



Management Succession in Korea: Tunneling, Semi-Tunneling, and the Reaction of Corporate Law

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ABSTRACT

Recently in Korea, certain issues of corporate law became the subjects of fierce political debates unlike many other jurisdictions where corporate law issues generally remain in the exclusive realm of professionals and academics. This Article begins with the question of why corporate law issues attracted so much political attention in Korea and whether such political attention actually helped improve the corporate law. In pursuing the answers to such questions, this Article identifies a recurring pattern: (i) existence of strict rules against seeking private benefits; (ii) various clever measures to circumvent such rules; (iii) failure of the courts to regulate such circumventing measures; (iv) many proposals for new statutes in the legislature, which often become politicized and lead to suboptimal results; and (v) the stricter new rules that prompt another round of circumvention.

This pattern of “rules—circumvention—passive judiciary—stricter statutory rules—further circumvention” is most salient

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when the controlling shareholders attempt to implement “management succession” (i.e., transferring ownership and managerial power to the descendants of the controlling family). This Article analyzes a few measures widely used in Korea for management succession: issuing stock at a low price, selling treasury stock at a low price, “funneling” of business, “tolling,” and conducting horizontal spin-offs. While some of these measures fall under the typical category of tunneling, some are dubious. By tracking the chain of actions (by the corporations and the controlling family members) and reactions (by the government, including the executive, judiciary, and legislative branches) along the line of the foregoing pattern, this Article shows the importance of the judiciary’s role in corporate law and the limitation of the political lawmaking process in corporate law. The stories involving management succession in Korea also show that the rules, being vulnerable to circumvention, cannot effectively address the corporate governance problems without the concurrent application of the standards.

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I. INTRODUCTION

Corporate law is usually an area of interest for professionals and academics. It is unusual that politicians and the media pay serious attention to the typical issues of corporate law. In Korea, however, certain corporate law issues have been heavily debated in the political arena. For example, in the presidential election of 2012, major candidates promised to implement “corporate law reforms” such as “multiple derivative action,” “mandatory cumulative vote,” and “separation of the board chair and CEO” by amending the Korean Commercial Code (KCC).¹ These items appeared in the campaign leaflets of major candidates as their campaign promises, but they failed to develop into statutes during the presidency of Park Geun-Hye, who won the 2012 election.² However, bills in a similar vein began to be submitted by various congress members in 2016 and similar campaign promises were made again in the presidential election of 2017 by both conservative and progressive candidates.³ As of December 2019, forty-five bills proposed by congress members from various parties are pending at the National Assembly for the amendment of the KCC regarding corporate governance issues.⁴

Why are corporate law issues so political in Korea? Is it good that corporate law issues are discussed at the legislature and made into statutes? These were the initial questions that prompted this research. In an attempt to answer these questions, the author found a recurring pattern: (i) existence of current rules, (ii) circumvention of the rules, (iii) passivity of the judiciary, (iv) new statutes that provide stricter rules, and (v) further circumvention.

To elaborate on the foregoing pattern, managers and controlling shareholders of Korean corporations often seek private benefits like those in other jurisdictions.⁵ Korean law, like the laws of other

1. Sangbeob [Korean Commercial Code], Act No. 1000, *amended by* Act No. 15755 (S. Kor.) [hereinafter KCC]. It is composed of six chapters, including Chapter 3: Corporation.

2. After Park Geun-Hye, the conservative candidate, took the presidency in 2013, the Ministry of Justice (MOJ) drafted a bill in accordance with her campaign promises. However, many major conservative newspapers severely criticized and demanded withdrawal of the bill through their seemingly coordinated editorials, some of which blamed the bill as a “leftist attack on Korean companies.” Within a week from the publication of these editorials, the President invited the “Chairs” of major Korean *chaebols* to the Presidential House and promised that the government will be “cautious” in amending the KCC. Soon the MOJ virtually suspended any more work on this issue, but the issues were revived in 2016.

3. Kyung-Hoon Chun, *Hoesa-beob Gae-jeong-an-e Gwan-han Bun-seok-gwa Pyeong-ga* [Analyses and Evaluations of the Amendment Bills on Korean Corporate Law], 30 GYEONG-YEONG-BEOB-RYUL [J. BUS. ADMIN. & L.] 1, 33 (2019) (S. Kor.).

4. *Id.* at 3–6 (providing the list of all forty-five bills in Korean).

5. *See, e.g., infra* Parts III.A, IV.A.

jurisdictions, provides strict rules that prohibit or penalize seeking private benefits.⁶ Rather than engaging in an outright violation of such rules, the managers and controlling shareholders often come up with various clever measures to circumvent the rules.⁷ When a case is brought in front of the court, however, Korean courts tend to take a conservative and formalistic approach in interpreting corporate law, and often fail to regulate circumventions.⁸ Such passivity of the judiciary prompts the need for new statutes and often leads to statutory amendment proposals in the legislature.⁹ Processes at the legislature tend to become politicized and usually end with suboptimal results.¹⁰ If stricter new rules are established, another round of circumvention occurs.¹¹

Such a pattern is most salient when the controlling shareholders attempt to implement “management succession” (i.e., transferring the ownership of the controlling block of shares and the de facto managerial power to the next generation member of the controlling family). Effective management succession is becoming a more and more serious issue among Korean companies in the presence of a few factors: a deeply rooted culture of owner management in many Korean companies, the aging of the controlling members of many Korean companies, and a high rate of inheritance tax (50 percent).

The purpose of this Article is to identify and examine the foregoing pattern in the context of management succession in Korean companies and to assess whether such a pattern contributed to improving corporate law. Tracking the chain of actions (by the corporations and the controlling family members) and reactions (by the government, including the executive, judiciary, and legislative branches) along the line of the foregoing pattern reveals the importance of the judiciary’s role and the limitation of the political lawmaking process in corporate law. The stories involving management succession in Korea also show that the rules, often vulnerable to circumvention, cannot effectively address the corporate governance problems without the concurrent application of the standards.

Part II provides a general background as to why management succession became an important issue in Korea. The following chapters analyze a few representative cases: Part III examines the so-called cheap stock tunneling, Part IV the related party transactions, and Part V the horizontal corporate divisions. Part VI concludes the discussion.

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6. See, e.g., *infra* Parts III.B, IV.B.
 7. See, e.g., *infra* Parts III.C, III.D, IV.C.1, IV.D.
 8. See, e.g., *infra* Parts III.C, III.D, IV.C.2, IV.D.
 9. See, e.g., *infra* Parts III.C, III.D, IV.C.3, IV.D.
 10. See, e.g., *infra* Parts III.C, III.D, IV.C.3, IV.D.
 11. See, e.g., *infra* Part IV.C.4.

II. BACKGROUND FOR MANAGEMENT SUCCESSION

In Korea, a number of large business groups, commonly known as *chaebols*, dominate the corporate scene.¹² *Chaebol* refers to a large group of related corporations engaged in diverse lines of business under highly concentrated family or individual control.¹³ Large *chaebols* such as Samsung, Hyundai Motors, LG, SK, Lotte, Hanwha, and Doosan have played a crucial role in Korea's economic development and still represent a critical portion of the Korean economy in terms of revenues, exports, hiring, patents, and so forth.¹⁴ Usually, a few large companies within the group are listed on the stock market, but many other affiliates remain unlisted. The controlling family members' shareholding ratio in the listed flagship companies of each group is usually far less than 50 percent, which creates a typical problem of "controlling minority shareholders."¹⁵

In most cases, the controlling shareholder holds a title such as Chair or Honorary Chair and exercises control over the management of the entire group, either as a board member (and the CEO) or as a *de facto* or shadow director who is not officially a member of the board elected at the shareholders' meeting. In other words, the controlling shareholders of Korean *chaebols* are, in most cases, not just passive investors but the heads of the management who have the ultimate power to make important business decisions and to hire and fire senior members of the management.¹⁶

Most *chaebols* started in the early or mid-twentieth century as small family-run enterprises and grew rapidly in the late twentieth century.¹⁷ Most of their founders have already passed away, and currently, their second (or third or even fourth, in the case of the aged *chaebols*) generation is in power.¹⁸ As the current "Chairs" become

12. Kyung-Hoon Chun, *Multiple Derivative Actions: Debates in Korea and the Implication for a Comparative Study*, 15 BERKELEY BUS. L.J. 306, 314 (2019).

13. Hwa-Jin Kim, *Living with the IMF: A New Approach to Corporate Governance and Regulation of Financial Institutions in Korea*, 17 BERKELEY J. INT'L L. 61, 63–64 (1999).

14. ECONOMIC REFORM RESEARCH INSTITUTE, CHAEBOL-EUI GYEONG-JE-RYEOK JIP-JUNG [CONCENTRATION OF ECONOMIC POWER BY CHAEBOLS] 7–10 (asset), 13–14 (revenue), 22–25 (hiring) (2018) (S. Kor.).

15. Ok-Rial Song, *The Legacy of Controlling Minority Structure: A Kaleidoscope of Corporate Governance Reform in Korean Chaebol*, 34 LAW & POL'Y INT'L BUS. 183, 196–202 (2002).

16. *Id.* at 202–03.

17. See Wonhyuk Lim, *The Emergence of the Chaebol and the Origins of the Chaebol Problem*, in ECONOMIC CRISIS AND CORPORATE RESTRUCTURING IN KOREA 35, 39–40 (Stephan Haggard, Wonhyuk Lim & Euysung Kim eds., 2003).

18. *E.g.*, the founder of Samsung Group, Byung-Chul Lee, died in 1987 and his grandson, Jae-Yong Lee, is the current leader of the group; the founder of Hyundai

aged, the *chaebols* are confronting serious questions of management succession: To whom should they pass the ownership and the managerial power? How should they implement the management succession?

In this regard, an important factor is the high rate of inheritance tax in Korea. Under the Inheritance and Gift Tax Act, the inheritance tax is levied at 50 percent of the tax base (the fair value of inherited assets, with certain deductions and add-ups) for the portion exceeding KRW 3 billion (approximately USD 2.8 million).¹⁹ As for the shares of a firm, the fair value is calculated based on the recent market price (for listed shares) or pursuant to a certain prescribed formula designed to reflect the firm's earning value and asset value (for unlisted shares).²⁰ In addition, for both listed and unlisted shares, a control premium is added up to produce the tax base if the inherited shares constitute the largest block.²¹ For example, if an heir inherits more than half of the total shares of a firm, the tax base is 120 percent of the fair value of the inherited shares.

Thus, unless the successor has sufficient funds, the successor will have to sell at least a part of the controlling block in order to pay such a large amount of inheritance tax. Then the family is likely to lose control over the entire group and this will totally change the corporate scene of Korea. Would it be good for the company and the Korean economy as a whole?

There are conflicting voices regarding this question. Some argue that Korea still needs to maintain entrepreneurial leadership of *chaebols* within the controlling family.²² They praise the owner-manager's strong incentive for long-term profits and the aggressive initiative that professional managers often lack.²³ Thus, they support such ideas as no inheritance tax, dual class shares, and tenure voting to maintain the family's control.²⁴ Others argue that the Korean economy cannot trust the spoiled children of the *chaebol* families

Group, Ju-Yung Chung, died in 2001, and his grandson, Eui-Sun Chung, is the current leader of Hyundai Motor Group (a major spin-off from the old Hyundai Group).

19. Sang-sok-se-mit-jeung-yeo-se-beob [Inheritance and Gift Tax Act], Act No. 114, amended by Act No. 16846 (S. Kor.).

20. *Id.* at art. 63.

21. *Id.* The control premium is 20 percent for the largest shareholder of a corporation and its specially related persons. *Id.*

22. See Choi Jong Hee, *Interview with Prof. Dong-Geun Cho*, NEW DAILY (Sept. 10, 2015), <http://biz.newdaily.co.kr/site/data/html/2015/09/10/2015091010122.html> [<https://perma.cc/L5P4-GFAB>] (archived Feb. 16, 2020).

23. See *id.* (citing to Ford, BMW, and Volkswagen as examples that family management can improve decision-making).

24. See, e.g., Korea Enterprises Federation, an influential association of businesses in Korea, submitted an opinion to the government in December 2018 with respect to the bills pending at the legislature. It proposed that the government lower inheritance tax, allow dual class shares, and restrict hostile acquisitions.

https://biz.chosun.com/site/data/html_dir/2018/12/09/2018120900621.html [<https://perma.cc/Z8ZJ-LHTT>] (archived Feb. 16, 2020).

anymore.²⁵ They identify family control as a serious risk factor and believe that the *chaebol* companies and the Korean economy as a whole have outgrown the size fit for family control.²⁶ Thus, some of them argue for stronger regulations on *chaebols*,²⁷ while others support more exposure of *chaebol* companies to the pressure of the capital market and even the market for corporate control.²⁸

It is a fundamental debate, but in any event, quite naturally, the *chaebol* families do not want to lose their control. For the *chaebol* families, it is imperative to increase the potential successors' shareholding ratios in advance and earn them as much cash as possible to pay the inheritance tax without having to sell the shares. This is why so many clever measures were invented for management succession. Some of such measures are classic forms of tunneling, but some are not clearly so.²⁹ From the following examples, a pattern can be identified: strict rules, circumvention, judiciary passivity, statutory amendment, and further circumvention.

III. LOW PRICE STOCK ISSUANCE TO THE POTENTIAL SUCCESSOR

A. Previous Practices

The most typical way for management succession is to issue large amounts of shares to the next generation member of the controlling family (hereinafter "N") at a low price. This will increase N's shareholding ratio and transfer wealth from the other shareholders to N. Figure 1 shows the typical flow: the controlling shareholder somehow causes Company B, the flagship listed company of the group, to issue new shares at a low price to N or Company A owned by N. N

25. In a family corporation where the children of a parent-controller compete to become the successor, children have an incentive to take on suboptimal projects by way of inefficient risk-taking, particularly when they have a small fraction of ownership in the corporation. *E.g.*, Sang Yop Kang, "Game of Thrones": Corporate Governance Issues of Children's Competition in Family Corporations, 15 BERKELEY BUS. L.J. 186, 186 (2018).

26. For a detailed discussion, see SANG-IN PARK, WAE JI-GEUM CHAEBOL GAE-HYEOK-IN-GA? [WHY CHAEBOL REFORM NOW?] 82–104 (2017).

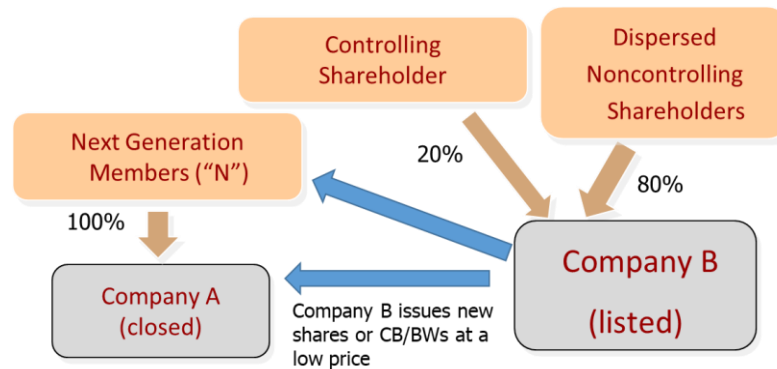
27. *Id.* at 189–208.

28. The author believes that one of the motivations that led to adopting the Korean version of Stewardship Code in 2016 was to increase market pressure on *chaebols*.

29. "Tunneling" is defined as the "transfer of resources out of a company to its controlling shareholder (who is typically also a top manager)." See Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22, 22 (2000). Some literatures use this term to also include "transfers to managers who are not controllers." See Vladimir Atanasov et al., *Law and Tunneling*, 37 J. CORP. L. 1, 5 (2011). Tunneling can be divided into three basic types: cash flow tunneling, asset tunneling, and equity tunneling. *Id.* at 5–9.

will, directly or through Company A, end up having larger shares in Company B by sacrificing the noncontrolling shareholders of Company B.

Figure 1



B. Rules

Korean law, however, is very strict on this matter. Since the issuance of new shares to a third party is likely to dilute the existing shareholders' rights, the KCC grants the existing shareholders preemptive rights. Under Article 418 of the KCC, each shareholder of a corporation has a preemptive right to subscribe to new shares in proportion to its shareholding.³⁰ Third-party allotment of new shares is allowed only when it is (i) permitted by the articles of incorporation and (ii) necessary to attain a proper business purpose, such as "introduction of new technology or improvement of financial structure."³¹

The first requirement is not an important issue, because most companies have provisions in their articles of incorporation restricting the existing shareholders' preemptive rights.³² However, the second requirement is strict in itself and, moreover, is quite narrowly interpreted by the courts. The Supreme Court even held that a defense against a hostile takeover does not constitute a proper business purpose and that the new shares issued to a third party who was friendly to the incumbent management were null and void.³³ Convertible bonds (CBs) and bonds with warrant (BWs) are subject to

30. KCC art. 418.

31. *Id.*

32. See KOREA LISTED CORPORATIONS ASSOCIATION, SANG-JANG HOESA PYO-JUN JEONG-GWAN [STANDARD ARTICLES OF INCORPORATION FOR LISTED CORPORATIONS] art. 10 (2019) (most listed firms in Korea use this as a basis of their articles of incorporation).

33. Supreme Court [S. Ct.], 2008Da50776, Jan. 30, 2009 (S. Kor.).

similar rules under the KCC.³⁴ In a few cases, those issuing CBs (with a low conversion price) or BWs (with a low exercise price) to a third party were found guilty of criminal breach of trust against the issuer.³⁵ Thus, issuance of new shares to N or Company A in the above case is likely to be found illegal and prohibited, and even criminally punishable if the price is lower than the fair price. Thus, companies had to come up with a circumventive measure.

C. Circumvention #1: Forfeited Shares

The first measure is reissuing forfeited shares. Company B (of Figure 1) launches a rights issue of new shares at a low price to the existing shareholders. Certain shareholders do not exercise their preemptive rights to buy new shares, and thus, their rights are “forfeited.” Then, the board of Company B reissues the forfeited shares to N or Company A at the original issue price (which is lower than the fair price). The end result is the same as in Figure 1, except that some smart and diligent shareholders may have exercised their preemptive rights and shared this good opportunity with N or Company A. In reality, many shareholders tend to remain inert in exercising their preemptive rights and some shareholders specially related to the controlling family voluntarily give up their rights.³⁶ Thus, this measure was quite popular.

However, it faced a serious challenge by prosecutors in the Everland case. Everland was a nonlisted, *de facto* holding company of Samsung Group, held by members of the Lee family and their affiliate companies.³⁷ In 1996, Everland decided to issue to its shareholders CBs that were convertible into common shares of Everland at a price lower than the fair market value of the Everland shares.³⁸ Of the existing shares, 97 percent gave up their preemptive rights, and the board of Everland reissued the forfeited 97 percent CBs to JY Lee, the son of the controlling shareholder.³⁹ Later, JY Lee realized huge profits by converting the CBs into shares and having them listed on the stock exchange.⁴⁰ In 2006, Everland’s directors were indicted for

34. See KCC arts. 513(3) (for CBs), 516-2(4) (for BWs).

35. Supreme Court [S. Ct.], 2008Do9436, May 29, 2009 (S. Kor.) (for BWs); Supreme Court [S. Ct.], 2001Do3191, Sept. 28, 2001 (S. Kor.) (for CBs).

36. See, e.g., the underlying facts of Supreme Court [S. Ct.], 2011Da57869, Sept. 12, 2013 (S. Kor.); *infra* notes 37, 48.

37. Supreme Court [S. Ct.], 2007Do4949, May 29, 2009 (S. Kor.).

38. *Id.*

39. *Id.*

40. *Id.*

criminal breach of trust on the ground that they breached their fiduciary duty towards Everland by reissuing the CBs at a low price.⁴¹

In the Supreme Court, the opinions were split. Both the majority and the minority opinions agreed that (i) a low issue price does not matter in the case of a rights issue and (ii) a low issue price is problematic in the case of a third-party allotment.⁴² The minority opinion identified this case as a third-party allotment because 97 percent of the existing shareholders gave up their preemptive rights and Everland practically reissued most of the CBs to a single third party.⁴³ The majority opinion, however, ruled that this case still qualified as a rights issue because the opportunity to buy the CBs on favorable terms (i.e., a low conversion price) was given to all the existing shareholders and they voluntarily gave up their rights.⁴⁴ According to the majority opinion, the defendants were found not guilty of a criminal breach of trust.⁴⁵

Many people perceived that the court avowedly sided with the *chaebol* and gave a wholesale blessing to the use of forfeited shares.⁴⁶ Such perception, however, is not entirely correct. In the Everland case, as the directors of Everland (i.e., the issuer) were indicted for criminal breach of trust owed to Everland, the issue was whether Everland suffered damage due to the misconduct of its directors.⁴⁷ But the economic substance of this case shows that it is not Everland but the 97 percent shareholders that suffered any damage, because the wealth was transferred from the 97 percent shareholders of Everland to JY Lee. Indeed, shareholders of Cheil Industries, one of the 97 percent shareholders of Everland, filed a derivative action against the directors of Cheil Industry.⁴⁸ Their cause of action was that the defendants breached their fiduciary duty towards Cheil Industry by wrongfully giving up its preemptive right to buy Everland's CBs at advantageous terms.⁴⁹ The court supported the plaintiffs' claim.⁵⁰ In sum, although the Everland ruling held that the issuer's directors were not guilty, it

41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.*

46. *E.g.*, Seung-Hyun Cho, *Sam-sung-eui In-jeok Ji-bae-gu-jo Byeon-hwa-wa Geu Beob-jeok Mun-je-jeom* [Legal Issues of the Change in the Governance Structure of Samsung], 67 MIN-JU-BEOB-HAK [DEMOCRATIC LEGAL STUD.] 191, 206 (2018) (S. Kor.).

47. The criminal breach of trust requires damage suffered by the person to whom the defendant owes a fiduciary duty. Hyeongbeob [Criminal Code], Act No. 293, amended by Act No. 15982, art. 355(2) (S. Kor.). A director owes fiduciary duty to the corporation rather than to the shareholders. KCC art. 382(2). Thus, damage suffered by the corporation is an element of the criminal breach of trust.

48. Daegu High Court [Daegu High Ct.], 2011Na2372, Aug. 22, 2012 (S. Kor.).

49. *Id.*

50. *Id.*

did not necessarily mean that the whole scheme was justifiable and legitimate.

In any event, the Everland ruling showed (or at least created the impression) that current rules were insufficient to block a similar deal. Keen on the antipathy of the general public against *chaebols*, the government and the National Assembly amended the statute to address this problem.⁵¹ According to the amendment, once an existing shareholder gives up its preemptive rights in the rights issue of a listed firm, such forfeited portion may be reissued only at a fair market price as if it were a third-party allotment.⁵² This amendment does not apply to a nonlisted firm such as Everland.

In sum, the judiciary was reluctant to regulate this circumvention and the Everland ruling was perceived by outsiders as having granted blessing to this circumventing practice. The legislative reaction was quick, but incomplete in scope.

D. Circumvention #2: Use of Treasury Stock

Another measure to circumvent the strict requirements of Article 418 of the KCC is to sell treasury shares in lieu of issuing new shares.

In the past, Korean law prohibited a company's acquisition of its own shares unless it met certain criteria for an exception.⁵³ Shares exceptionally acquired by the issuer had to be cancelled or disposed of within a reasonable time.⁵⁴ Through the 2011 amendment,⁵⁵ the KCC now allows acquisition by a company of its own shares to the extent that it does not impair the distributable earnings of the company and that it does not infringe on the equal treatment of shareholders.⁵⁶ It also allows a company to keep treasury shares, without needing to cancel or dispose of them.⁵⁷ The shares owned by the issuer, however, do not have voting rights,⁵⁸ and most commentators agree that such shares are not entitled to dividends.⁵⁹ In sum, the shares bought back by the issuer exist as treasury shares without voting rights and rights

51. Amendment to the Ja-bon-shi-jang-gwa Geum-yung-tu-ja-eob-e Gwan-han Beob-ryul [Financial Investment and Capital Markets Act], Act No. 11845, May 28, 2013, art. 165-6(2) (S. Kor.).

52. *Id.* There are several exceptions to this rule. *Id.*

53. The most important exception was that a listed company could buy its own shares on the market to the extent that its distributable earnings (defined in KCC art. 462) are not impaired. Jeung-gwon-geo-rae-beob [Securities Exchange Act], Act No. 972, amended by Act No. 8985, art.189-2 (before the 2009 abolishment).

54. KCC art. 341 (before the 2011 amendment).

55. Act No. 10600, Apr. 14, 2011 (S. Kor.).

56. KCC art. 341.

57. *Id.*

58. KCC art. 369(2).

59. See, e.g., KONSIK KIM ET AL., HOESA-BEOB [CORPORATE LAW] 660 (2018).

to dividends. The company may cancel such treasury shares or utilize them for other purposes, such as stock options or in-kind dividends, or instead sell them to a third party.

In terms of economic effects, selling treasury shares and issuing new shares are the same: both the number of votes and the assets of the company increase. Thus, the underlying rationale for granting preemptive rights to the existing shareholders should apply. However, the KCC does not clearly extend the preemptive rights of the existing shareholders to the sale of treasury shares—KCC only provides that the board of directors may decide to sell treasury shares, with determination of such details as the number of shares to be sold, the buyer, the price, the payment date, and the manner of sale.⁶⁰ It does not mention the preemptive rights of the existing shareholders or other requirements similar to Article 418.

Courts are also reluctant to regulate the sale of treasury shares. There was at least one trial court ruling that invalidated the sale of treasury shares based on the analogous application of the rules on the issuance of new shares,⁶¹ but it was rather an exception. Although there is not yet a Supreme Court decision on this point, many decisions of the trial courts or the appellate courts have held that the rules on the issuance of new shares were not directly or analogously applicable to the sale of treasury shares.⁶² Of course, the sale of treasury shares is subject to the general fiduciary duty of the directors of the issuer, but courts have been very passive in articulating and enforcing fiduciary duty in this context.⁶³ Therefore, a sale of treasury shares has become one of the most common methods to neutralize hostile takeover attempts or activists' interference and to increase N's shareholding.

Why are Korean courts and many lawyers reluctant to apply the rules on issuing new shares to the sale of treasury shares in spite of their economic similarity? First, the general tendency of Korean jurisprudence toward textualism may be one reason. Deeply influenced by civil law tradition (especially the code system of German law), the legal system of Korea is composed of hundreds of statutes made by the legislature.⁶⁴ The judiciary is expected to interpret the statutes rather

60. KCC art. 342.

61. Seoul Western District Court [Dist. Ct.], 2005Gahap8262, June 29, 2006 (S. Kor.).

62. *E.g.*, Seoul Northern District Court [Dist. Ct.], 2007Kahap1082, Oct. 25, 2007 (S. Kor.); Seoul Central District Court [Dist. Ct.], 2015Kahap80597, July 7, 2015 (S. Kor.).

63. *E.g.*, Seoul Northern District Court [Dist. Ct.], 2007Kahap1082, Oct. 25, 2007 (S. Kor.); Seoul Central District Court [Dist. Ct.], 2015Kahap80597, July 7, 2015 (S. Kor.).

64. According to the website of the Ministry of Government Legislation of Korea, the number of effective statutes as of January 16, 2020 is 1,848. *See* MINISTRY OF GOVERNMENT LEGISLATION OF KOREA, EFFECTIVE STATUTES (2020),

than create law.⁶⁵ Under such tradition, one tends to believe that any reform should be done by amending the statutes rather than by actively interpreting the existing ones. Second, there is a reasonable observation that the requirements under Article 418 are too strict. Companies often buy and sell their own shares on the stock exchange out of proper financial needs.⁶⁶ If the draconian approach of Article 418 is applied *per se* to every sale of treasury shares, the financial flexibility of companies will be unduly restricted.⁶⁷ Third, the absence of poison pills and dual class shares under Korean law strengthened the belief that a sale of treasury shares should be freely allowed as a defense measure against a hostile takeover. According to the prevailing view, a United States-style poison pill is not allowed under the current Korean law because it is against the doctrine of equal treatment of shareholders.⁶⁸ A bill that specifically allowed a poison pill was drafted and put on public notice by the Ministry of Justice in 2009⁶⁹ but failed to be made into a statute.⁷⁰ Dual class shares or golden shares are not allowed because the KCC clearly declares the doctrine of “one share, one vote.”⁷¹ Thus, the use of treasury shares as a defense measure gained popularity and some legitimacy.

However, a number of legal experts thought that, given the similarity in economic nature, the sale of treasury shares should be treated equally or at least similarly with the issuance of new shares, by amending the KCC (if not by interpreting it).⁷² A draft amendment to the KCC put on public notice in 2006 by the MOJ included a provision that Article 418 shall be applied *mutatis mutandis* to the sale of treasury shares.⁷³ That provision failed to survive in the final version of the 2011 amendment,⁷⁴ but a few bills in a similar vein were submitted by the congress members of the current ruling party (known

<https://www.moleg.go.kr/english/> [<https://perma.cc/33X4-SDZW>] (archived Mar. 18, 2020).

65. Daehanmingook Heonbeob [Constitution] art. 103 (S. Kor.).

66. ROBERT C. CLARK, CORPORATE LAW 625-631 (1986) (analyzing reasons for repurchasing the corporation’s own shares); JAMES D COX & THOMAS LEE HAZEN, BUSINESS ORGANIZATIONS LAW 494-95 (4th ed. 2016) (stating that sale of treasury shares is allowed even at less than par value).

67. KIM ET AL., *supra* note 59, at 661.

68. Kim, *supra* note 13, at 77 n.80.

69. Ministry of Justice of Korea, Preliminary Notice for (Draft) Amendment to the KCC (Dec. 1, 2009) (MOJ Public Notice 2009-171) (in Korean).

70. Currently, 3 bills that propose the adoption of a poison pill are pending at the National Assembly: Bill No. 3598, Nov. 15, 2016, Bill No. 9977, Nov. 1, 2017, and Bill No. 13575, May 15, 2018.

71. KCC art. 369(1).

72. KIM ET AL., *supra* note 59, at 661.

73. Ministry of Justice of Korea, Preliminary Notice for (Draft) Amendment to the KCC (Oct. 4, 2006) (MOJ Public Notice 2006-106) (in Korean).

74. *Supra* note 55.

as progressive) in 2016.⁷⁵ As a modified proposal, the recommendation draft made by a special advisory committee for the MOJ in 2017 not only extended the rules on issuing new shares to the sale of treasury shares but also provided a market exception under which the company may sell its treasury shares on the exchange up to 5 percent of its net assets per year without triggering the preemptive rights of shareholders and other complex procedures for issuing new shares.⁷⁶

The current opposition party (known as conservative) and business communities are generally against these proposals.⁷⁷ There is even an argument by a conservative but influential legal scholar that treasury shares should be deemed an asset of the company, and, thus, the sale of treasury shares should be free of any regulation.⁷⁸ A number of media articles, columns, and editorials argue that sale of treasury shares should not be restricted until effective defensive measures against hostile takeover are introduced by statutes.⁷⁹ As of March 2020, while the foregoing bills are still pending, no substantive discussions are going on within the National Assembly.

In sum, the courts not only failed to regulate but almost supported the use of treasury shares in lieu of issuing new shares. The legislative reaction, albeit timely launched, faced strong opposition and has not been effective to date.

IV. TUNNELING THROUGH RELATED PARTY TRANSACTIONS

A. Previous Practices

For an effective and stable management succession, N needs sufficient money to buy more shares in case of any threat to its control and to pay various taxes, in particular the inheritance tax. The most typical way to secure cash for N is engaging in related party

75. Bill No. 106, June 7, 2016 (S. Kor.); Bill No. 3952, Nov. 29, 2016 (S. Kor.).

76. This recommendation draft was not made publicly available.

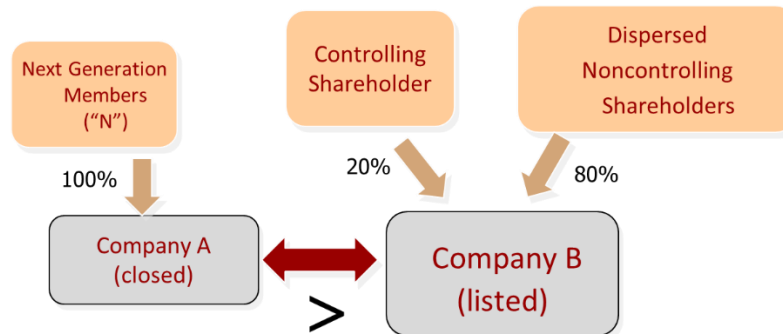
77. See, e.g., news articles cited in *infra* note 79.

78. JUN-SEON CHOI, HOESA-BEOB [CORPORATE LAW] 314–15 (2017). In the US, such “asset theory” existed in the early 20th century. See PROSPER REITER JR., PROFITS, DIVIDENDS AND THE LAW 238 (1926). Currently, no serious scholar of accounting or corporate law supports asset theory in the US or Europe anymore.

79. The English translation of the titles of some of those media articles may convey the general atmosphere. See generally Jang Eun-ji, *Revision to Commercial Law Amendment: Restrictions on Treasury Stock Disposal? What About Defense of Management Rights*, NEWS ONE (Feb. 15, 2017), <http://news1.kr/articles/?2912910> [<https://perma.cc/LPN8-BJN5>] (archived Feb. 16, 2020); Kim Ik-hwan, *Listed Firms with Treasury Stock Become Targets for Activist Hedge Funds*, KOREA ECON. DAILY (Oct. 13, 2017), <https://www.hankyung.com/finance/article/2017101309201> [<https://perma.cc/8R7L-7V7U>] (archived Feb. 16, 2020); *Foreign Speculative Capital Raids Are Raised . . . Hurry Legislation “Management Shield”*, DONG-A ILBO (May 18, 2018), <http://www.donga.com/news/home/article/all/20180518/90136352/1> [<https://perma.cc/8UEH-FUUJ>] (archived Feb. 16, 2020).

transactions, the most typical form of tunneling. Figure 2 shows the typical example. Company B is a listed flagship company of the business group, and Company A is a closed company owned by N. The controlling family owns 20 percent of the total shares of Company B but somehow controls it as a controlling-minority shareholder. If Company A and Company B enter into a transaction (e.g., sale of assets, securities, and services) under terms advantageous for Company A, then the wealth is transferred from Company B to Company A, ultimately from the noncontrolling shareholders of Company B to N. N will, directly or through Company A, end up having more cash or cash equivalents by sacrificing the noncontrolling shareholders of Company B.

Figure 2



B. Rules

Korean law prohibits or penalizes such an outright tunneling in various ways.

First, directors who executed or approved a transaction disadvantageous to Company B may be held liable toward Company B, either through a derivative action brought by the shareholders of Company B⁸⁰ or a direct suit brought by Company B,⁸¹ for their breach of fiduciary duty. The general perception in Korea, however, is that civil actions generally pose less threat to the directors and managers of a company than the administrative and criminal sanctions discussed below, due to a lack of plaintiff-friendly

80. KCC art. 403.

81. *Id.* at art. 399

mechanisms such as discovery systems, punitive damages, and class actions.

Second, Article 23(1)(vii) of the Monopoly Regulation and Fair Trade Law (FTL),⁸² the main statute regulating *chaebols*, prohibits “undue support” between affiliate companies.⁸³ More specifically, it prohibits “unduly supporting a specially related party or another company through . . . providing advanced payments, loans, manpower, real estate, commercial notes, goods, services, intangible property, etc., to a specially related party or another company, or *transacting on terms considerably advantageous for them* [emphasis added].”⁸⁴ Article 23(1)(vii) does not limit its scope to transactions between affiliate companies within a large business group, but in practice it has primarily been enforced against tunneling that occurred at *chaebols*.⁸⁵ Thus, roughly speaking, any intragroup transactions that are not on arms-length terms may constitute undue support. Violation of Article 23(1)(vii) is subject to a cease and desist order,⁸⁶ administrative fine (*gwa-jing-geum*, often translated into “surcharge”) up to 5 percent of the related revenue,⁸⁷ and/or criminal penalty of up to three-years’ imprisonment.⁸⁸ The Korea Fair Trade Commission (KFTC), the main competition authority of Korea, has been active in enforcing the undue support clause, adjudicating many cases for the last two decades.⁸⁹

Third, an unfair related party transaction may constitute “criminal breach of trust,” or *baeim* in Korean.⁹⁰ Pursuant to the Korean Criminal Code and the special statutes, if a person taking care of another person’s affairs breaches his duties and causes harm to such a person through obtaining (or causing a third party to obtain) unlawful profits, he will be subject to criminal fine or imprisonment,

82. Dok-jeom Gyu-je-mit Gong-jeong Geo-rae-e Gwan-han Beob-ryul [Monopoly Regulation and Fair Trade Law], Act No. 3320, amended by Act No. 15784 (S. Kor.) (hereinafter FTL).

83. Article 23 of the FTL addresses “unfair trade practices.” Paragraph (1) of this Article lists seven specific types of unfair trade practices and the seventh is “undue support.” The undue support clause was introduced to the FTL on December 30, 1996 (effective as of April 1, 1997). The stated primary legislative goal of this clause was to control economic concentration, and the corporate governance aspects of “undue support” (such as harm to creditors and minority shareholders) were not explicitly mentioned or discussed in the legislative documents. Yong Lim & Geeyoung Min, *Competition and Corporate Governance: Teaming Up to Police Tunneling*, 36 NW. J. INT’L L. & BUS. 267, 276–77 (2016).

84. FTL art. 23(1)(vii).

85. Lim & Min, *supra* note 83, at 273.

86. FTL art. 24.

87. *Id.* at art. 24–2. Originally, it was imposed on the party that made the undue support, not the party that received it. After the amendment in 2013, the party that received the undue support is also subject to the monetary penalty. *Id.*

88. *Id.* at art. 66(1)(ix-2).

89. The number of undue support cases adjudicated by the KFTC from 1998 to 2018 was 168. See KFTC, 2018 NYEON-DO TONG-GYE YEON-BO 66 [STATISTICAL YEARBOOK OF 2018] (2019).

90. See *supra* note 47.

which may be extended to lifetime imprisonment depending on the amount of the unlawful profit.⁹¹ The elements of criminal breach of trust are: (i) breach of duty, (ii) by a person who is taking care of another person's affairs, (iii) loss to such other person, and (iv) profit to the actor or a third party.⁹² In Figure 2, directors or managers of Company B breached their fiduciary duty by engaging in transactions disadvantageous to Company B and advantageous to Company A. Such a breach in the context of intragroup transactions was held by the court to constitute criminal breach of trust.⁹³ Given the severity of penalties, criminal breach of trust has been a strong threat to those who attempted to obtain personal gains through related party transactions.

C. Circumvention #1: Funneling of Business

1. New Practices

One measure designed to avoid the application of the undue support clause (and probably the criminal breach of trust) is the so-called *ilgam morajugi* in Korean, or "funneling of business."⁹⁴ It can be roughly defined as an exclusive or large volume of intragroup transactions, which intend to transfer wealth to the controlling shareholders and their related persons.⁹⁵ In Korea, member companies of business groups often enter into exclusive or semiexclusive contracts with other member companies to outsource various services, such as information technology, advertisement, building management, transportation, small construction, maintenance, and repair.⁹⁶

Assume that Company A, an IT service company within Group X, makes most of its revenue by providing IT services to other group companies including Company B, the listed flagship company of the group.⁹⁷ The price and other terms of each contract may be arm's length, but the large volume of business stably coming from the

91. Criminal Code, *supra* note 47, at arts. 355(2), 356; Teuk-jeong Gyeong-je Beom-joe Ga-jung-cheo-beol Deung-e Gwan-han Beob-ryul [Act on Aggravated Penalties on Specific Economic Crimes], Act No. 3693, *amended by* Act No. 15256, art. 3 (S. Kor.).

92. Criminal Code, *supra* note 47, at arts. 355(2), 356; Act on Aggravated Penalties on Specific Economic Crimes, *supra* note 91, at art. 3.

93. *E.g.*, Supreme Court [S. Ct.], 2013Do5214, Sept. 26, 2013 (S. Kor.).

94. This translation was used in Hwa-jin Kim et al., *Favoritism and Corporate Law: The Confused Corporate Opportunity Doctrine in the Hyundai Motor Case*, 3 MICH. BUS. & ENTREPRENEURIAL L. REV. 41, 51 (2013).

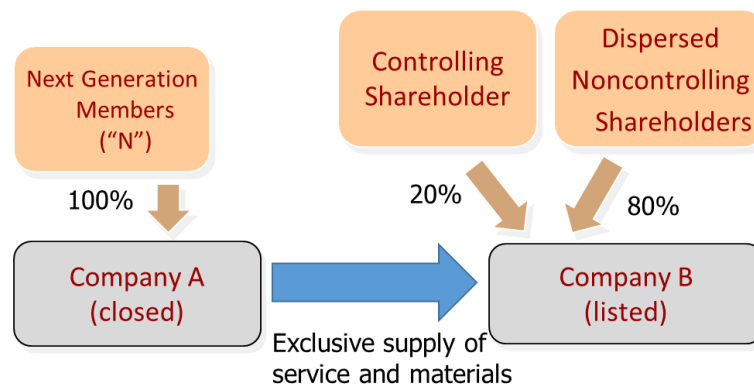
95. Kyung-Hoon Chun, *Corporate Opportunity Doctrine as a Basis for Directors' Liability: A New Statutory Experiment in Korea*, in GERMAN AND ASIAN PERSPECTIVES ON COMPANY LAW 63, 71–72 (Holger Fleischer et al. eds., 2016).

96. *Id.* at 72.

97. *Id.*

affiliate companies serves as a great advantage to Company A that its competitors cannot enjoy.⁹⁸ In most cases, Company A, the beneficiary of such “funneling” practices, is owned by the controlling person of Group X or the controlling person’s close relatives (usually son or daughter).⁹⁹ Thus, the wealth ultimately flows from the noncontrolling shareholders of other affiliates to the controlling family, as illustrated in Figure 3. This practice became widespread in the 2000s among Korean *chaebols* and caused the Korean public to become highly skeptical of the *chaebol*-centric economic structure of Korea.¹⁰⁰

Figure 3



2. The Glovis Case

The most notable case about funneling involved Hyundai Glovis Co. (hereinafter “Glovis”), a logistics service company set up within Hyundai Motor Company (HMC) Group in 2001.¹⁰¹ Its purpose was to provide its affiliate companies with specialized logistics services such as the transportation, delivery, and storage of parts, modules, and completed vehicles.¹⁰² The initial investors of Glovis were the controlling person of the Group (MK Chung) and his son (ES Chung).¹⁰³ HMC and other affiliates, such as Kia Motors (the second largest automobile manufacturer in Korea), Hyundai Mobis (the largest auto part company in Korea), and Hyundai Steel purchased various logistics services mainly from Glovis. Its revenue and profit dramatically increased, and its stock was listed on the Korea Exchange in 2005.¹⁰⁴

98. *Id.*

99. *Id.*

100. Hwa-jin Kim et al., *supra* note 94, at 44.

101. For an English account of this case, see Chun, *supra* note 95, at 70–72.

102. *Id.*

103. *Id.*

104. *Id.*

The value of Glovis's shares held by MK Chung and ES Chung increased to almost USD 5 billion by October 2010—a stunning one thousand times increase within less than ten years.¹⁰⁵

The story of Glovis first attracted the attention of the KFTC. After years of investigation, the KFTC ruled on October 24, 2007, that six counts of undue support had been made within HMC Group.¹⁰⁶ Undue support for Glovis was one of them, and the penalty imposed on HMC for supporting Glovis was KRW 4,655 million (the total penalty imposed on HMC for all six counts of undue support was KRW 50,793 million).¹⁰⁷

In the process of investigation and adjudication, however, the existence of undue support for Glovis was hard to prove because undue support required substantial deviation from a “normal price,” a benchmark used to determine whether the transaction was “undue.”¹⁰⁸ In its October 2007 decision, the KFTC found that the undue support for Glovis in the form of a funneling business only existed from its inception in March 2001 to June 2004.¹⁰⁹ The KFTC stated as follows:

From March 2001 to June 2004, it is acknowledged that excessive economic profits were provided to Glovis by doing transactions on the terms advantageous to Glovis Considering that Glovis completed the integrated transportation system in the first half of 2004 by investment in building logistics depots and developing information systems, . . . there is insufficient evidence to prove [undue support for Glovis regardless of the improvement of the logistics services] from July 2004.¹¹⁰

105. *Id.* at 70–71. Details of the Glovis case can be found in KFTC, Euigyeol 2007–504, Oct. 24, 2007, 67–106 (S. Kor.) (in Korean) (accessible by typing in the case number at <https://case.ftc.go.kr/ocp/co/ltfr.do> [<https://perma.cc/9H7B-5MDS>] (archived Apr. 23, 2020)). According to this decision, the KFTC found that Glovis received undue support in the manner of a “funneling business” from HMC, Kia Motors, Mobis, and Hyundai Steel, by selling the following services: (i) transporting parts between plants, (ii) delivering completed vehicles from the plant to the exporting harbors or domestic sales depots, (iii) delivering completed cars from the domestic sales depots to each buyer, (iv) pre-delivery inspection of vehicles, (v) delivering parts for warranty services from the logistics centers of Mobis to the repair locations, and (vi) leasing forklifts and other equipment to the affiliates. *Id.*

106. KFTC, *supra* note 105, at 2–3.

107. *Id.* at 3 and 122.

108. In reviewing undue support cases, the Supreme Court defined the “normal price” as an arms’ length price that would have been applied between nonrelated parties for a comparable transaction and held that the difference between the normal price and the actual price was the size of support. Supreme Court [S. Ct.], 2013du4255, June 12, 2014 (S. Kor.); Supreme Court [S. Ct.], 2005du3172 Oct. 26, 2007 (S. Kor.); Supreme Court [S. Ct.], 2004du11268, Dec. 7, 2006 (S. Kor.).

109. KFTC, *supra* note 105, at 71.

110. *Id.*

Although the KFTC's decision on the Glovis issue was generally supported by the courts,¹¹¹ it had only a limited meaning in regulating the funneling of business. The KFTC had to prove advantageous terms such as a higher price than market index—a large volume of transactions or exclusive dealings between affiliates were deemed insufficient to find undue support.¹¹² The volume of transactions “funneled” to Glovis grew even larger from July 2004 after it began to operate an integrated transport system, but the KFTC implied that better services under the improved system would justify the funneling.¹¹³ It did not pay any attention to the fact that Glovis, the beneficiary of the funneling, was owned by two controlling shareholders of the group. Enhanced efficiency through an integrated transport system may justify the exclusive dealing with Glovis, but it does not justify why the owners of Glovis should be the two Chungs instead of HMC.

This problem relates to the corporate governance of HMC and was handled as such. In 2008, the minority shareholders of HMC filed a derivative action against MK Chung (the controlling shareholder of HMC) and the CEO of HMC.¹¹⁴ The plaintiffs alleged that, among others, the defendants misappropriated the “corporate opportunity” of HMC in breach of their duties of loyalty.¹¹⁵ According to the plaintiffs' allegation, HMC could have operated the logistics service as an internal business unit or a new subsidiary, or HMC could have established Glovis as a joint venture of other affiliates who would have been faithful customers of Glovis.¹¹⁶ If HMC had chosen one of such alternatives, the shareholders of HMC could have shared the profits.¹¹⁷ Therefore, the plaintiffs argued that the board of HMC should have considered such alternatives for the best interest of HMC, and that the failure of such consideration constituted a breach of fiduciary duties which in effect transferred economic gains from the noncontrolling shareholders of HMC to the controlling shareholders.¹¹⁸

To persuade the court with this logic, the plaintiffs invoked the corporate opportunity doctrine pursuant to US law. They argued that this doctrine can also be inferred from the general provisions of the

111. Supreme Court [S. Ct.], 2009Du15494, Oct. 25, 2012 (S. Kor.); Seoul High Court [Seoul High Ct.], 2007Nu30903, Aug. 19, 2009 (S. Kor.).

112. See cases cited *supra* note 108. Thus, KFTC conducted detailed analyses to prove that the terms were “advantageous” compared to the “normal” terms of comparable transactions. KFTC, *supra* note 105, at 74–90.

113. See *supra* note 105 and accompanying text.

114. Chun, *supra* note 95, at 71 (ES Chung, the “N” of HMC Group, was not named as a defendant).

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

“duty of care”¹¹⁹ and “duty of loyalty”¹²⁰ under the KCC. On this point, the Seoul District Court ruled against the plaintiffs.¹²¹ Stating that only “actual and concrete business opportunities existing in the company” are subject to the prohibition of appropriation, the court ruled that the establishment of Glovis was not an actual and concrete business opportunity that had existed within HMC.¹²² Since neither party appealed this judgment, it became a final one.

3. Statutory Reaction

Two notable statutory reactions were made to the funneling of business: a new clause on the corporate opportunity doctrine in the KCC¹²³ and a new clause on “taking private benefit” in the FTL.¹²⁴

Article 397-2 of the KCC, which statutorily introduced the corporate opportunity doctrine, was newly added in 2011.¹²⁵ According to this provision, a business opportunity belongs to the company (and is thus deemed a corporate opportunity) if (a) the opportunity is actually or potentially profitable to the company, and (b) either (i) a director became aware of it by use of corporate information or in the course of performing duties, or (ii) it is closely related to the company’s current or planned business.¹²⁶ If a certain business opportunity is deemed a corporate one, the director can use that opportunity personally or for a third party only after disclosing it to, and obtaining approval from, the board of directors.¹²⁷ The board approval requires affirmative votes from two-thirds of all directors,¹²⁸ and the interested director must abstain from voting.¹²⁹

In the United States, a company may resort to constructive trust, accounting, or other equitable remedies when a corporate opportunity is improperly exploited by directors or senior executives.¹³⁰ Therefore,

119. Minbeob [Civil Act], Act No. 471, *amended by* Act No. 14965, art. 681 (S. Kor.); KCC art. 382-2.

120. KCC art. 382(3).

121. Seoul Central District Court [Dist. Ct.], 2008Gahap47881, Feb. 25, 2011 (S. Kor.). The plaintiff partially won against the defendants only with respect to certain transactions clearly unfavorable to HMC (and favorable to Glovis).

122. *Id.*

123. KCC art. 397(2).

124. FTL art. 23-2.

125. For an English account of this provision, see Chun, *supra* note 95, at 74–78.

126. The definition is under strong influence of Section 5.05(b) of the AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE 284 (1994).

127. KCC art. 397(2).

128. *Id.*

129. KCC art. 368(3).

130. Constructive trust was granted in, see, e.g., Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939); Durfee v. Durfee & Canning, Inc., 80 N.E.2d 522, 528–29 (Mass. 1948).

the company may claim the earnings that the fiduciary obtained from the opportunity in violation of the duty without needing to prove the amount of loss the company actually incurred. In Germany, the *Eintrittsrecht* (right to intervene) is sometimes acknowledged as a remedy for the misappropriation of a corporate opportunity whereby the company may take the earnings of the fiduciary without need to prove the company's loss.¹³¹ In the process of legislating Article 397-2, a few experts and congress members proposed remedies such as the constructive trust or *Eintrittsrecht* for disgorgement of profits but faced opposition.¹³² As a compromise, Article 397-2 maintains the traditional approach of loss compensation, but eased the company's burden of proof by presuming the gain of a director as the loss of the company.¹³³

More controversial than Article 397-2 of the KCC was the new Article 23-2 of the FTL on "taking private benefit."¹³⁴ It prohibits the provision of benefits from "a company within a large business group"¹³⁵ (Company) to "members of the controlling family and companies owned by them" (Beneficiaries), by way of the following: (i) doing transactions on terms substantially advantageous to the Beneficiary, (ii) granting to the Beneficiary business opportunities that may be substantially profitable to the Company, (iii) trading of cash or financial products on terms substantially advantageous to the Beneficiary, or (iv) doing a substantial amount of transactions with the Beneficiary without reasonable consideration of relevant factors or comparison with other suppliers.¹³⁶ Funneling of business is covered by items (ii) and (iv). Violators of this Article are subject to a cease and desist order,¹³⁷ administrative monetary penalty up to 5 percent of the relevant revenue,¹³⁸ and criminal penalty up to three-years' imprisonment.¹³⁹

The most apparent difference between Article 23-2 and the undue support clause of Article 23(1)(vii) is the scope of application. Article 23-2 applies only to large business groups, while Article 23 applies to

Accounting remedy was granted in, *see, e.g.*, *Irving Trust Co. v. Deutsch*, 73 F.2d 121, 125 (2d Cir. 1934); *Graham v. Mimms*, 444 N.E.2d 549, 555 (Ill. App. Ct. 1982).

131. Bundesgerichtshof [BGH] [Federal Court of Justice] May 8, 1989, *Neue Juristische Wochenschrift* [NJW] 1989, 2687 (Ger.).

132. Disgorgement of profit remedy was proposed in Bill No. 3913, Feb. 24, 2009, art. 397-2. It was not reflected in the final version of KCC, art. 397(2).

133. Comparatively, it is similar to the Japanese law's approach to a director who breached the duty to not compete with the company. *See* *Kaishaho* [Company Act], art. 423 (Japan).

134. FTL art. 23-2.

135. Currently, it applies to a business group of which total assets exceed KRW 5 trillion and for which a controlling natural person is identifiable. *Id.* at arts. 14(1), 23-2(1).

136. *Id.* at art. 23-2(1).

137. *Id.* at art. 24.

138. *Id.* at art. 24-2(4).

139. *Id.* at art. 66(1)(ix-2).

any company.¹⁴⁰ Article 23-2 is triggered only when the beneficiary is “an individual member of the controlling family of the large business group” or “companies in which the controlling family members hold at least 30% (for listed companies) or 20% (for unlisted companies) of the total issued shares.”¹⁴¹ No such restriction exists for Article 23.

Why was Article 23-2 added on top of the undue support clause of Article 23(1)(vii)? The most important reason was to ease the KFTC’s burden of proof in regulating the controlling family’s tunneling.¹⁴² It was difficult for the KFTC to prove “undue-ness” in enforcing the undue support clause, because the court interpreted “undue” as “hindering fair dealing by restricting competition or causing economic concentration in the market.”¹⁴³ For example, in a famous case where a listed company provided financial benefits to its controlling family members (who were natural persons), the Supreme Court ruled that it did not constitute undue support because there was no evidence that providing financial benefits to an individual would have negative impacts on the relevant market.¹⁴⁴ It specifically mentioned that the “transfer of wealth to the next generation and possible concentration of economic power” does not by itself lead to “hindering fair dealings.”¹⁴⁵

Thus, the KFTC wanted a new clause regulating related party transactions without needing to prove negative impacts on competition in the market, so long as there is a clear transfer of wealth from a company to the controlling family without just cause.¹⁴⁶ Legislative documents of the National Assembly for Article 23-2 clearly show that the legislators’ intent was the same.¹⁴⁷ However, as discussed below in relation to the tolling, such a legislative intent faced resistance from the court.¹⁴⁸

140. Apparent from the language of FTL. *Id.* at arts. 23 and 23-2.

141. *Id.* at arts. 23-2(1) and the Enforcement Decree of FTL, art. 38(2).

142. Yunjeong Kim, *Teuk-su Gwan-gye-in-e Dae-han Bu-dang-i-ik Je-gong Haeng-wi Gyu-je-eui Beob-jeok Jaeng-jeom-gwa Gae-seon Gwa-je* [Issues of and Improvements for the Regulations on Providing Undue Benefits to Specially Related Persons], 29 GYEONG-JAENG-BEOB YEON-GU [J. KOREAN COMPETITION L.] 80, 85–86 (2014) (S. Kor.); Lim & Min, *supra* note 83, at 274.

143. *E.g.*, Supreme Court [S. Ct.], 2009Du20366, Nov. 13, 2014 (S. Kor.); Supreme Court [S. Ct.], 2004Du1483, Dec. 22, 2006 (S. Kor.); Supreme Court [S. Ct.], 2001Du7220, Mar. 12, 2004 (S. Kor.).

144. Supreme Court [S. Ct.], 2001Du6364, Sept. 24, 2004 (S. Kor.) (Samsung SDS case).

145. *Id.*

146. Kim, *supra* note 142, at 86.

147. *Id.* at 87–88. See also the official reasons for the amendment of FTL (Aug. 13, 2013). Searchable at <http://www.law.go.kr/main.html> [<https://perma.cc/DM5P-3GCT>] (archived Feb. 16, 2020) (in Korean).

148. See *infra* note 164.

4. Re-Reaction and Further

Article 397-2 of the KCC has not been actively invoked since its introduction in 2011. Few Supreme Court cases have been reported where the directors or other fiduciaries were held liable for usurping corporate opportunity.¹⁴⁹ It is not entirely dormant, however, for the purpose of the internal compliance process—lawyers advise their corporate clients to take necessary steps under this article regarding questionable transactions, and the Korean Corporate Governance Code, a soft law on corporate governance, also implicitly touches upon this issue.¹⁵⁰ All in all, reactions of the companies to this article were not notable.

Reactions to Article 23-2 of FTL were more notable. To avoid triggering the threshold for being deemed a beneficiary, *chaebols* often lowered the family ownership in potential beneficiary companies to just below 20 percent (for nonlisted firms) or 30 percent (for listed firms) and held 19.99 percent or 29.99 percent of the total shares.¹⁵¹ The 20 or 30 percent threshold was designed as a bright but arbitrary cutline to determine whether such a company has the same economic interests as the controlling family. In substance, having 19.99 percent ownership and 20.0 percent ownership makes no difference. Also, *chaebols* could provide benefits to the subsidiaries of the beneficiaries, which are literally not within the scope of Article 23-2.¹⁵² As a typical rule-based norm, Article 23-2 was vulnerable to such circumventions.

Against such circumventions, the KFTC tried to strengthen the rules. Its further amendment proposal drafted and submitted to the National Assembly in 2018 lowers the threshold percentage to 20

149. A few Supreme Court rulings on this issue rendered after the enactment of the Article 397-2 were about misconducts committed before the enactment. Thus, technically, the Article 397-2 could not be applied. *See, e.g.*, Supreme Court [S. Ct.], 2016Da16191, Oct. 25, 2018 (S. Kor.); Supreme Court [S. Ct.], 2015Da70044, Sept. 12, 2017 (S. Kor.).

150. KOREAN CORPORATE GOVERNANCE SERVICE, GI-EOP JI-BAE-GU-JO MO-BEOM GYU-JUN [CORPORATE GOVERNANCE CODE] 25 (2016) (stating directors' duty to avoid conflict of interest and not to use confidential information of the corporation).

151. The combined shareholding ratio of MK Chung and ES Chung in Glovis (*see supra* Part IV.C.2) was 29.999976% (11,249,991 shares out of 37,500,000 shares) as of September 30, 2019. *See* DART, <http://dart.fss.or.kr/> (last visited Mar. 18, 2020) [<https://perma.cc/ET2E-PQBE>] (archived Feb. 17, 2020) (in Korean). The combined shareholding ratio of the LG Group's controlling family members in Pantos (LG Group's logistics service company) was 19.9% (398,000 shares out of 2,000,000 shares) and such shares were sold to outside purchasers in 2018. *See* HANKYUNG, <https://www.hankyung.com/finance/article/2018100430411> (last visited Mar. 18, 2020) [<https://perma.cc/4S57-DSWW>] (archived February 17, 2020) (in Korean). Similar examples are plentiful in smaller business groups although reliable statistics are not available.

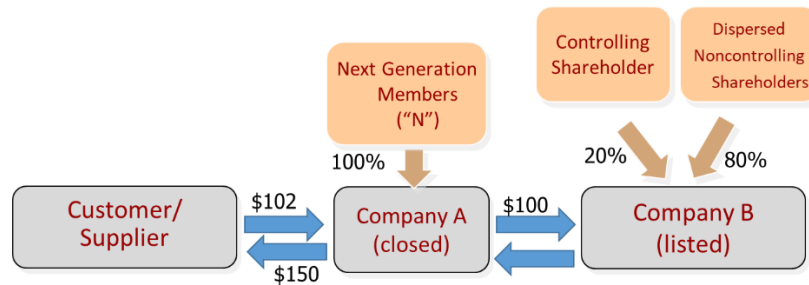
152. Reliable data is not available on this point, but KFTC expressed concern about such a practice when it proposed the amendment to FTL in 2018. *See infra* note 154.

percent in listed firms and includes such firm's subsidiaries¹⁵³ as beneficiaries.¹⁵⁴ Such a rule-based approach, however, always leaves loopholes—for example, the controlling family's ownership may be kept at 19.99 percent in listed firms and any benefits can be provided to the sub-subsubsidiary of the original beneficiary. As of March 2020, this proposal is pending at the National Assembly.

D. Circumvention #2: Tolling

So-called tolling is another practice that appeared instead of classic tunneling by way of a related party transaction. When group companies buy or sell services or materials, they often do it through a conduit company usually owned by N and drop some margins or commissions there.¹⁵⁵ As illustrated in Figure 4, Company B buys goods or services from the supplier through a vehicle owned by N, and sells goods or services to the customers through another vehicle owned by N.

Figure 4



It is a relatively small but a useful and stable source of income for N. It has been hard to challenge this practice as a breach of fiduciary duty because Company B may justify the deal structure as a business judgment. For example, one may argue that Company A's role is coordinating the group's purchase activities, taking care of administrative chores for purchasing, or handling customers' complaints as an intermediary. Assuming that Company A has a role positive to Company B's interest, even if such a role is insignificant or almost ignorable, it would not be easy to prove a breach of Company B

153. Defined as a company in which the parent company holds more than 50% of the total issued shares.

154. See Press Release, Korea Fair Trade Comm'n, Draft of Complete Amendment to Fair Trade Law Passes the Cabinet (Nov. 27, 2018).

155. Lim & Min, *supra* note 83, at 273–74.

director's fiduciary duty and the amount of loss incurred by Company B. Presumably on that ground, civil and criminal liability for tolling has rarely been sought. Whether tolling can be regulated as undue support under the FTL was not clear either, because it was difficult in this circumstance to prove the size of support which is the difference between the "(hypothetical) normal price" and the "actual price paid."¹⁵⁶

Two provisions were added to the FTL as a statutory reaction. First, in 2013, tolling was specified as an additional type of undue support.¹⁵⁷ It is defined as "an act of transacting with a counterparty through an intermediary which is the actor's specially related person or another company that has no substantive role in the transaction, despite the substantial benefits of directly transacting with the counterparty."¹⁵⁸ Second, in the same amendment, Article 23-2 was introduced as discussed above to regulate "private-benefit seeking" within a large business group.¹⁵⁹ Tolling was one of its targets.¹⁶⁰

In 2017, based on Article 23-2, the KFTC imposed penalties on certain transactions within Korea Air Group, including a tolling where a conduit vehicle owned by the descendants of the controlling shareholder took excessive commissions.¹⁶¹ According to the KFTC decision, Article 23-2 is applicable to the transfer of undue profit from the company to the controlling family by way of tolling "unless there are reasonable grounds for doing so,"¹⁶² without need to prove any negative impact on the competition in the relevant market or other concern for "hindering fair dealing."¹⁶³

The Seoul High Court, however, overruled the KFTC's decision.¹⁶⁴ The court ruled that Article 23-2 also requires "undue-ness," which, according to the court, means "a concern that economic power would be concentrated through private-benefit seeking."¹⁶⁵ The court did not find such an effect in this case because the proved tolling amount was too small to affect the level of competition or economic concentration in the relevant market.¹⁶⁶ The court also stated that the "normal price"

156. See *supra* note 108, for the standard established by the Korean Supreme Court in calculating the size of support.

157. FTL art. 23(1)(vii)(b).

158. *Id.*

159. See *supra* Part IV.C.3.

160. See *infra* note 161.

161. KFTC, Euigyeol 2017-009, Jan 10, 2017 (S. Kor.).

162. *Id.* at 2.

163. *Id.* at 48 (stating that the tolling activities at hand did violate Article 23-2 but did not violate Article 23(1) due to lack of negative impact on the competition in the relevant market).

164. Seoul High Court [Seoul High Ct.], 2017Nu36153, Sept. 1, 2017 (S. Kor.).

165. *Id.*

166. *Id.*

should be identified as a benchmark in determining whether the terms were substantially advantageous as provided in Article 23-2(1)(i).¹⁶⁷

It would be fair to say that the court tried to honor the Supreme Court precedents that have been formed regarding Article 23 for doctrinal consistency even when the new Article 23-2 was invoked. The court ruling was apparently against the legislative intent of Article 23-2 because it still required the KFTC to prove the “normal price” and the impact on the market, such as “concern for concentration of economic power.”¹⁶⁸ It caused (or reaffirmed) significant difficulty in enforcing Article 23-2. Although the case is currently pending at the Supreme Court as of April 2020, certain congress members are trying to amend the FTL again to clarify that “effect on the market” is not an element in Article 23-2, or at least to switch the burden of proof regarding “undue-ness.”¹⁶⁹

V. HORIZONTAL CORPORATE DIVISION

The practices examined thus far generally fall under the typical types of tunneling. A horizontal corporate division, which has been popular among Korean companies and often helped increase N’s shares, is harder to characterize as tunneling in a conventional meaning.¹⁷⁰

Division means an act of separating a part of a corporation by shareholders’ resolution.¹⁷¹ Division is classified as “simple-division vs. division-merger” and “horizontal division vs. vertical division,”¹⁷² and these two pairs make four combinations. Simple-division turns the

167. *Id.*

168. *See supra* notes 146–48 and accompanying text.

169. For instance, a seminar was held by Congressman HC Jeon regarding the amendment of Article 23–2 on September 3, 2019 with the presence of several legal and finance experts.

170. *See* Woojin Kim & Shu-Feng Wang, *Free Lunches for Insiders under Investor Inertia and Limited Arbitrage* (2015), <http://www.fmaconferences.org/Sydney/Papers/KimWang20151124.pdf> [<https://perma.cc/8RWX-6ZSV>] (archived Feb. 16, 2020) (analyzing how investor inertia benefits the controlling families of business groups through spin-offs followed by stock-for-stock tender offers in business group in Korea and stating that it is distinct from explicit tunneling or diversion of resources).

171. A spin-off or split-off may sound more familiar to US lawyers — “division” is the legal jargon used in EU Directives to describe this event. *See* Council Directive 2017/1132, 2017 O.J. (L 169) 46 (EU). Since the division regime under the KCC was created in 1998 under the strong influence of (and is similar to) continental European law, this Article uses the term “division.”

172. Direct translations of horizontal division (*in-jeok-bunhal* in Korean) and vertical division (*mul-jeok-bun-hal* in Korean) are ‘division in person’ and ‘division in rem,’ which indicate to whom the new shares of the new spun-off company are issued.

separated part into a new stand-alone company, while division-merger turns the separated part into a part of another company.¹⁷³ Shares of the new company (or a new part of another company) that represent the value of the separated part of the original company belong to the original company in a vertical division, while such shares belong to the shareholders of the original company in a horizontal division.¹⁷⁴

Figure 5 illustrates a horizontal division where Company X is divided into Companies X and Y that have the same owners. Horizontal division has often been used to adopt a holding company structure.¹⁷⁵ If Company X plans to be a holding company of the group, the division plan will allocate investments in other affiliates to the post-division Company X and substantive operations to the new Company Y.

Then Company X launches a tender offer to Company Y's shareholders in exchange for new shares issued by Company X. The exchange ratio is determined according to a regulatory formula based on the prevailing market prices of the two firms. Among Company Y's shareholders, members of the controlling family ("a" and "b" in the illustration) usually tender their shares in accordance with their plan and become shareholders of Company X, but other unrelated shareholders ("c" in the illustration) usually remain passive and do not tender their shares. Such "inertia" may seem rational because the investors have little reason to own the holding company shares instead of having the discretion to own or not own each subsidiary's shares. In addition, the market price of Company X shares is usually undervalued because of the phenomenon known as the "holding company discount." Therefore, family members receive a relatively higher ratio in Company X as a result of the exchange. Now Figure 6 shows that (a+b)'s control over the group (X+Y) is stronger than their control over pre-division Company X.

173. KCC art. 530–2.

174. *Id.* at arts. 530–5(1)(iv) (for a horizontal division), 530–12 (for a vertical division). *See also* KIM ET AL., *supra* note 59, at 782.

175. Kim & Wang, *supra* note 170, at 2–3.

Figure 5

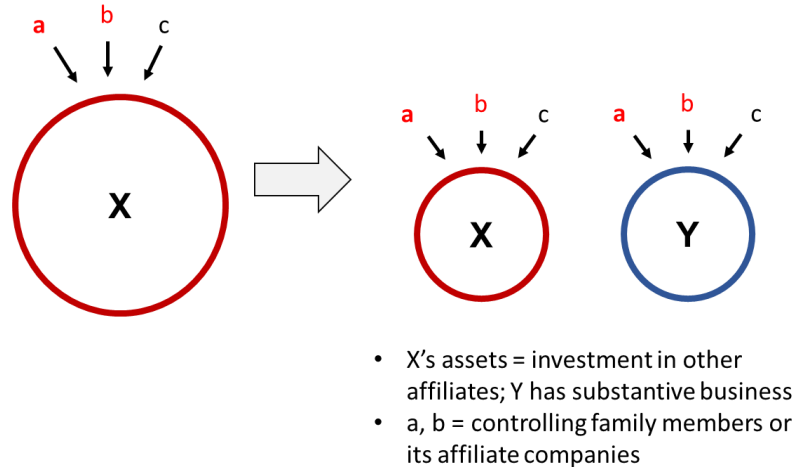
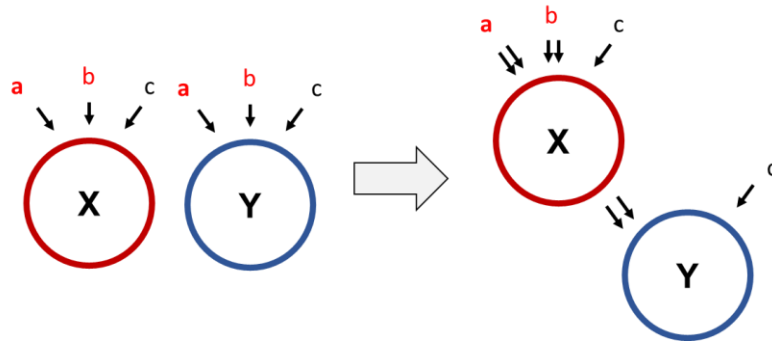


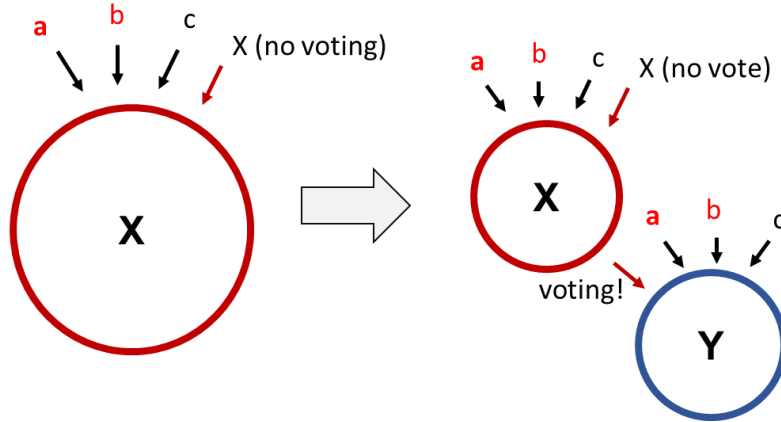
Figure 6



If Company X had treasury shares before the division, and if new shares of Company Y were allotted to the treasury shares as well (as if they were outstanding shares of Company X), the structure will be like Figure 7. In this picture, Company X's treasury shares are indicated as "X's ownership in X" with no voting right. Upon horizontal division, shares of Company Y are issued to the shareholders of Company X. If Company Y issues new shares to Company X as well (under the understanding that Company X is its own shareholder for the treasury shares), then Company X will have voting shares in Company Y. In effect, after the division, the voting right of the treasury shares resurrects partially with respect to Company Y. The family members

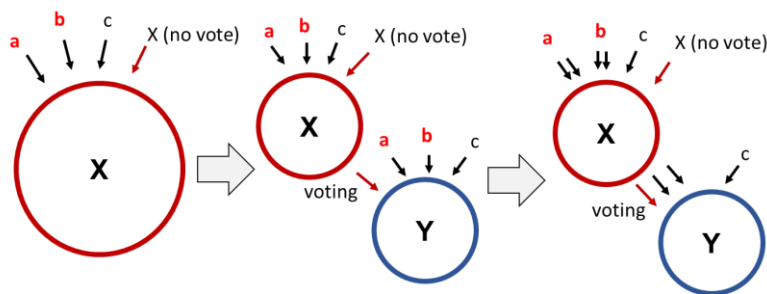
(a+b) now have leveraged control over Company Y through Company X.

Figure 7



If the “exchange tender offer” and the “allotment of new shares to the treasury shares” are combined, (a+b)’s control over (X+Y) becomes much stronger as Figure 8 illustrates. If we simply count the number of arrows in the diagram, (a+b) had 2/3 votes over predivision Company X but finally have 4/5 votes over postdivision Company X and control 3/4 votes over Company Y through Company X. If a and b are the Ns, this is a very efficient and clever measure to increase their control over the entire group.

Figure 8



This is often called the “magic of treasury stock” in Korea,¹⁷⁶ but the trick is simple. Allotment of new shares of Company Y to the treasury shares of Company X is in effect the same as distributing Company X’s dividends to Company X itself. Horizontal division is

176. See, e.g., SANG-IN PARK, *supra* note 26, at 196–98.

economically the same as vertical division (where the new shares of Company Y belong to Company X) followed by Company X's distribution of Company Y shares as in-kind dividends. Company X cannot receive such dividends (Company Y shares) even with respect to its own shares. Likewise, Company X should not receive Company Y's new shares at the time of horizontal division.

Certain scholars and shareholder activists pointed out the absurdity of this "magic" and argued against this practice,¹⁷⁷ but to the author's knowledge such deals have never been challenged by the courts, either in a civil, criminal, or administrative case. In 2016 and 2017, certain congress members proposed an amendment to the KCC that prohibits "allotment of new shares to the treasury stock of the original company" at the time of horizontal division.¹⁷⁸ Although very technical in nature, this issue also caught political nuance and is now awaiting discussion at the National Assembly.

VI. CONCLUSION

The controlling shareholders and the management of Korean companies designed clever measures to facilitate management succession, often by circumventing the current rules. The passive judiciary, the rule-oriented legal culture, and the widespread textualism among Korean lawyers and legal scholars prompted the need for statutory reactions to address the resulting problems. Statutory reactions, however, were sometimes late, limited, or irrelevant. These stories may have some implications for a comparative study of corporate law.

First, the cases discussed in this Article provide an opportunity to observe the classic trade-offs of rules and standards in the real corporate world.¹⁷⁹ Rules reduce the danger of official arbitrariness or bias, but may suppress relevant similarities and differences.¹⁸⁰ Rules afford certainty and predictability, but tend toward obsolescence and absurd rigidity.¹⁸¹ Rules reduce chances for rent seeking and agency problems, but are vulnerable to circumvention and avoidance—they "allow the bad man to engage in socially unproductive behavior right

177. See, e.g., Hyeok-Joon Roh, *Gi-eop-jae-pyeon-eui Hwal-seong-hwa-wa Gue Dilemma* [A Step Towards Business Friendly M&A Rules and Its Dilemma], 34-3 SANG-SA-BEOB YEON-GU [COM. L. REV.] 67, 76-78 (2015) (S. Kor.).

178. Bill No. 837, July 12, 2016; Bill No. 5633, Feb. 14, 2017.

179. For various arguments for rules and standards, see Kathleen Sullivan, *The Justices of Rules and Standards*, 106 HARV. L. REV. 22, 62-69 (1992).

180. *Id.* at 62, 66.

181. *Id.*

up to the line.”¹⁸² In the cases discussed in this Article, the rule-based approaches revealed their well-known limits. Preemptive rights that should be granted to the existing shareholders in case of issuing new shares were circumvented by reissuing forfeited shares or selling treasury shares.¹⁸³ Rules that determine the scope of the beneficiary under Article 23-2 of the FTL were avoided by decreasing the controlling family’s shareholding ratio just below the thresholds or by adding another layer of subsidiary.¹⁸⁴ The undue support clause was toothless when the formula of “the difference from the normal price” was incalculable as in the “funneling of business” or the tolling.¹⁸⁵ In these cases, supplementary or concurrent use of standards such as directors’ fiduciary duties would have been effective.

Second, the cases discussed in this Article also provide an opportunity to examine the traditional dichotomy between statutes and case law in the context of corporate law. Unlike case law formed by judges, statutes are the products of political processes in a democratic jurisdiction. Once the corporate law issues are handled in the parliament as a part of the political decision-making process, the bills tend to represent partisan interests and may be subject to political give-and-take with other agendas, including totally unrelated ones. Thus, the final products (i.e., the statutes) may have more political legitimacy but are often suboptimal in substance. In the cases discussed in this Article, reasonable proposals such as treating a sale of treasury shares in the same manner as issuance of new shares or barring allotment of new shares to the treasury shares in a horizontal division faced opposition from the conservative party and failed to be made into the statutes.¹⁸⁶ Likewise, reasonable proposals such as introduction of poison pills faced opposition from the progressive party and failed to survive the process for the amendment of the KCC.¹⁸⁷ Had judges addressed such issues in an individual court case, the inefficiency of overpoliticization could have been avoided.

Third, as a related matter, the cases discussed in this Article shed light on the roles of the judiciary in the context of corporate law. Active courts and passive courts have their own pros and cons, as debated for centuries in the literature of political science and constitutional law.¹⁸⁸ In the cases discussed in this Article, the formalistic and faithful-to-

182. *Id.* at 63.

183. *See supra* Parts III.C, III.D.

184. *See supra* Part IV.C.4.

185. *See supra* Parts IV.C.3 (in particular, note 108 and accompanying text), IV.D (in particular, note 168 and accompanying text).

186. *See supra* notes 72–79 and accompanying text (for the sale of treasury shares); *supra* notes 177–78 and accompanying text (for treasury shares in a horizontal division).

187. *See supra* notes 68–70 and accompanying text.

188. *See, e.g.*, various literatures cited in Keenan D. Kmiec, *The Origin and Current Meaning of “Judicial Activism”*, 92 CALIF. L. REV. 1441 (2004).

the-letter attitudes of the Korean courts brought too many corporate law issues to the legislature and prompted the overpoliticization of those issues. It was often argued that the passive courts fail to protect the liberty and human rights of the citizens from state power, and the cases discussed in this Article imply that the passive courts may also cause negative impacts on corporate law by tossing to the legislature corporate law issues that are more suitable for a judiciary problem-solving process rather than for a political decision-making process.