases, an M&A activity may be initiated under supervision of the court, or autonomously upon discussion between the creditor and the debtor after termination.

### *3) Reinforcing Functions and Authorities of Creditors' Committee*

In response to the adopting quasi-DIP receivership system, the DRBL has significantly reinforced and bestowed the authorities to supervise and control the former executives' business activities upon the creditors' committee. The creditors' committee has been bestowed with added authorities, such as the ability to state its opinions regarding designation of former executives, its right to make motion to dismiss the former executive from receivership, as well as its authority to examine the debtor and its business for reasons of unsatisfactory business results of the debtor.

Functions and authorities of the creditors' committee over M&A transactions have also been reinforced. Implementation of an M&A activity, designation of financial advisor and appraisal of corporate values, designating preferred bidder after submission of bidding letter, and negotiation and contracting of acquisition agreement are the authorities bestowed upon the receiver who, as the trustee of all the interested parties, shall carry out their business with impartiality. Furthermore, the receiver is under strong

supervision of the court in their business activities, and permitting involvement of another interested party thereby seems unnecessary. For these reasons, in the former corporate reorganization practice, the receiver and supervising court had not paid much attention to the creditors; it may be even said that they had a tendency to treat creditors as one of the hindrances to their M&A transaction.

The receiver-court oriented M&A provoked crucial criticism from the creditors for their lack of involvement despite their having the largest interests in the reorganization procedure. The DRBR has reflected such criticism to require the opinion of the creditors' committee in receiver's designation of the preferred bidders, the seller, or the legal entities to carry out due diligence upon the debtor's property and business (§ 49). The DRBR further requires notification of the results to the creditors' committee in case the committee presents its opinion to the court (§ 38), and, if such opinion is reasonable, it will be reflected in the execution of an M&A transaction; as the creditors' committee will require related information in forming an opinion on a proceeding M&A transaction, it is inevitable that the committee becomes involved in an M&A activity to a certain extent.

Therefore, M&A in the reorganization procedure will face more interested parties involved, and their conciliation process is bound to be much more complicated.

### **III. Types of Reorganization M&A Transaction**

The phrase "mergers and acquisitions" (abbreviated M&A) is a general term used to refer to various types of transactions to directly or indirectly obtain the control and/or management of a target company through the means of consolidation, takeover, or purchasing of voting shares.

There are mainly three (3) types of an M&A transactions used in Korean reorganization practice: (i) acquisition of new shares to assigned third party; (ii) business transfers; and (iii) asset transfers. Most deals take the form of (i), while the other two types are only partially used. In case a company owns a number of business parts with varying needs that may require more than one means of M&A transactions, a combination of the above types of transactions may be used, and if necessary for a smoother progression, procedures such as

corporate divestiture may be accompanied.<sup>6)</sup>

### *1. Acquisition of New Shares by Assigned Third Party*

#### *1) General*

As the most broadly used method of an M&A transaction for reorganizing companies, it allots and issues new shares of a reorganizing company to a third party through an increase of paid-in capital.

The objectives of an M&A transaction for a reorganizing company are basically to procure funds to pay off debt, and additionally to secure responsible managing entities;<sup>7)</sup> this method allows a third party, who has both the intention and the ability to manage a reorganizing company, to become the dominant shareholder by allotting and issuing her new shares. This procedure allows the company to depart from reorganization early by paying off its reorganization debt at once with the increased amount in the paid-in capital. This method has an advantage over a conventional M&A transaction in that it allows timely and economic changes to corporate governance structures, as it does not require undergoing special resolutions of general shareholders' meetings or creditor protection procedures in case of existing share write downs (§ 253, Para. 2 of the Corporate Reorganization Law, § 264 of DRBL, § 439, Para. 2 and § 232 of the Commercial Act), and as the shareholders will have no voting rights in the meeting of related parties in case the liabilities of a company outweighs its assets.

The prospective buyers may also become dominant shareholders by purchasing the reorganizing companies' shares in the stock market, or

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6) Hanbo Corp., facing difficulties to dispose its steel and construction businesses using one method, decided to dispose the steel business through business transfer, while divesting its construction business and disposing the business through allotting new shares to a third party, considering the fact that the records of construction will not be succeeded if construction business were to be disposed through business transfer. Hanbo Corp. then immediately terminated the reorganization procedures of the divested company.

7) As one of the designation standards of priority negotiators, it evaluates whether a managing entity has the intention and the ability to manage and develop an acquired reorganizing company. It is sometimes criticized, mostly from the prospective buyers, that it imposes excessive restrictions on the major assets. The main agreement requires the buyer to deposit 50% of the new shares she acquired to the Securities Depository, which is a means to secure a responsible controlling shareholder to manage the reorganizing company.

through individual contact with the shareholders of the company.<sup>8,9)</sup> However, such method of share acquisition is inappropriate as a means to carry out an M&A transaction of a company under reorganization procedures, as it merely changes the holder of the shares without improving the company's financial structures or pay off its debt.<sup>10)</sup>

## 2) How to inject for Paid-in Capital Increase (Chart 2)

The Chart 2 below depicts the methods a prospective buyer pays her loan in a diagram. In most instances of reorganization M&A transactions, the consortium member participates in increasing the paid-in capital by subscribing new shares in person and paying its advances to the reorganizing company, as demonstrated in Case 1. Case 2 below exhibits a simplified structure permitted in the Jinro case. The reasons for permitting such structures were to mitigate tax impositions on prospective buyers' investment methods, and to facilitate procurement of acquisition funds by adequately utilizing the fund procuring abilities of the intermediary companies. Case 2 was drawn under the assumption that the intermediary companies were

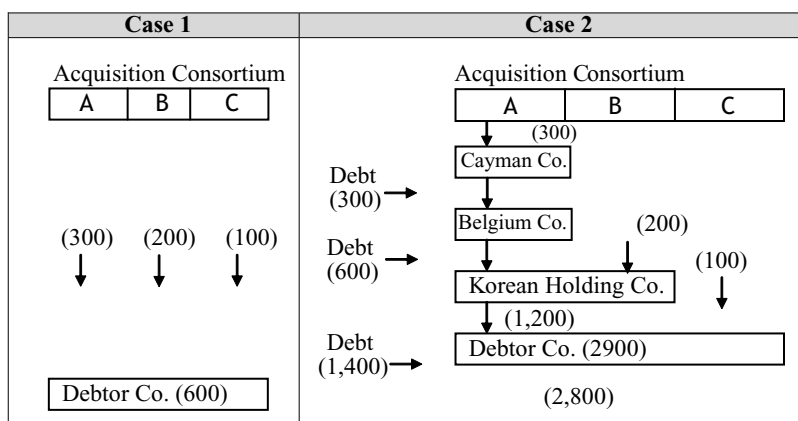
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8) Recently, there have been several large scale purchases of reorganizing companies whose assets outweigh their liabilities, retain significant amount of cash, or continue to be listed while maintaining solid earning powers. In the case of *Hankwang Corp.-Dongwon Development*, debtor-issued, non-listed shares were acquired in a similar fashion as above prior to the filing of reorganization petition with the DRBL. In this case, the arranged buyer was expected to additionally invest a fixed amount of operating capital.

9) In 2005, several potential buyers were involved in a stake competition in order to purchase the shares of the Korea Express, which was facing reorganization at the moment. Special considerations must be given when purchasing shares of a reorganizing company, since in M&A transactions of reorganizing companies, whose reorganizing plans are commonly subject to change, it is inevitable that the rights of shareholders are diminished unless the entire remaining debts are paid off.

10) A similar case may be that of *Ilhwa Corp.*, which terminated its reorganization procedures through the means of M&A. In this case, the head of the company expressed a view that prior to an M&A transaction, he would terminate the procedure early when some reorganization debts would be remaining after paying off parts of its reorganization debt by becoming a controlling shareholder by purchasing a great volume of reorganization bonds expected to be converted according to the reorganization plan, then converting parts of the bonds that he possesses, and acquiring new shares of the reorganizing company. In other words, the company was initiating an M&A transaction that accompanied conversion of investment through individual disposal, as a significant amount of the new capital investment was injected.





**Chart 2.**

capable of procuring an additional amount of funds equal to the amount of funds financed by the company at the higher end of the hierarchy. Comparing Case 2 to Case 1, the funds contributed by the consortium member is 600 as in Case 1, but as intermediary companies procure additional funds, it can be seen that the bid price has nearly multiplied fivefold, to 2900. In the Jinro case, a similar method to Case 2 was permitted, but it prevented an intervention of a mezzanine investor who might incur a change in the control of an intermediary company on condition that the company at the higher end will maintain entire control of the intermediary companies. Therefore, the only way intermediary companies could procure funds was by incurring liabilities.

*3) How to Acquire New Shares(Chart 3)*

The Chart 3 below demonstrates the simplified diagram of how a reorganizing company issues new shares. Most reorganizing M&A transactions utilize the structure where new shares are directly issued to prospective buyers, as in Case 1. In Case 2, as explained in the asset transfer method below, demonstrates a method where a reorganizing company establishes a new company, transfers its assets to her, and then issues the shares of the new company to the prospective buyers, in case a severance from existing debtor and creditor relationships concerning the public debt is required. The case of Daewoo Motors demonstrates a similar structure. Case 3 depicts the case where a reorganizing company with a number of business

parts divests parts of its business with potential buyers to establish a new legal entity and issues new shares of such new legal entity. This method may be appropriate when mergers and acquisitions of the entire business parts of the reorganizing company through third-party acquisition of new shares is difficult due to a resulting reduction in acquisition price, and when there are potential buyers for only some parts of the company's business, and when transferring these business parts prevents the buyer from taking advantage of the reorganizing company's business showings. The remaining parts of business will be subject to subsequent M&A activities, or liquidation.

The types illustrated in <Chart 2> and <Chart 3> may be combined as appropriately to the needs of reorganizing companies and structures of M&A activities.

#### *4) M&A Transactions Preceding Filing of petition for the Commencement of Reorganization Procedure*

##### *(1) New Forms of M&A Transaction Instituted into New Practice*

As mentioned earlier in II.1.③, an early institution of an M&A transaction may assist the rehabilitation and satisfaction of both the debtors and the creditors, respectively. Even if the debtor was forced to file for the petition of reorganization due to financial distress, if the company's basis for its business has not collapsed and it still maintains its earning powers, it shall be efficient to initiate an M&A transaction as early as possible. Also, in case such M&A transaction preceding the initiation of reorganization procedure is in control and progression of the debtor under an agreement with the major creditors, the agreement process must adequately reflect both the intention of the creditors and the required matters for rehabilitation under the debtor's discretion. Such M&A transaction shall, therefore, not differ from an M&A transaction proceeded by receiver under supervision of the court.

The new reorganization practice, therefore, takes into account and respect the results of an M&A transaction completed prior to the filing, and shall proceed with the company's reorganization procedure accordingly. However, close evaluation of going concern value and liquidation value and careful comparison of the two are necessary to successful reorganization process, because, when the liquidation value of debtor company is reported to exceed its going concern value after the commencement of the case, debtor company shall not be able to issue new shares.

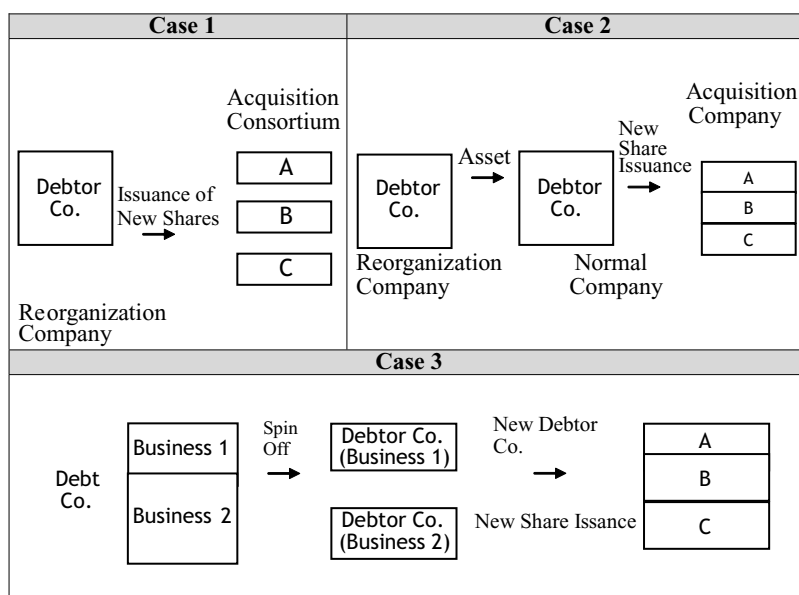


Chart 3.

(2) Factors to Consider in M&A Transaction Preceding Filing of Petition of Reorganization Procedure

In order for an M&A transaction preceded prior to filing of petition to be considered preferable as the ground of further going reorganization procedure, the M&A transaction is recommended to be conducted (i) under agreement of both debtor and creditor; and (ii) in a fair, transparent and reasonable way. If the transaction does not meet those requirements, court might request creditors' committee on the M&A transaction, and then potential buyers might be invited in public auction again by the receiver under the order of court and court could disregard the preceding M&A transaction.

Therefore, for such M&A activities to gain acknowledgement from the court, the debtors or the creditors must not pursue only for their own benefits without consulting the other interested parties. Further, in case of obtaining approval of the creditors' committee for an M&A transaction that designates a financial advisor, provides evaluation of the corporate values, and holds a competitive public tender, such procedures shall be approved as they stand. Particularly, fairness, transparency, and rationality of a transaction's

procedure are essential factors for securing adequate acquisition price through fair competition among prospective buyers, and they will be thoroughly examined.

If any doubt concerning the above factors arises, the debtor may be held for competitive public tender offer with better terms and conditions than what the preferred bidder of such M&A transaction has suggested, and if there are no prospective buyers with better conditions, the M&A transaction may be accepted under the consent of the creditors' committee and under the approval of court, even if doubts still exist concerning factors such as fairness and transparency (§ 7 of "Regulation regarding M&A Transactions in Reorganization Procedure" of Seoul Central District Court, Bankruptcy Division).

### (3) Non-Election of Receiver and Rapid Progress of Reorganization Procedure

① If an M&A transaction has been initiated prior to filing for the commencement of a reorganization procedure under an agreement between the debtor and the creditors, and for debtors that reached an agreement with the creditors concerning the main issues of a reorganization plan, the court may not choose to designate a receiver. Also, in case an M&A transaction predating reorganization case opening that regards the representative of the debtors as the receiver (§ 74 Para. 3 of DRBL and § 51, Para. 5 of DRBR) has been executed upon sufficient discussion among the debtors and the creditors, the court shall decide not to designate a receiver, but will allow the interested parties to autonomously elect a representative of the debtors (§ 74, Para. 4 of DRBL) and bestow various authorities of a receiver upon her.

② Upon approval of the creditors' committee, evaluation of the liquidation value and the going concern value<sup>11)</sup> of the debtor by the financial advisor of that transaction could be acknowledged after the commencement of reorganization procedure, unless special circumstances arise. In such cases the court shall not be required to elect examiner who conduct examination and report on the evaluation of liquidation value and going concern value (§ 9

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11) Going concern value refers to the value of a company when it continues to operate its business without liquidating and dissolving the properties. It is computed according to discounted cash flow method.

of “Regulation regarding ‘Selection and Compensation of an Examiner,’ Seoul Central District Court, Bankruptcy Division), which will reduce significant time required for such examinations.

#### (4) Early Closing of Reorganization Case

The reorganization procedure of the debtors that have established the foundations of rehabilitation through such M&A transactions may be terminated early upon approval and execution of their respective rehabilitation plans, so the reorganization case should be closed soon after those measures.

## 2. Business Transfer

### 1) *Transferring Business Upon Approval and Confirmation of Reorganization Plan*

The foregoing method transfers the entire business to a third party while maintaining the integrity of the organized whole, including the human and material organizations. In business transfers, organic materials including trading vessels, trade secrets and know-hows of a company, as well as its simple objects and obligatories, shall be subject to transfer, and the transferee shall obtain the position of a manager. Unless special circumstances arise, the transferee shall comprehensively succeed the labor relations of the company.

In case transferable operation parts (e.g., the profit-generating operation parts) and non-transferable operation parts (e.g., the operation parts that continually generate losses) coexist in a company, its acquisition price may be reduced if it chooses to assign new shares to a third party.<sup>12, 13)</sup> Similarly, when

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12) In case of *Haitai Confectionery & Foods Co. Ltd.*, the company has transferred the confectionery business, discontinued the operation of the construction business and changed its trade name, practically going through a liquidation procedure. Hanbo Co. Ltd. has transferred its steel business to the Yamato Industry, while going through splitting off construction business division, establishing a new company and transferring all its shares to Chinhung International Inc. The reorganization procedure of the divided company was soon terminated, and the operations of the surviving company have been discontinued.

13) An example of simultaneously transferring business and allotting new shares to third parties at the same time may be the case of *Jindo Co. Ltd.*, whose areas of business included (1) containers, (2) furs and clothing businesses, and (3) steel manufacturing business. It was understood in advance that prospective buyers offering significant acquisition prices had existed; however, there were concerns because the company possessed a number of non-

new shares are assigned to a third party when a company does not carry deficits brought forward, transferee may be imposed with significant burden as she may be incurred with large-scale income from cancellation of debt or additional tax burdens.

Business transfers through corporate reorganization procedure do not require a special resolutions of the general shareholders' meeting (§ 250, Para. 2 of the Company Reorganization Act, § 374, Para. 2 of the Commercial Act), nor it acknowledges the appraisal rights of the opposing shareholders (§ 250, Para. 2 of the Company Reorganization Act, § 374, Para. 2 of the Commercial Act); it is generally regarded as a more convenient method compared to normal business transfers process under the Commercial Act.

However, because a business transfer takes special succession procedures that individually transfers assets and liabilities to the transferee, the process has several drawbacks in that it can be more complicated in comparison to assigning new shares to third parties, and the time required for disposal of remaining assets prevents an immediate termination of the corporate reorganization procedures. In reorganization practice, business transfer method is used only when special circumstances arise as mentioned above. This type of transaction can be executed even though the liquidation value of debtor company exceeds its going concern value (§ 222 Para. 1 of DRBL).

## 2) *Transferring Business Prior to Confirmation of a Reorganization Plan*

### (1) Need for Business Transfers Prior to Confirmation of Plan

An ordinary corporation may transfer all or significant parts of its business through a special resolution of general shareholders' meeting (§ 374, Para. 1 of the Commercial Act), but in reorganization procedures, an action that may affect the foundations of a reorganizing company shall be allowed only within

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business related real estates that would hamper the company's efficiency, which might have resulted in a lower bidding price in comparison to a disposal through third party share allotment method. The M&A deal of *Jindo Co. Ltd.* had been initiated as a third party new share allotment method in principle, then simultaneously obtaining a bid proposal from each prospective buyer of each business part, as if these prospective buyers had had formed a consortium. It was expected that a higher price would be selected by comparing the highest price offered by the consortium, and the total amount of the maximum bidding prices of each business part. However, because effective bid packages were not submitted to all business parts, the M&A transaction had proceeded through the third party share allotment method.

the reorganization procedures (§ 52 of the Company Reorganization Act). A transfer of business within reorganization procedures requires an arrangement with a reorganization plan (§ 217 of the Company Reorganization Act, § 200 of DRBL), and whether a business transfer before confirmation of a reorganization plan should be allowed had been questioned and answered by the introduction of a new stipulation in the DRBL § 62. The DRBL has stipulated a clause for business transfers held before confirmation of reorganization plan, because companies were often unable to proceed with its reorganization procedures in a normal manner due to a dramatic degradation of its credit ratings, severance of business relations, and collapse of corporate organizations. If such impacts are significant, corporate value of the debtor may decline to the point where it falls short of its liquidation value; in such cases, transferring business before confirming of the plans may be more efficient than transferring in accordance with the plans, if better prices or conditions are available.

## (2) Requisites for Business Transfers Before Confirmation

① In order to transfer business before confirmation of reorganization plans, transfer of all or significant parts of business must be necessary for rehabilitation of the debtor. Being necessary for rehabilitation of the debtor indicates the cases where an early transfer of business is required in order to prevent the damage to the company's credit and resulting aggravation of business from its request of a reorganization procedure, and the decline of its conversion value. Therefore, when transferring business before confirmation of the plan, it is usually the case that transferee candidates already exist or are designated before or after its filing.<sup>14)</sup>

The DRBL stipulates that business may be transferred before confirmation of the reorganization plan being granted "in case all or significant parts of business are being transferred (§ 62, Para. 1)," but questions may arise

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14) In the *Hyundai LCD* case in 2006, a corporate restructuring proposal had been derived during the workout procedure, which failed to be executed by the opposition of several creditors. The company filed for the petition of commencement of the reorganization procedure, which aimed to complete the business transfer that had proceeded prior to the filing before confirmation of the reorganization procedure, but, finally, completed the transfer through reorganization plan.

whether the receiver has the ability to transfer parts of the business by exercising her rights to dispose properties when the parts being transferred are insignificant. As the DRBL stipulates that the receiver depends solely on the reorganization plan when transferring all or parts of the business or properties (§ 200 Para. 1, Subpara. 1), transferring business merely by an approval of the court does not seem to be permitted, in principle. However, if continuation of the concerned business is not a significant part of the debtor's business as a whole, and if such continuation continually incurs losses, transferring business without confirmation of the plan may be granted under approval of the court.<sup>15)</sup>

② Transfer of business in accordance with the § 62 of the DRBL may be granted until the confirmation of the plan, after the reorganization procedure has been commenced. Another question may arise whether, at the stage of just issuing the preservatory administration order before the procedure is not commenced, all or significant parts of business can be transferred. However, as such transfer surpasses the purposes of preservatory administration order, it shall not be allowed.

### 3. Procedures

① The court, when granting approval for business transfers prior to confirmation of reorganization plans, must hear the opinions of the management committee, the creditors' committee, and the labor union, constituted by the majority of the laborers of the debtor. If a company does not have a labor union, the court must hear the opinion of a representative who acts on behalf of the majority of the laborers of the debtor (§ 62, Para. 2 of DRBL). Such procedure is required of the court prior to its approval of a business transfer, since transferring business shall have a consequential impact on both the business of the debtor and the interests of the

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15) Under the Corporate Reorganization Law, the food business of Kolon T&S, whose main businesses comprised of the express bus transportation business and the tourism business, continually incurred losses prior to the commencement of its reorganization procedures, and it was deemed beneficial to dispose it prior to confirmation of the company's reorganization plan. Therefore, the Seoul District Central Court allowed Kolon T&S to transfer its food business to a third party before its corporate reorganization plan was confirmed.



reorganization creditors (secured<sup>16)</sup> or unsecured) and the shareholders.

② In case of a corporation whose liabilities outweighs its assets before the confirmation of a reorganization plan, the court may substitute a resolution of the general shareholders' meeting (§ 374, Para. 1 of the Commercial Act) with a decision according to the request of the receiver (§ 62, Para. 4 of DRBL), and in such cases, it may avoid undergoing the shareholder protection procedures (§ 374, Para. 2 of the Commercial Act, Art. 191 of the Securities and Exchange Act).

In case the court renders a decision that substitutes a resolution of the general shareholders' meeting, the court shall deliver the decision to the receiver, and a summarizing document of the decision to the shareholder. The decision shall take effect upon its delivery to the receiver (§ 62, Para. 1, Para. 2, Para. 3 of DRBL). The shareholder may immediately appeal the decision that substituted the resolution of the general shareholders' meeting (§ 63, Para. 3 of DRBL), and such immediate appeal may suspend the execution of the decision (§ 13, Para. 3 of DRBL).

#### *4. Approval of the Court*

① Upon granting the foregoing approval, the court shall often consider whether: (i) the designation method of the transferee candidates are reasonable; (ii) there are any unreasonable conditions attached to the bidding conditions that may lower the bidding price; and (iii) the designation procedure of the transferee candidates proceeded in a fair manner.

② When the court grants approval of a business transfer, it must devise a method of using the income generated from the transfer (§ 62, Para. 3). However, since there are various interested parties involved in a reorganization procedure, including public creditors, secured and unsecured reorganization creditors and shareholders, it is not an easy task for the court to rationally conciliate the entangled interests of the interested parties and

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16) For DRBL has no provision similar to § 363(f) of the U.S. Bankruptcy Code, any lien on the assets to be transferred shall not be cleared in Korean Reorganization Case. However, the secured creditors, who have the secured interest as of commencement of the case, shall not collect or enforce their interest unless the confirmed reorganization plan allows. In this sense, secured interest remains influenced notwithstanding the completion of the transfer.

unilaterally fix upon a method to use the income from the transfer when disposing the main assets of the debtors through business transfer. Therefore, in promoting business transfers prior to confirmation of reorganization plan, it is desirable for the debtors to agree upon the main contents of a reorganization plan ex ante, including the methods to use the income from the transfer among the major reorganization creditors secured and unsecured[in case such agreements had been made, reorganization procedure may be proceeded without designation of a receiver (§ 51, Para. 5 of DRBL), and the reorganization procedure may be closed early immediately after confirmation of the plan, after the reorganization debts have been paid off].

③ As there are no stipulations allowing immediate appeals to the court's decision to grant approvals to business transfers prior to confirmation, an appeal against the approval of court for business transfer itself shall not be allowed (§ 13, Para. 1 of DRBL).

#### **IV. Outline of an M&A Procedure**

Although the procedure of an M&A transaction of a reorganizing company may differ case by case, it generally follows the following step-by-step process. It shall take a minimum of six (6) months until the closing of the corporate reorganization procedures.

- ① Decision of M&A Initiation
- ② Designation of M&A Financial/Legal advisor
- ③ Internal Due Diligence of M&A Financial/Legal advisor and Devising a Strategy for M&A
- ④ Public Announcement of M&A
- ⑤ Receipt of Letter of Intent
- ⑥ Setting Designation Standards of Preferred bidders
- ⑦ Receipt of Proposal
- ⑧ Designation and Notification of Preferred bidders
- ⑨ Signing Memorandum of Understanding (MOU)
- ⑩ Detailed Due Diligence by Preferred bidder and Arrangement of Acquisition Price
- ⑪ Signing of Main Agreement
- ⑫ Succeeding Procedures: Devising Amendment Proposal for

Reorganization Plan → Meeting of Interested Parties → Confirmation of Change Proposal for Reorganization Plan → (Dispatching of Acquisition Planning Committee, Change Officers) → Execution of Procedures including Capital Reduction, Paid-in Capital Increase, and Underwriting of Corporate Obligations → Payoff of Reorganization Debt, Entrusting Registration Cancellation of Reorganization Securities → (Dispatching of Acquisition Planning Committee, Reformation of Board Members) → closing of Corporate Reorganization Procedures

### *1. Decision of M&A Initiation*

① The person to initiate M&A transaction of a reorganizing company is the receiver. The receiver is only entitled to manage, maintain and dispose the business operation and the assets of a reorganization company (§ 53 of the Company Reorganization Act), and is responsible for resuscitation of the reorganization company as the trustee of the interested parties, including the creditors, shareholders and the debtor company itself. Although an M&A activity of a reorganization company is under authority of the receiver, the receiver may not arbitrarily handle M&A related affairs, as the receiver requires an approval of a reorganization court in every step from initiation to termination of an M&A transaction.

① One of the most difficult matters for the court that supervises M&A transactions of receivers or reorganization companies is determining the point of time when the transaction could be initiated. One of the realistic restrictions to be considered when determining the time of an M&A initiation is the side effects of an M&A failure. A reorganization company, although it has established a foothold for rehabilitation after the confirmation of reorganization plan, is, in reality, in an unstable state where its rehabilitation is still uncertain, and because it has already gone through bankruptcy with a market failure experience, if its M&A transaction were to fail, negative images of market failure and organizational collapse may form. In some cases, the damage may be as serious as to threaten the corporate existence, and it is required of the receivers or the courts to give careful consideration to the chances of success of a M&A transaction in determining the timing of its initiation. Therefore, the receiver must thoroughly examine factors such as the present conditions of the relevant industries, tendencies of the potential

buyers, and whether any businesses of the same kind are out for sale when making the decision to determine the timing of M&A. There are some receivers who hurry to initiate M&A transaction without prudently determining its timing, but there may be cases where concentrating on enhancing corporate values prior to initiating an M&A transaction may be desirable.<sup>17)</sup>

All the reorganization plans proposed by receiver lately contain early M&A provisions, and a few instances are found that the time limits for M&A transactions are prearranged in the plans.<sup>18)</sup> M&A transactions will be initiated as prearranged in such reorganization plans as circumstances allow, however, it goes without saying that the possibilities of success of the M&A transactions should be given close examination in advance.

In case of a company yet to obtain confirmation of reorganization plans, an M&A transaction may actively be initiated and a reorganization plan that reflects these findings may be proposed,<sup>19)</sup> but upon reflection of personal

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17) Thrunet Co. Ltd., ruminating upon its past M&A failure when the prospective buyers submitted a bid proposal that were lower than the disposal price, has been assiduous in inducing subscribers to recover its market shares prior to re-initiating its M&A transaction. As a result, the bid was delivered at a much higher price than the disposal price. Haitai Stores Co. Ltd. also initiated its first M&A transaction in 2002, only to fail due to the economic decline and because there was not a company that submitted a bidding proposal that exceeded the minimum price required for the company to pay of its debt (the liquidation value). The company pursued an M&A transaction again by improving the company's earning powers by disposing unprofitable stores and through cost reduction, and by perceiving any changes in the market trends, which ultimately resulted in successfully paying off the company's debt and closing the reorganization procedures.

18) According to the reorganization plan of Kolon T&S, the receiver must file for the petition of nullification of the reorganization procedure if an M&A transaction remains uncompleted at the end of December, 2004. The reorganization plan of Jinro Co. Ltd. specifies that it shall initiate an M&A transaction so that it may be completed within a year of the confirmation of the reorganization plan. However, in case it is determined that an extension of the terms of the M&A transaction is necessary, an extension shall be granted under approval of the relevant courts up to a date not exceeding November 30, 2005.

19) In t case of *MPManDotCom Co. Ltd.*, the examiner found the company was economically feasible as its going concern value exceeded its liquidation value. However, the going concern value was largely deficient in comparison to the size of the company's reorganization debt. Furthermore, an early M&A transaction was pursued under discretion that an acquisition will take place at a price greater than the going concern value; the bid occurred at a price exceeding the going concern value of the company, and the company was approved of its reorganization plans within 11 months since the date of commencement. The company then paid off its

hands-on experience, early M&A initiation efforts before obtaining confirmation of reorganization plans were rarely successful.

The reasons of which may be following: (i) it is difficult to completely rule out the possibilities of contingent liabilities or unrecorded liabilities arising, because those liabilities have not lost their obligatory effects for the reason of failure to record prior to obtaining confirmation of reorganization plans, (ii) it may be difficult to find a buyer who suggests an acquisition fee large enough to obtain agreements of reorganization creditors, because the company's corporate organizations are not adequately maintained prior to obtaining confirmation of reorganization plans, thus making the company unattractive to the buyers,<sup>20)</sup> (iii) there remains uncertain whether evaluated amount of going concern value of the debtor company exceeds that of liquidation value, which is absolutely the precondition for the reorganization plan to be submitted, for this uncertainty keeps potential buyers away from affirmative consideration to take over the debtor company.<sup>21)</sup>

## *2. Designation of M&A Financial /Legal Advisor*

An M&A financial/Legal advisor (shall be referred as "financial advisor" hereafter) refers to a company that provides consulting and services relating to a series of business activities concerning M&A procedures to the receiver, the subjects of an M&A initiation. In practice, it is a general rule to designate a financial advisor through competitive public tender in order to secure expertise and fairness throughout the entire process of an M&A transaction. In order to further enhance fairness of the designation process, the receiver, after consultation with the court before receiving service proposals, has set detailed standards for designation of financial advisor that consider relevant factors,

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reorganization debt entirely through the price of paid-in capital increase paid by the buyers, and terminated its corporate reorganization procedure.

20) In 2006, instances have been located where a company will pay off the unrecorded and contingent liabilities through confirmation of its reorganization plan, and where M&A transactions are pursued prior to the filing of the petition of the commencement of the reorganization procedure (e.g. Donga Construction in straight bankruptcy procedure and Hyundai LCD).

21) This means M&A transaction initiated prior to the reorganization filing must be processed after conducting proper estimation of those two evaluations.

including the results of execution and consultation of M&A transactions, accomplishments, soundness of the service proposal, competence and experience of the participating personnel, whether or not a prospective buyer had been obtained, extent of knowledge on reorganization company, reorganization procedures and M&A activities, and the ability to propel the transaction. In most M&A transactions of reorganization companies, buyers require debt restructuring or capital reduction of existing shares; therefore, interest conciliation and negotiation abilities are also important factors to consider in designating a financial advisor.

Accordingly, the receiver will deliver service proposals to prospective financial advisor candidates and judge in consonance with the above standards upon submission of the proposals. All candidates will go through the file screening procedures, and selected companies will go through another presentation screening procedures. After these processes, the service proposer with the highest scores will be chosen as the financial advisor, after negotiating the terms and conditions of service agreements, including its fees<sup>22)</sup> and durations,<sup>23)</sup> and, finally, obtaining the approval from the court.

In general, financial advisors are selected among accounting firms, credit rating agencies, M&A divisions of banks or financial institutions, or corporate restructuring companies (CRCs). A financial advisor will proceed with the receiver a series of procedures, including evaluations of corporate value, devising strategies for M&A transactions, devising information memoranda (IM), inducing buyers, acceptance and evaluations of letters of intents (LOIs), forming debt restructuring proposals, and persuasion of creditors. In practice,

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22) The fee amount will not be included in the standards for selecting buyers. Instead, proposals of the service proposers will be evaluated in accordance with the buyer designation standards, and afterward, the manager will negotiate with the senior service proposer regarding the specific amount of the service fees. The service fees (the deposit and the contingent fees) are flexibly applied within the range of 30% above or below the standard price stipulated as the incoming funds [the entire price of paid-in capital increase and 1/2 of the underwriting prices of bonds (including convertible bonds)] in the "Regulation regarding M&A Transactions in Reorganization Procedures." The fees are subjected to change if negotiated otherwise between the manager and the buyer.

23) For a rapid progress of an M&A procedure, the service period will be six (6) months. Even if the service period expires, it is normal to extend the period in case an M&A transaction has not been completed.

there are many cases where accounting firms are independently selected as financial advisor,<sup>24)</sup> but, in recent M&A transactions of large reorganization companies, accounting firms and CRCs (or M&A divisions of banks or financial institutions) may form a consortium or may be designated as co-financial advisor, and there are instances where an investment bank was designated as a financial advisor, as well.<sup>25)</sup>

In addition, a manager may designate a financial advisor that only takes charge of duties such as planning and devising strategies for an M&A transaction and inducing buyers, and then separately designate accounting advisors that evaluate corporate value and legal advisors that advise on relevant legal matters under prior consent. In such cases, there are instances where the service fees of accounting and legal advisors are paid by the reorganization company, separate to the fees paid to the M&A financial advisor,<sup>26)</sup> and other instances where the advisor fees are paid from the service fees of the M&A financial advisor.<sup>27)</sup>

### 3. Internal Due Diligence of M&A Financial Advisor and Devising a Strategy for Disposal

① The financial advisor will carry out, either by herself or through an accounting firm, due diligence on the assets and liabilities of the reorganization company, and compute liquidation values<sup>28)</sup> and going concern values based on the information offered by and obtained from the receiver. Computation of liquidation value holds special meaning in that an

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24) In general, accounting firms exhibit extensive proficiencies and reliability in keeping accounting data and various management analyses, while their level of M&A-related know-hows or abilities to persuade creditors are somewhat mediocre. On the other hand, corporate restructuring companies have significant M&A-related know-hows, but are rather little known for their reliabilities.

25) In the case of *Thrunet Co. Ltd.*, an accounting firm, the Korea Development Bank, and a law firm have been designated as co-advisors; in the case of *Ilshin Stone Co. Ltd.*, an accounting firm, a corporate restructuring company, and a law firm have been designated as co-advisors in proceeding respective M&A transactions.

26) *Jinro Co. Ltd* case.

27) *Haitai Stores Co. Ltd* case.

28) The likely total price at the disposal of individual properties of a company when it dissolves or ceases to exist through liquidation.

M&A transaction shall not be initiated at an amount lower than the liquidation value, since it is the minimum amount guaranteed to the creditors in the amended reorganization plan that is devised upon success of an M&A transaction. The going concern value does not have a special bearing to the M&A transaction itself, but it is used as an important reference when forecasting the acquisition price of an M&A transaction, which is required for planning and devising disposal strategies of an M&A transaction.

② After such valuations, the financial advisor formulates plans and strategies of the M&A transaction, upon consulting with the receiver. At this stage, it tentatively decides the expected prices of disposal. The expected price of a disposal<sup>29)</sup> shall be determined between liquidation value and going concern value, and it assists in planning and setting strategies for an M&A transaction by estimating the possibilities of an agreement among the creditors in advance, and roughly predicting the amended reorganization plan. When examining disposal plans, a financial advisor will seek for a scheme that will both secure resources for debt payoff, and plan for rehabilitation of the company. At this point, the type of M&A transaction to be pursued will be decided among the below mentioned types: acquisition and allotment of new shares to a third party; business transfer; and asset disposal. In order to achieve the goal of company's existence and rehabilitation, allotting new shares to a third party seems to have an edge, but insisting only on this purpose may damage the interest relations of the creditors; when choosing the types of transactions, careful consideration to both of the above objectives must be given.

Recently, however, there have been numerous cases where M&A transactions of reorganization companies are held in intense competition

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29) The going concern value estimates a company's prospective flow of earnings, converting it into the present value; it may indicate an upper bound of the corporate values of a reorganizing company. In order to minimize investment losses, prospective buyers submit acquisition proposals upon evaluation of the corporate values of a reorganizing company through experts and professionals based on collectible information, such as the results of due diligence; thus, the proposed price of acquisition is almost always between the liquidation value and the going concern value. However, in cases when the competition among prospective buyers is intense, or when a prospective buyer places high value on the post-merger synergy, it is not uncommon for a prospective buyer to propose an acquisition price higher than the going concern value.



among a number of prospective buyers, and as a result, there frequently are instances where the price of acquisition actually suggested by a buyer greatly exceed the amount predicted in advance by the financial advisor. Accordingly, upon comparison of acquisition price of the third party assignment method and the business transfer method, the latter was predicted to have a greater ability to pay off debt to the creditors; however, such facts should not lead to the abandonment of the third party assignment method. Since the outbreak of economic crisis arising from Lehman Brothers Insolvency in September, 2008, Korean M&A market is still going downward, and the method above still works to attract potential buyers to M&A transaction.

In determining the expected price of disposal, there is no established method for determining priority claims; these claims are not paid off from the price of acquisition but are succeeded into the company. Therefore, the expected price of disposal may be determined based on the balances after priority claims have been deducted from the liquidation values and the going concern values, respectively. Also, there are cases where going concern values do not take priority claims into account in its computation, because these claims can be satisfied through operating profits, and will not affect the acquisition price as a matter already reflected in valuation of the going concern value.

Apart from this, it is normal to separately fix the amount of minimum bidding price to be applied when evaluating acquisition proposals at the time when the standards for preferred bidders are being decided. The minimum bidding price will be fixed upon consideration of factors such as the level of competition among the bidders, and it will be established somewhere between the liquidation value and the going concern value of the company. In case a reorganization company holds strong earning powers that may be exercisable in the M&A market and competition is intense, the minimum bidding price shall be fixed near the going concern value, whereas in case of dealing with companies that may require nullification of the reorganization procedures upon failure of the M&A transaction, the minimum bidding price will be determined near the company's liquidation value.<sup>30)</sup>

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30) If a proposed acquisition price falls short of the liquidation value, not only it is

There sometimes have been instances where companies fix upon the minimum bidding price, and determine invalidation of the relevant bid upon observing the submission status of the bid.

The liquidation value, going concern value and the minimum bidding price are withheld from public announcement, as their announcement may hinder the formation of a fair market price through competition, and because it may be possible that an unattractive company's acquisition price may plummet to its liquidation value.

③ The receiver and the financial advisor must formulate a detailed plan on how they will carry out their M&A transactions, search for potential buyers, and prepare necessary documents (invitation for bid, a draft of MOU, preferred bidder designation standards, company profile, etc). In formulating plans and strategies of an M&A transaction, they must give consideration to a number of factors, including

- ① the strengths and weaknesses of the company,
- ② the tendencies of the potential buyers,
- ③ analysis of creditor relationships, corporate governance and the tendencies of creditors, sometimes including shareholders, and
- ④ the tendencies of other interested parties.

Next, a number of other matters commonly examined in the usual M&A transactions through the third party new share assignment method shall be explained:

(i) One of the most important factors in planning and devising strategies for an M&A activity is setting the extents of the proportion of the increase in paid-in capital. From the perspectives of rehabilitation, it may be ideal to furnish the entire acquisition price for paid-in capital increase; however, the buyers are bound to prefer underwriting of corporate bonds or convertible bonds (CBs), where retrieval of investment is easier than the paid-in capital increase. If proportion of paid-in capital is set too high, then the uncertainty of investment retrieval likely increases, which might become a primary factor for

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impossible to confirm an amended reorganization plan based on such price, but annulling the corporate reorganization procedures conforms with the benefits of the related persons, including the creditors. Therefore, it will be difficult to proceed with an M&A procedure under such circumstances.

a drop in the acquisition price. On the other hand, in case the proportion of corporate bonds is exceedingly large in comparison to an increase in paid-in capital, it will only amount to paying off the reorganization debt with the fund out of the priority claims, which will not only improve the financial structures of the reorganization company but help it to rehabilitate. Therefore, determining the extent of the proportion of the increase in paid-in capital is a significant factor, and must be thoroughly examined.<sup>31)</sup>

Furthermore, the method for coping with cases of former company had stipulated that “the total assets of a company comfortably exceed its total liabilities” at closing of reorganization procedures, and it has been considered as one of the most important factors when determining closing in practice as well; in none of the cases where reorganization procedures were closed, the total liabilities of a company had not outweighed its total assets. Since a M&A transaction of a reorganizing company is carried out on the premise of its early closing, the structures of the amount of paid-in capital increase and acquisition price for company bonds must not interfere with the closing of reorganization procedures. Thus, by closely examining the determination of a company’s proportion for an increase in the paid-in capital and the size of corporate bonds that have a crucial impact on the remaining liabilities after an M&A transaction, careful consideration was given to whether a reorganization of the company’s assets exceeded its liabilities after it had cleared off its reorganization debts with the acquisition price at termination.

Under the assumption that the reorganization case may be closed even if the total assets of a company falls short of its total liabilities and if the company is generating sufficient ordinary income to manage its liabilities, and expected to do so in the future, it has been determined to accept an increase in the paid-in capital that may not be able to secure the assets of a company that outweighs its liabilities. It goes without saying, however, that there will be a certain lower limit on the proportion of the increase in paid-in capital, because

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31) During an M&A transaction, it is required to increase a certain amount of paid-in capital, but it is of a separate issue whether such requirement will be maintained after closing of a reorganization procedure. From the records of the Seoul Central District Court, one often encounters cases where companies increase a significant amount of paid-in capital during their M&A transactions, only to engage in paid capital reduction not long after termination of the reorganization procedures.

the company still must be able to deal with the liabilities expected to remain after its post-M&A earnings.

Depending on the company, the size of the company's debt settlements may be larger than its assets. In such case, to consider the above-stated point, company bonds of acquisition price may be limited to a specific amount.

From such a perspective, in case the portion of paid-in capital increase of the total undisclosed bids is below a specific level,<sup>32)</sup> in practice, the bidding is usually to be invalid. The higher such portion the more likely the candidate will be chosen as the preferred bidder. However, provided that a failure in achieving M&A due to a failure to meet the repayment under the reorganization plan and if the procedure for the reorganization needs to be discontinued, then the portion of paid-in capital increase shall not need to be earmarked high.<sup>33)</sup>

A review shall also be necessary to determine between issuance of shares at a premium or at par value in case of such paid-in capital increase.<sup>34)</sup>

In most reorganization cases, par issue is commonly in practice, as liabilities usually exceed assets. However, in case the share price of the listed company undergoing its reorganization is above the par value and the company's financial structure and business showings are satisfactory, the par issue shall result in benefitting the buyer, which is the reason why the issuance of shares at a premium is more advisable. Also, because the net property exceeding the par value will be inflowing by means of the issuance of shares at a premium, the financial structure will become sound. And, the issuance of shares at a premium will be called for, for the sake of maintaining a balance with the value of the shares owned by the existing shareholders.<sup>35)</sup> However, because it remains challenging to determine the proper price of the

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32) It usually is set forth at either 40% or 50%. However, the minimum level necessary for company to maintain net assets exceeding condition at the time of closing will be the standard.

33) In case of *Hanshin Engineering Construction*, the proportion of the paid-in capital increase out of the acquisition price was 38.8%, in case of New Core it was 32%, in case of Sammi Corporation it was 38.3% and in case of Chunji, it was 40.3%.

34) As for discount issuance below the face value, as the matter of principle of capital adequacy standard, it is not permitted (§ 330, Commercial Law) and there are rarely cases where it is in done in practice. See CHUL-SONG LEE, *CORPORATE LAW LECTURE* 681 (12<sup>th</sup> ed. Pakyoung-sa, 2005).

35) *Id.* at 682.

issuance of shares at a premium and risks may increase for investment following the rise of uncertainties of the shares after the acquisition, cautious reviews shall be necessary on deciding whether to issue shares at a premium and how much the price should be for the issuance.

(ii) Secondly, it is appropriate to discuss the issue with regard to the number of new shares to be issued to the buyers or shareholdings enough to secure their stakes. If the M&A of the company under reorganization is deemed for sale and purchase of control or management rights of the company, the number of new shares or the ownership of shares subject to such sale and purchase shall be significant in direct relation to the price of the transaction. The buyer shall be able to more accurately assess the value of control or management right to be bought, if he or she can predict the number of shares or shareholdings he or she will own after the M&A. Plus, as the profits made from the investment will also be projected with greater accuracy, he or she will be able to propose the appropriate bidding price. Meanwhile, the company facing reorganization will be able to secure undisclosed bids equivalent to the objective value by removing uncertainties with regard to shareholdings after the purchase. Disputes will be avoided over by securing shareholdings with the buyer when the M&A are in process in the future. However, in practice, the quantity of shares subject to sale and purchase is rarely clarified during the bidding stage as well as the stage of entering into an investment contract. Shareholdings of buyers, upon drawing up the amendment of the reorganization plan, are usually above 90% of the shares after the M&A. However, it may also hover at around 70~80%.

Shareholding of buyer depends on the degree of alteration of rights of the existing shareholders after the M&A. Because the alteration of rights of the existing shareholders may change, depending on alteration of security and reorganization claim/credit rights and the extent of such alteration, it will not be easy to confirm this in advance. However, close analysis on the structure of remaining shares and reorganization claim/credit rights will help to predict the degree of such alteration of rights. Thus, it will not be impossible at all to specify in advance the minimum shareholdings to be obtained by the buyer. However, although the shareholdings subject to sales and purchase are specified in advance, such shareholdings forecast in advance may differ from the real shareholdings of the buyer after the completion of M&A. Since it will be reasonable to presume that the bidding price proposed by the buyer

reflects the quantity of the shares subject to sale and purchase, in case such shareholdings differ from the real figure, it can be conciliated by means of adjusting the bidding price.<sup>36)</sup>

(iii) Review on legal restrictions and coming up with solutions, such as receiving an authorization from the administrative agency, is necessary for M&A. In recent cases, amid administrative law issues such as authorizations in accordance with relevant laws and regulations emerging as significant concerns, receivers are emphasizing that candidate buyer should solve such issues under their responsibilities and authorities by reviewing such issues in advance.

Examples that can be found in practice recently include business consolidation reporting policy and restrictive measures that are regulated by laws and regulations related to monopoly regulation and fair trade.

First of all, to scrutinize aspects that are in relations to business consolidation reporting policy, anyone who purchases shares of a company facing reorganization whose sales revenue or assets exceed 100 billion won shall not practically limit competition in the specific field. Anyone who has acquired shares of such company facing reorganization shall file for business consolidation report afterwards (§ 7 of Monopoly Regulation and Fair Trade Act). In case the fair trade commission deems that such person is practically restricting such competition, it may order strong corrective measures such as disposition of part of the whole of shares obtained (§ 16 of Monopoly Regulation and Fair Trade Act). Under such restrictive order, 'securing management with sense of responsibilities' may not be achieved, which is the principal purpose of M&A. However, the aforementioned business consolidation report is to be in progress in the aftermath of acquiring shares. On the other hand, as per reorganization procedures, shortly after the amendment plan of reorganization plan touching on M&A is adopted and authorized, it would enter the stages of a capital decrease of initial shares,

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36) As for Jinro, after M&A by buyer, minimum shareholdings were specified at 99% and as thereby object goods were stipulated in advance and capital reduction and debt-equity conversion were attempted later, the result showed that in case the ultimate shareholdings of the buyer exceeded it, additional payment of acquisition price followed suit in proportion thereto and exceeded the shareholdings guaranteed in advance indeed upon issuance of new shares, leading to payment of additional acquisition price.

issuance of new shares and company bonds and repayment of reorganization debt by engaging in an amendment plan, a reason why there is a need to, in advance solve the related problems before the issuance of new shares. In case business consolidation report becomes a problem in the process of M&A of reorganized company due to such problems, it is usually solved by utilizing the system of preliminary review request and thereby having the fair trade commission evaluate it before the issuance of new shares.<sup>37)</sup> Obviously, it is plausible for receivers to in advance review whether a takeover of control of reorganized company by candidates to participate in the bidding violates restrictive measures of the fair trade laws and regulations. However, in relation to this controversial issue, subject matters such as the definition of the “Relevant Market” may become a problem with regard to projects managed and developed by the participating candidates and reorganized company. However, while the definition of market will require close analysis on the details of the business of not only reorganized company but the participants of the bidding, the receivers will encounter with difficulties for acquiring such information in advance, and, even though the receivers in advance review on this issue, the result of the review may be different from the conclusion of the fair trade commission which is in charge of this subject matter. Thus, it is considered as the responsibility of the bidder to solve this issue.

(iv) There are measures taken for the purpose of fairness and maintaining bidding competition. The reason why company reorganization M&A is implemented under the open competition bidding scheme is that it is reasonable to presume that the bidding price conciliated by the market competition best reflects the value of the company. To this end, any activities of collusive tender resulting in lowering the competition will prevent securing fair bidding price.

Commonly in practice, in case of such collusive tender, measures are taken including cancelling the proposal submitted by the buyer, geared toward inducing competition among candidates.

However, for most cases, the candidates appoint financial, accounting or legal advisors at the time of participation in company reorganization M&A.

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<sup>37)</sup> Cases business consolidation report mounted as issues include Korea Thrunet, Jinro, Haitai Store, Anam Construction and Korea Express all of which solved the issue by means of system of preliminary review request.

Concerns occasionally mount that competition might be limited due to sharing of information among the personnel in charge of each participating companies, as the number of such advisors available to the candidates is limited and thus same advisor ends up providing services for the participants simultaneously. In the case of 'Jinro', such concern had been already brought to attention before the announcement of M&A, and the participants had their advisors sign a certificate that they will ensure to take measures against such conflict of interests including building the 'Chinese Wall' under their responsibilities, and in the event of breaches of such promise their candidacy will be cancelled and their undisclosed bids will be taken away. Effectiveness was up to par by taking such indirect measure.

Next, in the event that the reorganized company has received advices from accounting or legal advisors prior to M&A on matters such as restructuring and the advisors know crucial insider information that cannot be released outside, the other candidates might experience unfair competition due to lack of balance as to the information among the candidates when providing M&A consulting to some specific companies. Thus, sometimes, such advisors may face restrictions from providing M&A services.

#### *4. M&A Public Announcement*

Once the structure and strategy of M&A is determined, receivers make a public announcement on the M&A through public media such as daily news papers and company websites, by deciding on the period, the place and the documents for submission of letter of intent for acquisition and the schedule of the work after receiving a court permit. At this stage, the M&A process starts in full scale. Receivers and financial advisors begin engaging in marketing work by distributing 'teaser' (including company profile, information on value of investment and working schedule) to potential investors.

#### *5. Registration of Letter of Intent*

Not legally binding, a letter of intent is generally subject to amendments or changes during the M&A process and without price of acquisition. At this stage, confidential agreements are submitted from companies with a letter of



intent. In common practice, submission of letter of intent and qualifications for participating in the bidding are not linked to each other, because not submitting a letter of intent will not cause any trouble for submitting the proposal. However, in case the number of companies submitting the letter of intent is beyond reasonable expectations or disqualified companies make the submission that are not convincingly willing to make acquisitions or have questionable capabilities to make such acquisitions, previously set forth conditions may be adopted and applied to evaluate the companies to exclude some of them and select qualifying candidates for granting approvals for taking part in due diligence and bidding process. In the event that policy has been made for excluding such companies, usually notifications will be issued at the time of public announcement of M&A.

Afterwards, receivers distribute 'IM' to participants of due diligence. Although the IM does not include details deemed confidential information of the business, it diligently explains information on the real facts of the companies and any details on matters that might potentially have material impact on decisions made by the potential buyer on bidding price that are provided based on factual findings.

In practice, fees for access to information, in conciliated amounts, are sometimes charged to the candidates participating in due diligence. Such participants gain access to financial data and sales figures in a data room arranged by the company. There have been instances where physical data rooms and virtual data rooms had been installed and operated, off line and on line, respectively, based on the quantity of information to be released and the number of companies participating. In preliminary due diligence phase, the prospective buyers may get answers from the company by asking questions through the M&A financial advisor, and, if necessary, receivers, officers and employee might hold Q&A sessions for the candidates.

Receiver distributes bidding guideline to the participants in due diligence in this stage, which mainly covers the method for submitting acquisition proposal, which is legally binding, and guidelines on matters called for as well as an initial draft for the memorandum of understanding to be entered into with the preferred bidder.

## 6. *Preparing for Standards for Selecting Preferred Bidder*

### 1) *Preparing for Standards for Selecting Preferred Bidder in Advance*

Immediately after M&A was adopted into company reorganization practice, the receiver occasionally evaluated bidding proposal by receiving advices from their financial advisor, under the condition that the standards for selecting preferred bidders had not been determined. However, these days, such standards are set forth in advance before closing the bidding proposal. The purpose that such standards are determined beforehand is to maintain the fairness and objectivity in selecting the preferred bidders.

As such standards does not need to be drawn up prior to public announcement on M&A, because it might expose details of such standards to outsiders, the receiver, shortly before the date of submission of bidding proposal, usually submits authorized application to the court and the court delivers authorized certified copy immediately after the closing of bidding to the receiver. Without public announcement on the standards, and for the purpose of seeking convenience of preparing for bidding and leading the actual bidding of the candidates favorably to the company, certain items of evaluations for bidding proposal and standards for evaluation within restricted scope may sometimes be announced to the participants in the bidding.

### 2) *Details with Regard to Standards for Selecting Preferred Bidders*

#### (1) *Items to be Evaluated Etc.*

As far as drawing up the standards for selecting preferred bidders is concerned, under consideration in common practice have been the size of undisclosed bids, rate of paid-in capital increase, conditions for procurement of liabilities of undisclosed bids, capabilities of procuring undisclosed bids, management quality after acquisition, and financial soundness of the buyer<sup>38)</sup> and succession of employment. Recently, whether request has been made for amending the initial draft of memorandum of understanding is sometimes

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38) It refers to investor with the highest acquisition price by paid-in capital increase of members of consortium.

one of the factors in setting forth the standards. The size of undisclosed bids obviously takes up a significant portion of the standards. Close reviews shall be made on whether distinction as for the size of undisclosed bids has been assessed enormously low in comparison with qualitative measurement index (management capacity after acquisition, succession of employment, financial soundness of main buyer, request for amending initial draft of memorandum of understanding), whether<sup>39)</sup> allotment should be discriminated under the proportion of the paid-in capital increase, allotment of the qualitative measurement index is appropriate and whether strategic investors are allotted to receive more benefits than financial investors. To this end, appropriateness of allotment shall be on review by launching simulations with various projection data.

(2) Elements to Consider for Each Item to be evaluated

① Size of undisclosed bids and Scope of Paid-in Capital Increase

Because the foremost concern of reorganizing company is to prepare financial source for repayment, the size of undisclosed bids poses the largest significance in evaluation. In evaluation of this element, conversion of points scored in accordance with the size of undisclosed bids is calculated first and then that number is multiplied by the proportion of the paid-in capital increase. In evaluation of the size of undisclosed bids, there is a method that the acquisition unit price is first set forth and the whole undisclosed bids are conversed by multiplying it with unit undisclosed bids and another method is that the amount subtracted from the whole undisclosed bids by a certain amount is conversed by dividing with the unit acquisition price.

In practice, the higher the bidding price and the rate of paid-in capital increase, the more favorably the evaluation resulted. However, in case the bidding price exceeds the remainder of reorganization debt, the exceeding portion returns to the shareholders or the buyers. Thus, the author does not think that it is proper that evaluation results favorably only because of

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39) In case the interest rate under issuance of company bonds can be afforded by reorganizing company after the transaction, it may not be necessary to grant additional points merely due to highest proportion of paid-in capital increase. It is largely due to the fact that while only public bonds will be remaining after repayment of reorganizing bond debts as acquisition price, generation of certain size of public bonds from issuance of company should be allowed, and, for buyer, the higher proportion of paid-in capital increase the higher uncertainties due to collection of dividends, causing acquisition price to drop.

bidding price. Also, it will be sufficient for the rate of paid-in capital increase to be evaluated with having a reasonable weight within the necessary degree of financial structure improvement of the company after the completion of M&A and overly emphasizing this factor beyond such necessity would be inappropriate.

#### ② Conditions of Procurement of Liabilities Portion of undisclosed bids

As the size of the liabilities of undisclosed bids is automatically determined as provided in ①, separate evaluation shall be double evaluation on the same subject matter. That's why evaluation of the liabilities size is not conducted separately. However, the condition of procurement of the liabilities part of the undisclosed bids will increase the burden of the company after the M&A. Thus, this area is subject to another separate evaluation. The condition of procurement of the liabilities part of the undisclosed bids are evaluated by, i) the period of maturity of bonds and ii) interest rate of company bonds, and long maturity period and low interest rate result in higher evaluation score. In process of preparing the evaluation standard, considering future cash flow of the company evaluated by the M&A financial advisor, the period where the company can by itself prepare financial sources for repayment are deemed a proper maturity period or sometimes any interest rate causing the interest coverage ratio to hover at around 2.5~3 after the M&A closing are deemed to be the proper interest rate. In some cases, the capacity of the company is the standard to evaluate the conditions of the company bonds without determining the maturity period and interest rates.

#### ③ Undisclosed bids Procurement Capacity

There are instances where financing capacity of the buyer is often evaluated with documentary evidence of procurement of undisclosed bids or else sometimes the procurement method of undisclosed bids may be subject to evaluation. In case the financing procurement capacity is assessed below a certain level, it is a common practice that the concerned bidding proposal is cancelled. Evaluation is made and ranks among bidders are given by examining the types of documentary evidence of financing procurement and the portion of undisclosed bid with documentary evidence of financing procurement. The reason why the procurement capacity for undisclosed bids is assessed is because it is best to avoid a situation where a candidate without necessary procurement capacity proposes an undisclosed bid that is too high and exceeds its capacity to become a preferred bidder, which makes the

following M&A procedure unstable. Hence, if an overly strict requirement exists for the documentary evidence of financing documents or the portion of undisclosed bid with documentary evidence is too high, then it may lead into switching the identity of the preferred bidder, so flexibly applying standard is advisable.

What would usually be accepted as fund procurement documentary evidence include the certificate of balance under the name of the bidding participant, balance certificate of marketable securities such as listed shares, loan agreements issued by heads of financial institutions etc. Plus, others include lenders' letters of intent issued under the name of branch chief and directors instead of heads of financial institutions as well as lenders' letters of intent or investment agreements with conditions related to implementation of the loan (for instance, in compliance with the company's internal regulations, requiring approval of the board of directors, or holding a mortgage on assets of company that is target of M&A) attached. The latter is subject to demerit marks. In addition, although usually pertaining to private equity funds, (i) certificate for financial procurement of the amount determined by the bidding at any time by pursuing credit line of a certain amount from publicly trusted financial institutions, (ii) agreement as to the total amount of loan available from limited partners as of the time of bidding, to renowned general partner of PEF and a third party's statement proving that such loan is unconditional, (iii) investment agreement of publicly trusted financial institutions as a bidding participant, have been approved as fund procurement documentary evidence.

#### ④ Management Capability after Acquisition

It is essential to evaluate management capability of the candidates, as one of the objectives of company reorganization, M&A is to secure the responsible management entity. In this item, subject to evaluation are experiences of the buyer's management of the same type of business and understanding of the reorganized company as well as the management plan. The experiences might be evaluated on the manager himself or herself, as the representative of the consortium is in practice in charge of management of the company after acquisition. Or else, members of the entire company of the consortium might be evaluated, to compute the average point of the entire group. In case of evaluating the future management plan with emphasis, the contents included into the management plan should obviously be introduced in advance.

#### ⑤ Financial Transparency of Buyer

While this evaluation item is to evaluate the effectiveness of the reorganized company after the acquisition along with the above provided ④, as the company has already experienced financial meltdown before, in case another company with weak financial structure acquires the reorganized company, then the goal of improving final structure of reorganization company by M&A may be threatened by the fact that early redemption of investment fund may be needed by the buyer, which makes this item as such item to be used for evaluation. In common practice, due to the reason cited above, evaluation is conducted centered on the representative of the consortium for credit rating, and debt to equity ratio, and sometimes assessing financial soundness of all of the members of the consortium and calculating their average is done as well. In addition, this item is to predict the effects of the reorganized company after acquisition and thus the debt to equity ratio among others may be subject to evaluation after acquisition by the buyer.

#### ⑥ Employment Succession and Conditions

While it is obvious that the creditors are those with the largest interest in the M&A of the reorganized company, in the perspective of the current employees of the reorganizing company, job security and improvement of the working conditions are also important matters. Thus, the issue with regard to succession of employment for the manager pushing for M&A must be significant. Indeed, it is not rare that labor unions request for securing their employment and oppose the M&A in process or even cause hindrance to it by taking action. Thus, it is important to consider succession of employment for protecting workers and stabilize M&A process, which is why bidding proposal that does not succeed employee or not guarantee such succession is disqualified.

In case the labor union has a great deal of opposing voices with regard to maintenance of employment, there have been instances where the company had the union in charge of drawing up the standards of bidding proposal related to employment succession and working conditions and evaluation of bidding proposal.

Most of bidding proposals confirm the plan for employment succession of all of the employees. However, sometimes they may suggest pushing for restructuring after the acquisition. From the viewpoint of Korean labor law, it remains questionable whether the employee relation maintained during the

process of reorganization while the company was in the state of financial meltdown can legally be cut off after the company undergoes the M&A and escapes financial difficulty.

### *7. Acceptance of Acquisition Proposal*

The buyer candidates, based on the results of preliminary due diligence, will submit acquisition proposals which are legally binding with the price of acquisition written in it. Right after the deadline passes, in practice, receivers and financial advisors often bring the proposals and open them in court.

After submission of the proposals, in accordance with general principles, membership of the consortium shall not be changed arbitrarily. In exceptional cases, if unavoidable, the receiver may permit the changes of consortium's membership with court's approval. As per such changes, in addition, in case of selecting candidates who can participate in the preliminary due diligence at the stage of submitting the proposal, the membership changes may face restrictions until submission of the proposal. For the period following such submission, membership change faces far more strict restrictions in a sense that it may have an impact on the evaluation of candidates for preferred bidders.

### *8. Selection and Notification of Preferred Bidders*

#### *1) Entity Subject to Evaluation of Bidding Proposal*

Only the receiver is legally entitled to evaluate bidding proposals submitted and select preferred bidder. In most M&A cases in reorganization practice, the receiver uses advice from the financial advisors to evaluate the proposals, and decide on the preferred bidder with the court's approval. The receiver sometimes creates a commission to evaluate the bidding consisting of a multiple number of commissioners who will participate in the evaluation. Under such case, the commission usually consists of managers, management personnel and M&A personnel of the financial advisor.

#### *2) Appointment of Preferred Bidders and Payment of Performance Guarantee*

At the time of selecting the preferred bidders, the priority is determined according to the result of the evaluation of the bidding proposal submitted by

the candidates. In case there is more than one candidate with the same evaluation points, whichever proposed the larger amount of acquisition price will win the seat. If such amount is same, the amount of paid-in capital increase will determine the result, as the one with a larger amount will be appointed, and, in case the amount is also equal, whichever scores higher in qualitative measurement index will win the preferred bidder appointment. In the process of such appointment, under the ranking of evaluation points, additional preliminary preferred bidders may often be appointed. This is for the purpose of continuing with the M&A procedure by being able to grant the status of new preferred bidders to the preliminary bidders as well as depriving them of the status of preferred bidders without the need of returning to the first stage of the procedure to prepare for failure in negotiations with the preferred bidders. In practice, because the presence of preferred bidders itself may improve the negotiation capacity of the manager, in case there is one submitting a multiple number of acquisition proposals exceeding the selling price set forth in advance, it will prove to be an advantage to appoint preliminary bidders in many aspects.

Meanwhile, in case there are a multiple number of those submitting acquisition proposals and it happens to be difficult to discern who is more qualified, in particular, although the difference in bidding price is minimal and qualitative measurement index has somewhat noticeable differences, if there is an intention to improve the conditions proposed in qualitative measurement index favorably to the debtors, the preferred bidders may be selected in a multiple number and then they can bid for another round for the final selection.

The preferred bidder is then required to enter into a memorandum of understanding within a few days from the notification date (however, provided that court permit will allow extension of the deadline), and up to the date before signing the memorandum of understanding 5% of the acquisition proposal amount need to be paid as performance guarantee.

### *9. Closing Memorandum of Understanding*

After negotiations over the distributed initial draft of memorandum of understanding with the preferred bidder, managers obtain the court's permit. There is a possibility that the deal may end with a rupture at this stage. For



instance, a company which had been appointed as the preferred bidder requested amendment of the terms and conditions generally accepted as customary (removal of performance guarantee system, designating overseas arbitration institution as forum, limitlessly permitting scope of due diligence) in reorganization M&A which caused a delay in negotiation. The company ended with wavering the negotiation and thereby lost its position. In another instance, amid pushing for M&A under the business transfer scheme, the preferred bidder caused a failure in negotiation after requesting indefinite keeping of acquisition price till the date of business transfer. In common practice, the receiver first appoints the preferred bidder before carrying out negotiations over memorandum of understanding. However, in case there is no other alternative, while success in M&A is desperately necessary by making a number of corrections and amendments on the initial draft of memorandum of understanding as requested by the preferred bidder, the order will be reversed by carrying out the negotiations before selecting the preferred bidder.

#### *10. Detailed Due Diligence of Preferred Bidder and Conciliation of Undisclosed Bids*

The preferred bidder carries out due diligence on the reorganized company in the manner set forth by the memorandum of understanding. The due diligence period is usually for two weeks. Some companies take more than a month depending on the size of the company. In case an additional period is necessary, court permits will be attained for extension.

The purpose of the due diligence of the preferred bidder is to check whether the evaluations were conducted duly over assets and debts falling in the scope of the due diligence as the due diligence standards would require. After the detailed due diligence, the preferred bidder submits undisclosed bids conciliation application or final acquisition proposal. As some preferred bidders may request conciliation of undisclosed bids with fluctuation data of assets and debts after the due diligence date, the receiver will need to tell in advance preferred bidders of the scope of such conciliation. Subject to such conciliation shall be cases where the due diligence is on obvious and material errors or omission.

Company reorganization M&A has little possibility for generating

unrecorded liability contingent liabilities, unlike in general M&A, undisclosed bids may be conciliated within the range of up to 5% on usual memorandum of understanding as determined in most cases. If the preferred bidder requests conciliation of undisclosed bids, the court supervising M&A requests the receiver to submit details of conciliation requested by the preferred bidder, existence of causes for conciliation set forth in the memorandum of understanding, opinions on accepting it or not and detailed evidence with regard to it. In particular, with regard to the financial advisor who conducted due diligence prior to the announcement on sale, it requests such financial advisor to provide explanation on the reasons for the differences between the results of the detailed due diligence by the buyer and the previous due diligence. At first, one may think that it is a bit too harsh to request reasonable evidence for conciliating undisclosed bids, as it would mean to adjust undisclosed bids as agreed upon thereby and to allow the creditors to make decisions by seeking a resolution at a meeting among related parties, once consent is made with regard to conciliation of undisclosed bids between the receiver and the preferred bidder. However, as to reduce the proposed bidding price is to reduce the distributed portion to creditors, it shall be deemed natural to request reasonable grounds for such reduction. In addition, recently criticism is rising among the creditors' committee over the concern that the receiver and the court are controlling too much of M&A which determines the satisfactory level of interests of general creditors in realistic terms, which is why making decision on such reduction shall require harsh grounds.

Conciliating such common undisclosed bids not only takes number of days but poses an important chance for assessing the negotiation capability of both parties. As a receiver, there is a need for fully utilizing his or her negotiating capacity in order to prevent the preferred bidder from wavering the contract and the process from being delayed, while denying groundless requests for conciliation. Realistically, once M&A reaches this stage, the financial advisor tends to be not paying enough attention to the fact that the fundamental purpose of pushing for M&A is to financing to the fullest to maximize general creditors' satisfaction. On the other hand, court might again review deeply how the ground for reducing undisclosed bids proposed by receiver and the financial advisor would be reasonable.

In reviewing the application for conciliating undisclosed bids, it is greatly

different for each buyer. There are instances where the conciliation amount exceeds the maximum limit of undisclosed bids conciliation request amount, while the buyer requests for undisclosed bids conciliation and submits other requests such as those under the standards set forth by memorandum of understanding. On the other hand, rather than conciliating undisclosed bids, bidding price may become the final undisclosed bids as there has not been requests for conciliation for the sake of fast closing (Heung Chang, Ilhwa). The former case, however, is more common.

### *11. Closing of Main Contract*

After negotiations over conciliating undisclosed bids are complete, main contract will be entered into after reaching an agreement following detailed negotiations over conditions of the acquisition. This contract shall include details on all matters negotiated so far such as the amount of undisclosed bids, the timing and the method of undisclosed bids payment as well as follow-up measures (matters related to procedures for amending reorganization plans, reorganization security right, repayment of reorganization credit, capital reduction, paid-in capital increase, acquisition of company bonds, dispatching team for acquisition planning, and closing of company reorganization procedures).

In practice, for most cases, the problem lies in the rate of capital reduction. Previously, at the time of signing main contract, decision on whether to engage in capital reduction and implementation of rate of the capital reduction was regulated to the extent where in later time receivers prepare amendment plans and decide under mutual discussions, yet, recently requests have been made frequently that a certain rate of capital reduction should be specified in this contract. Reasoning cited by the buyer in such progress is that the existing shareholders with the value of (-) end with having the value of (+) due to investment by the buyer. In case the liabilities of the reorganizing company exceed the assets and the existing shareholders' value ceased to exist, there is no problem with accepting such argument. However, in case there is value of existing shareholders because the asset of the reorganizing company exceeds the liabilities and the shareholders possess the right to vote for resolution on amendment plan, it will not be easy to accept such argument. The question is how much of the remaining value of the existing shareholders

need to be left intact after the M&A in the end. However, this is not the issue to be resolved between the buyer acquiring new shares and the existing shareholders. Instead, it is an issue to be resolved in the perspectives of 'Grading under fairness and equality,' by comparing term between the rate of loss of the reorganizing creditors and the rate of loss of existing shareholders, determined in the amendment plan. Previously, under reorganization plan, it became an issue whether it was fair and equal to leave grades between interested parties. However, these days, although it would be rightful to draw distinction between the related parties and have grades, since occasionally disputes mount over to what extent of such distinction shall be deemed fair and equal, determining the detailed proportion of the capital reduction shall be dire.

Under the main contract, in case the buyer is a consortium, it shall be noted that the members of the consortium have jointly and severally liable relationship, and in principle member of the consortium may not be changed, and by letting them change the members with court permit, if necessary in exceptional cases, payment of undisclosed bids is secured.

Also, on the date of entering into this contract, the buyer shall deposit 10% of undisclosed bids as down payment (including 5% as performance guarantee paid in) and in case of termination or cancellation of main contract for the reason attributable to buyer, the above mentioned amount will be taken as a penalty, loss or damages, and thus the buyer is bound to be prevented from breaching or cancelling the contract improperly.

The remaining amount of undisclosed bids exclusive of the down payment is required to be deposited several days before the meeting of related parties for hearings and resolutions on amendment plans. However, depending on buyer, for the reason that undisclosed bids has not been prepared after the signing of this contract, request will often be made for an extension of the period of deposit of undisclosed bids.<sup>40)</sup> For the buyer,

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40) There was a case the contract was terminated and performance guarantee payment was taken back due to failure to prepare acquisition price despite two consecutive offers of extension of period following the failure to prepare acquisition price till deadline of depositing remainders by buyer in practice [AK Capital Consortium which was appointed preferred bidder during 2003 M&A of Hanbo Steel and Heavy Industries]. Meantime, after extension of same kind was made following failure to deposit remaining amount until the deadline, merely amount for

company reorganization M&A should be relatively safe investment with little possibility of contingent liabilities. On the other hand, as for the reorganizing company, as this contract does not immediately end and usually takes several months till submission of amendment plans and resolution at the meeting of related parties, in order to secure binding power with regard to payment of undisclosed bids, imposing damages or penalties may be unavoidable.

## 12. Follow-up Measures

Reorganization M&A has fundamental structure that financial structure is improved with full repayment of secured/unsecured reorganization debt with undisclosed bids paid by the buyer (therefore, the buyer usually only succeeds priority claims)<sup>41)</sup> and the buyer becomes the controlling shareholder and begins operating the business that has recovered with improved financial structure after closing of the reorganization case. To this end, the receiver prepares and submits amendment plan on paying for reorganization debts with the acquisition fund as the financial source. However, just as the case of having to repay only part through rescheduling instead of full repayment of reorganization debt with undisclosed bids because the size of reorganization debt to be paid by the the company is too enormous, in case the amendment plans have adverse impact on related parties of interest, the receiver shall submit an amendment plan on reconciliation of debt and seek inquiries and resolutions of a meeting among related parties (Company Reorganization Act § 270 Para. 2).

As a debt restructuring mechanism, if it is possible to establish an

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paid-in capital increase was deposited without depositing of price for company bonds, which was finally implemented on the very date of meeting of related parties a moment before commencement of the meeting.

41) However, in case of reorganizing claims requiring presumption of possibilities for realization for early repayment such as disputed or contingent reorganization claims and reorganization guarantee claims still in due litigation process, when opinions differ over possibilities for realization between reorganization company and concerned creditors, the capital may be separated from the acquisition fund and be reserved in company in the amount equivalent to the amount payable at the time of confirmation until realization of the bond by negotiation with buyer. Or else, repayment financial source may be entrusted in case of confirmation of those claims by appointing concerned creditors as the beneficiaries.

amendment plan that allows for cash repayment of all reorganization claims secured or unsecured, in the amount that is discounted to their present values by the IRR<sup>42)</sup> which is equal to the IRR that makes financial resource amount (in practice, refers to the amount that can actually used for reorganization debt payment, which is calculated by the price of acquisition minus expenses, such as success fee for financial advisor and buffer expense) to be equal to the annual Repayment Amount<sup>43)</sup> discounted as of the day prior to the day of interested parties' meeting to vote on the amendment plan, then that amended reorganization plan is a desirable plan because it does not damage the spirit of fair and equal allocation while rationally allocates financial resource.<sup>44)</sup>

However, since the above-stipulated distribution method results in reduction of repayment amount with regard to the unsecured creditors who are under unfavorable conditions of repayment in comparison with secured creditors under the initial reorganization plans, it may be an obstacle to gain the consent of reorganization credit holders in case there is a lack of financial sources for repayment. In practice, a popular distribution method is: out of financial resource, the amount equal to liquidating value of collateral<sup>45)</sup> is distributed to secured reorganization creditors as preferred distribution, and the amount of claim the secured reorganizing creditors hold in excess of collateral is considered as unsecured reorganization credit and distributed with lower priority.

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42) Internal Rate of Return ("IRR") refers, as discount rate setting net present value at zero, to rate of return equalizing present value of cash inflow to present value of cash outflow.

43) It refers to principal and interest payable every year for each individual creditor during the period of reorganization under the initial reorganization plan.

44) In case of *Korea Thrunet Co.*, the receiver has received recognition for preparing and submitting amendment reorganization plan by means of above method from reorganization security right holders and reorganization creditors.

45) There is a room for controversy over whether liquidation value should be determined as of confirmation of initial reorganization plan or the amended plan. In case of depreciation of value of collateral over time such as building, machinery and equipments, if the liquidation value at the time of confirmation of amendment reorganization plan is distributed first, it shall be as if not repaying as the amount of such liquidation value to such holder, producing cruel result in the eyes of such holder. Under the absolute priority rule of US Federal Bankruptcy Code, assets should not be distributed to junior creditors until senior creditors are satisfied with such rights in full, with a premise of distributing continuing corporate value before distributing liquidation value to senior security right holder.

After the amendment reorganization plan is confirmed, the acquisition planning group is dispatched as desired by the buyer. If there is no immediate appeal, efforts are made to prevent delaying of exercising of management power by the buyer who has become the controlling shareholder, by taking follow-up measures such as paid-in capital increase toward capital reduction of initial shares and buyer and issuance of company bonds, repayment of reorganization debt by means of undisclosed bids, old shares entrusting with cancellation registration in accordance with amendment plan. After those procedures, follow-up measures are taken such as realignment of management. Once reorganization credit is repaid, the receiver files for closing of case of reorganization immediately, and the court listens to the opinions of creditors' committee and management committee, to finally decide on closing of reorganization case.

## **V. Procedural Problems in M&A**

### *1. Company Reorganization M&A and Reorganization Plan - Pros and Cons*

#### *1) Legal Relations between Reorganization M&A and Amendment of Reorganization Plan – Pros and Cons*

Exclusive of special cases where the reorganizing company fully repays remaining reorganization debt on its own, M&A has to be accompanied with procedures for amendment of reorganizing plan for conciliating the relations of the interested party. Thus, after implementing M&A, in case the initial reorganizing plan cannot be amended as provided in M&A, then the purpose of the M&A cannot be achieved, which is why close reviews are important on details regarding reorganization plan prior to making decision to carry out the M&A, size and structure of remaining reorganizing liabilities and management structure of reorganizing company and based on such review, determination should be made on whether amendment on reorganization plan is possible.

#### *2) Needs for Reorganization Plan Amendment*

Reorganization Plan Amendment shall not be easily permitted because it

was confirmed by the court following the resolution of creditors' meeting, as it has been conciliated under interest of secured creditors, unsecured creditors, and shareholders and the rights of all the interested parties were seriously undergone and discharged by the confirmation of the court. It means the resolution of the incorporated their own interests on the assets and going concern value of the company, and thus, reorganization plan once approved and confirmed became the fundament of the company's way to survive the financial distress. However, in any case, without approving such amendment, if just because such authorized reorganization plans or self-recovery plan cannot be carried out due to economic or any other reasons, procedures have to be eradicated at all times and end with reorganization procedures, then it will not be desirable socio-economically and against the interests of related parties reflected on initial reorganization plan. If the debtors can be recovered by allowing such changes, it will foster socio-economic efficiency and live up to the interests of interested parties, which is why the amendment needs to be permitted in case there are inevitable reasons.<sup>46)</sup>

### 3) *Requirements in Amendment of Reorganization Plan*

Amendment on reorganization plan shall only be allowed when it is necessary due to unexpected reasons as of the date of confirmation of the initial plan (§ 282 Para. 1 of DRBL).

In this context, 'unexpected reasons' are to mean<sup>47)</sup> such circumstance that there is a reason to have born a different plan than the present plan had it been forecasted at the time of confirmation of the initial plan. Thus, if such reasons had been in place, not after, but before the confirmation, amendment shall not be allowed. They would take place in the form of drastic changes of economic conditions, enactment and termination of laws, cancellation of authorization required for implementation of business, and business showings below forecast. In most cases of reorganizing companies, they would have under such reasons as economic conditions have changed after initial confirmation, thawing business showing etc., and thus it will not matter much in real cases.

'Need for Amendment' is to mean that the reorganized company will be

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46) See *supra* note 6, at 137

47) *Id.* at 141



incapable of or face difficult waters in carrying out part or all of the reorganization plan in case the initial plan stays unchanged and, thus, if plans are changed, the rehabilitation of the company through carrying out the new plan will be realized by lifting such troubles.<sup>48)</sup>

#### *4) Pushing for Company Reorganization M&A and Amendment Reorganization plan*

The need for amending reorganization plans shall be studied in the perspectives of possibilities for carrying out the initial plan. In case the reorganizing company stably implements the reorganization plans and possesses capital to execute such implementation in future or otherwise circumstance that may hinder implementation does not exist, but a potential buyer is nevertheless sought and M&A is pursued, this has no relations with interests of satisfaction of liabilities owned by the creditors and rehabilitation of the reorganizing company, and will result in just causing handover of the control over the reorganizing company by issuing new shares to a buyer. In other words, as for such reorganizing company, the interest of creditor, which is repayment of reorganization liabilities, and the interest of reorganization company itself, which is closing of reorganization procedure through repayment of reorganized liabilities, are both proceeding as determined in the original reorganization plan, and the controlling structure of the company is already completely determined under the approved and confirmed initial plan. Thus there will not be problem with carrying out the plan, which is why the reorganization plans does not need to be amended.

For efficiently carrying out the business by the company and continuously existing as a normal company in future, it might had to have a better controlling shareholder as a transparent and responsible management entity. On the other hand, even if a new controlling structure is established under the initial reorganization plan, the creditors are mainly the financial institutions, who become the controlling shareholders by debt-equity swap. These

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48) While in past practice the shareholders of Kukdong Construction as reorganized company have submitted amendment plan requesting for gratuitous distribution of new shares, court rejected the appeal for changing the plan for the reason that "the amendment plan does not have a context that can avoid causes troubling the implementation of the plan and foster maintenance and reorganization of a company."

shareholders usually are not interested in the management of the company and do not possess adequate qualification as managers, which is why there should be a realistic need for securing a new management leadership through M&A. However, there have been cases where the financial institutions themselves take steps as the acquisition candidates to participate in the paid-in capital increase, and, after the enforcement of DRBL in 2006, led by the local banks, "The Management Guideline for Restructuring the Financial Institutes as Obligations" has been made and the process of implementing the recovery plan and management recovery for the debtors have been evaluated, to ensure the post-reorganization M&A is working out as planned. As the financial institutions themselves can benefit, by collecting their loan, from regaining the value of the shares through debt-equity swaps and recovery of the company's management, it will be unreasonable to say that the financial institutions are not interested in managerial issues of the reorganizing company and can even go as far as taking part in it by appointing qualified managers by means of exercising their rights as shareholders. Thus, it will be improper to generalize their apathetic attitudes or lacking qualifications for management of the company. To this end, for the financial institutions to remain as shareholders after the closing of the procedures does not necessarily contrast securing responsible management of the company.

Even if this is not so, provided that the reorganization plan set forth to arrange the conflict of interest is being carried out normally, to push for the M&A that will only cause changes in the controlling structure within the process and will be beyond the scope of the initial plan for debtor rehabilitation. Thus, it will not be appropriate for the cause of the M&A of reorganizing company, and the amendment of reorganization plan will not have such conditions and this type of M&A should not be allowed.

## *2. Agreement for Investment and Capital Reduction for Existing Shares*

One of the barriers emerging in the series of negotiations for M&A investment agreements for most reorganizing companies is the buyer's request for deciding on the rate for such capital reduction for existing shares in investment agreements.

In common practice, after entering into investment agreement, the receiver prepares and submits to court amendment plan which is based on M&A,

while one of the difficulties emerging in the process is to decide reduction of existing shares and to which degree the capital reduction rate should be implemented. The amendment plan mainly covers how to distribute the transaction amount to secured creditors and unsecured creditors in the process of rescheduling for the purpose of full repayment of remaining reorganization debt by using M&A transaction amount.

Also, as for the amendment plan based on M&A, requirements for confirmation of the reorganization plans still apply, and, re-discharge of any remained credits and shares shall satisfy the principle of 'fairness and equitability' among all the interested parties. Since the precedents insist that to reduce, not the rights of shareholders but only of the reorganization creditor is not permitted under this principle,<sup>49)</sup> the entire remaining debts must be satisfied before the interests of shareholders are unaffected by the amendment plan caused by the outcome of the M&A. In contrast, the answer to the question on whether only the rights of shareholders can be reduced without the reduction of any other interests or secured/unsecured should be answered negatively as matter of principle. However, in case of economic recovery after the reorganization procedure or the reorganizing company can be re-established by closing of reorganization case by investment of capital through amending the rights of shareholders by appearance of a buyer who will invest in a large size due to other reasons, amending the rights of shareholders without reduction of reorganization credit may be an option.<sup>50)</sup> However, even in such case, it is a difficult problem to decide to which degree such amendment should be made toward the shareholders to be proper under the principle of fairness and equality. The grades of right amendments between shareholders and creditors cannot be judged indiscriminately by comparing just the rates of reduction of reorganization credit and the number of shares, and in addition, various factors, such as reduction in capital and its ratio, reduction rate of actual share composition by issuance of new shares,

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49) Supreme Court Decision Case No. 2002geu121 as of December 10, 2004 (Dure Air Metal Case) stated that "as the fairness and equality principle can be said to mean that it does not guarantee preference with regard to wealth distribution upon profits and liquidation for senior creditors nor grant preferences to junior creditors over senior creditors, and thus does not allow reduction of rights of reorganization creditors without reducing the rights of shareholders."

50) LIM, CHAE-HONG & PAK, CHANG-HOON, COMPANY REORGANIZATION ACT 189-190.

shareholding ratio in case issuance of new shares issued in M&A, the amount of capital belonging to existing shareholder determined by their holding in net asset of reorganizing company, and post- reorganization and post-adjustment of share ratio by the issuance of new shares for M&A, ratio of reorganization debt recovery ratio, and consideration should also be made for shareholder's interest in future income of the company, and, therefore, it is extremely difficult to lay out a general rule that determines the degree of change in existing shareholders' rights.<sup>51, 52, 53)</sup>

As stated above, in M&A of reorganized companies, it will be more often challenging to determine with the potential buyer at the phase of signing investment contracts in advance the question of whether to change the shareholders' rights and to what degree such change will be reflected in the amendment plan conclusively. In addition, realistically speaking, in case the assets exceed debts at the time of M&A, even the opinions of shareholders should be considered for whether and to what degree the capital reduction shall be made. Thus, instead of fair and equitable treatment for related parties at the phase of signing investment contract, this should be considered with awareness that this issue cannot be resolved by negotiations with the buyer seeking to maximize the efficiency in investment by securing shares of the

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51) Supreme Court Decision Case No. 2002geu121 as of December 10, 2004.

52) Original ruling of above supreme court decision of Seoul High Court as of November 3 2002 stated that "reduction of rights for both reorganized credits and shares shall be satisfying the fairness, equality principal only if reduction rate of junior shares is higher than that of senior reorganized credits, and the two cannot simply rely on comparison under reduction rate of reorganized credits and shares, due to fundamental differences based on the nature of credits and shares, yet, in general, reorganized credits are to mean rate of projected repayment amount including adopting to present value the value of shares under cash repayment and investment conversion(as for guarantee credits, adopting to present value the main shares shall be considered and thus the rate of projected repayment amount considering repaid amount and amount secured for future repayment), and as for shareholders reduction of rights is to mean proportion-based lowering of status of shareholders for the company, and thus, rather than a simple reduction rate, the shareholdings of former shareholders altered after paid-in capital decrease and issuance of new shares shall be considered reduction rate of such rights for each."

53) Above provided Seoul High Court's decision seems to have calculated reduction rate of existing shareholders under the method of relative share rating. As for a method to assess the extent of rights reduction of existing shareholders, method for net profit approaching computing the reduction rate by comparing net profit price to be distributed to existing shareholders after paid in capital decrease by means of M&A with net profit price to be distributed to existing shareholders before M&A.

reorganizing company following the M&A.

### *3. New Share Issuance and Rights Amendments under Initial Reorganization Plan*

In recent M&A of reorganizing companies, there is often no need for amending reorganization plan for re-conciliating liabilities as the acquisition price can fully repay the remaining reorganization debt. However, in a relatively recently prepared reorganization plans, while responsibilities for pushing the M&A under the scheme of new share appointment to a third party are granted to the receiver with securing ample size of authorized capital, there are usually articles stating that the receiver may issue new shares for M&A under court's approval within the scope of the amount of authorized capital. As a result of the receiver's pushing for the M&A under those reorganization plans as provided above, the buyer proposed the undisclosed bids exceeding the reorganization debt, and the problem lies in whether reorganization plan amendment procedure will be necessary in case of being able to issue new shares for the buyer within the authorized capital set forth under the reorganization plans.

According to the practice of the bankruptcy division of the Seoul Central District Court, while dilution of shareholding of existing shareholders due to issuance of new shares for the buyer itself is unfavorable towards initial shares and thus procedures for amendment of reorganization plans should be applicable, if such shareholding's reduction is within the scope set forth by the initial reorganization plan. Since the disadvantages resulting from it is already projected in the initial reorganization plan, only issuing new shares for the buyer should not trigger initiating the new amendment procedures.<sup>54)</sup>

Thus, in case of reduction of rights of reorganization credit holder in amendment plan to be prepared after entering into main contract, without any exceptions the rights of shareholders by means of capital reduction by

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54) Companies which have issued new shares and completed M&A without changing reorganization plan under such assumption include Shinsung Tongsang, SEGYE Inc, Shinhan and Jinro. Supreme Court decision Case No. 2004geu84 dated June 15, 2005 related to reorganizing company "Kukje Trading" seems to be accepting such practice as legally permitted.

share consolidation are being reduced. In such case, the extent of reduction of rights of shareholders should not be smaller than that of reorganization credit holder.<sup>55)</sup> The method for figuring out the extent of reducing rights is not simply the rate of the capital reduction but the relative method for share portion which is to consider the shareholdings of the existing shareholders changed after the capital reduction and issuance of new shares as the rate of reduction of rights of shareholders.<sup>56)</sup>

In case shareholders have voting power for accepting the plan with assets exceeding debts at the time of voting, some minority shareholders may show up in the meeting as related parties and present their dissatisfaction toward capital reduction or file appeal against the confirmation of court for amendment plans, which could delay the closing of the procedures for company reorganization, and the shareholders who are also reorganization credit holder who have received conversion of some of the claim into shares may react sensitively toward the capital reduction, which is why there is a need for the receiver and the financial advisor to closely study appropriateness of the rate of such reduction and explain enough on the inevitability of capital reduction toward the related parties of interest.

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55) The Appeals Court decision Case No. 2002ra209 dated November 4, 2002, from which the above Supreme Court decision arose, held that "reduction of rights for both reorganized credits and shares shall be satisfying the fairness, equality principal only if reduction rate of shares, which are low in priority, is higher than that of reorganized credits, which are high in priority, and the two cannot simply rely on comparison under reduction rate of reorganized credits and shares, due to fundamental differences based on the nature of credits and shares; yet, in general, in case of reorganized credits, the rate of reduction for its rights shall be the rate of projected repayment amount which includes cash payment and the present value of shares subsequent to debt-equity conversion (as for guarantee credits, the rate of projected repayment shall consider the repaid amount from the original obligor and the amount that may be repaid with certainty in future because it is necessary to consider the fact that the main obligation can be actualized) and in case of shareholder, the reduction rate for its rights shall not be mere capital reduction ratio but the changed shareholding ratio of existing shares caused by capital reduction and issuance of new shares, because the reduction of shareholder's right means reduction in shareholder's pro rata status with respect to the company."

56) Above provided Seoul High Court's decision seems to have calculated the reduction rate of existing shareholders under the method of relative share rating. Additional method to measure the degree of existing shareholders' rights reduction is approach from net asset in which reduction rate is calculated by comparing the amount of net asset that would have been distributed to the existing shareholders prior to M&A to the amount that would be distributed to the existing shareholders after capital reduction via M&A.

#### *4. Grounds for Appointing Third Party for New Shares*

There are cases where the reorganization plans confirmed long ago and wholly stipulates that the receiver, when issuing new shares, decide the method for assignment of them by obtaining court's approval.

As in reorganization procedures, provisions applicable on corporate law with regard to right for acquisition of new shares by the existing shareholders are explicitly excluded, (§ 255 Company Reorganization Act, § 266 DRBL) requests of existing shareholders for assignment of new shares based on provisions of corporate law can properly excluded. However, requests made by secured creditors and unsecured creditors for assignment of acquisition rights for new shares need to be reviewed from a different perspective. In case of securing profitability to a certain degree, a buyer paying a great deal of acquisition price and obtaining control rights of a reorganizing company would mean that it will be able to obtain a great deal of economic benefit in future, and this is the reason why M&A of reorganizing company is popular in Korea. Because obtaining control rights and management rights of a future reorganized company can realistically allow an enormous amount of economic profits, there can be a request for the ranking of distribution of economic profits under the principle of fairness, equitability in the order of secured and unsecured creditors.<sup>57)</sup>

Hence, in case of having decided to push for a third party M&A by the methods of open competition bidding with excluding assignment of new shares of security right holder, creditors who are related parties of interest, the reorganization plan shall explicitly state that the new shares shall be issued to third party buyer. Such provisions are explicitly stipulated in reorganizing plan that are drafted these days.

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<sup>57)</sup> In case of reorganizing company of Jinro, submitted reorganization plan with the frame of pushing for M&A by financial institutions' creditors themselves after closing following their becoming major shareholders by means of debt-equity swap. On a separate matter, one secured reorganizing creditor had submitted reorganization plan that the right to acquire new shares of reorganizing company would belong to him.

5. *Closing of Reorganized Company M&A and Reorganization Case*  
– *Issues with Immediate Appeal, Special Appeal (Re-appeal)*

As the buyer injects a great deal of capital for reorganizing company, realistically the M&A transaction of reorganizing company cannot be thought of separate from closing of the reorganization case. In relation to it, what has been an issue in practice has been whether procedures for reorganizing company can be closed in case of noncompliance against decision of confirming the amendment plans on M&A.

The former Company Reorganization Act allowed immediate appeal only in case there were provisions permitting noncompliance in the Company Reorganization Act in relation to ruling on reorganizing process (§ 11), court's decision of confirming amendment plan was subject to immediate appeal to appellant court. However, due to construing the relevant provisions, Supreme Court has been insisting that only special appeals may be permitted against the appellant court's decision on the amendment plan.<sup>58)</sup>

Special appeals may be made only when there have been constitutional violations influencing court decisions or constitutions of orders, regulations and deposition that were grounds for ruling or ruling on violations it is due to improperness (§ 499, Civil Procedure Act) and, as special appeals is a method for not accepting decisions after the ruling is settled down, settlement on original rulings cannot be blocked just because such special appeals have been made as an urgent rejecting procedures that were similar to retrial instead of common appeal. Thus, decision on confirming amendment reorganization plan is finalized as appellate review decision was notified. Hence, if the reorganizing company was equipped with other conditions, after the decision of appellate review, the reorganization case can be closed. Theoretically, however, after special appeal is brought up, there is still a chance for decision of confirmation to be cancelled. But, the reorganization plan has been approved by the consent of majority of interested parties which satisfies the requirements for court's confirmation and the plan has already been executed.

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58) Supreme Court decision Case No. 87ma277 dated December 29, 1987 was first such ruling and ever since decisions have been made for such intention.



Furthermore, to consider that decision for confirming the reorganization plan exerts a fairly large amount of social and economic impact. In case there are partial legal violations in approving and confirmation, instead of cancelling the decision, considering relationships with other related parties of interest and possibilities for implementing reorganization plans, it has been solved by methods for modifying relating part of the plan by setting forth provisions defending rights for the party bringing up special appeals. Therefore, reorganizing companies have been able to avoid conflicts once they perform obligations for repayment added from it.<sup>59)</sup> The reorganizing companies would not need to deal with troubles as long as they performed obligations for repayment added as such.

To look back at several incidents<sup>60)</sup> where immediate appeals were made against amendment plans after the year of 2000, it took 12~52 months to arrive at the decision for special appeals after the date of confirmation date, and of them, it took 9~32 months from appellate review ruling to the decision on special appeals. The recent case that the Supreme Court ruled on the special appeal for amendment plans of Korea Cement as a reorganization company took 50 months to reach the decision of remanding after reversal. As such, in cases of noncompliance against decisions on approvals for reorganization plan, it is the reality that it takes a long period of time to complete all the process until the final ruling. After the above provided ruling, it was a settled precedent and practice that only special appeal would be allowed for the decision on approvals for reorganization plans. In the aftermath of January 26th 2002 full revision of Civil Procedure Act, as presented above, the circumstance which gives rise for special appeals was reduced from its previous scope, which was a violation of constitution or law, into violation of constitution only, and opinions were emerging that because the circumstances giving rise for special appeals were overly restrictive, the ability to protect necessary rights became severely constrained, and thus even when separate provisions for special appeals, such as the decision on reorganization plan, exist, re-appeals should be possible, and the DRBL permits re-appeal for

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59) Supreme Court decision Case No. 2002geu62 dated May 12, 2006, Supreme Court decision Case No. 99geu35 dated January 5<sup>th</sup>, 2000.

60) Supreme Court decisions Case No.2000geu98, 2002geu101, 2001geu132, 134, 135, 2002geu121.

ruling of appellate court (§ 247, Para 7)<sup>61)</sup> and the identical mechanism applies for decision of confirmation on the amendment reorganization plan. Thus,<sup>62)</sup> in case in the procedures under the DRBL, certain interested parties may appeal and re-appeal against that decision, it may be hard to close reorganization case before the decision of re-appeal ruling with the same logic as before.

## VI. Conclusion

Thus far, roughly touching upon the practice of M&A for the company reorganization is offered in this article, drawing up the reorganization plan, and problems emerging in practice. As provided in the beginning, the M&A of reorganizing company may be affected by various factors such as the circumstance facing the company, the economic conditions at the time and the trend of the participants in the M&A and this is why this article cannot explain every possible scenario. Furthermore, a new reorganization practice since 2006 has emerged under the DRBL and, in reorganization procedures, conciliation and processing the procedures through independent discussions among the related parties of interest, M&A will grow more flexible as per the procedural aspect and start seeing the growth in the number of participating parties for M&A.

As the corporate reorganization procedure in Korea still stands on the basis of the two objectives of satisfaction of the related parties of interest and rehabilitation of the debtors, the two objectives shall be considered sufficiently. It should be practiced in a way that the objectives of related parties and recovery of creditors shall be achieved. For that purpose, receivers shall, if needed, actively exercise their power granted to themselves as the

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61) § 247 of DRBL (appeal) ① Immediate appeals may be made for deciding whether to authorize a recovery plan; however, provided that it applies for recovery creditors, recovery security right holders, shareholders and other shareholding parties who have not been listed or reported.

⑦ Not complying with the ruling on immediate appeal as above prescribed in clause ① shall be under the provisions of § 442 of CIVIL PROCEDURE ACT (re-appeal). In such case, provisions of either clause 1 or clause 6 shall be adopted.

62) DRBL, § 282, Para. 3; § 247, Para. 7.

conductors of the interests, and the court should also take responsibilities as a fair supervisor to ensure rightful exercise of such power. Further the reorganization procedure may be the alternatives only if necessary for the purpose of achieving the above objectives. It will not be just for the receivers as the executor or the court as the supervisor to abuse its power to fail to stay within the scope of such achievement or use its power for an unrelated cause.

Since the year of 2008, Korea suffers worldwide and nationwide economic recession. Now, it raises new, but very tough problems. The business surroundings of companies both large and small rapidly deteriorate, and numerous corporations fall bankrupt, and file the petitions for the commencement of reorganization procedure.

It is necessary for all the interested parties to move forward more swiftly and reasonably to avoid undesirable and avoidable inefficiency and take all possible measures into consideration to let the bankrupt survive. New Korean Reorganization practice including M&A under the supervision of court has just begun to change. It means a lot of possible measures remain still untouched and the M&A practice also may move forward changing.

KEY WORDS: mergers and acquisitions, new share issuance, amendment of reorganization plan, Debtor Relief and Bankruptcy Law, receiver system, early closing



# Legal Status of Joint Ventures under Korean Competition Law

Bong-Eui Lee\*

## Abstract

*This article reviews the regulatory framework for joint ventures and presents some proposals for its improvement. Korean competition law does not define a joint venture, not even a concentration from substantive points of view. An establishment of a joint venture can be assumed as either a concentration or a cartel. Therefore, there is a possibility of double control of this single behavior, which could severely threaten legal certainty and predictability.*

*Against this background, this article attempts to define the establishment of a joint venture substantively, and it means an acquisition of joint control to a newly created company by two or more undertakings. Considering that a joint venture has an ambivalent nature, or pro- and anticompetitive effects, it is suggested that a joint venture accompanied by structural changes in the participating firms will be dealt with in principle under merger control, where its cooperative effects are reviewed altogether. A joint venture for simple cooperation should be processed within a simplified procedure under certain circumstances. This would result in procedural economies without harming effective competition.*

## I. Introduction

### 1. Background

The Monopoly Regulation and Fair Trade Act of Korea (hereafter “the Act”) contains various kinds of instruments for the protection of fair and free competition. It prohibits abuse of market dominance, cartels, and unfair trade practices on the one hand, and market concentrations on the other hand. The regulation of market concentrations requires, unlike other things, assessment

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of competitive effects due to the challenged M&A transaction in a prospective manner. The Korea Fair Trade Commission (hereafter “the KFTC”), upon finding any serious competitive concerns, has the authority to impose corrective measures and surcharges, and to file a criminal complaint for prosecution (Article 5, 6, 16, 21, 22, 24, 24-2, 71 I of the Act). Any undertaking that has caused injury to other persons in violation of the Act is liable for compensation of actual damages (Article 56 of the Act).

Along with ongoing environmental changes, especially globalization, liberalization and consolidation during the last two decades, firms have come to cooperate with one another. One of the main instruments for their collaboration has been an establishment of a joint venture. In response to these rapid market changes, the KFTC has continuously modernized the competition laws of Korea in terms of substantive and procedural aspects. Above all, the KFTC reformed in 2007 the Notice on Merger Review<sup>1)</sup> (enacted in 1998) and applied vigorously the merger controls of Korea to a number of concentrations, whether domestic or international. Further, the Guidelines for Cartel Review was published in 2002 (revised in 2007)<sup>2)</sup> which accepted to some extent the recent developments of cartel regulation abroad. However, there remain many uncertain issues, which could threaten the effective protection of the competition order in Korea.

So is the case with an establishment of a joint venture. A joint venture is by nature of structural change and behavioral coordination neither *de lege lata* clearly classified into mergers or collaborative conducts, nor reviewed in terms of well-defined legal principles. Setting reasonable rules for joint ventures from substantive and procedural standpoints is of utmost importance, because joint ventures constitute about 20 to 30% of all notified concentrations yearly and those joint ventures are exposed to the risk of double control as discussed below. However, there has been no case where an establishment of joint venture was declared to substantially lessen competition in the relevant market and thereby prohibited. In the area of cartel enforcement, uncertainty prevails, mainly because a joint venture without being notified could be prohibited through an ex post investigation

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1) KFTC, Notice No. 2007/12 on Merger Review, 12. 20. 2007.

2) KFTC, Guidelines No. 49 for Cartel Review, 12. 21. 2007.

by the KFTC.

## 2. *Challenging Issues*

Under the Act, there is a basic and long-standing question of what kind of combination between undertakings should be understood as a merger or a cartel from a competition law perspective. After any answer is given to this problem, joint ventures as legal terminology could find certain contours of their own. And then, it can be clarified how the collaborative nature of a joint venture could be assessed under consideration that an agreement to establish structural change of participating undertakings is likely to raise concerns of competitor collaboration.

Collaborative conducts, which are in practice called joint ventures, strategic alliances, etc., could have some conflicting effects on the relevant markets due to their ambivalent nature. Therefore, the ways for the KFTC to assess such complicated effects of a joint venture, taking all the circumstances into account and avoiding procedural diseconomies, should be developed. For that purpose, not only substantive but also procedural rules for reviewing joint ventures should be improved. Such rules can be called as “an integrated and simplified approach”.

## II. Legal Definition of Joint Ventures

### 1. *Definition of concentrations*

#### 1) *De lege lata*

The Act defines concentrations between undertakings simply as one of the conducts described exhaustively under Article 7 I. There are 5 types of conduct, as follows:

- a. the acquisition or ownership of stocks of another company;
- b. the concurrent holding of an officer’s position in another company by an officer or employee;
- c. a merger with another company;
- d. an acquisition by transfer, lease or acceptance by mandate of the

whole or material part of the business of another company, or the acquisition by transfer of the whole or material part of the fixed assets used for the business of another company; or

e. participation in the establishment of a new company, i.e. a joint venture.

The legal definition above is said to focus mainly on formal instruments rather than any substantive feature of a concentration. This accompanies some legal uncertainties and hampers procedural economies by unnecessarily encompassing too many concentrations under merger control.<sup>3)</sup> In case of a joint venture, any joint acquisition of other stocks satisfies the requirement of concentration, notwithstanding an obligation to notify it to the KFTC. Moreover, the Act does not distinguish between transactions which are likely to cause any structural change of corporate control or simply to accompany any behavioral coordination.

## 2) *Substantive element of a concentration*

As described above, the Act does not contain any substantive element of a concentration in terms of competition law. Theoretically, the distinguishing feature of concentrations from simply collaborative activities lies in that one of the pre-existing undertakings, as a result of the concentration, ceases to exist as an independent economic entity.<sup>4)</sup> This corresponds to the purpose of market concentration regulation. Integration into a single economic entity occurs on a legal or de facto basis; the former, a merger agreement, the latter, an acquisition of shares.

It is necessary to first discuss whether such a substantive definition of a concentration can be derived from any provisions concerning prior notification, because only concentrations subject to mandatory notification under Article 12 of the Act could raise competition concerns requiring further review. Under the Act, a company should notify to the KFTC, especially if it holds at least 20% (15% for a publicly listed or registered corporation) of the total number of stocks issued by another company, it becomes the largest

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3) Bong-Eui Lee, *Review of Joint Ventures under Korean Competition Law*, 7 JOURNAL OF COMPETITION LAW 54 (2001).

4) JONATHAN FAULL & ALI NIKPAY, *THE EC LAW OF COMPETITION* 208 (1999).



shareholder by additionally acquiring shares of another company after notifying the combination of enterprises, or it acquires the largest stocks of a new company to be established (§12 I No. 1, 2 and 5 of the Act). Whereas being the largest stockholder normally implies a kind of control relationship between acquiring and acquired firm, acquisition of 15 or 20% of total stocks would not automatically show any strong links between them.

The concept of a control relationship, which tends to view two separate legal entities as a single economic entity, is found in the Notice for Merger Review, although it was misplaced because the Notice was aimed at providing an approach to be taken by the KFTC and the criteria for determining whether a concentration, as defined per Article 7 of the Act, may substantially restrain competition in the relevant market, and then whether there would be any objective justifications that outweigh the competition concerns, e.g. efficiency-enhancing effect or acquisition of failing firms (Article 7 II No. 1, 2. and V of the Act). The logic is, however, somewhat ironic, because a transaction lacking any control relationship between participants cannot be deemed a concentration from a teleological perspective and it therefore needs not be subject to competition scrutiny at all.

From the discussion above, “control relationship” can be inferred as a core element of the legal definition of a concentration, and what matters is the acquisition of control of one undertaking by another. Control can be acquired by a single undertaking or by several undertakings. The latter represents the case of a joint venture, as follows. It can be suggested *de lege ferenda* that a general, comprehensive clause based on the substantive element of “single or joint control” should substitute for exhaustive illustration of legal instruments of concentration. In this case, the criteria for identifying a control relationship would rather be provided in detail in another Notice instead of the current Notice.

## 2. *Joint ventures under merger regulation*

### 1) *Approaches*

The Act neither uses nor defines the term “joint ventures” at any place. Commentators argue without doubt that No. 5 of Article 7 I of the Act, which illustrates “the participation into a creation of new company” as one type of a concentration, means a joint venture. No. 7 of Article 19 I of the Act, which

describes “a creation of companies etc. to carry out jointly the main area of commercial activities” as one example of cartel, also represents a kind of joint venture.<sup>5)</sup> Here, to define a joint venture in detail has been left to lawyers and economists.

Antitrust discussions on joint ventures developed in the U.S. during the last several decades seem to give no clear guidance to this dogmatic work. Prof. Pitofsky, the former chairman of the Federal Trade Commission (1995-2001), lamented earlier that, in the antitrust field of the U.S., there has not been any generally accepted legal definition of joint ventures.<sup>6)</sup> One defined joint venture as “any association of two or more firms for carrying out some activities that each firm might otherwise perform alone,”<sup>7)</sup> another defined it as “a cooperation that falls short of a complete merger.”<sup>8)</sup> However, this overly broad definition of joint ventures does not help to clarify their genuine competition concerns. The former excludes, without any reasonable explanation, joint ventures between companies which otherwise individually could not enter a new market,<sup>9)</sup> while the latter ignores the substantive differences among various forms of collaboration, e.g. equity joint ventures, stock-swapping, joint R&D, and sharing of production facilities and/or distribution networks, etc. A typology such as that joint ventures can be divided per their functions into R&D, production, distribution ventures etc., is nothing but a simple description of economic phenomena, and it therefore does not provide any useful guides in order to systematically analyze the complicated effects of a joint venture from a competition law perspective. Furthermore, even the definition developed in company law cannot work without modification,<sup>10)</sup> mainly because definitions in law should be made

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5) OH-SEUNG KWON, *THE ECONOMIC LAW* 170 (7<sup>th</sup> ed. 2009) ; HO-YEOL JUNG, *THE ECONOMIC LAW* 203 (2<sup>nd</sup> ed. 2008).

6) Robert Pitofsky, *Joint Ventures under the Antitrust Laws: Some Reflections on the Significance of Penn-Olin*, 82 *HARVARD L. R.* 1007 (1969); see also Joseph F. Brodley, *Joint Ventures and Antitrust Policy*, 95 *HARVARD L. R.* 1521, 1524 (1982).

7) ROBERT HOVENKAMP, *FEDERAL ANTITRUST POLICY* 200 (2005).

8) FTC/DOJ, *Antitrust Guidelines for Collaborations among Competitors*, April 2000, 1. 1. It is commonly referred to as the “Joint Venture Guidelines.”

9) It is especially the case that a certain business entails huge investment and high risks, namely R&D ventures.

10) For example, joint ventures are defined as a company composed of domestic and foreign capital. DONG-YOON JUNG, *THE COMPANY LAW* 44 (2000); HUN-JAE SEO, *CASEBOOK COMPANY*

under consideration of its own goal.<sup>11)</sup>

Here, the starting point is the definition of a concentration described above: control of another undertaking by one or more undertaking(s). Joint ventures subject to merger regulation can be thereby assumed from joint control of another undertaking by two or more undertakings. That is, in case of an establishment of a new joint venture, it is deemed to be a concentration between several acquiring companies on the one hand, and the acquired joint venture on the other hand. That is of much importance, attempting to classify various forms of joint ventures into horizontal, vertical or conglomerate merger and calculating turnover and market shares of participating firms on the basis of any classification.<sup>12)</sup>

Under merger regulations of Korea, the establishment of a joint venture is not captured by No. 5 of Article 7I of the Act if all the participating companies are “specially related persons” as defined under Article 11 of the Enforcement Decree of the Act (hereafter “the Decree”). That means, the participating companies which stand under the same control and therefore belong to the same corporate group, are deemed to be a single economic entity, and therefore, the establishment of a joint venture where only such affiliates are involved gives rise to a single dominance (Article 3 of the Decree).<sup>13)</sup> Besides, an establishment of a joint venture whose stocks are owned 100% by one company will be neither a joint venture nor even any concentration subject to the merger control under the Act.<sup>14)</sup>

Finally, a joint venture could be deemed a concentration in terms of No. 5 merger regulation only where its legal form is a corporation, whereas a joint venture could exist as a cartel regardless of its legal form, i.e. corporation, association, etc. Joint ventures in the form of a corporation should be one that

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LAW 45 (2000). However, in antitrust law, the nationality of participating companies is not relevant.

11) GEORG JELLINEK, *SYSTEM DER SUBJEKTIVEN ÖFFENTLICHEN RECHTE* 224 (2. Aufl. 1919).

12) For details, see BONG-EUI LEE, *DIE BEURTEILUNG VON FORSCHUNGS- UND ENTWICKLUNGSGEMEINSCHAFTS-UNTERNEHMEN IM EUROPÄISCHEN KARTELLRECHT* 93 (2000); FRITZ RITTNER/MEINRAD DREHER, *EUROPÄISCHES UND DEUTSCHES WIRTSCHAFTSRECHT* 599 (2008).

13) KWON, *supra* note 5, at 170.

14) In-Ok Son, *Guidelines of Korean Merger Control*, *LECTURES ON THE KOREAN FAIR TRADE LAW* 153 (2000). Before 1999, the single establishment of an affiliate company was to be notified and reviewed under the Act.

is newly created, if that joint venture can be regulated by merger or cartel controls.<sup>15)</sup> Therefore, if C acquires 50% stocks of B which is 100% controlled by A, and then a joint control between A and C is established, then the acquisition of C cannot be subject to Article 7 I No. 5 of the Act. In the same context, a transition from single control to joint control due to corporate restructuring is not a participation in the establishment of a joint venture, but simply an another acquisition of stocks.

## 2) *Assessment of joint control*

In Korean merger control regime, it does not matter whether and how “joint” control is established. More important is that two or more companies jointly acquire stocks of the newly created joint venture for the purpose of control. Therefore, in case that two or more companies jointly acquire stocks of another non-newly created firm, a concentration in the meaning of Article 7 I No. 1, not No. 5, matters. So the element “joint” is given little importance. For further criteria in order to assess joint control, the Jurisdictional Notice of the EC will be helpful.<sup>16)</sup> Whether any control relationship between two or more acquiring firms and the acquired joint venture is likely to be created through the challenged transaction, is assessed as follows.

In principle, control relationship as of a joint venture is to be assessed under the same criteria applied to single control through stock acquisition. In case of an acquisition or ownership of shares, a control relationship can be easily inferred, provided that the shareholding ratio of the acquiring firms is 50% or more. Even if the shareholding ratio of the acquiring firms is less than 50%, a control relationship can be inferred if the acquiring firms can influence the acquired joint venture considering the following in general (V 1, 3 of the 2007 Notice):

- (1) shareholding ratio of each stockholder, distribution of shares, mutual relationship among stockholders;

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15) Lee, *supra* note 3, at 62.

16) The Commission, Consolidated Jurisdictional Notice on the control of concentrations between undertakings, OJ 2008 C, 95/1. This Notice replaces the Notice on the concept of concentration, the Notice on the concept of full-function joint ventures, the Notice on the concept of undertakings concerned and the Notice on calculation of turnover.

- (2) whether the acquired joint venture gets its main raw materials from the acquiring firms;
- (3) interlocking directorate between the acquiring firms and the acquired joint venture; and
- (4) the existence of transactional relation, money relation, or affiliate relation between the acquiring firms and acquired joint venture.

Additionally, if more than 2 companies acquire stocks of another company, which corresponds not necessarily to the creation of a joint venture, the shareholding ratio, gap, and mutual relation of each acquiring companies and the purpose of acquiring stock and contractual relation for the acquiring stock, are to be considered. The control does not have to be non-transitory; only temporary control is sufficient.

The Act does not differentiate between full-function and partial function joint venture. As a result, an establishment of a joint venture carrying out only a small part of business activities can be regulated as a concentration. The same applies for a joint venture regulated as a cartel.

### 3. *Nature and effects of joint ventures*

#### 1) *Ambivalent nature of joint ventures*

Under the Act, an establishment of a joint venture pursuing common management of a “main” business part could also be challenged *ex post* by the KFTC, considering whether it is likely to unduly restrain competition (Article 19 I No. 7 of the Act). As a result, provisions concerning merger regulation and cartel prohibition are likely to apply to an agreement to establish a joint venture in parallel but within different procedures. This raises the problem of double control to a single identical behavior.<sup>17)</sup> It should also be noted that an establishment of a joint venture would be treated as a cartel between the participating companies that compete in the same product and geographical market.<sup>18)</sup> Ancillary agreements accompanying the establishment of a joint venture will be reviewed as a whole under the Guidelines. Therefore, the

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17) FRITZ RITTNER/MEINRAD DREHER, *supra* note 12, at 599.

18) See JUNG, *supra* note 5, at 309.

establishment of a joint venture which is likely to be allowed as a concentration due to lack of substantial lessening of competition in the meaning of Article 7 I of the Act, could be prohibited *ex post* as an unduly anti-competitive cartel.

There are more differences from the procedural treatment of joint ventures. In case of a concentration, the contracting parties to a joint venture have the obligation to pre-notify it to the KFTC under certain requirements, whereas there is no obligatory notification for a cartel-like joint venture. The KFTC should notify the results of its merger review to the parties within 30 days—it can be delayed to within 90 days if necessary—(Article 12 VI and VII of the Act), whereas a cartel case has neither obligatory notification nor any time limit to be finished.<sup>19)</sup>

Most serious is the difference of their legal effects. If a joint venture is considered to substantially lessen competition in the market, the KFTC may impose corrective measures and, if necessary, periodical fine (Article 16, 17-3 I of the Act). On the contrary, firms that engaged in a cartel-like joint venture will almost always be sanctioned by fine of up to 10% of the related turnover (Article 22 of the Act).

All of this increases legal uncertainty and unpredictability. As a result, undertakings committing to an establishment of a joint venture are obliged to notify the timeline for the concentration and are persuaded to simultaneously apply for an exemption for anti-competitive but outweighing, efficiency-generating cartel. This would necessarily threaten economies of procedure. In sum, the destiny of a joint venture to a large extent will be up to the art of the initiated procedure.<sup>20)</sup>

## 2) *Ambivalent effects of joint ventures*

A joint venture between competitors is likely to warrant economies of scale based on cost savings, to make possible risk-sharing in especially high-

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19) See general time limit for administrative procedure (Article 49 IV of the Act). According to this, if five years has passed since a violation of the provisions of this Act was committed, the Fair Trade Commission shall not issue orders for corrective measures or impose surcharges as prescribed by this Act against such offense. Note, however, that this provision shall not apply in case a corrective measure or the imposition of surcharge is canceled by a court judgment and if a new disposition is made based on the relevant reasons for judgment.

20) Lee, *supra* note 3, at 65.

tech industries, synergy effects etc. and thereby to facilitate effective competition in the long run.<sup>21)</sup> On the contrary, joint ventures may help to coordinate competitive behaviors between participating companies on the relevant market and/or aggravate market structure through monopolization and foreclosure effects.<sup>22)</sup>

Positive and negative effects of a joint venture can be assessed according to the theoretical backgrounds. However, the identification of its various, often conflicting competitive effects is not so simple. Calculation of efficiency is often unclear and there are still many obstacles to its legal acceptance.<sup>23)</sup> Therefore, any definite answer to probable effects of a joint venture is not allowed. As follows, however, some policy implications can be derived from controversial discussions on the possible effects of joint ventures.

First, joint venture as an optimal form of organization has the potential to bring about innovation, which tends in turn to facilitate further rivalry. Second, supplementary relationship between efficiency and competition should be taken into account in assessing competitive effects of joint ventures, provided the efficiency can be proved as specific to the joint venture, verifiable and likely to arise in the short term. Finally, economies of procedure and legal certainty do not always work in contradiction to the just results of substantive analysis. It is especially the case, when effects anticipated from the joint venture necessarily seem conflicting and the legal survival of it depends on the selected procedure under the current regime of double control as proceeded below.

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21) Jeffrey Pfeffer & Phillip Nowak, *ANTITRUST BULLETIN* 315, 319 (1976); Thomas M. Jorde & David J. Teece, 4 *J. Eco. PERSP.* 75, 77, 81 (1990); Joseph Kattan, 61 *ANTITRUST L.J.* 937, 939 (1993); CARSTEN THOMAS EBENROTH & MARTIN SCHICK, *EWS* 218 (1994); ANDREAS FUCHS, *KARTELLRECHTLICHE GRENZEN DER FORSCHUNGSKOOPERATION* 189, 273 (1989).

22) Hartmut Berg, *Marktphasen, Zeitwettbewerb und Strategische Allianzen: Die Beispiele „Mikroelektronik und Personal-Computer“*, in *FS KANTZENBACH* 197, 213 (1996); Michael Bräulke, *Contestable Markets - Wettbewerbskonzept mit Zukunft?*, *WuW* 945, 947 (1983).

23) MEINRAD DREHER, *KONGLOMERATE ZUSAMMENSCHLÜSSE, VERMUTUNGEN UND WIDERLEGUNGSGRÜNDE* 78 (1987).

### III. The Privilege of Concentration

#### 1. Practice of the KFTC

The possibility of double control of a single behavior for establishing a joint venture does not seem desirable as mentioned above. Double control threatens legal certainty and predictability in applying the Act. Looking into the practice of the KFTC, the problem of double control has not yet been realized. Undertakings which are willing to establish a joint venture notify their plans in advance to the KFTC, but so far there has not been a single case where corrective measures were imposed because of its anti-competitive effects as a concentration. More precisely, there has been no joint venture case where in-depth investigation was initiated under merger control.

On the contrary, there have been several cartel cases where the KFTC intervened *ex post*. Almost all the joint venture cases prohibited as a cartel by the KFTC concerned sales or marketing venture between actual competitors.<sup>24)</sup> According to the consistent precedents, the KFTC took a somewhat strict structural approach to a cartel-like joint venture, where the aggregate market share of the participants was considered as of highest importance. Therefore, the KFTC found those joint ventures as threatening to substantially lessen competition based directly on the fact that the aggregate market shares of their participants amounted to over 60% or 90.9%.<sup>25)</sup> Sometimes, it was also considered, although not most importantly, whether the joint venture pursuing cooperation of each sales activities restricted price or output of the targeted item.<sup>26)</sup> Recently, a joint organization for bid-rigging was challenged and sanctioned because of its anti-competitive pricing behaviors.<sup>27)</sup>

However, the problem of double control may come true at any time. For setting effective regulatory framework in the future, it will be helpful to carry out comparative analysis on the procedural approaches to a joint venture.

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24) To date, a total of 16 cases concerning cartel-like joint ventures have been prohibited.

25) KFTC, 3.14.2000, Decision No. 2000-44; 6.18.1996, Decision No. 96-98.

26) KFTC, 7.26.1989, Decision No. 89-45; 9.30.1997, Decision No. 97-218.

27) KFTC, 4.22.2009, Decision No. 2009-99.



## 2. Examples of the EC and Germany

### 1) EC Law

Article 3 IV of the EC Merger Regulation (hereafter “the ECMR”), amended 2004, provides that the creation of a joint venture performing on a lasting basis all the functions of an autonomous economic entity shall constitute a concentration within the meaning of Article 3 I b. Before the ECMR had been adopted in 1989, the European Commission (hereafter “the Commission”) was able to regulate concentrations and cartels according to Article 81 and 82 of the EC Treaty. An establishment of a joint venture had been treated as a coordination of competitors’ behaviors, i.e. cartel. At the time the ECMR was adopted, the legal status of joint ventures was fiercely discussed in order to clearly delineate the jurisdiction of European and national competition laws<sup>28)</sup> and to favor concentrative ventures from substantive and procedural aspects. This was named as “the privilege of concentration”.<sup>29)</sup> And until the 1st revision of the ECMR in 1997, the distinction between concentrative and cooperative joint ventures, which was developed earlier in German competition law, had been widely accepted in the practice of competition authorities in the EU. As a result, a joint venture that performs on a lasting basis all the functions of an independent economic unit, was to be under exclusive jurisdiction of European merger control, unless it is likely to coordinate competitive behaviors between participating companies.

Meanwhile, the Commission had interpreted the two elements of concentrative joint ventures so broadly that most of the joint ventures had been brought into the scrutiny of European merger control. And the revised ECMR of 1997 codified the practice of the Commission by substituting concentrative, cooperative joint ventures for full-function, partial function

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28) Under the ECMR, the Commission had exclusive jurisdiction over concentrations having importance of European dimension, whereas competition authorities of each Member States were able to apply Article 81 I EC Treaty to anti-competitive agreements in parallel.

29) Simon Hirsbrunner, *Die revidierte EG-Fusionskontroll-Verordnung*, EuZW .69, 72 (1998); see critical views, Carolin B. Hösch, *Rechtssicherheit im EG-Wettbewerbsrecht nun auch für kooperative Gemeinschaftsunternehmen*, EWS 5, 8 (1997).

ones. After that revision, in case of a full-function joint venture, whether or not there is a possibility to coordinate participators' behavior, the Commission was to review all the competitive concerns resulting from those ventures and various ancillary agreements in a more transparent and unified procedure of European merger control. It was anticipated to enhance legal certainty at least with respect to collaborations between competitors like joint ventures.<sup>30)</sup>

## 2) German Law

In German competition law, namely "Gesetz gegen Wettbewerbsbeschränkungen" (GWB), a joint venture is understood somewhat differently from that of European competition law. Article 37 I No. 3 paragraph 3 GWB provides that if two or more undertakings acquire equity of another undertaking simultaneously or one after another, then a concentration between them is deemed to be created in the market where the joint ventures is supposed to be active. It is thereby assumed to be a partial merger (so called, Teilfusion) between participating companies,<sup>31)</sup> and such an approach was said to be fit for taking spill-over effects between them into account that are likely to arise through that joint venture.

Under the concept of "partial merger," many commentators and the practice of the German competition authority, i.e. the Bundeskartellamt, divided joint ventures into two categories: concentrative and cooperative ventures. The former is subject to merger control, and the latter the prohibition of cartel (so called Trennungstheorie).<sup>32)</sup> In the meanwhile, the BGH accepted the Zweischranken-Theorie that, in certain circumstances, prohibition of cartel and merger control could be applied parallel to a joint venture because the two are supplementary with each other and the categorization of joint ventures into the above two, is not always simple.<sup>33)</sup> The BGH accepted,

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30) Alexander Schaub & Rüdiger Dohms, *Das Weißbuch der Europäischen Kommission über die Modernisierung der Vorschriften zur Anwendung der Artikel 81 und 82 EG-Vertrag 1055*, WuW (1999).

31) FRITZ RITTNER & MEINRAD DREHER, *supra* note 12, at 598.

32) Peter Ulmer, *Gemeinschaftsunternehmen im EG-Kartellrecht*, WuW 438 (1979); Ulrich Huber, *Gemeinschaftsunternehmen im deutschen Wettbewerbsrecht*, in HUBER/BÖRNER, *GEMEINSCHAFTS-UNTERNEHMEN IM DEUTSCHEN UND EUROPÄISCHEN WETTBEWERBSRECHT* 162, 166 (1978).

33) WuW/E BGH 2169 = BGH 96, 69 "Mischwerke" (1986). See comments to this BGH decision, Kurt Stockmann, *Verwaltungsgrundsätze und Gemeinschaftsunternehmen*, WuW 269

however, the exclusive application of merger control to an establishment of a joint venture not accompanying any behavioral coordination between the participating companies.<sup>34)</sup> After that, in the practice of the Bundeskartellamt, concentrative joint ventures have been so widely construed and exclusively subject to merger control, considering that merger control has some procedural and substantive merits in contrast with cartel prohibition.<sup>35)</sup> By means of this approach, the Bundeskartellamt no doubt aims at facilitating innovative joint ventures and thereby enhancing international competitiveness of domestic industries.

### 3. Some implications

Joint ventures cannot be defined and tested *sui generis* as a concentration or a cartel. The division of concentrative/cooperative or full-function/partial function joint venture had been conceptualized from the perspective of competition policy, not from legal dogmatism or theoretical perfectionism. The only common character found in various forms of joint ventures is ambivalence of their nature: structural change and possible coordination thereto.

Therefore, the point is how to construct legal conditions that joint ventures need to be processed in terms of a merger, which are able to contribute toward eliminating expensive double control in favor of legal certainty and predictability of participating companies. This will be helpful for taking a number of complicated factors into account, which makes possible a comprehensive assessment of a joint venture as a whole.<sup>36)</sup> To this end, it seems thinkable to make only joint ventures lacking any structural change on a lasting basis subject to the cartel prohibition; other joint ventures will be reviewed under the merger control, where the danger of competitors'

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(1988); Karsten Schmidt, *Gemeinschaftsunternehmen im Recht der Wettbewerbsbeschränkungen*, AG 271 (1987); Otto-Friedrich v. Gamm, *Das Gemeinschaftsunternehmen im Kartell- und Fusionskontrollrecht unter Berücksichtigung kartellbehördlicher Unbedenklichkeitserklärung und allgemeiner Verwaltungs-grundsätze*, AG 329 (1987).

34) BGHZ 96, 69 = WuW/E BGH 2169 "Mischwerke."

35) The elements of concentrative joint ventures are in general identical with those of full-function ones.

36) Lee, *supra* note 3, at 78.

collusion can be checked as a whole under the Act.

#### **IV. Integrated procedure for Joint Ventures as a Concentration**

##### *1. Examples of the EU and the U.S. and Korea*

As explained above, a joint venture of full-functionality is subject exclusively to merger control in Europe, if it has a Community dimension (Article 3 IV of the ECMR). The participating companies are obliged therefore to pre-notify that joint venture to the Commission, which in turn is reviewed in terms of the “significant impediment to effective competition” (SIEC) test. Ancillary restraints accompanying the joint venture, which would be by their nature subject to Article 81 EC Treaty, are appraised within the same procedural framework (so called, “one-stop-shop”).

On the contrary, there is not any special, integrated procedure designed to effectively review two different aspects of a joint venture in the U.S. Such an integrated procedure concerning mergers, including joint ventures, is not found in Korea.

##### *2. Proposals*

In Korea, where firms decide to establish a joint venture, they are obliged to pre-notify it to the KFTC and will also be challenged ex post in terms of illegal collusion. Under the current KFTC’s organization chart, business concentrations and cartel cases are reviewed by “the Merger Division” and “the Cartel Investigation Bureau”, respectively. This dual procedure threatens legal certainty and consistence of decisions made by the KFTC. Not the least, it is difficult for the involved Division and the Bureau to cooperate and screen all the competition concerns imminent in the same joint venture. In order to escape from this problematic situation, it can be desirable to introduce one-stop shop in the sense that concentrative and cooperative effects of a joint venture would be reviewed under an integrated procedure. For this task to be carried out, some organizational changes will also be needed.

## V. Simplified procedure for certain Joint Ventures

### 1. *Examples of the EU and the U.S. and Korea*

In Europe, “the Notice on a simplified procedure for treatment of certain concentrations under Council Regulation No. 139/2004 of 2005”<sup>37)</sup> and “the Notice on agreements of minor importance which do not appreciably restrict competition under Article 81 (1) of 2001”<sup>38)</sup> set out a simplified procedure for full-function joint ventures subject to the ECMR and for partial function ones subject to Article 81 of the EC Treaty, respectively. The former provides that the Commission will apply the simplified procedure to certain categories of concentrations in terms of turnover and market share, and it will adopt a short-form decision declaring a concentration compatible with the common market:

(a) two or more undertakings acquire joint control of a joint venture, provided that the joint venture has no, or negligible, actual or foreseen activities within the territory of the European Economic Area (EEA). Such cases occur where:

- (i) the turnover of the joint venture and/or the turnover of the contributed activities is less than EUR 100 million in the EEA territory; and
- (ii) the total value of assets transferred to the joint venture is less than EUR 100 million in the EEA territory;

(b) two or more undertakings acquire joint control of another undertaking, provided that none of the parties to the concentration are engaged in business activities in the same product and geographical market, or in a product market which is upstream or downstream of a product market in which any other party to the concentration is engaged;

(c) two or more undertakings acquire joint control of another

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37) The Commission, OJ 2005/C 56/04.

38) The Commission, OJ 2001/C 368/07(so called “de minimis Notice”).

undertaking and:

- (i) two or more of the parties to the concentration are engaged in business activities in the same product and geographical market (horizontal relationships) provided that their combined market share is less than 15 %; or
- (ii) one or more of the parties to the concentration are engaged in business activities in a product market which is upstream or downstream of a product market in which any other party to the concentration is engaged (vertical relationships), provided that none of their individual or combined market shares is at either level 25% or more;

In case of the latter Notice, the Commission will not institute proceedings either upon application or on its own initiative, if the aggregate market share held by the parties to the agreement does not exceed 10% on any of the relevant markets affected by the agreement, where the agreement is made between actual or potential competitors on any of these markets; or if the market share held by each of the parties to the agreement does not exceed 15% on any of the relevant markets affected by the agreement, where the agreement is made between non-competitors on any of these markets. In cases where it is difficult to classify the agreement as either an agreement between competitors or an agreement between non-competitors, the 10% threshold is applicable.

On the contrary, a special procedure for joint venture is not found in the U.S. Therefore, it is not clear whether a joint venture will be subject to Section 2 of the Sherman Act or Section 7 of the Clayton Act. Instead, the Collaboration Guidelines of 2000 in the U.S.<sup>39)</sup> provides only a safe harbor for certain joint activities in order to enhance legal certainty and economies of procedure. In case of joint ventures, for example, antitrust authorities will not challenge a joint venture unless the aggregate market share of participating companies and the joint venture exceeds 20% on the relevant market.

In Korea, there is neither in the Act nor in the Guidelines a safe harbor for joint ventures considered to be a collusion. According to the Guidelines, joint

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39) See FTC/DOJ, Collaboration Guidelines of 2000, 4.2., 4.2.

ventures are treated as a non-hardcore cartel and reviewed in terms of the rule of reason. As above described, the revised Notice for Merger Review of 2007 provides for several cases subject to a simplified review procedure, where the notified concentration is presumed to create no competition concerns and in principle reviewed with respect to the truth of notified facts to be cleared within 15 days from the date of acceptance of that notification (III of the 2007 Notice). The cases for this fast track are assumed, for example, if the participating companies are in a special relationship with each other, or between acquiring or acquired firms any control relationship is not created, or companies other than Large Corporations in the meaning of Article 12-2 of the Decree are involved in a conglomerate merger, or in the event the market share of the company or market concentration of the transaction territory after the combination falls under the following criteria (II 1 of the 2007 Notice):

- (A) the following for horizontal M&A:
  - ① less than 1,200 Herfindahl-Hirschman Index (a measure of market concentration; hereinafter referred to as “HHI”)
  - ② 1,200 to 2,500 HHI, HHI increase of less than 250
  - ③ more than 2,500 HHI, and HHI increase of less than 150
- (B) the following for vertical M&A or conglomerate M&A:
  - ① the HHI is less than 2,500, and the market share is less than 25%.
  - ② the ranking of the company in each area of trade is less than no. 4.

## 2. *Proposals*

However, it seems to be unclear whether, under the current regime, an establishment of a joint venture will be subject to such a simplified review procedure or not. A joint venture, which is to be subject to merger control because of its concentrative nature, should be notified to the KFTC under Article 12 of the Act. Unless it satisfies any of the above mentioned cases, it will be reviewed in depth with respect to the criteria of whether effective competition is likely to be harmed through the challenged joint venture. However, it is not clear how the thresholds for simplified procedure be applied or interpreted in case of concentrative full-function joint ventures. It

can be also very controversial how joint ventures are to be classified into horizontal, vertical or conglomerate mergers. In this context, most important is that substantive matters, e.g. calculation methods of joint venture's turnover<sup>40)</sup> and classification criteria of joint ventures, should be clearly provided in the Notice.

If a joint venture is otherwise characterized by its cooperative nature, it can be suggested that it enjoys a safe harbor too in that joint ventures by companies with small market share would not be likely to unduly restrict competition in the market. For example, one can conceive of joint ventures whose mother companies have less than 20 percent aggregate market share. This suggestion can also be desirable for other forms of competitors' cooperation except for several hardcore cartels.

## VI. Conclusion

Korean competition law does not define a joint venture, not even a concentration from the substantive points of view. An establishment of a joint venture can be assumed either as a concentration or a cartel to a broader extent. Therefore, there is a possibility of double control of this single behavior. This would thereby severely threaten legal certainty and predictability.

An establishment of a joint venture should be defined substantively as an acquisition of joint control to a newly created company by two or more undertakings under merger control. Otherwise, it should be dealt as a simple collaboration under the Act. Considering that a joint venture has an ambivalent nature, with pro- and anticompetitive effects, it is suggested that a joint venture accompanied by structural changes in the participating firms will be dealt with in principle under merger control, where its cooperative effects are reviewed altogether. A joint venture for simple cooperation should be

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40) The Commission, Notice on a simplified procedure for treatment of certain concentrations under Council Regulation No. 139/2004, Note 5, where the turnover of the joint ventures should be determined according to the most recent audited accounts of the parent companies, or the joint venture itself, depending upon the availability of separate accounts for the resources combined in the joint venture.



processed within a simplified procedure under certain circumstances. This would result in procedural economies without harming effective competition.

KEY WORDS: joint ventures, competition law, legal definition, joint control, ambivalent nature, market concentration, cartel, double control, simplified procedure, safety zone, unified approach, one-stop shop



# The Challenges and Outlook of Trial by Jury in Korea

Junho Kim\*

## Abstract

*As of January 1, 2008, a system for civil participation in criminal trials was introduced and enforced in Korea. This system is of particular importance as it is the first jury system in the history of Korean criminal justice. The jury system of Korea shares, prima facie, certain similarities with the prewar jury system of Japan: it exclusively deals with felony cases, allows majority verdicts, and does not recognize the binding effect of the verdict. Based on such a simple comparison one might predict for the jury system of Korea to fail to gain the support of the people, as the Japanese jury system did before.*

*This article, however, takes a different outlook. The fate of the Korean jury system might prove to be brighter than that of the Japanese jury system for several reasons. Firstly, the circumstances surrounding Korean criminal justice today are fairly different from pre-war Japan, where militarism was on the rise. Secondly, the simple majority vote produces no theoretical issues, as it honors the self-determinations of the largest number of people. Thirdly, a sense of equality and a refusal to recognize privileged classes are deeply ingrained among the Korean public. Fourthly, the introduction of the jury system in Korea was a bottom-up reformation implementing the wishes of the public toward the democratization of justice. Lastly, Korea's introduction of the jury system was implemented concurrently with the reform of the Criminal Procedure Code, which enhances the principle of oral proceedings.*

*Now the challenge at hand is to build an extensive consensus and respect among the people for jury verdicts. The decisions and choices of the jury deserve respect just as much as those of the judges. To this end, the judiciary must make efforts to enhance its democratic legitimacy as well.*

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## I. Introduction

The jury is before everything a political institution;  
one ought to consider it as a mode of the sovereignty of the people.

- Alexis de Tocqueville, *Democracy in America* -

Despite the fairly measurable progress of Korean democracy well beyond the wall of authoritarianism, the public's thirst for democracy in its full-blooded form has not yet been quenched. The increase in the level of democracy achieved in Korea has been limited when it comes to legislation and administration, but now the Korean public aspires to make the legal system more democratic as well. It has often been pointed out that Korean judicature has problems in terms of democratic legitimacy, as its power is not directly authorized by the public, but indirectly by way of the National Assembly and the President.<sup>1)</sup>

The demand that not only legislative and executive but also judicial power obey the will of the public, however, is in essence an absolute bedrock of democracy. Even without mentioning Article 1 (2) of the Constitution of the Republic of Korea that reads, "The sovereignty of the Republic of Korea shall reside in the people, and all state authority shall emanate from the people," the premise that judicial power must derive from the people is self-evident. In this respect, the last few years have seen heated debate in the country about the institutionalization of the public's participation in justice, resulting in the Civil participation in Criminal Trial Act of 2007.<sup>2)</sup>

The French political theorist Alexis de Tocqueville (1805-1859) argued in his work *Democracy in America* that universal suffrage and trial by jury were like the two wheels of a cart called democracy. Assuming that his intuitive insight was right, it would also be safe to state that Korea has now broken away from half-baked democracy and established a moderately unimpaired foundation of democracy.<sup>3)</sup> The increasing number of countries implementing

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1) Korean judges are appointed by the Chief Justice, who is nominated by the President with the consent of the National Assembly. To summarize, the President, the National Assembly and the Chief Justice intervene in the process of the appointment of judges in Korea.

2) Law No. 8495 of 2007.

3) It cannot be said that the cart of democracy in Korea is fully equipped with its two

democracy indicate that citizen's participation in justice has positioned itself as an irresistible current of the times. Only a tiny minority of countries refuse to allow for civil participation in criminal trials in any form.<sup>4)</sup> The above Act is of substantial historical significance as it is a sign that Korea has taken the first step in jury trial, in line with this global trend.

As mentioned before, the current jury system of Korea shares certain similarities with the prewar system of Japan. As the implementation of the jury system is the first to be seen in the history of Korean criminal justice, the outlook for its success or failure draws significant attention. This in turn calls for a comparative study of the prewar Japanese jury trial system in order to assess where the Korean jury system stands now. In this connection, this article reviews the prewar Japanese jury system. It then examines the discussions concerning the introduction of jury trial in Korea since the end of the Japanese colonial era up to this point, before moving on to a comparative analysis of the current jury systems. Then, based on these examinations, it intends to provide a careful outlook of the future of the Korean jury system.

## II. The Jury System in Prewar Japan

The jury trial system of Japan differs in its creation.  
This institution was not produced by the effort of the people,  
but established by the government  
to pursue the enhancement of the judicial system.

- Yুক্তoki Takigawa, *The Jury Act* -

### 1. *The Backdrop for the Introduction of the Jury System*

Jury system refers to the institution of a legal proceeding where a jury of selected members of the public makes findings of fact and a professional judge interprets and applies law. In a nutshell, the jury system may be referred to as a collaborative trial system involving the public and judicial officers. Japan once had a jury system in place in this sense: the Jury Act of

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wheels, because Korea has not yet introduced a jury system in civil trials.

4) See NEIL VIDMAR, *WORLD JURY SYSTEMS* 3 (2000).

1923<sup>5)</sup> governed jury trials for fifteen years from 1928 until 1943.

The history of the jury system in Japan may be chronologically divided into the following three stages: (i) the Meiji Constitution establishment period, (ii) the Taisho Democracy period, and (iii) the period of lay participation in trials.<sup>6)</sup>

Perfunctorily based on this chronological demarcation, the jury system that was in force in prewar Japan may appear, at a glance, as a product of Taisho Democracy. 1923, or Taisho 12, the year in which the Jury Act was established, technically fell within the Taisho Democracy period. Moreover, the jury trial system was consistent with the goals of Taisho democracy, which may be roughly broken down into two: (i) universal suffrage and (ii) the implementation of the jury system.<sup>7)</sup> It is therefore not entirely farfetched that the Jury Act appeared as a product of Taisho democracy, as it were. However, the Jury Act was not a product of Taisho democracy alone. On the contrary, it is this paper's view that it was far more of a product of political ploys spanning nearly a half decade<sup>8)</sup> since the Meiji era.

It was during the Meiji Constitution establishment period, starting around Meiji 10 (1877), when the discussion of the legislation of the jury system was initiated for the first time in Japan.<sup>9)</sup> The draft bill of the Penal Code, prepared by the Ministry of Justice of Japan from July of Meiji 10 to June of Meiji 12, already contained the provisions for the jury system.<sup>10)</sup> The incorporation of these provisions in the draft was largely done by Gustave Emile Boissonade (1825-1910), the then legal advisor from France.<sup>11)</sup> It was his idea that the revision of unequal treaties would require the enhancement of the Japanese legal system to a level on a par with those of Western Europe, which in turn would make it necessary to introduce a jury trial system.<sup>12)</sup> As such, the first

5) Law No. 50 of 1923.

6) As for the chronological classification of the development of the Japanese jury system, this article is based on TAICHIRO MITANI, *THE JURY SYSTEM AS A POLITICAL INSTITUTION* 3-7 (2001) (available only in Japanese).

7) *Id.* at 137.

8) To be more exact, it took 46 years from the preparation of draft Penal Code in Meiji 10 (1877) to the establishment of the Jury Act of Taisho 12 (1923).

9) MITANI, *supra* note 6, at 3, 97.

10) *Id.*

11) *Id.* at 97-98.

12) *Id.* at 98. It is paradoxical that, contrary to Boissonade's idea, Hirobumi Ito, the most

step of the Japanese jury system stemmed from political considerations.

Following the drafting of the Penal Code, the Penal Code Review Board, established in October of Meiji 12 (1879), conducted an article-by-article review of the draft and applied certain modifications before submitting a proposed revision of the bill to the Chancellor of the Realm (*Daijōdaishin*), which revision preserved the jury system provisions nearly intact.<sup>13)</sup> The proposed revision submitted to the Chamber of Elders (*Genrōin*) in March of Meiji 13 (1880), merely one month after the filing of the bill to the Chancellor, however, had no trace of the jury system provisions.<sup>14)</sup> In the end, the Penal Code was promulgated in July of Meiji 13 (1880) with these provisions completely deleted.<sup>15)</sup>

Although the attempt to incorporate a jury system in the Penal Code was thus thwarted, this did not mean that the cry for the introduction of the jury system faded away. On the contrary, the camp arguing for its introduction was winning an increasing number of supporters outside of the government. A series of events was triggered by the Satsuma Rebellion. In order to ensure fairness in the trials of those involved in the Rebellion, Yukichi Fukuzawa (1835-1901) argued that jury trials be held.<sup>16)</sup> The Meiji government, however, went on to execute these people without even going through judicial formalities, which Fukuzawa strongly criticized.<sup>17)</sup> This criticism was then propagated to the entire rank and file of the Freedom and People's Rights Movement that was then on the rise, and served to cause this movement to make the establishment of the jury system one of its objectives.<sup>18)</sup> The newspapers in the civil rights camp unanimously ran editorials advocating the merits of the jury system,<sup>19)</sup> and a large number of constitutional drafts proposed by the private sector contained provisions for it.<sup>20)</sup>

Despite these efforts, however, the Meiji Constitution as promulgated in

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influential figure then, considered the jury system as an obstacle to the revision of the unequal treaties.

13) *Id.* at 99.

14) *Id.* at 100.

15) *Id.* at 101.

16) *Id.* at 4, 104.

17) *Id.*

18) *Id.* at 4, 108.

19) *Id.* at 4, 109.

20) *Id.* at 4.

Meiji 23 (1890) did not incorporate trial by jury. Although the Constitution of the Kingdom of Prussia, which the Meiji Constitution was modeled after, did provide for jury trial,<sup>21)</sup> those who drafted the Meiji Constitution deliberately rejected it.<sup>22)</sup> Most decisively, the jury system failed to persuade Toshimichi Okubo (1830-1878), the most influential figure in the Meiji government, and his successor Hirobumi Ito (1841-1909).<sup>23)</sup> Having placed the revision of unequal treaties at the top of the state agenda, Ito concentrated his efforts on maximizing the wealth and military might of Japan, even at the expense of the jury system, if necessary.<sup>24)</sup> The attempts made in the Meiji Constitution era towards the introduction of the jury system, in the end, were repeatedly thwarted.

Following the Meiji Constitution era, it was during the so-called Taisho Democracy period, spanning the Russo-Japanese War in 1905 and the Manchurian Incident in 1931, when the second wave toward the jury system arose. A proposal for the establishment of a jury system was submitted by the *Seiyukai*, the opposing party, to the Diet in February of Meiji 43 (1910) and unanimously passed by the House of Representatives in February of Meiji 43 (1910).<sup>25)</sup> Taking the lead in this passage was Takashi Hara,<sup>26)</sup> the then *de-facto* leader of the party and a disciple of Boissonade,<sup>27)</sup> which gives rise to the presumption that Boissonade had a major influence on Hara spearheading the proposal.

An aspect that deserves more attention, however, is that political rationales served as a basis for the passage of the proposition. One of these rationales is as follows:<sup>28)</sup> the Meiji Constitution dictates that trials be held in the name of *Tenno*, the Japanese Emperor. What was at issue was that if findings of fact were to be made in his name as well, it would inevitably give rise to issues of Emperor's liability. This led to the reasoning that the maintenance of the

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21) The Constitution of the Kingdom of Prussia § 94 provided that felony cases should be dealt with by jury trials.

22) MITANI, *supra* note 6, at 117.

23) *Id.* at 3, 117. It is said, however, that Ito had deliberately examined the introduction of the jury system as a premise of the establishment of the Meiji Constitution.

24) *Id.* at 106-7.

25) *Id.* at 125.

26) *Id.*

27) *Id.* at 5.

28) *See id.* at 126.



inviolability of Emperor would require the establishment of a jury system so that liability might be spread among the public.

At any rate, the proposal passed in Meiji 43 (1910) was the beginning of a renewed round of legislative efforts for the jury system in the Taisho Democracy period. When Takashi Hara came to head the cabinet in September of Taisho 7 (1918), he immediately set out to have the jury system incorporated in the legal framework.<sup>29)</sup> The *Seiyukai*, which was an opposing party when it made the Meiji 43 proposal, had already become the dominant ruling party by December of Taisho 9 (1920), when the Jury Act was drafted.<sup>30)</sup> Although Hara was assassinated in November of Taisho 10 (1921) and his cabinet soon dissolved, he left behind the Jury Act bill, which was inherited by the Takahashi cabinet.<sup>31)</sup> After being discarded by the Takahashi cabinet and then once more revived by the Tomosaburo Kato cabinet,<sup>32)</sup> the bill finally passed the Imperial Diet and resulted in the Jury Act in April of Taisho 12 (1923).<sup>33)</sup>

There is a paper explaining the genuine motive behind the enactment of the Jury Act that is worthy of mentioning. Naomichi Toyoshima (1871-1930), who took part in the drafting of the bill in the Ministry of Justice of the Hara cabinet and introduced the bill to the Privy Council Review Committee as a government committeeman, presents in his paper, *On the Occasion of the First Anniversary of the Jury Act*, the following statement:

The [Japanese] jury system never originated from a democratic idea of, say, the people being entitled to participate in judicial procedures. It may rather be ascribed to a notion of the people protecting the judicial power exercised in the name of the Emperor. The Jury Act has made it clear that this duty to vindicate judicial power lies with the public.<sup>34)</sup>

As discussed above, the jury system in prewar Japan was a political institution conceived and created by political considerations such as the

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29) *Id.* at 129.

30) *Id.* at 173, 179.

31) *Id.* at 211.

32) *Id.* at 240-41.

33) *Id.* at 244.

34) *See id.* at 250.

revision of unequal treaties and the vindication of the Imperial power. Although the jury system had consistently been advocated by the Freedom and People's Rights Movement and the atmosphere of Taisho democracy was in general favorable to its introduction, it went through several ups and downs, being at times thwarted, at other times hailed due to political considerations. While the jury systems in Western Europe were trophies of the political struggles of the masses as pointed out by Yukitoki Takigawa,<sup>35)</sup> that of Japan was a byproduct of the government's political agenda. These inherent limitations of the jury system of prewar Japan would have adverse impact on its substance and operation as discussed below.

## *2. The Substance of the Jury System*

The jury trial system as provided for in the Jury Act of 1923 was what may be specifically referred to as a Japanese version in that it had substantial differences from those of the UK or the US in the following aspects: Firstly, jury trials were exclusively limited to felony cases. Jury trials may have been granted only (i) where the maximum statutory penalty was a capital punishment or a life sentence,<sup>36)</sup> or (ii) where the maximum statutory term of imprisonment was no less than three years and the minimum no less than one year.<sup>37)</sup> In the former case, a jury trial was available unless waived by the defendant (statutory jury trial),<sup>38)</sup> whereas in the latter, it was available only when specifically requested by the defendant (requested jury trial).<sup>39)</sup> Secondly, the jury was not permitted to reach a verdict of 'guilty' or 'not guilty.' The duty of the jury was to give answers to the questions asked by the judge relating to the existence or nonexistence of facts.<sup>40)</sup> These verdicts were determined by majority voting of twelve jurors.<sup>41)</sup> Lastly, the answer of the jury was not binding.<sup>42)</sup> If the court deemed the verdict of the previous jury

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35) YUKITOKI TAKIGAWA, THE JURY ACT 42 (1938) (available only in Japanese).

36) The Jury Act § 2.

37) The Jury Act § 3.

38) The Jury Act § 2, 6.

39) The Jury Act § 3.

40) The Jury Act § 88.

41) The Jury Act § 91.

42) The Jury Act § 95.

unwarranted, it was possible to organize a new jury to deliberate on the case.<sup>43)</sup>

The shaping of the prewar Japanese jury system in the above form was heavily influenced by political intentions. Article 24 of the Meiji Constitution stipulated, "No Japanese subject shall be deprived of his right of being tried by the judges determined by law," while Article 57 (1) prescribed, "The judicature shall be exercised by the courts according to law, in the name of the Emperor." Article 58 (1) also provided that "The judges shall be appointed from among those, who possess proper qualifications according to law." At any rate, according to the explicit provisions of the Meiji Constitution, trials were required to be conducted by judges and judicature exercised by courts. This gave rise to criticism that having jurors who did not possess the necessary qualifications to be a judge take part in trial procedures infringed on the authority of the judges and courts and was thus unconstitutional.

It was for no other reason than to evade this criticism why the Jury Act limited the duty of the jury to findings of fact, refused to recognize the binding effect of the verdict, and allowed for the replacement of the jury. The reasoning was, in other words, that the trial-by-jury system did not infringe on the authority of the judge or the court since the verdict returned by the jury was not binding the judge and the judge was allowed to replace the jury. As such, not only the introduction of the jury system but also its substance was not free from the influence of political agendas.

### 3. *The Development of the Jury System*

The prewar Japanese jury system was in place for a total of fifteen years from 1928 until 1943. The following is a tabular analysis of the annual statistics for the jury system: the number of jury trial cases and the number of cases where the defendants were found not guilty.

**Table 1.**

| Year             | 1928 | 1929 | 1930 | 1931 | 1932 | 1933 | 1934 | 1935 | 1936 | 1937 | 1938 | 1939 | 1940 | 1941 | 1942 | Total |
|------------------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|-------|
| Jury cases       | 31   | 143  | 66   | 60   | 55   | 36   | 26   | 18   | 19   | 15   | 4    | 4    | 4    | 1    | 2    | 484   |
| Not-guilty cases | 5    | 14   | 3    | 17   | 14   | 6    | 5    | 8    | 4    | 3    | 0    | 0    | 1    | 1    | 0    | 81    |

43) The Jury Act § 95.

As indicated in the above table, although the jury system was made relatively active use of in the earlier years of its implementation, the number of the users declined over the years, with the annual number of the jury cases reaching a single-digit figure by 1938, which indicates that the jury trial system somehow failed to draw the attention of the Japanese public. In the end, the jury system of prewar Japan was abrogated by the Act on the Abolition of the Jury System of 1943<sup>44)</sup> and has been regarded as an institutional failure.<sup>45)</sup>

Such being the case, what could have been the cause of the failure? A number of analyses have been presented on this matter as follows. Firstly, military actors were rapidly increasing their power on the Japanese political scene when the jury system was put in place.<sup>46)</sup> The peace preservation law regime started by the enactment of the Peace Preservation Act of 1925 (*Chian ijihō*), was further reinforced by the 1928 revision of the same Act.<sup>47)</sup> In addition, although a significant number of communists were arrested in 1928, they were entirely denied the right to jury trial,<sup>48)</sup> as the Jury Act excluded any and all violations of the Peace Preservation Act from jury trials.<sup>49)</sup>

Secondly, an inherent flaw of the jury system also contributed to its demise.<sup>50)</sup> As judges were allowed to disregard verdicts and replace juries, defendants were hardly motivated to insist on jury trials.<sup>51)</sup> Besides, it has

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44) Law No. 88 of 1943.

45) However, it is remarkable that the average rate of not-guilty cases during the 15 years even reaches 16.7%, whereas the Japanese criminal justice is famous for its high guilty rate of 99.9%. The prewar Japanese jury system might as well be considered to have contributed to the democratization of the Japanese criminal procedure.

46) See Mamoru Urabe, *A Study on Trial by Jury in Japan*, in *THE JAPANESE LEGAL SYSTEM* 487 (Hideo Takana ed., 1976); VIDMAR, *supra* note 4 at 361.

47) After the revision of the Peace Preservation Act in 1928, the statutory maximum punishment was reinforced to capital punishment from no more than 10 years imprisonment with or without forced labor.

48) Urabe, *supra* note 46 at 487; VIDMAR, *supra* note 4 at 361.

49) The Jury Act § 4; Urabe, *id.* at 484.

50) In this respect, noteworthy is the following assertion of Professor Nobuyosi Toshitani: "The miserable state of affairs which developed in the actual operation of the Jury Act had been expected at the time of its enactment. One should feel surprised not at this point [*i.e.*, the failure of the jury system] but at the remarkable success of various devices which were built into the system in order to prevent the smooth working of trial by jury in Japan." (Urabe, *id.* at 487.)

51) Urabe, *id.* at 490; VIDMAR, *supra* note 4 at 362.

been reported that as a finding produced in a jury trial could not be appealed against,<sup>52)</sup> a significant number of defendants waived jury trials with the sole purpose of preserving the right to appeal.<sup>53)</sup> The Jury Act did not permit objections against the jury instructions given by the judge, either.<sup>54)</sup> This led to the criticism among defending counsels that the judges' instructions encouraged verdicts unfavorable to the defendants.

Lastly, the failure of the jury system is often ascribed to the vertical nature of Japanese society. In the cultural soil of Japan stressing hierarchical relationships, the Japanese reportedly prefer to be tried by *those in superior positions* than by their *peers*.<sup>55)</sup> It is also reported that the Japanese tend to believe that the judges would give fair trials with high moral standards as they preside over trials *in the name of the Emperor*.<sup>56)</sup>

As discussed above, the failure of the Japanese jury system is attributed to a number of factors. This article, however, intends to present a few additional factors based on the author's own analysis and intuition. Firstly, it is noteworthy that the introduction of the jury system in Japan was not a reformation achieved by the people but by the government.<sup>57)</sup> Put another way, the prewar jury trial system of Japan was not a trophy of the struggles of the Japanese people, but a byproduct of the aspirations of the ruling class. This was why its substance conformed to the political agenda of the government, instead of encouraging the participation by the people in judicial affairs. It is probably not surprising at all that a jury system in this form failed to gain the

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52) The Jury Act § 101; § 102.

53) TAKIGAWA, *supra* note 35 at 37. More importantly, there was a general tendency to mitigate the sentence on the appellate trial, and therefore the Japanese people preferred to preserve the right to appeal rather than go on the jury trial.

54) The Jury Act § 78.

55) Urabe, *supra* note 46 at 485; VIDMAR, *supra* note 4 at 63.

56) Urabe, *id.*; VIDMAR, *id.* at 363. The high guilty rate of 99.9% of Japanese Criminal Justice explicitly shows the Japanese people's deep confidence in the bureaucrat. As for the detailed research on this, see Noah Stuart Stephens, 99.9: The Japanese Conviction Rate (2008) (unpublished Master thesis, Seoul National University).

57) Yukioki Takigawa points out sharply as follows: "The jury trial systems of the Western Europe are all the products of the political revolutions. That is, they are institutions acquired by the strife of the people to the tyrannies. However, the jury trial system of Japan differs in its creation. This institution was not produced by the effort of the people, but established by the government to pursue the enhancement of the judicial system." TAKIGAWA, *supra* note 35 at 41.

support of the people.

Lastly, it was not very feasible to implement the purpose of the jury system when oral proceedings were not properly held. The jurors, who are not legal experts, merely hear the statements of the witnesses present in court and observe evidence submitted to the court before bringing in verdicts. The principle of oral proceedings, the absolute precept of the modern criminal procedure code, is essential to jury trials. It is out of the question that a jury system could have been successful when this principle was neglected and the so-called trial by dossier rampant. Accordingly, the following argument made by Mamoru Urabe well illustrates the atmosphere prevalent in the courtrooms back then:

The law of criminal procedure at that time was [basically inquisitorial] following the pattern of Continental law. The Jury Act was engrafted upon this [inquisitorial] system . . . . If it had been true, as it often said, that jurors were inclined to see the case as if they had been attorneys for the accused, and thereby returned answers negating the existence of those facts necessary to constitute a crime, I guess the reason might have been the inquisitorial attitude to the conduct of the trial taken by most judges, which might have had the effect of creating an antagonistic attitude to the court among jurors, which in turn might have made them [unduly] sympathetic to the accused.

. . . [If such an observation is correct] the present framework of criminal procedure, which has adopted various adversary principles from Anglo-American law, seems to fit much better a system in which criminal cases are tried by jury.<sup>58)</sup>

This article does not wish to promote the overly simplified view that the adversary system is compatible with the jury system while the inquisitorial system is not. In both systems the implementation of a jury system would require the adherence to the principle of oral proceedings. The jury system proved to be unsuccessful in prewar Japan because this principle was neglected.

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58) Urabe, *supra* note 46 at 490.

### III. The Current Jury System of Korea

Trial by jury is more than an instrument of justice  
and more than one wheel of the constitution:  
it is the lamp that shows that freedom lives.

- Patrick Devlin, *Trial by Jury* -

#### 1. *The Backdrop for the Introduction of the Jury System*

The Jury Act that was in place in prewar Japan was never enforced in its colony, Joseon. It was difficult for the members of the Korean public to qualify as jurors under the Jury Act,<sup>59)</sup> while the essential objectives of the Act were not related to Joseon, either. The political reasoning of vindicating the judicial power exercised in the name of the Emperor, was of no concern to the Korean public.

The discussion of the introduction of the jury system to Korea was first initiated in the period of the U.S. Military Government in Korea after the country was liberated. In May 1947, the U.S.-Soviet Joint Commission required the parties and organizations in both halves of Korea to file responses regarding the organization and platform of a provisional government. A proposal jointly filed in response by the Supreme Public Prosecutor's Office, the Seoul High Prosecutor's Office, and the Seoul District Prosecutor's Office in June 1947 contained details regarding the introduction of a jury system.<sup>60)</sup>

Subsequently in June 1948, its introduction was briefly discussed during the course of the review of the draft of the first Constitution. In response to a written question of the assemblyman Byeong-hoe Kim as to whether to introduce a jury system, Expert Member of the Committee Seung-ryeol Gwon

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59) Jurors were chosen by lot from those (i) who were Japanese male citizens over thirty years of age, (ii) who had resided in the same city, town or village for two years or longer, (iii) who paid not less than three yen in national direct tax for the preceding two consecutive years, and (iv) who were literate (The Jury Act § 12, 23 & 27).

60) As for details, see Joon Young Moon, *The Failure in Attempts toward Democratic Justice in South Korea from 1945 to 1949: debates upon the introduction of the jury system and the selection of judges by legal professions*, 21 DEMOCRATIC LEGAL STUDIES 141, 155 (2002) (available only in Korean).

replied as follows:

Trial by jury is a judicial component. It is therefore conventional to incorporate jury trial in the judicial system. Article 75 stipulates, "Judicial power is exercised by courts consisting of judges. The organization of the Supreme Court and lower courts shall be determined by Act." This "determined by Act" phrase may imply that a jury system is either incorporated or not. The National Assembly could insert certain provisions in the Court Organization Act and the Criminal Procedure Code. This is why the constitutional bill does not deal with trial by jury.

In actuality, however, neither the Court Organization Act of 1949<sup>61)</sup> nor the Criminal Procedure Code of 1954<sup>62)</sup> contained any provisions for jury trial. Afterwards, the jury system became a matter of little concern to the Koreans, and for nearly a half century, no official discussions were initiated to introduce it.

Although a number of analyses may be produced as to why the institution failed to garner attention among the Korean judicial community over the course of establishing the Constitution, the Court Organization Act, and the Criminal Procedure Code following the end of the Colonial Era, this article wishes to stress the importance of certain circumstances that were in many ways similar to those surrounding the prewar Japanese jury system. As noted earlier, the prewar jury system of Japan was realized in courtrooms where oral proceedings were neglected and thus failed to find a way of effective operation. Under the authoritarian, bureaucratic judicial system that lacked criminal procedures protecting human rights, the Japanese public did not find it compelling to go out of their way to make use of the jury system. More fundamentally, this is because the jury system of that time was introduced to further political agendas, not to implement civil participation in judicial affairs.

In this sense, the criminal justice of post-liberation Korea was not very

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61) Law No. 51 of 1949.

62) Law No. 341 of 1954.



different from that of prewar Japan. The criminal justice of post-liberation Korea inherited the criminal justice system of the Colonial Era nearly intact. As the trial by dossier was practically unquestioned, the members of the judicial community must have found the introduction of a trial-by-jury system less than compelling. There were no political motives for its introduction as a political institution, either. The following analysis made by Professor Joon Young Moon is straightforward testimony of the situations surrounding post-liberation Korea.

It is obvious that with respect to the discussions of civil participation in the judicial system engaged in after the liberation, the key to its success was how its political implications might be newly reorganized. As discussed below, however, the public awareness of the political implications was, counting out those on the left wing, very limited at best. Most judicial officers grew up within the bureaucratic and precise judicial framework of the Colonial Era and thus required strong political intervention from the outside if they were to break out of such framework, which intervention, however, was not permitted by the circumstances of the time.<sup>63)</sup>

Another round of official discussions of the introduction of the jury system in Korea began when a series of Presidential Committees on Judicial Reform were successively organized since the 1990s. The first Committee organized in May 1999 concluded its May 2000 proposal stating that civil participation in the judicial system was “a project to be studied and reviewed over a long haul in an affirmative manner.” Thereafter, the second Committee established in October 2003 presented their opinion in its December 2004 proposal: “It is appropriate to have in place an institution of civil participation in the judicial system.” Then, the last Committee launched in January 2005 submitted to the National Assembly a bill of the Civil participation in Criminal Trial Act in December 2005, which passed the Assembly on April 30, 2007, resulting in its enactment.

Korea now took a step closer to the democratization of justice by

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63) Moon, *supra* note 60 at 151.

implementing civil participation. The collective competence of the Korean public that achieved democracy in legislation and administration, finally demonstrated itself in justice as well. The jury trial system of Korea was not created as a byproduct of political considerations as in Japan. Rather, it would be correct to say that the Korean jury system was a product of this collective competence that has been accumulated to date. The specific basis for this argument is presented below.

## *2. The Substance of the Jury System*

The substance of the Korean jury trial system may be summarized as follows, with a focus on a comparison with that of prewar Japan. Firstly, in a similar manner with its Japanese counterpart, the jury trials of Korea deal with felony cases only. This is a makeshift measure to minimize the adverse effects in the early stages of the implementation, and the aim is to gradually expand the applicability over its course.

Secondly, the Korean juries are expected to deliver verdicts of guilty and not guilty. The verdicts are to be reached by unanimous voting.<sup>64)</sup> If no unanimous decision is made, the jurors are required to hear the opinions of the judge before reaching a verdict by a majority vote.<sup>65)</sup> If a guilty verdict has been delivered, the jurors are to present their opinions on sentencing after engaging in a discussion with the judge.<sup>66)</sup>

Lastly, the verdict and sentencing opinions given by the jury do not bind the court.<sup>67)</sup> The judge, however, is required to explain to the defendant in the courtroom and state in the court decision the reason for a ruling inconsistent with the jury's verdict.<sup>68)</sup>

As shown above, although the jury trial of Korea differs from that of Japan in that it produces verdicts of guilty and not guilty, it also shares certain similarities with it: it exclusively deals with felony cases, allows for a verdict

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64) Civil Participation in Criminal Trials Act (hereinafter referred to as the CPCT Act) § 46 Sec. 2.

65) The CPCT Act § 46 Sec. 3.

66) The CPCT Act § 46 Sec. 4.

67) The CPCT Act § 46 Sec. 5.

68) The CPCT Act § 48 Sec. 4, § 49 Sec. 2.

by a majority vote, and does not recognize the binding effect of the verdict. It is therefore necessary for the Korean lawmakers to take precautions against the kind of failures that were experienced in Japan in the past.

The following Chapter reviews where the criminal justice of Korea stands today and analyzes it in comparison to the situation surrounding the criminal justice of prewar Japan. Based on this analysis, it argues that the outlook for the Korean jury trial is promising, and that the Korean jury system most likely will not share the faith of its Japanese counterpart. It then intends to explore some of the challenges to be faced by the Korean jury trial on the road to a better future.

#### **IV. The Outlook of Civil Participation in Criminal Trials in Korea**

Kings, marquises, generals, and chancellors are made, not born.

- Sima Qian, *The Records of the Grand Historian* -

The Civil participation in Criminal Trial Act has been in force for one year since January 1, 2008. A current overview of civil participation in criminal trials is as follows:<sup>69)</sup> As of January 1, 2009, a total of 223 cases of trial by jury have been filed for, resulting in 60 holdings and 30 cases still pending. In the remaining 133 cases, either the defendants withdrew the application, or the courts precluded jury trials. As it has only been one year since the jury system started, it would be premature to evaluate the performance of this system. It is necessary to observe how it fares over a longer term. This article, however, presents a careful forecast of the future of civil participation in proceedings, based on a comparative analysis of the reality in which Korean criminal justice is rooted.

Firstly, the circumstances surrounding Korean criminal justice of today are fairly different from the fascist regime of Japan in the past. South Korea is cited as one of the very few examples where economic development and

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69) For the detailed statistics of the Korean jury trial over the last one year, see THE CHOSUN ILBO, December 26, 2008, at A27.

democracy were concurrently accomplished. Given its moderately adequate levels of economic conditions and democratic values, the failure of the jury system seems unlikely.

Secondly, this article finds the civil participation system in its current form fairly well organized in substance. Some may note that it does not require unanimous verdicts, unlike the Anglo-American jury system. It stands, however, to good reason that a legal institution reflects the society that it is rooted in. The differences of the Korean jury system from those of other countries alone do not warrant belittlement. Moreover, there are no grounds to presume that unanimous decision-making is superior to a majority vote. People often resort to majority voting when it comes to collective decision making, and there are several theories that argue for the legitimacy of majority voting.<sup>70</sup> If unanimity is required for group decision-making, an objection raised by a single person reverses the decisions made by everyone else. To put it another way, only the decision of a single person is honored.<sup>71</sup> If a group decision-making process requires two thirds of the decision makers to cast favorable votes, the opposing votes cast by only one third are enough to reverse the self-determinations made by the remaining two thirds. Expressed in other terms, only the self-determinations of the one third are honored. This leads to the conclusion that a simple majority vote would honor the self-determinations of the largest number of people.<sup>72</sup> Besides, the American economist Kenneth Arrow (1921- ) once produced mathematical proof that it was impossible to determine a collective preference of a group by aggregating the preferences of its members, no matter what methods are employed, including simple majority voting, weighted majority voting, or unanimous voting.<sup>73</sup> Conclusively, the fact that the Korean jury system has elected to use

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70) As for the theories which justify the majority rule, see generally ROBERT ALAN DAHL, *DEMOCRACY AND ITS CRITICS* 138-44 (1989); YASUO HASEBE, *THE LABYRINTH OF INCOMMENSURABLE VALUES: STUDIES IN CONSTITUTIONAL LAW AND LIBERAL DEMOCRACY* 89-98 (2000) (available only in Japanese).

71) In the well-known classical film *Twelve Angry Men* (1957), which is often said to illustrate the virtues of the jury system, the stubborn objection of only one person finally resulted in the justice. However, a fictitious case of the movie should not be generalized to advocate the unanimous voting.

72) DAHL, *supra* note 70, at 138-39.

73) This is called the *Arrow's Impossibility Theorem*. Kenneth Arrow was awarded a Nobel

simple majority votes for verdicts, produces no particular issues in theoretical terms. It is also permitted to file an appeal against a holding produced in a jury trial of Korea,<sup>74)</sup> which precludes the likelihood of defendants waiving jury trials, as was the case with Japan in the past, so that they could later appeal.

Thirdly, the level of the sense of equality in Korea is virtually unparalleled in any other countries. Korea has no royal families or aristocracy. A sense of equality and a refusal to recognize privileged classes are deeply ingrained among the Korean public. Furthermore, the seemingly unending vine of distrust of the judiciary system among the public since the foundation of the republic, has reached an alarming level. These factors rule out any remote likelihood of the Korean people preferring trials by professional judges over trials by jury.

Fourthly, the introduction of the civil participation in criminal proceedings was a bottom-up reformation implementing the wishes of the public toward the democratization of justice. This stands in stark contrast to the Japanese experience in that it was a top-down reformation stemming from political agendas.

Lastly, Korea's introduction of the jury trial system was implemented concurrently with the reform of the Criminal Procedure Code. This descended from the recognition of the lawmakers that the successful implementation of the jury system would be unfeasible without the reform. The reform of the Criminal Procedure Code of 2007 is regarded as the most extensive and most desirable revision since its establishment in 1954. Enhancing the principle of oral proceedings as well as the principle of adjudication based on evidence, the revised Criminal Procedure Code laid solid foundations on which the jury system could take root.

Based on these grounds, this article maintains that the future of the civil participation system is not bleak at all, and considers it necessary to observe how it fares for some time to come. Just as it is unwarranted to have an

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Prize in 1972 for this theorem. For the theoretical attempt to repute the *Arrow's Impossibility Theorem* and re-evaluate democracy, see HONG SIK CHO, *DEMOCRACY AND MARKET ECONOMY* Ch. IV (2007) (available only in Korean).

74) For a discussion of the egalitarian spirit of the Korean, see HO-KEUN SONG, *WHAT EGALITARIANISM MEANS TO KOREA* (2006) (available only in Korean).

entirely rosy view of the future, it is equally unnecessary to be overly pessimistic. The task the Korean public has at hand is to explore the future challenges on the road in order to ensure the successful operation of the system.

## V. Conclusion

Never mind that the jury was not, nor could it be realistically expected to be, a perfect institution. It was viewed as better than the alternatives.

- Neil Vidmar, *World Jury Systems* -

Like it or not, the system of civil participation in trials has been implemented into the legal program and will stay operational in this country for a substantial period. The challenge we have on hand is to successfully operate this institution. To this end, this article deems it necessary to build an extensive consensus and respect among the public for jury verdicts. Empirical studies indicate that the percentage of verdicts consistent with judge decisions is approximately 75%. The remaining 25% inconsistency reportedly eventuates from differences in values, where judges also agree that different values share the same weight and it would be unreasonable to put some above others. Such being the case, the respect for jury verdicts boils down to the issue of the respect for different values.

Man does not entirely depend on reason in a decision-making process. Intuition is sometimes relied upon. Human beings make reasonable decisions but they also make subjective choices. Subjective choices involved in decision making, therefore, deserves respect just as much as reasonable judgments do. So do the subjective choices of the jury as well as those of the judges. Any seemingly undesirable and subjective values incorporated in the 25% of dissenting opinions, do not justify the claim that the civil participation system is unreasonable.

To be sure, the public support for the system requires efforts within the judicature as well. The implementation of the system does not translate into the complete achievement of judicial democracy. Insofar as the Korean jury trial does not recognize the binding effect of the jury verdict and leaves the final decisive power to the judge, the judiciary must make efforts to enhance

its democratic legitimacy. It could be a practical option to consider introducing a system of electing judges, which was attempted in the early 1960s.

KEY WORDS: democracy, jury system, trial by jury, Meiji Constitution, Taisho Democracy, Jury Act, Judicial Reform, civil participation in criminal trials, majority rule





# Capital Markets and Financial Investment Services Act of 2007: An Overview

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## I. Introduction

On March 2006, the then Ministry of Finance and Economy of Korea (“MOFE”), now the Financial Services Commission, announced its intention to consolidate existing capital market-related laws into a single statute. The reform, said the MOFE, is to enhance the quality of capital markets and to promote the development of financial investment services in Korea. Korea was traditionally considered to be a bank-based system rather than a market-based system. One of the main purposes of the reform was said to make our capital circulation system more multiple. The *Capital Markets and Financial Investment Services Act 2007* (hereinafter the “CMFISA”), which passed the National Assembly on 13 June 2007, came into effect on February 4th, 2009.

## II. Background of CMFISA

The CMFISA was enacted in an effort to revamp the capital market regulatory system based on product and institutional distinctions. Such an institution or product-based regulation was a creature of the days when sectoral differences in capital markets were clear enough to justify different regulatory approaches. Capital markets existing today are markedly different

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\* This memo is based on Kon Sik Kim & Sunseop Jung, *Consolidation of Financial Services Laws in Korea: An Interim Report* in REGULATORY REFORM IN THE AGE OF FINANCIAL CONSOLIDATION (Lee-Jay Cho & Joon-Kyung Kim eds., Korea Development Institute, 2006).

from the model presupposed by the traditional regulations. It was noted that the previous laws were deficient primarily in the following three respects: insufficient and inflexible key statutory definitions, regulatory inequality among financial sectors, and unsystematic vertical and horizontal distribution of regulatory measures. Truly, the CMFISA is not necessarily the only option to address these alleged defects. It is believed, however, to be a most ideal solution to these problems.

### III. Scope and Structure of the CMFISA

#### 1. *Scope of the CMFISA*

The applicability of the CMFISA is, in principle, dependent on two core concepts, **financial investment products** and **financial investment services**. “Financial investment products” involve the extent to which the areas of financial regulation should be covered in the CMFISA. “Financial investment services” are concerned with the scope of financial activities included in the CMFISA.

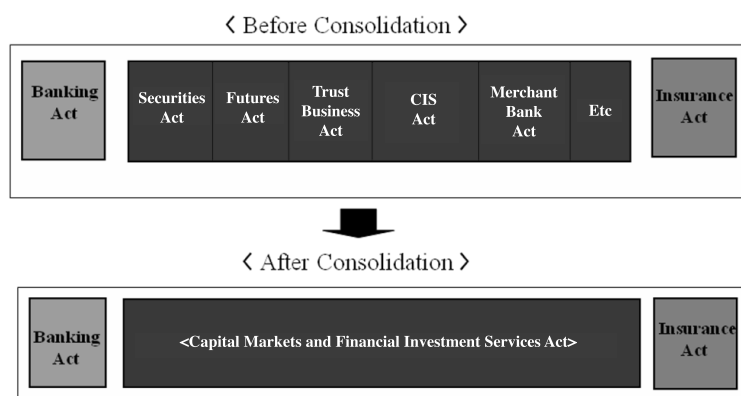
The CMFISA will cover all areas of capital markets and financial investment services including licensing, prudential regulation and non-prudential regulation of financial investment services providers. It will also cover market infrastructures such as exchanges, clearing and settlement facilities. The table below shows the acts to be incorporated into the CMFISA.

#### Acts Covered by the CMFISA

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1. Securities Transaction Act
  2. Futures Trading Act
  3. Trust Business Act
  4. Indirect Investment Asset Management Business Act
  5. Merchant Bank Act
  6. Korea Securities and Futures Exchange Act
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The scope of regulated activities covered by the CMFISA will be determined based on the three core concepts: financial investment products, financial investment services and classification of the investors. In principle,

the CMFISA applies to all financial investment services dealing with financial investment products. Financial investment products refer to products carrying out specific financial investment functions, while financial investment services cover dealing, brokerage, advising and other activities involving financial investment products. The CMFISA distinguishes between wholesale and retail investors. Several conduct of business regulations do not apply to the financial investment services with professional investors.



## 2. Structure of the CMFISA

The CMFISA consists of the following 10 parts.

| Part   | Chapter   |  |
|--|-----------|--|
| Part 1<br>General Provisions                         | -         | General Provisions                         |
| Part 2<br>Financial Investment<br>Services           | Chapter 1 | Authorization and registration             |
|  | Chapter 2 | Corporate governance                       |
|  | Chapter 3 | Maintenance of Prudent Management          |
|  | Chapter 4 | Regulations on Conduct of Business         |
| Part 3<br>Issuance and Distribution<br>of Securities | Chapter 1 | Registration statement                     |
|  | Chapter 2 | Corporate Merger and Acquisition           |
|  | Chapter 3 | Annual Report of Stock-listed Corporations |
|  | Chapter 4 | Over-the-counter Transactions              |

(continued)

| Part  | Chapter                     |   |
|---|-----------------------------|---|
| Part 4<br>Market Misconduct                                     | Chapters 1~2<br>Chapter 3   | Insider trading, market manipulation<br>Market misconduct               |
| Part 5<br>Collective Investment Scheme                          | Chapters 1~10<br>Chapter 11 | Collective investment scheme<br>Foreign Collective Investment Securitie |
| Part 6<br>Financial Investment<br>Services-related Institutions | Chapters 1~8                | Financial investment services-related<br>institutions                   |
| Part 7<br>Korea Exchange  | Chapters 1~6                | Korea Exchange  |
| Part 8<br>Supervision and Disciplinary<br>Action                | Chapters 1~4                | Enforcement   |
| Part 9<br>Supplementary Provisions                              | -                           |   |
| Part 10<br>Penal Provisions                                     | -                           | Penalties   |

## IV. Financial Investment Products, Financial Investment Services, Investors

### 1. Financial Investment Products

#### 1) Overview

The term “financial investment products” is a core concept for determining the coverage of the CMFISA. In defining the term “financial investment products,” the following two issues were considered: (1) comprehensive definition of financial products; and (2) consumer protection by minimizing the regulatory gap.

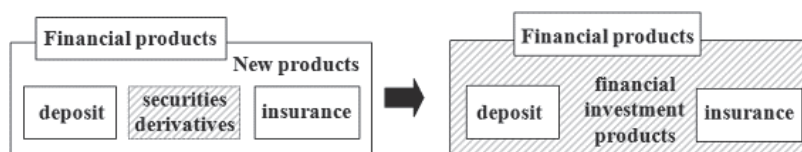
In principle, the new concept “financial investment products” covers all products regulated under the current capital market laws. If a certain instrument meets the requirements for “financial investment products,” it must in principle be regarded as such, regardless whether the law covering it

is in the jurisdiction of the MOFE.

2) *Financial investment products*

There are 4 elements in defining financial investment products: rights, purpose, investment factor, and money. Financial investment products are contractual rights. Its purpose should be to get profits or to avoid losses. There should be an investment factor which means potential loss of principal or potential liability of additional payment (contingent liability). This element may differentiate deposit and insurance products from financial investment products. Financial investment products involve the movement of money or money equivalent from one party to the other.

Financial investment products consist of securities and derivatives. Derivatives are classified into on-exchange derivatives and off-exchange (OTC) derivatives according to their trading place.



3) *Securities*

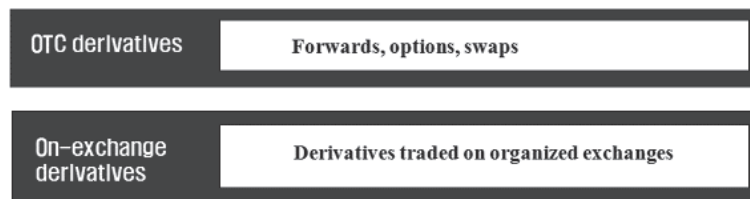
Securities are classified into 6 types, debt securities, equity securities, beneficiary certificates, securities deposit receipts, investment contract securities and derivatives-linked securities, according to the nature of rights embodied in the securities.

|                         | Definition                       | Example                |                      |
|-------------------------|----------------------------------|------------------------|----------------------|
| Traditional Securities  | Debt securities                  | Debt                   | Treasury bond, CP et |
|                         | Equity securities                | Investment share       | Stock etc            |
|                         | Beneficial securities            | Beneficial right       | Investment trust etc |
|                         | Securities depository securities | Depository receipt     | KDR, GDR, ADR etc    |
| Investment Contract     | Investment contract securities   | Non-typical CIS etc    |                      |
| Securitized Derivatives | Derivatives-linked securities    | CLS, ELS, ELW, ILS etc |                      |

Debt security is a security indicating rights to claim a monetary obligation to the issuer. It includes government bonds, municipal bonds, special bonds,<sup>1)</sup> corporate bonds, commercial papers<sup>2)</sup> and other similar securities. Equity security is a security indicating invested equity to the issuer. It covers stock certificates, instruments representing preemptive rights, certificates of contribution issued by a corporation established by statute, invested equity of limited partnership companies, limited liability companies, or undisclosed associations under the Commercial Act, invested equity of associations under the Civil Act and others similar securities. Beneficiary certificate means a security indicating beneficiary's interests in a trust structure. Investment contract security is modeled after the concept of invest contract in the US securities law. And derivative-linked security is a securitized derivative, whose returns are fixed according to a predetermined method based on changes in the price, interest rate, indicator, unit of underlying assets or index based thereon. Securities depository receipt is a facility indicating rights of deposited securities, which has been issued outside the country where such relevant securities were issued.

#### 4) Derivatives

Derivatives are composed of forwards, options and swaps (§5(1)). The CMFISA classifies derivatives into exchange-traded derivatives and OTC derivatives. Exchange-traded derivatives are those traded on a derivatives markets or foreign derivatives markets. Over-the-counter derivatives are those which are traded on an organized exchanges.

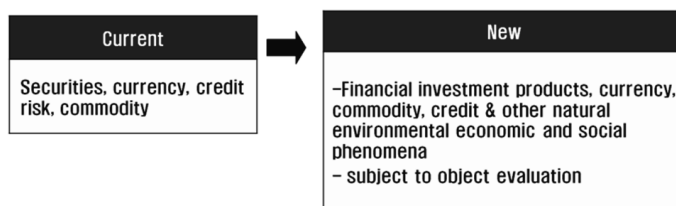



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1) Refers to bonds issued by a corporation established in accordance with a statute.

2) Refers to bills meeting the requirements prescribed by the *Presidential Decree* issued for the purpose of raising funds for businesses.

The CMFISA broadly defines the underlying assets of derivatives. Formerly, the STA listed only four types of underlying assets, including securities, currency, commodity and credit risk. However the CMFISA adds “other risks derived by natural, environmental, or economical phenomena, etc. whose price, interest rate, index, and unit can be calculated or assessed in a reasonable and appropriate method” to the list (§4(10)). This comprehensive definition is subject to only one condition that the underlying assets’ price, interest rate, index, and unit can be calculated or assessed in a reasonable and appropriate method. The financial regulator and the court can use the “reasonableness and appropriateness test” as a last resort to expel pure bets or gamings from the markets.



## 2. Financial Investment Services

The second element that is crucial in determining the applicability of the CMFISA is the concept of “financial investment services”. Under the CMFISA, “financial investment services” will serve as a core concept. In principle, all financial activities regulated under the previous capital market-related laws may be included in the definition of “financial services”. The term “financial investment services” may cover two sub-categories of services: one is services directly related to financial investment products; and, the other is services not directly related to financial investment products, but performs a financial investment function. The former may include dealing, brokerage or other transactions involving newly defined “financial investment products”. The latter may include the business of trust.

Under the CMFISA, “financial investment services” covers 6 investment businesses including dealing, brokerage, collective investment scheme service, non-discretionary investment advisory service, discretionary investment advisory service, and trust service (§6(1)). “Dealing” means a service, for its

own account regardless of the title, purchasing and selling financial investment products, issuing and underwriting securities, or soliciting an offer, offering, and accepting an offer thereof (§6(2)). “Brokerage” refers to a service, for other’s account regardless of the title thereof, purchasing and selling financial investment products, soliciting an offer, offering, and accepting an offer or such soliciting, offering and accepting as to issuance and underwriting of securities (§6(3)). The difference of these two services is who holds the economic risks and returns of the transaction. “Collective investment scheme service” is a collective investment management service (§6(4)). Collective investment is an activity to manage money, etc. raised by soliciting more than two investors in a way of acquiring, disposing of, or otherwise managing investment assets with property values without any ordinary direction from the investors or each fund manager, and to distribute the result thereof to the investors or each fund manager (§6(5)). The term “non-discretionary investment advisory service” shall mean a service provided upon request for advice on the value of financial investment products or the investment decision on the financial investment products (§6(6)). “Discretionary investment advisory service” is a service to acquire, dispose of, or otherwise manage financial investment products for each investor after the delegation from investors of all or a part of investment decisions on the financial investment products (§6(7)). The term “trust service” refers to a service carrying on a trust (§6(8)).

### 3. *Investors*

The CMFISA classifies the investors into professional and non-professional investors according to their risk-taking capacity. The term “professional investor” refers to “an investor who has risk-taking capacity over the investment taking into account its expertise for the financial investment products and its asset size” (§9(5)). Professional investors include the Government, the Bank of Korea, financial institutions, stock-listed corporations or others prescribed by the Presidential Decree. Non-professional investor means an investor who is not a professional investor (§9(6)). Several conduct of business regulation such as suitability and appropriateness rule (§§46 & 46-2) and the duty to explain (§47) do not apply to a financial investment transaction with professional investors.



So far, there has been no such approach in Korea except in the case of OTC derivatives. Presidential Decree for the Securities Transaction Act §84-28(2) limited the capacity of counterparties for OTC derivatives transactions of securities companies to a small group of wholesale investors. By concentrating regulatory resources on the retail, non-professional investors, the CMFISA tries to promote efficient use of scarce regulatory resources and to lower the overall level of regulation in capital markets. As a whole, this could be a momentum to convert investor protection by “prohibition of risky products” to investor protection by “isolation of non-professional clients from risky products”. This feature of the CMFISA may work to reduce apprehension on the comprehensive definition of financial investment product.

## **V. Investor Protection Regime**

Investor protection is one of the main features of the CMFISA. With the comprehensive definition of financial products and expanded scope of investment businesses, there arises a concern on the potential market abuse and investors’ information asymmetry. The CMFISA enhanced the level of investor protection compared to the Securities Transaction Act.

In particular, the CMFISA adds Know your customer/suitability rule (§46), duty to provide product information (§47), prohibition of unsolicited call (§49(iii)) and financial promotion regulation (§57) to the current investor protection measures. In addition, the CMFISA also introduced the appropriateness rule (§46-2). Suitability rule means that a financial investment firm shall not solicit investment from non-professional investors where the solicitation is found to be unsuitable for the investors taking into account their investment objectives, financial status, investment experiences, etc. However, it should be noted that the suitability rule is applicable only if there exists a financial investment firm’s solicitation to a non-professional investor. If there exists no elements of solicitation, then the appropriateness rule will be applicable. Where a non-professional investor asks a financial investment firm to sell him risky products such as derivatives, the firm must check the appropriateness of the products to the investor.

In addition, a financial investment firm, when it intends to solicit investment from non-professional investors, must provide product

information such risks associated with the investment, and other details prescribed by the Presidential Decree in order to help the understanding of non-professional investors. If not, the financial investment firm shall be liable to non-professional investors for damages caused by such violation. The damages shall be presumed to be the amount calculated by deducting the total amount of money, etc. recovered or to be recovered by non-professional investors through the disposition of a financial investment product or any other method from the total amount of money, etc. paid or to be paid by the non-professional investors for acquiring the financial investment products.

## **VI. Conclusion**

The CMFISA may have the following benefits. First, it is expected that the new Act will eliminate room for regulatory inequality without reasonable grounds. Second, the Act may address the insufficient regulatory definition of financial products with a comprehensive definition. It could significantly reduce concern about the tradability of a new financial product on the part of financial institutions, and provide adequate protection to those investing in new types of financial production. Third, it is also expected to eliminate room for regulatory inequality without reasonable grounds.

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