THE ROLE OF JUDGES IN CORPORATE GOVERNANCE:
KOREAN EXPERIENCE

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I. INTRODUCTION

In comparative corporate governance discourse, a debate is still under way among researchers in different parts of the world as to whether (and as to the extent to which) law matters in improving corporate governance. It seems now generally agreed, however, that law in practice matters far more than law on the books. What makes law in practice approach law on the books is enforcement. Although enforcement is now being discussed widely, the concept of enforcement seems to differ depending on commentators. Although the focus has been traditionally placed on enforcement of law (hard law, to be precise), the term “enforcement” is now often broadly defined as a process of generating a desirable behavior on the part of market participants.

In this broad sense of the word, enforcement may depend on various elements of society. Not only formal elements such as government agencies, SROs, outside directors and private lawsuits but also informal elements such as market pressures, mass media and NGOs all affect corporate governance practice in one way or another.
Although enforcement consists of various factors, law enforcement occupies a central, if not dominant, position. And in conventional law enforcement, judges play a major role, although their exact role differs depending on the country.

As for Korea, law did not matter much in corporate governance prior to the financial crisis in 1997. Lawsuits filed in relation to a corporate governance dispute (“corporate governance lawsuits”) were rare, if not absent. The judge’s role was insignificant on the corporate governance stage. Since the crisis, however, the situation is changing dramatically. Corporate governance lawsuits are rapidly on the rise. The increase of such lawsuits may be attributable to various factors. First, the corporate statutes have been revised to make it easier to file a shareholder derivative suit. Second, shareholder activists, especially those affiliated with People's Solidarity for Participatory Democracy (PSPD), have been relying heavily on lawsuits in achieving its objectives.¹ PSPD has been taking a variety of legal measures, civil as well as criminal, against managers of chaebol, family-controlled conglomerates in Korea. Third, since the crisis, the share of foreign investors in the stock market has gone up tremendously. Now, they account for more than 30 percent on the average, and, in blue chip firms, more than 50 percent. Foreign investors tend to be less patient than their domestic counterparts and some of them are less hesitant to resort to lawsuits.

With the increase of lawsuits, the role of judges is becoming crucial in corporate governance practice. Their decision may not only determine the outcome of a particular corporate governance dispute but also shape (or distort) the actual picture of corporate governance. For the last decade, the judiciary has been faced with various corporate

¹ For a survey of the role of NGOs in corporate governance in Asia, see Curtis J. Milhaupt, "Nonprofit Organizations as Investor Protection: Economic Theory, and Evidence from East Asia". Yale Journal of International Law, Vol. 29, No. 169, 2004
governance disputes. Dealing with these disputes, judges show a somewhat “schizophrenic” attitude. They would sometimes adopt a highly formalistic approach, sticking with the letters of a statutory provision, while in other cases they would liberally digress from the statutes to reach an outcome not explicitly supported by the statutes. The purpose of this paper is to examine the role of judges in Korea’s corporate governance on the basis of these decisions showing different attitudes in judicial decision-making.

This paper proceeds as follows: Part II will survey the status of corporate governance lawsuits. It will discuss factors causing the increase of such lawsuits and cover diverse types of such lawsuits. Part III introduces a sample of corporate governance lawsuits which appear contradictory to each other in judicial reasoning. Part IV attempts to present a few perspectives from which one may explain these apparently inconsistent decisions. Part V is a conclusion.

II. RISE OF CORPORATE GOVERNANCE LAWSUITS

Lawsuits related to Shareholder Resolution

Under Korean law, shareholder lawsuits may arise in various contexts of corporate governance. For example, a shareholder may sue to vacate a shareholder resolution for violation of law or the articles of incorporation, or to nullify a merger or issuance of shares. Minority shareholders holding a certain number of shares may file a lawsuit to seek dismissal of a director for violation of law or illicit behavior (Art. 385 II) or a derivative suit against a wrongdoing director for damages (Art. 403).
Prior to the financial crisis, shareholder lawsuits were largely confined to those seeking to invalidate a shareholder resolution. The prevalence of such lawsuits may be primarily due to three factors. First, unlike shareholder derivative suits, even a shareholder holding one share is qualified to file this kind of lawsuit. Second, the general shareholders meeting (GSM) of corporations, smaller firms in particular, is often conducted in disregard of formal procedures under the corporate statutes. As long as there are no disputes among shareholders, no one pays attention to this kind of technical flaws. Third, filing such a lawsuit is often about the only effective legal remedy available to a disgruntled shareholder.

This lawsuit invalidating a shareholder resolution is indeed a powerful weapon against majority shareholders. This remedy, however, is not without limits. First, it may not address the real complaint of discontented shareholders. Such a lawsuit is a product of a long, ruptured relationship, not just a one-time misconduct. Invalidating a particular move by majority shareholders does not help restore the broken relationship. Second, this remedy is prone to abuse by opportunistic shareholders. Third, more significantly, this remedy is of limited relevance in corporate governance disputes. The limit derives from the limited power of the GSM as a corporate organ. Under Korean law, the jurisdiction of the GSM is broader than in the United States. For example, dividends are declared by the GSM, not the board of directors, under Korean law. Still, the power of the GSM is largely limited to fundamental changes such as mergers and amendments to the articles of incorporation. The division of power between the GSM and the board is not as strict as in the United States as the power of the GSM may be liberally expanded.

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2 The situation is similar in other civil law countries as well. For Italy, see, Luca Enriques, Do Corporate Law Judges Matter? Some Evidence from Milan, 3 European Business Organization Law Review 765, 784-86 (2002) For Germany, Pistor & Xu
by the articles of incorporation. It may not be a practical option, however, to further expand the power of the GSM, because it will then hinder timely and flexible corporate decision-making. Thus, material business decisions are mostly being made in the boardroom. From the corporate governance perspective, it is thus more important to restrain the behavior of the board and individual directors, than the GSM.

**Lawsuits aimed at the Board and Directors**

Korea does have a statutory framework designed for restraining the abuse by directors. First of all, the corporate statutes recognize a Korean version of fiduciary duties, i.e., the “duty of care of a good manager” ("good manager duty") (Civil Code, Art. 681) and the duty of loyalty (Art. 382-3) introduced in 1998. As to the conceptual relationship between the two duties, academics still dispute. It is now well accepted, however, that the two duties can be interpreted as a functional equivalent of the fiduciary duties imposed on directors under the U.S. corporate law.³

The two statutory duties, however, failed to grow into an equivalent of its American counterpart. This is largely due to the inadequacy of shareholders’ derivative suits under Korean law. Although the shareholder's derivative suit was adopted in KCC in 1962, no known derivative suits were recorded until 1997. The absence of derivative suits does not necessarily mean the absence of wrongs against shareholders. A primary cause of the absence of such suits was the five-percent shareholding requirement imposed on a plaintiff shareholder. For a large listed firm, this shareholding requirement served as a

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³ This paragraph is partly based on Kon Sik Kim & Joongi Kim, Revamping Fiduciary Duties in Korea: Does Law Matter in Corporate Governance?, in Curtis Milhaupt ed., Global Markets, Local Institutions(Columbia University Press 2003)
virtually insurmountable hurdle.

Inadequacy of Criminal Sanction

This does not necessarily mean that management abuse was completely beyond control. Tunneling activities by managers may constitute a breach of trust, a crime under the criminal code in Korea. Unlucky managers, those of bankrupt firms in particular, have often been indicted and convicted for a breach of trust. Examples of criminal sanctions against top executives abound, including recent scandals involving SK, Hyundai, Doosan and Samsung. This approach of imposing criminal sanctions does have merits, as it is simple, powerful and flexible. It has its own shortcomings as well. First, prosecutors may be more susceptible to public pressure. Although they do not receive orders from the Blue House, the office of the president, they are not entirely free from political considerations. Indeed, prosecutors have been exercising much discretion in indicting managers. In two recent, but separate cases, for example, the CEO of a medium-sized company was indicted and then found guilty of embezzling company funds for issuing private placements of bonds with warrants to himself at a substantial discount.4 In contrast, in a nearly identical case involving a leading chaebol firm that issued convertible bonds by private offering to the chairman's son and daughters, prosecutors chose not to indict the CEO of the firm. The inaction of prosecutors drew criticism from shareholder activists as the children of the chairman gained over $100 million in the process. [Jang and Kim, 91]. Then, in 2005, three years

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4 Seoul District Court (Judgment of Aug. 30, 2001); Supreme Court No. 2001Do3191 (Judgment of September 28, 2001).
after the charge had been filed, the prosecutor’s office changed its mind and indicted
the two representative directors. The poor defendants were convicted at the trial court.\(^5\)

Second, as the breach of trust is subject to a criminal punishment, the scope of
misconduct covered by it should be limited to highly reprehensible behavior. Indeed, a
breach of duty, a central element of the crime of breach of trust, is rather vague and
amenable to a quite liberal interpretation.\(^6\) Prosecutors, however, seem relatively
cautious in addressing management misconduct.

Third, the level of criminal sanction imposed on wrongdoing managers is regarded as
relatively low in Korea. This is well illustrated in a recent criminal case involving yet
another chaebol. Several members of its controlling family were found to have long
engaged in usurping tens of million dollars from firms under their control.\(^7\) Although
the facts were not disputed, they were not even arrested unlike other white collar
criminals in a similar situation. They were all convicted, but could get away with a
suspended sentence.\(^8\) Finally, even if the wrongdoing controlling shareholder is sent to
prison, he is normally released from prison after a few months and resumes his position
eventually. The government would feel strong pressure from the business community
and the media to put him back to the helm of the stray ship by staying the sentence or
granting amnesty.

\(^5\) Seoul Central District Court No. 2003Kohap1300 (Judgment of October 4, 2005).
\(^6\) Punishing managerial misconduct with the breach of trust is heavily criticized by commentators on this
ground.
\(^7\) The whole scheme was disclosed to the public by a disgruntled family member who had been ousted
from the chairman’s office.
\(^8\) This incident has led to yet another controversy. A few days after this decision, the chief justice of the
Supreme Court severely criticized the overly lenient attitude of judges at a dinner with senior judges. He
was reported to have said, “if a thief steals one hundred million Won, you will surely send him to prison
for a few years at least. If a person who stole from his company tens of billion Won is set free with a
suspended sentence, how would the general public react?”
Corporate Governance Reform after the Crisis

Thus, criminal sanction should not be allowed to take the front seat in corporate governance. Since the financial crisis, the government has made efforts to facilitate shareholder suits. Through a series of revisions, the shareholding requirement for a derivative suit has been substantially alleviated. For a large listed firm, the shareholding threshold has been lowered to as low as 0.01 percent of the shares (Securities Exchange Act Art.191-13(1)). If the firm is really large, it may be still not easy to clear this hurdle. In such case, the only realistic option is to find a willing foreign investor.

Attorney fees are known to be a critical element in shareholder lawsuits. Now, there is a possibility that plaintiff’s lawyers may be compensated for their services. Korea has finally enacted a provision entitling plaintiff shareholders to seek reasonable compensation from the company for their litigation costs. (Art. 405; SEA, Art. 191-13 (6)). The litigation costs include attorney fees. And it will be up to the court to determine the reasonable amount of attorney fees that the company should pay to the successful plaintiff. It is not entirely clear, however, whether Korean judges will be as generous as their U.S. counterparts in determining attorney fees. In Korea, it is still a foreign idea to give an incentive to private individuals to file a lawsuit in the interest of others.

Rise of Lawsuits against Managers

Given the cumbersome shareholding requirement and the lack of incentive to sue, it is somewhat surprising to observe at all shareholders’ derivative suits in Korea. So far,
PSPD and public-minded lawyers have been behind these few lawsuits. These lawsuits have sent shockwaves throughout the Korean business community by holding managers liable for breaches of fiduciary duties. The first landmark decision is the decision involving Korea First Bank. The case is based on KFB’s questionable loans to the Hanbo Group, which went under after making a string of overly optimistic investments. At the time of the loan decisions, Hanbo was regarded as “unqualified” under KFB’s own internal loan standards. Moreover, KFB’s top executives received bribes from the chairman of Hanbo. A group of shareholders organized by PSPD filed, for the first time in Korea, a shareholder derivative suit against directors for damages. Although the defendant directors argued that their decision was basically a business judgment, the district court reject this argument by saying that “a director made a mistake that cannot be passed over lightly and that exceeded their scope of discretion.” (emphasis added).

The Korea First Bank Decision attracted much attention from the mass media, partly because the directors were held liable for as much as 40 billion Won, an exorbitant sum of money for salaried managers. Less spectacular, but more influential are the lawsuits filed by Korea Deposit Insurance Corporation (KDIC) against responsible managers of bankrupt financial institutions and debtor firms. In the wake of the financial crisis, KDIC began to sue those accountable much like the U.S. Federal Deposit Insurance Corporation following the savings and loans crisis. As of the end of 2005, KDIC have civil liability actions filed against 9,144 executives of 489 financial institutions for more than 1.6 trillion won in total. Also, KDIC have demanded that financial institutions file lawsuits against 698 managers of 132 distressed firms. The

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9 For details of this famous decision, see Kim & Kim.
10 The amount was later reduced to one billion Won on appeal.
litigation activities of KDIC will not continue indefinitely, however. KDIC may exercise its broad litigation power only in exceptional circumstances where public funds are injected to a distressed financial institution (Deposit Protection Act, Art. 21-2).

**Duty of Care**

In the KFB case, it was the duty of care that was formally violated. But the case involves a conflict-of-interest aspect as defendant directors were found to have received a bribe from Chairman Chung of Hanbo. Indeed, cases where a director is held liable purely on the grounds of the duty of care are rare, as the Korean court recognizes a Korean version of the business judgment rule. [Hwa-Jin Kim] It is not clear, however, to what extent this business judgment rule reaches. As shown later, there are cases where related party transactions are at issue. In theory, it may be treated as a duty of care case for those directors who are not “specially interested” in the transaction in question. Then the court could apply the business judgment rule to the directors’ decision to approve the transaction. Holding the directors liable for damages, the court made no distinction between the two duties, nor did it discuss the business judgment rule. In one recent case, outside as well as inside directors were held liable for approving an unfair related party transaction.

A subset of the duty of care, the duty to monitor is growing more and more relevant for outside directors. Primarily under the influence of the Sarbanes-Oxley Act, the concept of internal control is now being discussed and has been adopted in the statutes. Enforced strictly, this concept may lead to an increase in cases regarding the duty of care. It is not clear, however, how the court will react to this concept.
**Duty of Loyalty**

In Korea’s corporate governance practice, the duty of loyalty should be far more important, as an overwhelming majority of largest firms in Korea have controlling shareholders. As the controlling shareholders’ control is based on complicated pyramid and cross shareholding schemes, there is a wide gap between the controlling shareholder’s voting power and economic stake. [statistics] Related party transactions are rampant and not effectively regulated. An endless stream of scandals involving controlling families demonstrates the inefficacy of the corporate statutes in restraining abuse. It is well known that the corporate statutes have many holes in regulating related party transactions. For example, the statutes do not explicitly cover corporate opportunities and controlling shareholders. But the statutes are bound to be incomplete in this area, as there are so many different ways of tunneling. [Pistor & Xu] It is up to the judges to fill these holes by way of interpretation. As shown later, however, judges do not seem to be enthusiastic about playing this crucial role.

Since the financial crisis, the statutes have been strengthened as regards related party transactions. Related party transactions encompass a wide variety of transactions, including sale of assets or issuance of securities to affiliates of the controlling shareholders. What has come into the spotlight in recent years is sale of shares of a non-listed firm. Under the revised statutes, these transactions are now subject to board approval and disclosure requirements. The board approval requirement turned out not as effective as expected in filtering out shady transactions. Under the corporate statutes, a director “specially interested” in a transaction in question is not allowed to vote in a
board resolution. The concept, however, is rather narrowly construed by commentators. For example, suppose Firm A is selling a major asset to Firm B, an affiliate firm under the control of the controlling shareholder C. The sales transaction is now to be approved by the board in both firms. Although C is excluded from voting in Firm A’s board meeting, other inside directors may, and do, vote unless they serve on Firm B’s board at the same time. It is not difficult to predict how these insiders, mostly longtime subordinates of C, would vote on this matter. True, listed firms are now required to have outside directors, up to 50% of the board in large listed firms. Since such transactions are normally presented as legitimate tractions on fair terms, passive outsiders would not dare ask awkward questions in the board meeting. It is thus no wonder that controversial related party transactions, which later caused lawsuits, were formally approved by the board.

As a matter of principle, shareholders may still sue directors for damages if they can prove loss of the firm incurred by a particular transaction. In reality, however, it is difficult to obtain information for proving the unfairness of the transaction. Even if you have all the information, you still have to meet the burdensome shareholding requirement. Once a derivative suit is filed, however, the court may make its own judgment as to the fairness of the transaction. In a few recent cases involving a sale of unlisted shares, the court has examined in detail the fairness of the price.

**Lawsuits related to Control Disputes**

Prior to the financial crisis, the controlling family normally enjoyed almost absolute control even in the largest firms in Korea. With those of affiliate firms, the
shareholdings of the controlling family usually exceeded 50% of the votes. Consequently, a hostile takeover attempt was quite rare. Things have changed somewhat after the crisis, however. In some of the largest firms, the voting share of the controlling shareholders falls well below 50%, even 30% in some cases. A vacuum created by controlling shareholders in retreat has been filled up by institutional investors, especially foreign investors. Foreign investors now occupy more than 30% of the Korea Exchange. As their investment concentrates on blue-chip firms, their share is now over 50% in top firms such as Samsung Electronics and POSCO. As a result, the controlling family’s control is now much less secure than before.

An immediate consequence of this change is a growing number of instances where the controlling shareholders are challenged. Challenge against the controlling family may take the form of a formal tender offer. Formal tender offers, however, are rarely found even in a hostile takeover context. Proxy fights are more common. Proxy fights have been initiated not only by foreign investors such as Tiger Fund, Sovereign and Carl Icahn, but also by domestic shareholders. In connection with the proxy contest, parties file various types of lawsuit, including lawsuits seeking preliminary injunction. Disgruntled shareholders may, for instance, attempt to gain access to the books and accounts of the firm, or to block the firm’s issuance of equity securities to a white knight. On the other hand, management may try to prevent the raiders from voting shares acquired in violation of the five percent rule.

These new types of corporate governance lawsuits pose a challenge to judges, who are not well versed in policy implications of control disputes. Korea does not have a developed set of statutory rules applicable to takeovers, except for tender offer provisions included in the Securities Transaction Act. Thus, judges are the ones who
should make rules in this area. In Korea, defensive measures available to management under the corporate statutes are quite limited. Dual class voting shares are not allowed. More importantly, poison pills, a widely popular and powerful weapon against hostile takeovers, are not available, largely due to strict statutory provisions on securities. Pyramidal and circular shareholding patterns commonly observed in almost every chaebol may be regarded as a byproduct of the rigid statutes. It is difficult to predict how long controlling families can afford to maintain these complicated ownership structures. With the increase of challenges against the controlling family, however, we will observe more and more corporate governance lawsuits of various types.

III. RECENT CORPORATE GOVERNANCE LAWSUITS

As shown above, corporate governance lawsuits become more common and diverse in the corporate governance scene of post-crisis Korea. Dealing with these lawsuits, judges seem to adopt somewhat inconsistent attitudes depending on circumstances. In some cases, the court employs a rather formalistic approach, sticking to the letters of the statutes. In other cases, however, the court relies on a flexible interpretation to reach a desirable outcome, not explicitly supported by the statutes. This kind of inconsistency in case law may be unavoidable to a certain extent, and observed in other jurisdictions as well. It seems notable, however, that decisions issued only during a relatively short period of time show such contrasting perspectives. This Part will illustrate the contrast by presenting a group of leading court decisions.

\[12\) Non-voting preferred shares may be issued up to a certain limit.\]
Decisions Adopting a Formalistic Approach

Civil law Judges are generally believed to be more formalistic than their common law counterparts. It is not difficult to find in the corporate governance area decisions based on a formalistic reasoning. Here, only two of them will be discussed.

[Samsung Electronics CB Case]

A prime example showing Korean judges’ formalistic mindset in the corporate governance area is the famous Samsung Electronics Convertible Bond Case. On March 24, 1997, Samsung Electronics issued by private offering convertible bonds (CBs) in the amount of 60 billion Won, 15 billion Won to Samsung Corporation, a member firm of Samsung Group, and 45 billion Won to the 29-year old son of Chairman Lee of the Samsung group. The terms and conditions were as follows:

Due date: March 24, 2002
Conversion price: 50,000 Won
Conversion period: from September 25, 1997 to March 24, 2002
Interest rate: 7%

On September 29, 1997, Lee Jr. exercised his conversion right and acquired about 900 thousand common shares, 0.9% of the total shares. PSPD filed a lawsuit to invalidate the CB issuance, arguing, among other things, that the conversion price

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13 For a translation of the lower court decision, see 1 Journal of Korean Law (2001).
50,000 Won is unduly low, given the fact that the share price at the time of issuance was 56,700 Won and that the conversion price of CBs issued two months later was 123,635 Won.\textsuperscript{14} The Seoul High Court admitted that the conversion price is relatively low. It refused to invalidate the CBs, stating as follows:\textsuperscript{15}

“This fact may justify a shareholder’s claim for injunctive relief prior to the issuance of the convertible debentures, a claim against directors for damages, or a claim against the purchasers of the convertible debentures in question for additional payment. It by no means justifies, however, invalidation of the convertible debentures already issued.”

The formalistic attitude of the court is well illustrated in the following passage:

“The current KCC does not require an advance notice or public announcement to the shareholders concerning the total amount of convertible debentures, issue price, terms of conversion, conditions for the shares to be issued as a result of conversion, and conversion period at the time of issuance. It may be acknowledged that such a legal deficiency should be remedied. But even when the board of directors has deprived a shareholder of an opportunity to exercise his right to enjoin by secretly and promptly issuing convertible debentures without making an advance public announcement of such matters, the issuance of the convertible debentures should not become illegal.”

The Supreme Court upheld the lower court decision basically on the same grounds. The Supreme Court also stated that even the CBs suspected to be issued for purposes of prior inheritance, gift or control transfer cannot be invalidated without other grounds. Following precedents on securities issuance, the Supreme Court emphasized the so-called “stability of the marketplace.” Although PSPD got a preliminary injunction

\textsuperscript{14} Although this case involved other interesting legal issues, only the conversion price issue will be discussed here.
\textsuperscript{15} Seoul High Court, June 23, 2000, No. 98Na4608.
enjoining the listing of the CBs on the stock exchange, the Supreme Court undervalued the injunction, by stating that it does not block a sale outside the exchange. The Supreme Court, however, did not remark as to whether or not Lee Jr. has sold the converted shares to a third party. On a similar note, stating that shareholders may recover damages instead by filing a shareholder derivative suit, the court did not go into whether or not the plaintiff shareholder can satisfy the shareholding requirement.

[Double Derivative Suit Case]

Another example showing the judiciary’s formalistic approach to statutory interpretation is a recent decision by the Supreme Court denying the so-called double derivative suit. The facts of the case are as follows: Y, the defendant, is the representative director of Company A, who was alleged to have misappropriated A’s fund. X, the plaintiff, is a minority shareholder of Company B, 80% shareholder of Company A. Although X is not formally a shareholder of Company A, he filed a derivative suit against Y. The most significant issue involved was whether or not a shareholder of the parent company has a standing to file a derivative suit against directors of the subsidiary company, in other words, whether or not to recognize a double derivative suit. This issue was of the first impression in Korea. The Seoul High Court surprised the legal profession by holding in favor of X.

The criticism on the double derivative suit is two-fold. The first criticism is based on a literal interpretation of the statutes. Under the statutes, a derivative suit may be brought by shareholders holding certain shares (Article 403 of the Commercial Code, Article 191-13 of the Securities Exchange Act). One may argue that shareholders of the parent
are not counted as shareholders of the subsidiary. The second criticism is based on a practical consideration that shareholders of the parent have alternative remedies. According to this line of reasoning, the parent’s shareholder may first demand that the parent's board of directors take action against the subsidiary’s directors. If the board refuses to act, the shareholders can file a regular derivative action against the parent's directors for violating the duty of care to protect the parent's investment in the subsidiary.

The Seoul High Court, however, permitted a double derivative suit on the following practical grounds. First, it may be very difficult to appraise the indirect loss of the parent company caused by the act of the subsidiary’s director. Second, if a double derivative suit is not permitted, managers controlling both the parent and the subsidiary may shield themselves from legal liability by having a director of the subsidiary commit an illicit conduct. Third, a double derivative suit would not only have a deterrent effect on the subsidiary’s directors but also help the parent reduce its damages.

It is noteworthy that the court emphasized “the necessity of a double derivative suit” in interpreting “shareholders” under Article 403 of the Commercial Code as including “shareholder of a corporate shareholder.” The Supreme Court, however, reversed this flexible holding of the High Court. Turning a blind eye to the effect of the decision, the Supreme Court simply stated that the double derivative suit is not allowed as the shareholders under Art. 403 are those of the company involved, not its parent.

Although this decision involves a relatively small firm, it has been closely watched by the big business and PSPD. Many firms in Korea now have a subsidiary. If the subsidiary enters into a dubious transaction with an affiliate, minority shareholders of the parent company have no remedy under the current law. In relation to recent
corporate scandals, PSPD is reported to have given up on a double derivative suit as they were not sure of the legality of such suits under the current law. The Ministry of Justice has just completed a bill to revise the corporate statutes, which includes a provision explicitly allowing a shareholder of a parent company to file a derivative suit against directors of its subsidiary. This provision is being heavily criticized by the Federation of Korean Industries, a main trade association for chaebol. PSPD, on the other hand, is also critical of this provision, arguing for further relaxing the requirements.

**Decisions Adopting a Liberalistic Approach**

Despite the popular perception that civil law judges are rather passive in statutory interpretation, Korean judges sometimes digress from the letters of the statutes in reaching a conclusion they find appropriate. Two examples will be discussed here.

[Samsung Electronics Derivative Suit]

The first example again relates to Samsung Electronics. In 1998, PSPD filed a shareholder derivative suit against directors of the Samsung Electronics including Chairman Lee and his top executives. Although this case deals with many interesting issues, only an issue related to damages will be discussed here. In December 1994, Samsung Electronics sold an affiliated company's shares that it had acquired 8 months ago to another related company at 2,600 Won per share, 74% discount from the purchase price 10,000 Won per share. Samsung Electronics followed the widespread
practice by retaining a reputable accounting firm to determine the value based on a valuation formula for unlisted stock under the Inheritance and Gift Tax Law. The formula is a combination of the net asset value and the profit value. The accounting firm came up with 2,361 Won per share (50% X 4,723 Won + 50% X 0 Won). The accounting firm reached the final figure, 2,597 Won, by adding 10% control premium. But the Suwon District Court held that the tax law formula should not govern as the context is different, and that the fair value should have been calculated based on the net asset value only. The court calculated its own net asset value to be 5,733 Won. Finding no factors justifying the low sales price as opposed to the net asset value, the court held that the directors had violated the duty of care and had to pay more than 62 billion Won for damages. The Seoul High Court upheld the district court decision, but reduced the damages by as much as 80% based on various redeeming factors. The High Court decision was again upheld in 2005 by the Supreme Court. The Supreme Court based the reduction of damages on “the ideal of equitable allocation of losses.” As redeeming factors considered in reducing the damages, the court enumerates not only factors related to the conduct causing the damages but also general factors such as the degree of the director’s past contribution.

This decision is particularly noteworthy because it appears inconsistent with Article 400 of the Commercial Code, which requires the consent of all the shareholders to reduce the liability of directors. Article 400 has been criticized as unduly restrictive. In one recent case, the Supreme Court even held that the consent of shareholders holding 96% of the shares is not sufficient. It has been generally presumed that there is no other way to reduce the liability. The judges achieved by way of interpretation what

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16 Seoul High Court, No. 2002Na6595 (November 20, 2003).
17 Supreme Court, No. 2002Da90467, 60474 (December 10, 2004).
even the 96% shareholders could not achieve. In the process, they showed how flexible and creative even the civil law judges could be in reaching a favored conclusion which appears to contradict the explicit letters of the statutes.

[Preliminary Injunction Related to the Shareholders Meeting of SK]

The court’s creativity is also revealed in our second case, which derived from a dispute between SK and Sovereign, a Dubai-based private fund run by two New Zealanders. The controversy started when Sovereign bought in early 2003 about 15% shares of SK Corp., a *de facto* holding company of the SK Group. At the time of the purchase the SK Group was in trouble as Chairman Chey, the controlling shareholder of the SK Group, was indicted for accounting and share transfer scandals.

[Figure: Share Ownership Structure of SK Group]

After the purchase Sovereign began a campaign to neutralize Chairman Chey and enhance SK’s transparency. In March 2004, it vigorously waged a failed proxy fight against the management. Sovereign nominated five candidates, all respectable Korean nationals. In an effort to boost the public image of SK, Chairman Chey presented his own slate of distinguished outsiders. At the March 2004 shareholders meeting, Chairman Chey could manage to defeat Sovereign by a narrow margin, filling all five slots of the board with his nominees.

In October 2004, Sovereign requested SK Corp. to call an extraordinary GSM for changing the articles of incorporation to oust ex-convicts (Chairman Chey was the one)
from the board. When SK Corp’s board rejected Sovereign’s request, Sovereign filed a petition for the court’s approval of an extraordinary GSM. In December 2004, the Seoul District Court rejected Sovereign’s petition.

Under the statutes, a shareholder holding at least 1.5% of the shares for the last six months is qualified to call a GSM with the court’s approval. Commentators generally agree that the court must approve unless the minority shareholder’s exercise of this right amounts to “an abuse of right.” Holding that there was no abuse of right, the court still refused to approve Sovereign’s petition. The court stated that in approving the shareholder’s request, it should consider the necessity of an extraordinary GSM from a paternalistic perspective based on various factors such as the possibility of passing a resolution or impact on the national economy. The court mentioned so many different factors. The court stated, for example, that “because continuous instability in management control might lead to the departure of investors and the decline in the investment value, given the nature of SK Corp’s business, requiring long-term investment and business plan, a benefit from stabilizing management control at least until the GSM next year is not insignificant.” The court also noted that in exercising shareholder rights, a corporate, as opposed to individual, shareholder is more likely to sacrifice the interests of the corporation for its own firm interest.” The court even mentioned that “it is not impossible for SK Corp to voluntarily propose to make a similar change to the articles of incorporation at the next March 2005 GSM.

At the March 2005 GSM, Chairman Chey was reelected to the board, receiving 55.3% of the votes. In May 2005, the Seoul High Court upheld the lower court’s ruling denying Sovereign’s petition, holding that Sovereign’s request to call the GSM constituted an “abuse of right.” Not long after the decision, Sovereign sold its SK
holdings at a substantial profit.

Conflicting Decisions Concerning the Sale of Treasury Shares

Formalistic and liberalistic decisions discussed above relate to different corporate law issues. In one example, however, different judges took conflicting attitudes on the same issue. The issue relates to the sale of treasury shares in the presence of takeover threats.

[SK Corp Case]

The first case again derives from the SK Corp’s fight against Sovereign. As a defensive measure against Sovereign’s challenge to Chairman Chey, SK Corp came up with a plan to sell treasury shares carrying 10.4% of the votes to a group of friendly banks, which promised to vote the shares in favor of Chairman Chey at the March 2004 GSM. Sovereign sued to enjoin SK Corp from selling the shares. Although the corporate statutes provide for shareholders’ preemptive rights for newly issued shares, there is a statutory gap on the sale of treasury shares. Sovereign, however, argued that the company should not favor a particular group of outsiders to the exclusion of the existing shareholders in selling the shares. Rejecting Sovereign’s argument, the Seoul District Court allowed the sales to go forward. The court simply stated that “faced with Sovereign’s possible takeover, the decision by SK Corp’s board, which was made to defend its management control, is legitimate.” [Seoul District Court, Dec. 23, 2003]

[Daelim Trading Case]
A different court, however, manifested a contrary attitude on the same issue. The case involves Daelim-Trading ("Daelim"), a listed firm largely owned by two factions of the same family. The facts can be simplified as follows. As of the end of 2004, Factions A and B controlled 34.11%, and 29.98%, respectively. The dispute arose as a member of Faction B was ousted in 2003 from Daelim’s management dominated by Faction A. In 2005, Faction A had Daelim sell a large chunk of treasury shares to Faction A, and issue new shares to the exiting shareholders. At the end of these transactions, it turned out that Faction A controlled 47.49% of the vote while Faction B’s share (including shares of their allies) amounted to 30.24%. When Faction A called the GSM for dividing the company, Faction B filed a petition for preliminary injunction, enjoining Faction A from voting the shares acquired from Daelim. Contrary to the Seoul Central District Court above, the Seoul Western District Court granted the preliminary injunction and then held the sales transaction invalid.

Until this decision, the SK ruling discussed above was the only decision on the sale of treasury shares. A few years ago, there was a ruling on the issuance of shares. When there was a fight for control of Hyundai Elevator, a de-facto holding company of Hyundai Group, Hyundai Elevator attempted to issue a large number of shares to the general public.\textsuperscript{18} Its primary purpose was to dilute the share of KCC, the raider. At the request of KCC, the court enjoined Hyundai Elevator from conducting the offering.

Although the corporate statutes explicitly provide for a lawsuit for invalidating issuance of shares, they were silent as to the invalidation of the sale of treasury shares. Central to the reasoning of the court is the fact that the sale of treasury shares is

\textsuperscript{18} Under the articles of incorporation, the shareholders do not have the preemptive right if shares are issued by public offering.
functionally similar to the issuance of shares. A leading corporate law expert criticizes this decision for exceeding the scope of interpretation. The sale of treasury shares, his argument goes, is not different from the sale of company assets and so the company should be free to sell those treasury shares to a particular shareholder.

IV. UNDERSTANDING THE DECISIONS

Traditionally, civil law judges are known to be less active than their common law colleagues in their role of making rules. It is now widely agreed that the differences between continental courts and common-law courts are not as wide as is commonly thought. The sample of cases described in Part III is certainly too small to warrant a definite conclusion on this issue. Judges’ attitudes revealed in the cases are somewhat confusing. In some decisions, judges can be quite flexible in interpreting statutes to reach a conclusion they want. In other decisions, judges adopt a formalistic attitude, turning a blind eye to the practical consequences of their reasoning. How do we understand these conflicting attitudes of judges? One may try three possible explanations: favorable, neutral, and cynical ones.

**Favorable Explanation**

One may argue that judges adopt sometimes a formalistic approach and sometimes a liberal approach in statutory interpretation, depending on the situation. In other words, as judges care about the result only, they are ready to sacrifice consistency to achieve a
just result. Indeed, for the judiciary, this explanation may be most favorable, as it assumes the judges to be both capable and acting in good faith.

If true, this attitude of judges is not acceptable for following reasons. First of all, it will be difficult to prevent an arbitrary decision. Second, if the judge adopts a formalistic approach in a particular decision, it will be difficult to know the real reasons why the conclusion is justified. An answer that the conclusion is mandated by the statutes does not suffice alone as the judge is always free to find a way to avoid the statutes.

Neutral Explanation

One may try a more neutral explanation. Inconsistent decisions may be construed as a reflection of different ways of thinking on the part of judges. Like other parts of Korean society, the judiciary is also in transition. The mindset of judges varies depending on individuals. Some judges are more conservative in the sense that they place much weight on the letters of the statutes. Other judges are more liberal in the sense that they emphasize the actual consequences of the conclusion.

A conservative tendency of Korean judges may be attributable to their upbringing. Law school training in Korea still emphasizes deductive reasoning unrelated to sophisticated policy considerations. Their heavy caseload also makes judges reluctant to tread on unfamiliar territory, adopting novel concepts or theories. It may be far more tempting to a busy judge to stick to a formalistic approach. [Sale, Judging Heuristics]

Cynical Explanation: An Entrapment Theory?
One may try to explain these cases from a more cynical perspective. It may be interesting to examine these cases from the perspective of who won and who lost. Let’s start with formalistic decisions. In the Samsung CB case, Samsung Electronics won, and PSPD lost. In the double derivative suit case, the decision was favorable to chaebol firms with numerous subsidiaries, and detrimental to shareholder activist lawyers. Let’s turn to the liberalistic decisions. In Samsung Electronics derivative suit case, the court’s decision to reduce the amount of damages was beneficial to Samsung’s directors. The SK GSM ruling was obviously favorable to SK Corp, and detrimental to Sovereign, a foreign shareholder.

In the SK Treasury Share ruling, the court, adopting a formalistic approach, refused to grant an injunctive remedy to a foreign fund challenging the controlling shareholder of a major chaebol. On the other hand, in Daelim Trading case, which derived from a family feud among domestic shareholders, the court granted a remedy, based on a flexible reasoning emphasizing the practical effect of the decision.

One may hardly fail to notice a trend in this group of decisions. Regardless of the type of reasoning adopted, those related to the big business won, while activist shareholders and foreign investors lost. True, given the small size of sample, one must not have too much confidence in this rather cynical observation. One may point to other decisions which may contradict this observation. Indeed, shareholder activists have recorded a victory in a small number of lawsuits against chaebol, in which judges would reach a result favoring minority shareholders based on a substantive analysis. The decisions discussed in Part III may be more important, however, in terms of number and
significance. They are by no means aberrations, but mainstream decisions carefully written by elite judges.

It is difficult to find a proper word for this kind of pro-chaebol, anti-shareholder activist, and anti-foreign investor attitudes. Let’s use the adjective, “conservative” for the sake of simplicity. A cynical observer may try to explain the conservative tendency of Korean judges, elite judges in particular, as follows. First, elite judges may be close to business executives working for chaebol and lawyers representing these chaebol clients.[Sale, Judging Heuristics] They may be tied to each other by common educational, professional and social backgrounds. Second, of more significance may be a career pattern of Korean judges. Most judges, including judges of the Supreme Court, practice after retiring from the bench, often affiliated with top law firms representing chaebol firms. One may presume that retired judges known for an anti-chaebol record may find hard time landing a position with a major law firm, let alone finding chaebol clients. In a sense, judges, like other players of Korean society, may be engulfed by chaebol interests.

What exacerbates this pro-chaebol mindset is a growing antipathy against foreign investors, activism of foreign funds, to be more precise. Recently, the local media, business dailies in particular, has become heavily critical of foreign funds for various reasons such as seeking short-term profits and threatening management control. It is becoming increasingly awkward to take sides with foreign investors in public. It may be difficult to expect the judiciary to ignore this pressure in making a decision.

_Evaluation_

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19 Foreign investors suffering from image or even legal problems are numerous, including Sovereign, Tiger Fund, Hermes, Lonestar, Newbridge Capital and Carl Icahn.
It is not clear which of the three explanations is most persuasive. All three may have some explanatory power at least. Regardless of the explanations, one may feel rather uncomfortable after reading the decisions discussed in Part III. It must be emphasized, however, that the picture of case law in the corporate governance area, composed of the decisions, may change in future in accordance with Korea’s changing corporate governance environment.

V. CONCLUDING REMARKS

The more the court is allowed discretion, the more likely becomes the court to abuse its discretion. An obvious solution for this kind of abuse may be enacting more detailed statutory rules. The solution may not be technically feasible, however. As there are numerous ways in which a conflict of interest develops between managers and shareholders, a flexible and general concept such as fiduciary duty is essential for addressing such conflicts. As for conflict-of-interest transactions, it may be better, if not inevitable, to leave law “incomplete”. [Pistor & Xu]

In Korea, relying on judges may not be as bad as in other countries. First, the judiciary is relatively clean, compared with other sectors of Korean society. True, a corruption scandal involving judges is exposed from time to time, and the general public’s perception of judges is not necessarily favorable. It is widely believed that a judge would not change her holding in return for an outright bribe. [Enriques] Second, most judges are quite capable. In terms of integrity and competence, it may be difficult to find those who are better qualified than judges.
This does not mean, however, that judges are perfect. Although they would not accept a bribe from the parties, they may be prone to a more subtle form of pressure. It is still a widespread practice in Korea that parties select counsel based on the strength of social ties between the presiding judge and counsel. Also, career judges with no business experience, they may often lack sophistication in business matters. This may not be a serious defect, however, in the long run. Fast learners, judges will quickly achieve a level of expertise as they are exposed to more cases.

It may not be realistic to expect Korean judges to be as flexible as common law judges in a short period of time. So even in the presence of fiduciary duties in the corporate statutes, it may make sense to put more concrete provisions in the statutes. The provision on *de facto* directors (KCC Art. 401-2) is a prime example. Along this line of reasoning, the draft new Commercial Code includes a new provision on double derivative suits (Art. 406-2) and expands the scope of self-dealing transactions under Art. 398.

Admittedly, the role of judges in restraining management behavior seeking the private benefit of control is still limited. It may be particularly relevant in Korea to activate market pressure on owner-managers. Market pressure may turn out more effective because it tends to restrain even an undesirable behavior not formally constituting a violation of fiduciary duty. So far, pressure from the market for control has been minimal in Korea. If cross or pyramidal share ownership schemes are crumbling, threats of hostile takeovers will loom large. Then, Korea may need to consider introducing a Korean version of poison pill. In such case, the role of judges will become even more crucial. It is not clear whether Korean judges are well prepared to assume such a delicate role. Indeed, as the new draft Commercial Code gives management more
freedom on finance matters such as dividends and types of securities, judges are expected to play a more active role in minimizing management abuses. It will be fascinating to observe how the role of Korean judges evolves in the coming years.

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