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Liability of Directors in Leveraged Buyout: Hi-Mart Case—Supreme Court Decision 2016Do10654 (Oct. 15, 2020)*

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I. Hi-Mart Case

1. Overview of LBO Cases in Korea

The case concerns the acquisition of Hi-Mart by Affinity Equity Partners (hereinafter "Affinity"), a Hong Kong-based private equity fund. The basic structure of the transaction was as follows: Affinity founded an SPC (Special Purpose Company), Hi-Mart Holdings, as a 100% subsidiary for the acquisition. Hi-Mart Holdings acquired a 100% stake in Hi-Mart, and these two companies merged two years later, with Hi-Mart being the surviving company; this deal structure was set up from the beginning. Hi-Mart Holdings and Hi-Mart established collateral security rights for the land and buildings owned by Hi-Mart when obtaining a syndicated loan, but the English and Korean versions of the contract differed regarding the extent of debt secured by the collateral security right. The English version explicitly stipulated that prior to the merger, the debt of Hi-Mart Holdings was to be excluded from the debt secured by collateral security rights. The

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Korean version, which was submitted to the registry office, however, did not mention such an exclusion, causing a dispute regarding whether Hi-Mart established the right to collateral security for Hi-Mart Holdings' loan financing. The lower court acknowledged the English version, while the Supreme Court upheld the Korean version.

The acquisition of a target company through raising a large loan, which is normally collateralized on the assets of the target company, is commonly referred to as a "leveraged buyout" (LBO). In Korea, LBO transactions may be subject to criminal liability of a so-called "breach of trust." Through a series of judgments since 2006, the Korean Supreme Court has developed a legal principle stating that collateral-type LBOs are prohibited, while merger-type and distribution-type LBOs are not. This principle seems to be widely acknowledged in legal practices. The following paragraphs briefly describe the logic and history of judgments concerning collateral-type and merger-type LBOs, which will be crucial in understanding the Hi-Mart decision.

The Shinhan case is the start of the history behind the Hi-Mart decision.[1] A typical collateral-type LBO was in dispute here, where the acquiring company raised loans secured by the assets of the target company under insolvency. The damage to existing creditors was negligible because the target company was already in insolvency before the merger, and it turned a profit after the merger. Nevertheless, the Korean Supreme Court found the board of directors guilty of a breach of trust; the Court held that from the perspective of the target company, it bore the risk of losing its assets provided as collateral without being given anything in return. The fact that the debtor was the sole shareholder of the target company did not make any difference because the shareholders and company separately have legal personalities. Therefore, the Shinhan decision delivered the legal precedence that LBO acquisitions are prohibited, regardless of business considerations, such as a specific level of debt, the financial structure of the company after the acquisition, or the need for borrowing funds.

In 2010, the Korean Supreme Court dealt with the issue LBOs again in

1) Supreme Court [S. Ct.], 2004Do7027, Nov. 9, 2006 (S. Kor.); Supreme Court [S. Ct.], 2007Do5987, Feb. 28, 2008 (S. Kor.).

the Hanil Fibers case.[2] In this case, the acquiror founded an SPC, which acquired the target company's shares using large bank loans. Then, the acquiror merged into the SPC, and again, the SPC merged into the target company. The economic substance of this transaction was not essentially different from that of the Shinhan case, in that the acquisition loan was repaid by the assets of the target company and the acquiring company held the target company as a subsidiary during the acquisition process. The Supreme Court held, however, that such transactions were not subject to criminal liability of a breach of trust. The asset of the target company, the Court held, was not provided as collateral, and the merger process accompanies the procedure for protecting the shareholders and creditors of the target. Although the Korean Supreme Court reserved that "it cannot be concluded that the criminal liability depends solely on the type of LBO," the schematic understanding that a collateral-type LBO will be criminally punished while a merger-type LBO will not prevailed among legal practitioners after the Hanil Fibers decision.

2. Factual Background

1) The acquisition contract and loan agreement

The defendant, the CEO of Hi-Mart, initiated sales negotiations with Affinity in May 2004. After conducting due diligence, Affinity offered to purchase 100% of Hi-Mart's shares in September 2004, which was approved by Hi-Mart's board of directors on September 24, 2004. Affinity then offered a price of 464 billion won for a 100% stake in Hi-Mart on December 16, 2004, and the offer was approved by Hi-Mart's board of directors on December 22, 2004.

Affinity then founded Hi-Mart Holdings as an SPC holding 100% of the shares of Hi-Mart. Hi-Mart Holdings signed a syndicated loan agreement totaling 472 billion won, which was subdivided into five separate individual loans—loan A, B, C, D, and E—each designated with a different borrower. For loans B and C, which totaled 255 billion won, the borrower was Hi-Mart Holdings, and the purpose was to pay for the acquisition of

2) Supreme Court [S. Ct.], 2009Do6634, Apr. 15, 2010 (S. Kor.).

Hi-Mart shares. For loans A, D, and E, which accounted for the remaining 217 billion won, the borrower was Hi-Mart, and the purpose was to supplement working funds and refinance existing loans.

The following features of the loan agreement were taken special note of by the Korean Supreme Court: (1) The condition precedent for the loan was that Hi-Mart become a borrower[3)] by April 6, 2005, the closing date, and that Hi-Mart establish a collateral security right for its own debt and other legitimate debt born by other debtors during the acquisition process. (2) Hi-Mart Holdings was also required to submit a contract to establish collateral pledge rights for its deposits and Hi-Mart shares to be acquired in the future. (3) The merger procedure was to proceed within 27 months, beginning from the loan closing date, and all the collateral provided to the group of lenders would maintain their priority and validity to the surviving company.

2) The establishment of collateral security rights

Under the loan agreement, Hi-Mart signed a contract establishing the right to collateral security for 223 lots of land and buildings, including the land for Hi-Mart's headquarters building, with the group of lenders on April 6, 2005, completing the registration for the collateral security right on April 13, 2005. The maximum security amount was 613.6 billion won, and the debtor was Hi-Mart. However, the English and Korean versions of the contract differed in the way they stipulated the extent of the secured debt.

Regarding the debt secured by the collateral security right, the English version stipulated that Hi-Mart would be the sole debtor prior to the merger, while the merged company would be the debtor after the merger. In contrast, Art. 2 of the Korean version that was submitted to the registrar states, "The entity establishing a collateral security right set the first priority collateral security on the real estate listed in Appendix 2 ... to secure the debt that Hi-Mart and Hi-Mart Holdings currently bear or will bear in the future according to the loan contracts and related financial contracts." This phrase does not rule out the possibility that the collateral security of this

3) Under this prerequisite, Hi-Mart submitted a debtor joining certificate to the group of lenders on April 6, 2005. The certificate states, "Hi-Mart joins the loan agreement as a debtor and agrees to be bound by the obligations set forth by the loan agreement."

case would also be securing the debt of Hi-Mart Holdings. Art. 6 of the Korean version, on the other hand, states that if the English version and Korean version contradict, the English version shall prevail in all respects.

The Korean Supreme Court also took note of the auditor's opinion. In the 2005 audit report on Hi-Mart Holdings regarding the above loans, it is stated that "the above long-term borrowings are all acquisition finance loans for the purchase of shares in Hi-Mart, and in this regard, the company's stocks and deposits and the company's stocks of Hi-Mart are provided as collateral. In addition, Hi-Mart's buildings and land are provided as collateral to the lending group (maximum bond amount of KRW 613.6 billion) in relation to the company's borrowing agreement and Hi-Mart's borrowing agreement."

3) Merger

Hi-Mart Holdings purchased shares from the shareholders of Hi-Mart, including the defendant, with the loan executed under the above loan contract, and as of December 31, 2005, Hi-Mart Holdings owned 99.78% of the shares of Hi-Mart. On March 14, it succeeded in acquiring 100% of the shares of Hi-Mart; finally, on May 31, 2007, the two companies merged, with Hi-Mart being the surviving company.

3. Ruling

In this case, the lower court acquitted the defendant of a breach of trust, but the Korean Supreme Court reversed this decision and remanded it to the effect of guilt. The reason is that the scope of the collateralized debt of collateral security was judged differently between the lower court and the Supreme Court.

1) The scope of the secured debt

The Korean Supreme Court held that Hi-Mart Holding's debt was included in the secured debt of the collateral security. The rationale can be summarized as follows: First, the collateral ratio arguably supports the prosecution's argument. Hi-Mart Holdings provided Hi-Mart shares to be acquired in the future as collateral, per the loan contract of this case, but this does not seem sufficient because the collateral in light of the size of the

loan amounted to 255 billion won. On the other hand, Hi-Mart set up collateral security of 613.6 billion won, more than twice the loan amount of 217 billion won. As a matter of fact, 613.6 billion won was equivalent to 130% of Hi-Mart Holdings and Hi-Mart's total loan of 472 billion won, which is in line with the legal practice among financial institutions.

Second, the Supreme Court made a judgment based on the Korean version of the contract, establishing the right to collateral security. According to the register, the cause of registration of collateral security is the contract that establishes the right to collateral security on April 9, 2005, so the debtor and secured debt should also be determined accordingly. Although the Korean version states that the English version of the contract, which appears to have been written around April 6, 2005, prevails when there are conflicts between the two versions, this does not necessarily conclude that the intentions of the parties were in line with the English version because the Korean version was written later than the English version and submitted to the registry office as a document for registration. In addition, some of the financial institutions listed as creditors in the Korean version are only the creditors of Hi-Mart Holdings and do not have any bonds in Hi-Mart. This is inconsistent with the purpose of the English contract, which only secured bonds to Hi-Mart before the merger.

Finally, the background and purpose of the loan contract also support the fact that Hi-Mart Holdings' loan was also included in the secured debt of the collateral security. The loan was signed not out of the need for its own business operations, but out of the need to finance the acquisition of Hi-Mart. The loan contract stipulates that the collateral security established by Hi-Mart also secures the debts borne by other debtors over the course of the acquisition, and it is reasonable to hold that the "other debtors" refer to Hi-Mart Holdings. Thus, at the time of signing the loan contract, the parties to the contract agreed to the fact that the collateral security also secured Hi-Mart Holdings' debt during the acquisition.

2) The existence of damage to the company

The scope of collateral security automatically determines whether the LBO of this case is a collateral or merger type. The lower court saw this as a merger type, while the Korean Supreme Court saw this as a collateral type, affirming the legal principle of previously established precedents like the

Shinhan case.

Regarding existing legal principles, the Supreme Court states, "The LBO transactions are not always subject to breach of trust, and the criminal liability depends on the specific facts of each case. … Since a corporation and a shareholder are entities with separate legal personality and cannot be said to be the same, a sole shareholder is subject to criminal liability of breach of trust when he or she causes damage to the company. The fact that the shareholder's consent was obtained does not mean that there was no damage to the company, or that there was no intention of breach of trust. … If the acquiring company gets a loan from a financial institution and later provides the assets of the acquired company as collateral in order to raise funds necessary for the acquisition, the acquired company bears the risk of losing the assets provided as collateral if the debt is not reimbursed. Therefore, if the acquiring company does not provide any compensation to the acquired company and the CEO of the acquired company arbitrarily provides the acquired company's property as collateral, it should be deemed that the acquiring company obtained proprietary benefits equivalent to the collateral value, and the acquired company suffered losses."[4)]

Applying this basic legal principle, this case constitutes a breach of trust as a collateral-type LBO. The collateral security secures not only Hi-Mart's debt, but also Hi-Mart Holdings' loan obligations. By providing its property as collateral to secure Hi-Mart Holdings' debts, Hi-Mart suffered damage from losing its assets if Hi-Mart Holdings failed to reimburse its debts. Although, the debts were converted to Hi-Mart's after the merger, this has no effect on establishing a breach of trust, as long as the damage exists at the time of the breach of trust. Accordingly, the defendant conspired with other directors of Hi-Mart to have Hi-Mart establish collateral security, violating his duties as CEO and causing Hi-Mart Holdings to acquire profits and inflicting damage on Hi-Mart.

However, the Korean Supreme Court adds a slightly different nuance to this conclusion: "Because Hi-Mart Holdings is merely a special purpose company without any economic substance, it is difficult for a merger between Hi-Mart Holdings and Hi-Mart to create a synergy, which is

4) Supreme Court [S. Ct], 2016Do10654, Oct. 15, 2020 (S. Kor.).

usually expected in an ordinary merger. Also, since almost all of Hi-Mart Holdings' assets are shares issued by Hi-Mart itself, Hi-Mart has not obtained any substantially valuable assets even though such assets are succeeded to Hi-Mart through the merger. … Furthermore, the remaining current assets—such as cash—could not be used for Hi-Mart's business as disposal was strictly restricted under the loan contract. … In the end, Hi-Mart has suffered damage—such as significant increase of debt payment burdens and the risk of losing its real estate in case of non-payment—without being provided any benefit in return by the acquiror."

II. Analysis

1. Legal Principles Regarding LBO

As the term itself implies, LBO refers to the technique of "utilizing the assets of the target company"[5] to finance the acquisition of the target company. It was used as a method for hostile acquisitions in the United States during the 1980s, but all LBOs that take place in Korea have been friendly acquisitions. The most common method of utilizing the asset is the target company providing the collateral, but in Korea, an LBO also refers to the method by which the acquiring company borrows funds and merges with the target company or by which the acquiring company acquires the target company and obtains the assets through dividends or capital reduction with consideration. In practice, these methods are called collateral-type, merger-type, and distribution-type LBOs, respectively. Among these types, the decision at hand is regarding collateral-type and merger-type LBOs. When the judgment of the first instance came out in January 2015,[6] it was seen as a merger-type LBO.[7] However, the

5) *Id*.

6) Seoul Central District Court [Seoul Central Dist. Ct.], 2012Go-Hap450, 2013Go-Hap319, Jan. 22, 2015 (S. Kor.).

7) Bo-Yong Ahn, Young-Min Lee & Tae-Oh Kim, *Chaibmaesuleu lTtonghan Insugeumyungui Choegeun Jaengjeom [Recent Issues Regarding Acquisition Financing Through Leveraged Buyouts]*, 73 Bus. Fin. L. 6, 10 (2015) (In Korean). The judgment of the first instance also contended whether the case involved a merger-type or collateral-type LBO.

practitioners were shocked five years later when the Korean Supreme Court recognized it as a collateral-type LBO and declared it a breach of trust. The current paper elaborates on the impact of the decision on the current legal principle regarding LBOs, emphasizing the negative direction of this change.

The original benefit of an LBO is that it enables the target company to acquire another company by issuing debt from financial institutions, even if it does not have sufficient funds for the acquisition. The logic behind an LBO is the same as buying an apartment using a mortgage; the only difference is the legal formalities. In housing mortgage loans, the right to collateral security is established when one starts to own the apartment, but in an LBO, this right is established in advance of the apartment, which is currently owned by others. However, this does not pose a major problem because the purchase of apartment is already determined. The advantages and disadvantages of an LBO, therefore, are analogous to those of mortgage loans. An LBO enhances social efficiency by enabling business acquisitions, even if the target company does not have enough acquisition funds, invigorating the business acquisition market. However, the debt that has to be repaid accumulates during the acquisition process, which can easily lead to bankruptcy if the business deteriorates after the acquisition. This can have a particularly significant impact on the interests of creditors of the target company. However, similar to mortgage loans, the problem does not reside in the debt itself—it is "excessive" debt that is problematic. Just as mortgage rate regulations are used as solutions for the problems arising from mortgage loans, the right policy objective regarding the LBO should be to control the use of excessive debts.

However, in its 2006 Shinhan decision, the Korean Supreme Court determined the director's obligation merely based on whether the director provided security to an entity that had a different legal personality, without focusing on this essential characteristic of an LBO. This 2006 decision led to LBO transactions that had been rampant in practice before suddenly disappearing.[8] The Korean Supreme Court then developed a rather bizarre

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8) Chang-Won Lee, Sang-Hyun Lee & Jin-Seok Park, *LBOui Gibongujo mit Saryebunseok [Basic Structure of LBO and Case Study]*, 24 Bus. Fin. L. 6, 13-16 (2015) (In Korean). The paper introduces Haitai Confectionery & Foods LBO (2004), Fila Korea LBO (2005), Bridge

legal principle that an LBO constitutes a breach of trust for the collateral type, which necessitates providing security to the entity with a different legal personality, but it does not constitute a breach of trust in the merger type because the legal personality remains the same. However, this legal principle is theoretically flawed. Whether it be a merger type, collateral type, or distribution type, the facts that the acquisition is financed through debt and that the value of assets of the target company is utilized for the financing of debt do not change. The distinction between the three types of an LBO does not imply any normative difference in terms of the level of criminal liability. The only difference implied through this taxonomy would be nothing more than a legal personality dogma, and this legal principle also necessitates reappraisal. Fortunately, in its 2015 Onse Telecom decision,[9] the Korean Supreme Court had been normalizing the abovementioned legal principle by turning to a more flexible approach regarding the collateral-type LBO. However, the decision at hand is problematic because it not only reverted the legal principle back to the 15-year-old version but also suggested the possibility that even a merger-type LBO can constitute a breach of trust in its *obiter dictum*.

2. Collateral-type LBO and Breach of Trust

1) Economic effects of an LBO

If Hi-Mart's assets secured the debt of Hi-Mart Holdings, the one and only shareholder of Hi-Mart, did the director of Hi-Mart damage its company because of his or her breach of duty? If yes, "who" faced a reduction of the actual value of property because of such damage? As explained above, the biggest characteristic of LBO transactions is that the debt of the target company increases as a result of business acquisition. There are many empirical studies, mostly from samples of 1980s U.S.

Investment & Securities LBO (2005), and Carrefour Korea LBO (2006), pointing out that the SPC's debt-to equity ratio was maintained at about 1:1 in the Haitai and Fila Korea cases. The debt-to-equity ratio was about 1:2 in the Carrefour Korea case as well, meaning that the parties involved in the LBO transactions took precautions against an excessive increase of the target company's debt ratio. However, because of the 2006 Shinhan decision, the practitioners could no longer utilize such traditional LBOs.

9) Supreme Court [S. Ct.], 2012Do9148, Mar. 12, 2015 (S. Kor.).

companies, regarding the impact on the interests of relevant stakeholders.[10)]

First, almost all empirical studies agree that an LBO increases the shareholder value of the target company. LBO acquisitions have resulted in, at best, 37% of the abnormal return rate, which exceeds the average abnormal return rate of 20% resulting from an ordinary acquisition in the American business acquisition market in the 1980s.[11)] This is because the benefit of financing through debt is added on top of the ordinary benefit of business acquisition that occurs for the shareholders of the target company. In other words, Affinity has taken over 100% of the shares of Hi-Mart, paying an even higher price than the current shareholder value of Hi-Mart. The theoretical explanation for these focuses on the reduction of agency costs:[12)] (1) the new dominant shareholder has a larger incentive to increase the business performance of the company because the formerly distributed ownership structure becomes more concentrated as a result of the LBO; (2) it is more difficult for the board of directors to dissipate the free cash flow because the cash flow of the company should be periodically utilized for repaying the principal and interest; and (3) the board of directors is pressured to consistently make a profit to repay the debt. In fact, there are many positive reports regarding whether business performance has improved on average because of the active utilization of the LBO method during business acquisitions. Even if this is not the case, the acquiring company is the one bearing the costs. The LBO does not infringe on the interests of most of the original shareholders of the target company because they dispose the shares at a price reflecting acquisition premium and exit. In particular, there is no problem regarding residual minority shareholders in transactions that take over 100% of the shares.

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10) J. Fred Weston, Mark L. Mitchell & J. Harold Mulherin, Takeovers, Restructuring, and Corporate Governance 415-426 (4th ed., 2004).

11) Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 Yale J. on Reg. 119, 122 (1992).

12) We can also think of the effect of decreasing the corporate tax rate. Because interest on debt is considered a reduction of the income of a corporation, the higher the amount of borrowed capital, the less corporate tax will be calculated. However, empirical studies diverge on whether this reduction of corporate tax contributes to the increase of shareholder values. The following study suggests that most of acquisition premium is because of the tax reduction effect: Steven Kaplan, *Management Buyouts: Evidence on Taxes as a Source of Value*, 44 J. Fin. 611, 611 (1989).

Here, the interests of shareholders refer to the interests of the already "existing" shareholders of the target company, not the interests of Hi-Mart Holdings. Here, Affinity or Hi-Mart Holdings, which also became a 100% shareholder of Hi-Mart and has a high debt ratio, will be affected if Hi-Mart's debt ratio rises. However, because it is their own decision, there is no room to consider it as an economic loss.

Next, numerous empirical analyses cover the bankruptcy risk of the target company, that is, the impact on the interests of the creditors.[13] This increase in bankruptcy risk is the biggest problem with an LBO acquisition, and indeed, the reason for the disappearance of LBO transactions in the 1990s in the United States was because the acquisitions eventually led to the target company's bankruptcy. Even though some studies claim that there is no decrease in the yield of creditors due to the disclosure of LBO transactions, other studies report that the abnormal return of bonds tends to decrease by 7%. The latter studies sometimes argue that the cause of the increase in shareholder value in LBO transactions is simply the transfer of wealth from creditors. In general, however, it is accepted that the transfer of wealth from creditors only explains a part of the increase in shareholder value. Another possibility is that the increase in shareholder value is because of a transfer from workers' profits. This is because after an LBO, the target company is likely to undergo strong restructuring to repay its debts, and in the process, the interests of workers may be infringed upon. There are many empirical studies on this, but the conclusions tend to diverge in some aspects.

As such, most empirical analyses reveal that LBO transactions themselves bring socially efficient results. However, in the process, creditors' wealth may decrease, and the risk of bankruptcy may increase, which may incur social costs. The issue, then, is how to control the costs. This is a natural conclusion from the point of view that an LBO transaction is essentially a transaction in which the target company's capital structure is changed from equity to debt capital.

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13) *See* Weston et al., *supra* note 10, at 415-426 for a summary of the research.

2) Relations with the single-shareholder company principle

If Hi-Mart's existing shareholders, as well as Affinity or Hi-Mart Holdings, suffered no loss, does the company's damage mentioned in the decision at hand refer specifically to the decrease in the property value of the creditors? Arguably, the courts may respond that the "damage to the company" does not specifically refer to the loss of the creditor but to the "damage to the company itself." This is the familiar single-shareholder company principle. In the context of this legal principle, even if the company secures 100% of a shareholder's debt, it is held that damage has been inflicted on the company if the shareholder does not provide any compensation to the company.

In fact, it is the single shareholder principle that should be discussed in more earnest. The judicial precedent firmly recognizes the crime of embezzlement or breach of trust by a director who is a single shareholder of a single-shareholder company.[14)] The principle has been established in the Korean Supreme Court decisions since 1983, but the rationale has not been revealed by the Court. There has been little in the way of productive discussions regarding the matter. The lack of criticism was not because of the legitimacy of the rationale but because it was unclear exactly what to criticize. Most of the judicial decisions are presumed to be cases where the interests of the creditors are infringed upon. However, the decisions simply explain only to the extent that "a stock company and a shareholder cannot be considered as the same entity since they are of separate legal personality."[15)] They do not elaborate on whether the legal principle behind it considers the damage of creditors. Indeed, the decisions do not even fully examine the damage suffered by the creditors. However, among recent decisions, one decision notes that "in cases where the resolution of the general meeting of shareholders has illegal purpose of harming the creditors, the chief director should not abide by it blindly," hence admitting a breach of trust.[16)] This shows that it considers the interest of the creditors.

14) Supreme Court [S. Ct.], 82Do2330, Dec. 13, 1983 (S. Kor.); Supreme Court [S. Ct.], 89Do570, May. 23, 1989 (S. Kor.); Supreme Court [S. Ct.], 2005Do2330, Oct. 28, 2005 (S. Kor.).

15) *Supra* note 1.

16) Supreme Court [S. Ct.], 2005Do4915, Oct. 28, 2005 (S. Kor.).

However, it still refrains from revealing whether the interest of the creditors constitutes the core of the single-shareholder company principle.

First, the "separate legal personality" referred to by the precedents is difficult to serve as a basis for acknowledging a breach of duty of a director or damage of the company. This is because—setting aside the pedantic discussion of the theory of legal personality—it is hard to understand why directors should be held civilly or criminally liable if no shareholders, creditors, workers, or consumers have complaints.

From this point of view, there are two major ways to theoretically justify the legal principle of a single-shareholder company. One is to focus on the procedure. For example, it is possible to differentiate the case where a single-shareholder company pays attorney fees for the single shareholder from the case where the shareholder him- or herself pays the attorney's fees with the received dividends of the company. This seems reasonable at first glance. However, in the case of a single-shareholder company, especially regarding the general meeting of shareholders, the procedural rigor is relaxed, so a single shareholder can easily go through the procedure at any time, as long as a distributable gain exists. If so, the real difference between the two is, at most, the matter of taxes. Because the issue of taxes can be resolved with constructive dividends, it is questionable whether it is necessary to use the duty of directors to ensure the appropriateness of taxation. In particular, because in LBO transactions the provision of collateral goes through all necessary procedures, such as resolution by the board of directors, this distinction that focuses on the procedure is largely meaningless.

The other major way is to focus on the interests of stakeholders other than shareholders, in particular the creditors. This is convincing, considering the characteristics of LBO transactions, such as the increased debt of the target company. However, because the debt does not always cause damage to the creditor, the issue of establishing judicial standards remains.

3) Theory

After the Shinhan case, dozens of LBO-related papers emerged. First, most views are critical of the Shinhan judgment acknowledging the breach of duty of the directors of the target company, here simply based on the

corporate personality of the company.[17] These views conclude that even in judging a director's liability regarding an LBO, "one should not make a legal Judgment simply by calculating the increase or decrease in property, and instead should consider various aspects while judging appropriateness, such as the target company's cashflow, debt increase or decrease, and future yields."[18] However, there are views in favor of the judicial precedent's focus on the legal personality.[19] From this point of view, "Considering the abundance of cases in which the target company failed after the acquisition using LBO transaction, certain judicial restrictions are necessary," and the judicial standard of "providing a compensation in return corresponding to the provision of collateral by the target company" is regarded as "an interpretation consistent with the spirit of our company

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17) For example, Yun Yung Sin, *Chaibmaesusi Piinsuhoesaui Jasaneul Damboro Jegonghaneun Haengwiwa Eobmusang Baeimjoe [The Act of Providing the Assets of the Target Company as Collateral in the Case of Leveraged Buyout and Occupational Breach of Trust]*, 7 Sangsa Pallye Yeongu [Review of Commercial Law Cases] 365, 383-385 (Kiwon Choi eds., 2007) (In Korean) ("What is worrisome is that ... the act of providing collateral may be judged unconditionally as breach of trust without a rigorous analysis of the company's capacity to effect performance or the subject of the director's fiduciary duty."); Byung-Yun Kim, *Chaibmaesuwa Baeimjoeui Jeogyong: Shinhan LBO mit Hanilhabseom LBO Saryewa Gwanlyeonhayeo [Application of Leveraged Buyout and Breach of Trust: In Relation to the Case of Shinhan LBO and Hanil Synthetic Fiber LBO]* 29(1) Korean Com. L. Ass'n 217, 248 (2010) (In Korean) ("It would be more appropriate to view it as a different issue from the criteria for judging what is in the best interests of the company and the recognition of the company's independent legal personality."); Cheon Gyeonghun, *LBO Pangyeolui Hoesabeobjeok Uimi: Isaneun Nuguui Iigeul Bohohaeya Haneunga? [Company Law Meaning of LBO Judgment: Whose Interests Should the Directors Protect?]*, 127 Just. 204, 240 (2011) (In Korean) ("If SPC owned 100% of Shinhan, there would be no basis for acknowledging damage to shareholders, creditors, or other stakeholders. In other words, it is impossible to agree with the part of the decision that stated that breach of trust would be established even if Shinhan was a single-shareholder company, even with stakeholder-oriented considerations.").

18) Byung-Yun Kim, *supra* note 17, at 248; Bo-Yong An et al., *supra* note 7, at 15-17.

19) Jong-Jun Song, Hoesabeobsang LBOui Baeimjoe Seongbuwa Ipbeobgwaje [LBO's Breach of Trust in the Company Law and Legislative Tasks], 10(2) The Korean J. Sec. L. 319, 339 (2009) (In Korean) ("The approach of judging a company's profit or loss by analyzing only the profit and loss of each stakeholder, such as shareholders and creditors, is difficult to accept as a generalization in that it has a large potential to result in the denial of most directors' liability to the company in specific cases. ... The concept of loss of a company should also be understood based on the independent risk of decrease or decrease in the property value of a company, and therefore it is not valid as a general principle to judge based on the temporary profit or loss of each stakeholder such as a shareholder or a creditor.").

law."[20] However, this view remains in the minority. In general, academia also seems to oppose rigid application of a breach of trust in LBO transactions; correspondingly, the decisions of the Hanil Synthetic Fiber case and Daesun case merger-type and distribution-type LBOs were recognized as legal. This trend led to the Onse Telecom decision.

4) Onse Telecom Case

(1) Background

Because the Supreme Court ruled consecutively that the merger-type and distribution-type LBOs were not guilty of a breach of trust, attention shifted back to the collateral type. In 2015, the Onse Telecom case[21] reached the opposite conclusion on factual grounds almost similar to the Shinhan case, and it is difficult to ascertain why the legal principles of the two cases have changed by examining the differences in factual grounds. In this case, Uvista, the acquiring company, acquired a 100% stake in Onse Telecom, the target company that was undergoing reorganization procedures. In the process of debt financing, the target company promised creditors it would set up collateral on its assets if the reorganization procedures were completed. Onse Telecom provided collateral on its assets for Uvista's acquisition debt, which had become a complete parent company. Compared with the factual grounds of the Shinhan case, the following differences exist: in the Shinhan case, the acquiring company acquired a 66.2% stake in the target company without a merger, while the acquiring company in the Onse Telecom case acquired a 100% stake in the target company, with the merger taking place in the end after the provision of collateral. The basic structure of the transaction was the same as in the Shinhan case.

(2) Holding

The first trial of the Shinhan case determined that a breach of trust was established because the target company provided the asset as collateral for the acquiring company's financing without any consideration. However,

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20) *Id.* at 342.

21) *Supra* note 9.

the appellate trial and the Korean Supreme Court denied the willfulness of the violation. The appellate trial, in particular, listed the differences with the Shinhan case in detail: (1) 46% of the acquisition funds were prepared autonomously by the acquiring company, (2) the 100% acquisition of the shares of the target company harmonized the economic interests of both companies, (3) the acquiring company negotiated on the premise of the merger from the beginning and retained the target company in the end, (4) the acquiring company's debt ratio was 193%, which was lower than the 363% of the target company, and (5) the acquiring company promised the job security of the target company's employees in the acquisition process and did indeed retain employment. Based on these differences, the appellate trial even denied the requirement of damage to the company. However, the Korean Supreme Court decided to admit the damage but to deny the willfulness of a breach of trust.

What the Korean Supreme Court was most concerned about would have been the relationship with the Shinhan case. Because consideration was not provided to the target company in exchange for collateral in the Onse Telecom case, the same conclusion should be reached for the Shinhan case, save for a sudden change in ruling. From this perspective, it is possible to conclude that the Onse Telecom case and Shinhan case contradict each other. However, to avoid such contradictions, the Korean Supreme Court did not cover the requirement of property damage, instead choosing to deny the willfulness of a breach of trust. Explaining the overall circumstances of the acquisition process in detail or explaining the business judgment rule at the beginning of the ruling can be seen as the cornerstone for such a detour. Of course, considering the overall circumstances of the acquisition process in the Shinhan case, it would not be easy for the management of the target company to be found willful of a breach of trust, but presumably, the Korean Supreme Court focused on the company's damage in the Shinhan case as a way to avoid this.

(3) Comment

The Onse Telecom case can be viewed as a positive development because it opened up the possibility that even in the case of a collateral-type LBO, there could be a situation in which it is difficult to say that the target company had the intention of damaging the acquiring company.[22] Several

of the presented criteria are accurate in that they relate to the actual effects of LBO transactions. When a 100% stake acquisition of the target company is the case, the increase in the debt ratio caused by the LBO and the resulting issue of controlling the bankruptcy risk are eventually resolved in the interests of the target company's creditors or workers. Therefore, how much the bankruptcy risk has increased and whether the protection of creditors or workers has been sufficient are important parts of the normative evaluation. In this respect, it was a step forward that the Onse Telecom case emphasized that about 46% of the target company's acquisition funds were equity, that the acquiring company's overall debt ratio did not increase after the acquisition because it was low from the beginning, and that employment was retained in the acquisition process.

If the Onse Telecom case had delivered a message that "the LBO, of which the bankruptcy risk is controlled at an appropriate level, … in a transaction to acquire 100% stake in the target company" is read as legitimate "even if it sets up collateral on the assets of the target company"[23] and, in fact, changed the ruling of the Shinhan case, it would have made great progress in the legal theory of LBOs. However, it failed to eliminate the general concern about collateral-type LBOs in practice because it has solved the problem in such a way that relies on a variety of unclear facts, such as judging the intent of a breach of trust. In addition, when it comes to legal theory, the flaws of the existing LBO precedents are not being addressed in that the damage to the target company is still considered to have occurred and that the substance of the damage is not being asked. This position would presumably be difficult to rectify unless discussions of the single-shareholder company principle are advanced.

5) Concluding remarks

From the perspective of LBO legal theory, the biggest problem with the decision at hand is that it retreated the level of discussions to the Shinhan case, which came before the Onse Telecom case. The decision at hand decided the case was a collateral-type LBO by determining the scope of the secured debt and then immediately recognized a breach of duty and the

22) Bo-Yong Ahn et al., *supra* note 7, at 9.

23) *Supra* note 9.

damage to the company in accordance with the logic of the Shinhan case. As a result, the limitations of the Shinhan case, which have not deviated from the single-shareholder company principle, remain intact. Although the Korean Supreme Court has veered away from previous judgments in the Onse Telecom case by practically allowing a side-door for accommodating judgments on the level of bankruptcy risk or the impact on stakeholders, reading the decision at hand makes us feel as if the Onse Telecom case did not exist. The Onse Telecom case also failed to overcome the practical concerns of the collateral-type LBO, and now, the possibility thereof has been completely eliminated. It goes without saying that it is also a turn in the wrong direction from a theoretical perspective.

3. The Merger-type LBO

1) SPC and the legal principles of the merger-type LBO

Although it did not receive much attention in the Onse Telecom case, what is meaningful here is that from the beginning, the transaction was carried out by the acquiring company on the premise of a merger. This is because through the creditor protection process, a merger at least guarantees the creditors of the target company the opportunity to determine the impact of the merger on their own interests. For example, in the Hanil Synthetic case,[24] the acquiring company, Dongyang Major, raised funds with its assets as collateral and purchased a stake in Hanil Synthetic, the target company, with the funds raised and eventually merged. After the merger, the company repaid all its debts using the cash held by Hanil Synthetic.

However, the decision at hand is problematic in terms of making comments on the legality of a merger-type LBO. The rulings presented previously imply that because dealing with this case ended up in a merger between the target company and SPC, not reaching a direct merger between the target and acquiring company, the target company itself had no profit to gain, thus constituting a breach of duty for the director of the target company. In this case, the merger itself was a fact after the breach of

24) *Supra* note 2.

trust, so it was unnecessary to mention the merger. The decision at hand probably kept the possibility of this case forming a merger-type LBO in view.

This kind of reasoning was not first suggested. The trial court of the Hanil Synthetic case, where the legal theory of a merger-type LBO first originated, made dictum that a merger between a target company and an SPC would constitute a breach of trust and that the target company would only take charge of the takeover payment without any substantive increase in asset value as a result of a merger with the SPC. In other words, a merger with an SPC would be the case in which—despite the condition that the target company's financial structure being too poor—it could be definitely foreseen that the merger would result in capital impairment of the acquiring company; however, the merger was realized and so was the capital impairment. Because almost every LBO transaction includes utilizing an SPC to merge the target company, such a dictum led to the perception that a merger-type LBO cannot be seen as completely legal in practice.[25] Although the appellate court and Korean Supreme Court rulings for the Hanil Synthetic case did not include such dictum—which means concerns of the legal risks regarding the merger-type LBO were not emphasized—because the rulings of the decision at hand commented on "capital impairments" as a result of a merger-type LBO, the legality concern regarding a merger-type LBO arose again.

2) Legality of a merger-type LBO

The decision at hand has another problem regarding its rulings: it seems to confine the legality of merger-type LBO only to those cases of a direct merger between the target company and acquiring company. Of course, the decision did not explicitly declare such a principle. However, it is not appropriate to turn a blind eye to this obiter dictum because they were suggested in analyzing the legality of the transaction, not in mentioning the general jurisprudence. The Hi-Mart case made the legality of a merger-type LBO uncertain, in which the target company was merged into an SPC. Such uncertainty raised by the Hi-Mart case, however, should be criticized.

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25) Chun, *supra* note 17, at 219.

First, the Korean Supreme Court only looked at the merger with the SPC, which is only a part of the whole structure of Affinity Equity Partners. However, judgment on the effects of the transaction, whether it impairs the interests of the stakeholders or Hi-Mart itself, should be made from the perspective of the whole M&A structure. For example, the Korean Supreme Court held that the merger with the SPC would not bring excess earnings or synergies to Hi-Mart itself. Such a statement is self-evident because a merger with the SPC is intended to change the composition of shareholders without any substantial economic change. It is not convincing to argue that such a transaction has no impact on Hi-Mart because such an assertion simply ignores the fact that the original purpose of the entire transaction was letting Affinity Equity Partners hold 100% of the shares of Hi-Mart. The Court also held that Hi-Mart did not obtain a substantive financial gain, even though it succeeded in gaining the assets of Hi-Mart Holdings through the merger. Such an argument is also self-evident, in that the merger itself was only a change in formalities, that is, change the parent–subsidiary structure into a single entity.

Second, the logic that a merger-type LBO does not constitute a breach of trust also applies to a merger with an SPC. As previously explained, two basic logics for ruling a merger-type LBO as not guilty of a breach of trust in the Hanil Synthetic case were (1) the debt charged for the target company would be the debt of the surviving company after the merger, and (2) the merger procedure entails creditor protection procedures. These two logics apply to the case in which the counterpart of a merger is not an acquiring company but an SPC. After all, the debt of the SPC is passed along to the surviving company, and during the merger procedure, the creditors of the target company are allowed to exit. Therefore, it is not reasonable to rule out a merger with an SPC from a merger-type LBO.

Third, it is up to the acquiring company whether to sustain the target company as a complete subsidiary or merge it to make it one business entity. The Commercial Law also introduces the triangular merger as a way of sustaining the target company as a complete subsidiary.[26] It cannot be subject to criminal penalty to maintain a parent–subsidiary structure when

26) Commercial Act, Art. 523, 523-2 (S. Kor.).

a merger is available. The Hi-Mart case, which restricts the scope of the merger-type LBO only to a merger between the acquiror and the target, however, asserts such an unreasonable argument.

After all, the Korean Supreme Court seemed to deny the notion of "a merger without the substance of merger" or "a merger with a purpose other than merger itself." However, many cases borrow legal formalities without substance. In such cases, legal forms should not be deemed illegal only for the reason that they do not have substances or that such forms do not match the economic substances. Instead, they should be analyzed from a functional perspective, in which the purpose of the parties and impact of adopting such forms are carefully considered. The decision lacked such an analytical perspective. Instead, the Court seems to be obsessed with the notion that "every merger should have a substance of merger." In this case, the director of Hi-Mart should make appropriate management decisions, but such decisions should be made in terms of an entire acquisition transaction with Affinity Equity Partners, not within a small range of the merger with the SPC.

III. Conclusion

The decision at hand was given four years after the original trial, and it set back every advance on legal theory made throughout the past 15 years by the Korean Supreme Court's decisions, as a result confusing legal theory regarding LBOs in practice. Above all, the decision was astounding in that it subverted preceding decisions by the original trials. As explained in the present article, the logic of the decision at hand is also unacceptable from the perspective of corporate law theory. The decision focuses on the rigid legal theory of the single-shareholder company principle, showing distorted understandings of what dealing means, such as the utilization of an SPC. As a result, certain confusion in legal practice regarding LBOs seems inevitable. However, it is expected that in the future, this case will be followed by the formation of legal theory that grasps the financial substance of LBO dealings.