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

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Abstract

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

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

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

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

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

I. Introduction

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

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

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

2) *Id.*

3) *Id.*

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

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

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

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

5) *See* Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 134 (Harvard University Press, 1st ed. 1991).

6) *See* Reinier R. Kraakman et al., The Anatomy of Corporate Law: A Comparative and Functional Approach 142 (Oxford University Press, 1st ed. 2004).

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

context of a freeze-out.

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

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

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

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

10) *See Id.* at 32.

11) *See Id.*

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

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

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

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

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

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

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

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

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

This Article proceeds in two major parts. In Part II, we review and evaluate the current freeze-out mechanism: a combination of tender offer and voluntary delisting, and propose certain changes to the existing laws. In Part III, we explain and analyze the cash-out merger and the compulsory buy-out set forth in the Bill and recommend amendments of the Bill in order to attain the two major policy goals of promoting transactional efficiency in freeze-outs and providing adequate protection to minority shareholders.

II. Current Freeze-Out Mechanism

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

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

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

1. Freeze-out Tender Offer

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

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

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

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

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

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

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

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

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

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

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

19) *See id.* at 786.

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

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

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

(1) Uniform Price Rule

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

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

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

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

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

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

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

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

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

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

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

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

(2) Disclosure Requirement

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

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

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

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

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

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

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

(3) Company's Opinion on Tender Offer

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

3) Proposal for Reform

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

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

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

controlling shareholder or the management of the company during the tender offer, and also to include safe harbor provisions.[32] This would definitely help

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

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

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

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

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

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

In Japan, to address conflict-of-interest issues and to promote the fairness of the offer price, the tender offer rules require that if the offeror is either (a) the management or is acting at the request of, and has common interests with, the management or (b) the parent of the target company, then the disclosure of the following matters must be made in registration statement: (i) measures designed to ensure the fairness of the offer price (if any); (ii) the process leading to the commencement of the tender offer; and (iii) measures intended to avoid a conflict of interest (if any). The tender offer regulations do not mandate that the offeror take such measures to ensure fairness of the offer price or avoid a conflict of interest, but if such measures are taken, foreign jurisdictions such as U.S., U.K., and Japan, adopt rules mandating the expression of an opinion of the company in the tender.[34)] If compulsory rules regarding the expression of the opinion of management are adopted, the management will become subject to the disclosure regulations, violation of which will lead to civil and/or criminal liability. The target management will, accordingly, act more prudently and carefully in their delivery of opinion to the public for fear of being subject to legal liability arising from a disclosure violation. Under these circumstances, the monitoring cost of minority shareholders will be significantly lowered so that the overall welfare of the minority shareholders will be increased at the relatively smaller cost borne by the controlling shareholder or the company.

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

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

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

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

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

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

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

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

2. Voluntary Delisting

1) Delisting Process

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

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

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

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

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

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

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

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

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

2) Proposal for Reform

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

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

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

III. New Freeze-Out Mechanisms Proposed in the Bill

1. Proposed Amendment to the Korean Commercial Code

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

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

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

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

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

2. Cash-out Merger

1) Overview

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

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

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

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

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

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

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

(1) Shareholders' Approval

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

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

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

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

(2) Dissenting Shareholders' Appraisal right

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

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

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

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

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

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

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

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

(3) Merger Ratio

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

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

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

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

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

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

3) Economic Analysis: Rational Behavior of Minority Shareholders

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

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

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

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

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

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

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

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

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

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

where,
p = the probability of the success of the merger;
$1 - p$ = the probability of the failure of merger

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

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

where,
q = the probability of the success of the merger;
$1 - q$ = the probability of the failure of merger

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

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

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

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

$$p \times (A - S) > q \times (B - S)$$
(such formula, "Formula 1")

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

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

$$A - S > B - S$$

$$A > B$$

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

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

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

$$A - S > 0$$

$$A > S$$

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

In sum, from the perspective of a controlling shareholder whose shareholding ratio is less than 2/3 of the outstanding voting shares, it can promote the cash-out merger only when the amount of cash to be given to a minority shareholder as merger consideration is greater than either (i) the value of shares when the merger does not occur (S) or (ii) the appraisal value of shares when appraisal rights are exercised (B).

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

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

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

The FSCMA formulas for merger ratio and appraisal value are, seemingly, designed as a device to protect minority shareholders from the controlling shareholder's opportunistic behavior. However, it is unclear whether the FSCMA formulas fully serve the intended purpose. There can be a variety of different methods in evaluating the value of shares. We cannot find any justifiable reason to favor one statutory method over the other. The most appropriate valuation method may depend upon the circumstances surrounding the concerned company and its shareholding structure. Therefore, in some cases, the draconian requirement of mandating the use of the FSCMA formulas may result in an unintended harm to shareholders.

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

(2) Case B: Shareholding Ratio of Controlling Shareholder is not less than 66 2/3%

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

	Minority Shareholder's Decision	
	Consent to Merger	Dissent to Merger
Expected Return	Cash as merger consideration	Cash equivalent to appraisal value (*B*)

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

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

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

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

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

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

for the concerned period.[46)]

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

(3) Summary

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

4) Protecting the Interest of Minority Shareholders

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

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

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

(1) *Ex Ante* Protections

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

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

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

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

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

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

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

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

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

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

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

53) *Id*.

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

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

(2) *Ex Post* Protections

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

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

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54) *Id*.

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

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

57) *See* the Korean Commercial Code art. 529.

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

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

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

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

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

A fraud action based upon the Civil Code may also be considered as an alternative option. For example, if the minority shareholders believe that the controlling shareholders has manipulated the merger ratio, the aggrieved minority shareholder may bring a fraud claim against the controlling shareholder. However, it is not certain whether the court would accept a fraud claim based upon the cause of action for a rescissory suit, because (i) the requisite elements for fraud claim and rescissory claim are different and (ii) a fraud action requires a higher threshold (i.e., fraudulent intent) than a rescissory action. To date, there has been hardly any case law, acknowledging a fraud claim in the merger context.

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

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

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

59) *See* Umwandlungsgesetz art. 15.

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

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

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

3. Controlling Shareholder's Compulsory Buy-out Right

1) Overview

(1) Compulsory Buy-out

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

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

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

62) *See* the Bill art. 360-24.

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

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

(2) Compulsory Sell-out

The Bill also empowers minority shareholders to sell their shares to the controlling shareholder when the controlling shareholder holds 95% or more of the shares in the company (the "compulsory sell-out right").[67] This

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

64) *See* Phillippe Merle, Droit Commercial, Societes Commerciales 812, 813 (Dalloz, 1st ed. 2007); Code monétaire et financier §L.433-4; Règlement général de l'AMF §§237-1~237-13.

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

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

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

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

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

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

2) Balancing of Competing Interests

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

Oct. 2008, at 80-82.

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

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

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

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

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

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

(1) Shareholders Approval

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

69) *See* the Korean Commercial Code art. 360-24(3).

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

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

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

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

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

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

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

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

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

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

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

(2) Purpose of Compulsory Buy-out

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

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

(3) Process of Determining Share Price

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(1) Requirement for Sell-out Right

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

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

(2) Method of valuation

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

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75) *See* the Bill art. 360-25.

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

IV. Conclusion

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

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

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

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

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