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Accommodating Venture Capital Investors' Contractual Rights in the Korean Corporate Law*

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Abstract

With the remarkable growth of the Korean startup ecosystem, VC investors, one of the key players in startup fundraising, have used contractual protections to mitigate the risks associated with the high risks and uncertainties of startup investments. Although VC investors have typically acquired consent rights for essential decisions regarding startups through contracts, the effects of these contractual rights have been controversial in Korea, mainly due to conflicts with the principle of equal treatment of shareholders. Recently, the Korean Supreme Court clarified some of the uncertainties by allowing for exceptions to the principle when three requirements are met. However, ambiguities remain when it comes to applying the court's standards to practices because they are context-specific.

This article finds the root causes of the complexities concerning investors' contractual rights from the discrepancies between the Korean corporate law framework and the VC investment schemes from Silicon Valley. In response to the need to diversify funding options for startups, this article proposes that Korean corporate law allows startups to structure flexible governance to accommodate VC investors' control rights over startups through the articles of incorporation. Alternatively, startups can be authorized to arrange VC investors' control rights at the board level by requiring the prior consent of VC-nominated directors for the board's approval on major corporate decisions. The extensive private ordering of startups should be controlled and monitored by ex post review through the enhanced application of fiduciary duties of VC-nominated directors and VC investors as controlling shareholders.

Keywords: VC investment, Startups in Korea, Consent rights, Investors' rights, The principle of equal treatment of shareholders, Preferred shares.

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* Please note that this article represents an independent contribution, building upon the foundations in the author's previous Ph.D. dissertation titled *Seutateueob-ui jibaegujo-e gwanhan beobjeog yeongu [A Study on the Legal Aspects of Startup Governance in Korea].* While drawing on the insights gained from that earlier research, the content, analysis, and conclusions presented herein have been developed anew, reflecting the evolution of the author's understanding of the subject matter.

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I. Introduction

With vigorous policy initiatives and government support, Korea's startup ecosystem has grown significantly over the past 30 years. In line with the widespread adoption of information technology infrastructure in the 1990s, Korea experienced a startup boom in the late 1990s.[1] Despite the boom and bust experienced in the early 2000s, the startup ecosystem in Korea expanded with the 2005 establishment of the Korean Fund of Funds, which has actively provided financing to venture capital (VC) funds.[2] As a result, the total volume of startup investments by venture capital investors in Korea ranked fifth among OECD countries in 2019, and the total amount of VC funding in Korea was KRW 7.6 trillion in 2021.[3] Along with these active investments, there were 22 unicorn startups based in Korea with a valuation of more than USD 1 billion in 2022.[4]

Like many other countries, the Korean venture ecosystem imported VC

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1) Ministry of SMEs and Startups, Hangug changeob saengtaegye-ui byeonhwa bunseog [Analysis on the Changes in the Startup Ecosystem in Korea] (2021), https://www.mss.go.kr/site/smba/ex/bbs/View.do?cbIdx=86&bcIdx=1026105&parentSeq=1026105 (In Korean); Ministry of SMEs and Startups, Cahngeob·bencheo saengtaehye, 11nyeon-dongan 3bae isang seongjang [Startups and Venture Business Ecosystem have Grown More than Three Times for the Last 11 Years] (2022), https://www.mss.go.kr/site/smba/ex/bbs/View.do?cbIdx=86&bcIdx=1033867&parentSeq=1033867 (In Korean).

2) Jonghoon Lee, Taehyun Jung, *Bencheokaepital-e daehan jeongbuchuljageum-ui chogidangyegieob tuja-e daehan yeonghyang: hangug-ui bencheokaepital-e gwanhan siljeungyeongu [The Impact of Government Funds in Venture Capital on Investment in Early-Stage Firms: An Evidence from Korean Venture Capital]*, 11(2) Asia-Pacific J. Bus. Venturing & Entrepreneurship 75, 76 (2016) (In Korean); Kab Lae Kim, *Implication of U.S. Venture Capital Theories for the Korean Venture Ecosystem*, 2 J. Bus. Entrepreneurship & L.142, 144 (2008) (explaining the Korean venture business development history in three stages until 2008).

3) OECD. Stat, Venture capital investments, https://stats.oecd.org/Index.aspx?DataSetCode=VC_INVEST# (last visited Feb. 21, 2024); Ministry of SMEs and Startups, 2022nyeon bencheo tuja donghyang balpyo [Announcement of VC Investment Trend in 2022] (2023), https://www.mss.go.kr/site/smba/ex/bbs/View.do?cbIdx=86&bcIdx=1038984&parentSeq=1038984 (In Korean) (Although the total amount of VC investment in 2022 reduced to 6.7 trillion KRW, macroeconomic situation worldwide in relation to high inflation and interest rates affected the result in 2022).

4) Ministry of SMEs and Startups, 2022nyeon gugnaeyunikongieob-eun 22gaesa [22 Unicorn Startups in 2022] (2023), https://www.mss.go.kr/site/smba/ex/bbs/View.do?cbIdx=86&bcIdx=1039404&parentSeq=1039404 (In Korean).

investment models from Silicon Valley with several tweaks. While one essential aspect of VC investors in the United States is exerting control over startups to mitigate risks and uncertainty,[5] VC investors in Korea have often encountered challenges in participating in startup governance. Whereas VC investors' governance rights require the reallocation of authorities to VC investors beyond their statutory rights in startups,[6] such practices may conflict with the mandatory principles of corporate law, particularly the principle of equal treatment of shareholders. For example, while it is common for most Korean VC investors to acquire consent rights that require startups to obtain their prior approval for major corporate decisions, there has been discussion about whether such additional rights for investors are legally valid. In addition, although investors typically have contractual remedies such as appraisal rights or liquidated damages that can be exercised in the event of a breach of their consent rights, these rights may conflict with the maintenance of capital principle, a cornerstone of the Korean Corporate Code (KComC).

These investment practices by VC investors have raised new issues under the KComC regarding the extent to which mandatory principles and rules should be applied. Under the mandatory rule-based KComC, which allows exceptions to the rules and principles only when explicitly authorized by law, these principles have been taken for granted in Korea as mandatory norms applicable to all types of companies, including startups. Moreover, because the KComC does not explicitly distinguish between public and private corporations in regulating governance structures, save for certain exceptions for unlisted corporations with low levels of legal capital and listed corporations,[7] the concept of permitting different types of

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5) Ronald J.Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1084 (2003); William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1875 (2013) ("[VCs] holding preferred sometimes take voting control and can dominate the boards even when holding a minority of the votes.").

6) Rauterberg referred to this phenomenon as "the separation of voting and control" in Gabriel Rauterberg, *The Separation of Voting and Control: The Role of Contract in Corporate Governance*, 38 YALE J. ON REGUL. 1124, 1137 (2021).

7) Examples of exceptions for small corporations below 1 billion KRW legal capital include provisions for simplified call and approval processes of the General Shareholders Meeting Sangbeob [Commercial Act] art. 363 para. 4 (S. Kor.); *id.* art. 363 para. 5 (S. Kor.), for permission

governance for startups has been unfamiliar in Korea. Nevertheless, these mandatory principles and rules under the KComC are incompatible with VC investment arrangements that have been made using private ordering under the enabling corporate law in Delaware, which permits the reallocation of rights and authorities among parties.[8)]

Therefore, in line with the need to limit the application of these mandatory corporate law principles and rules in specific circumstances, scholars have called for avoiding the broad application of mandatory corporate law principles to all corporate circumstances.[9)] However, previous literature in Korea has paid little attention to the unique characteristics of startups in the ensuing discussions, even though startups have unique ownership and board structures. This article aims to fill this gap by analyzing VC investors' contractual rights and remedies for breach in relation to Korea's startup investment context and ultimately offering suggestions for dealing with the VC investors' contractual rights under the KComC. Based on the underlying need to accommodate deviations from standard corporate governance, this article suggests that private ordering through articles of incorporation should be expanded for startups. At the same time, the scope of the mandatory principles in the KComC should be limited to only essential cases that may endanger shareholders' fundamental rights. Furthermore, this article argues that the expansion of private ordering should be supported by the advanced application of directors' fiduciary duties and mature market practices in which entrepreneurs and VC investors

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of board composition with less than three directors *id.* art. 383 para. 1 (S. Kor.), and optional appointment of a statutory auditor *id.* art. 409 para. 4 (S. Kor.) On the other hand, for listed corporations, exceptions including the broader scope of stock options *id.* art. 542-3 (S. Kor.) and the stringent requirements for independent director and auditor appointments *id.* art. 542-8, 10, 11 (S. Kor.) are promulgated in Section 13 of Chapter IV of the KComC.

8) Gilson, *supra* note 5, at 1069 ("The argument's most important step is to recognize that the keystone of the U.S. venture capital market is private ordering-the contracting structure that developed to manage the extreme uncertainty, information asymmetry, and agency costs that inevitably bedevil early-stage, high-technology financing.").

9) Kyung-Hoon Chun, *Hoesa-wa sinjuinsuin ganui tujajabohoyagjeong-ui hyolyeog -jujupyeongdeungwonchig-gwaui gwangye-lueul jungsim-eulo- [Validity of Investor Protection Arrangements between the Corporation and the Investor]*, 40(3) Korean Com. L. Ass'n 71, 81-83 (2021) (In Korean); Joon-Hyug Chung, *Jujupyeongdeungwonchig-ui baljeonjeog haeche-wa jaejeonglib [Rebuilding the Principle on Equal Treatment of Shareholders]*, 35(4) Com. Cases Rev. 207, 224-225 (2022) (In Korean).

can negotiate market terms on an equal footing in active competition among VC investors.

The structure of this paper is as follows. Part II offers an examination of the current practices of VC investment in Korea through preferred shares and contracts, while Part III elucidates the controversies associated with conflicts between investors' contractual rights and mandatory corporate law principles, analyzing Korean Supreme Court cases on these issues. Based on that analysis, Part IV proposes ways to accommodate investors' rights within the corporate law framework by expanding the scope of private ordering for startups. Part V concludes.

II. Preferred Shares and Investors' Contractual Rights in Korea

As a backdrop to the discussion, this part compares VC investment practices in Korea with those in the United States, where startup investment originated, by focusing on the rights VC investors obtain through preferred shares and investment contracts.

A. VC Investment Arrangements

A VC investor is a specific type of investor who specializes in startup investments in firms that need funding. Equipped with expertise and experience in startup industries as repeat players, VC investors establish funds in the form of limited partnerships and invest in startups. As general partners of those VC funds, VC investors are required to return the investments to limited partners within a fund's fixed term, which in Korea is usually about eight years, shorter than the typical ten-year term of US-based VC funds.[10] Due to the lack of liquidity in startup shares, VC investors need to secure exit options from startups within the limited life of the fund, through startups' initial public offerings (IPOs), merger and

10) William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. Fin. Econ. 473, 490 (1990).

acquisition (M&A) transactions, or even liquidation.[11)]

As VC investors have fiduciary duties to limited partners, investors in the United States have developed investment approaches to manage the high levels of uncertainty and risk associated with startups.[12)] Since startups are not required to publicly disclose information, VC investors face information asymmetry problems that make it difficult to assess their fair value without a market price. Even if VC investors disagree with decisions by startup management, they cannot immediately exit their investments due to the illiquid nature of startup stock. Accordingly, VC investors typically create an interim startup governance structure that lasts until a startup goes public or the investors exit their investments, an approach that differs from the typical governance structures of public companies.[13)] Three characteristics are found in the structures deployed by VC investors.[14)]

First, they have adopted staged financing, in which they provide startups with only the amount of funds needed to achieve a given milestone, after which more funds are provided to meet the next goal, rather than providing all the funding at once.[15)] As new rounds of funding arise, VC investors can review the startup's development and negotiate valuation and investment terms based on progress to date. A staged financing

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11) D. Gordon, *The Exit Structure of Venture Capital*, 53 UCLA L. Rev. 315, 339 (2005); Douglas J. Cumming & Jeffrey G. MacIntosh, *Venture-Capital Exits in Canada and the United States*, 53 U. Toronto L. J. 101, 189 (2003).

12) Gilson, *supra* note 5, at 1070; Darian M. Ibrahim, *Financing the Next Silicon Valley*, 87 Wash. U. L. Rev. 717, 725 (2010); Elizabeth Pollman, *Startup Governance*, 168 U. Pa. L. Rev. 155, 185 (2019); Jennifer S. Fan, *The Landscape of Startup Corporate Governance in the Founder-Friendly Era*, 18 N.Y.U. J. L. & Bus. 317, 332 (2022).

13) Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. Fin. Econ. 243, 246 (1998) ("The potential to exit through an IPO allows the entrepreneur and the venture capital fund to enter into a self-enforcing implicit contract over control, in which the venture capital fund agrees to return control to a successful entrepreneur by exiting through an IPO."); Pollman, *supra* note 12, at 176.

14) Gilson, *supra* note 5, at 1084 ("In effect, the venture capital fund and the entrepreneur enter into a combination explicit and implicit contract that returns to the entrepreneur the disproportionate control transferred to the venture capital fund if the portfolio company is successful."); Black & Gilson, *supra* note 13, at 261 ("In effect, the prospect of an IPO exit gives the entrepreneur something of a call option on control, contingent on the firm's success.").

15) Broughman & Wansley, *Risk-Seeking Governance*, 76 Vand. L. Rev. 1299, 1302 (2023); Robert P. Bartlett, *Shareholder Wealth Maximization as Means to an End*, 38 Seattle U. L. Rev. 255, 264 (2015).

approach means that a startup's ownership structure changes gradually as entrepreneurs' stakes are incrementally diluted while VC investors' shares increase through the various investment rounds.[16)]

Second, VC investors can invest in preferred shares with additional rights unavailable to common shareholders. In addition to preferential economic rights that come with these shares, VC investors can acquire contractual rights to engage in startup governance, such as consent or veto rights.[17)] By actively participating in a startup's decision-making process, VC investors can prevent entrepreneurs from reaping benefits at the investors' expense. According to Nicholas, this approach goes back to the risk control mechanism for high-risk venture investments in the 19th century in the United States among investors who held only small stakes but received additional governance rights, including board seats.[18)]

Third, because boards are one of the most important control mechanisms over startups, VC investors can participate in startup boards through the right to nominate one or more directors. Given that contractual arrangements with entrepreneurs are inherently imperfect in dealing with unexpected situations, VC investors can acquire protection through their rights regarding startup boards.[19)] VC investors generally acquire additional board nomination rights as they participate in later rounds of investment in startups under staged financing, and the number of VC-nominated directors in startups increases as they mature.[20)] Accordingly, startup boards, which are typically controlled by entrepreneurs in the early stage, shift to shared control between entrepreneurs and VC investors in the growth stage and finally become controlled by VC investors by the time firms are mature

16) Brian Broughman & Jesse M. Fried, *Do Founders Control Startup Firms that Go Public?*, 10 Harv. Bus. L. Rev. 49, 72-73 (2020) (finding that only 7% of the startups have retained founders/entrepreneurs as blockholders and CEOs out of 18,000 US-based startups invested by VC investors from 1990 to 2012).

17) *Supra* note, at 15.

18) Tom Nicholas, VC: An American History 63-69 (2019).

19) Bartlett, *supra* note 15, at 262-269; Simone M. Sepe, *Intruders in the Boardroom: The Case of Constituency Directors*, 91 Wash. U. L. Rev. 309, 313 (2013); Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. Rev. 967, 987-988 (2006).

20) Michael Ewens & Nadya Malenko, Board Dynamics over the Startup Life Cycle 3 (2020) (finding that after the fourth round of investments, the average firm has 53% of board seats controlled by investors); Rauterberg, *supra* note 6, at 1144.

enough to go public.[21]

Although Korean VC investors appear to have adopted these approaches, how they play out in Korea is quite different from practices in the United States.[22] While Korean VC investors have deployed staged financing in the same way as in that country, the ways in which VC investors acquire and exercise additional rights and participate in startup governance are quite different, as discussed below.

B. Preferred Shares

Korean VC investors have adopted the US approach of deploying a mixture of preferred shares and investment contracts to protect their rights. Preferred shares, which grant statutory rights to preferred shareholders, are one of the few statutory exceptions to the principle that requires corporations to treat shareholders equally.[23] Under the KComC, authorized class rights are restricted to shares with limited voting rights (Article 344-3) and preferential shares in terms of dividend distribution rights (Article 344-2(1)), remaining asset distribution rights upon corporate liquidation (Article 344-2(2)), redemption rights (Article 345(3)), and conversion rights (Article 346(1)).[24]

By combining these statutory rights in the KComC, VC investors typically use redeemable convertible preferred shares (RCPS) or convertible preferred shares (CPS), which grant investors conversion and/or redemption rights.[25] As active investors, VC investors generally possess

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21) Bartlett, *supra* note 15, at 263-266.

22) Eugene Kim, *Venture Capital Contracting under the Korean Commercial Code: Adopting U.S. Techniques in South Korean Transactions*, 13 Pac. Rim L. & Pol'y J. 439, 439-470 (2004) (arguing that the KComC can accommodate VC investment schemes originated from the US).

23) Ok-ryeol Song, Sangbeobgangui [The Lecture on Commercial Law] 795 (2020) (In Korean).

24) According to the statutory provisions in the KComC, the redemption and conversion rights can be structured and exercised by either preferred shareholders or corporations.

25) Sung Hoon Cho, Sanghwanjeonhwanuseonju-leul iyonghan bencheokaepital tuja gwanlyeon isyu-ui bunseog [Analysis of Venture Capital Investment Deploying Redeemable Convertible Preferred Shares] 5-7 (2020) (In Korean) (While 75% of VC investors invest in preferred shares in the case of equity financing, most unicorn startups have issued either RCPS or CPS when getting VC funding as of Q1 2020.).

voting rights as shareholders at the general meeting of shareholders (GMS). In addition, given VC investors' limited exit options, they often prefer to receive statutory redemption rights that can be exercised against startups. With respect to conversion rights of preferred shareholders, many VC investors obtain anti-dilution protection by adjusting a conversion rate to common shares in order to protect their economic interests in startups in the event of subsequent down-round investments, where the value of investment in a startup declines with additional financing rounds.[26] Among the two conversion rate adjustment approaches, full ratchet provisions are more commonly used in Korea than weighted average ratchet provisions.[27]

Notably, while the class rights that VC investors have as preferred shareholders are corporate rights exercisable against corporations and third parties, the KComC strictly limits the authorized types and scope of variation to be granted to class shareholders. In other words, even if corporations include specific types of preferred shares beyond the scope permitted by the law in the articles of incorporation, those provisions can be legally invalid.[28] For example, dual-class shares, which provide multiple voting rights to their holders, had been construed as legally invalid under the KComC until the adoption of special provisions for them in the Act on Special Measures for the Promotion of Venture Businesses in 2023.[29] Because the KComC only prescribes class shares with limited voting rights (Article 344-3), class shares that provide superior voting rights to the

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26) Joseph L. Lemon Jr., *Don't Let Me Down (Round): Avoiding Illusory Terms in Venture Capital Financing in the Post-Internet Bubble Era*, 39 Tex. J. Bus. L. 1, 13-14 (2003).

27) Regarding the differences between the full ratchet provisions and weighted average ratchet provisions, see Lemon Jr., *supra* note 26, at 14; Startup Alliance & Delight LLC, Tujayuchi-leul apdun changeobja-leul wihan tujagyeyagseo gaideubug [Guidebook on Investment Agreement for Founders Preparing Funding through Investments] 2019 (2022) (In Korean).

28) Jeong-Kuk Park, *Jonglyujusig-ui beobjeog jaengjeom-e daehan sogo [A Study on Legal Issues of Classes of Shares]*, 22(4) Inha L. Rev. 185, 190 (2019) (In Korean).

29) Article 16-11 of the Act effective from November 17, 2023, upon a revision on May 16, 2023; Shinyoung Kim, *Gugnae chadeunguigyeolgwonjedo doib bangan-e gwanhan yeongu -ilbon, hongkong, singgapoleu, sanghai chadeunguigyeolgwonjedo-waui bigyo-leul jungsimeulo- [A study on the Enactment of Dual Class Shares in Korea -Focusing on the comparison with Japan, Hong Kong, Singapore, and Shanghai-]*, 17(2) Korean. J. Fin. L. 191, 223 (2020) (In Korean).

holders had been illegitimate until 2023.

In addition, whereas deemed liquidation preference rights that provide holders with the right to receive distributions before other shareholders in the event of a company's sale or involvement in M&A activity, are one of the most commonly used exit options for VC investors in the United States, such rights are not recognized as valid to be granted to shareholders in Korea.[30] Although they may appear similar to the statutory class rights of liquidation preference in the KComC (Article 344-2(2)), they are regarded as different from the statutory liquidation preference rights that are presumed to be exercisable upon the dissolution of corporate entities other than transactions involving sale of control, transfer of substantial assets, or M&A activity.[31] Because class rights are treated as anomalies in terms of the principle of equal treatment of shareholders that could potentially take advantage of the rights of other shareholders, Korean courts tend to interpret statutory class rights in the KComC strictly.[32]

C. Investment Agreements

1. The Use of Investment Agreements in the KComC Context

In addition to using preferred shares, VC investors typically require entrepreneurs and startups to arrange protective provisions for investors

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30) To distinguish from the statutory class rights of liquidation preference rights, the liquidation preference rights that are triggered by M&A or sales of control of corporations are referred to in Korean literature as "deemed liquidation preference."; Brad Feld & Jason Mendelson, Venture Deals: Be Smarter Than Your Lawyer and Venture Capitalist 41 (2nd ed. 2011).

31) Sangchul Park, *Bencheotujagyeyag-ui gugnaebeobsang suyong-gwa gwanlyeonhan jaengjeom -sanghwanjeonhwanuseonju johang-ui hyolyeog-eul jungsimeulo- [The Enforceability of Venture Capital Terms under the Korean Law: With a Focus on the Redeemable Convertible Preferred Shares]* 37(2) Korean Com. L. Ass'n 383, 404-405 (2018) (In Korean); Sung-kyun Hong, *Seonggonghaji moshan bencheotuja-e gwanhan beobjeog bunseog -sillikonbaeli bencheokaepital-gwa changeobja sai-ui ginjanggwangye-leul jungsimeulo- [Exit from a Silicon Valley Startup with Scant Growth: Lopsided, but fair enough?],* 64(2) Seoul L. J. 141, 146 (2023) (In Korean).

32) Concerning an investment scheme under which a lender to a corporation had the right to acquire the number of shares issued by the company equal to the principal and interests of the loan, the Korean Supreme Court invalidated the scheme, because the shares were issued outside of the scope of the authorized class in breach of the approved protocols in the KComC. Daebeobwon [S. Ct.], Feb. 22, 2007, 2005Da73020 (S. Kor.).

through contracts. Although preferred stock provides VC investors with additional class rights, those rights are not sufficient to mitigate all the high risks inherent in startups. Given that VC investors usually take small stakes in startups in early investment rounds, they are vulnerable to the agency problems of entrepreneurs who manage and control startups as chief executives and majority shareholders.[33] As shown in the case of WeWork and Theranos, startups are not free from entrepreneurs' agency problems caused by self-dealing transactions, tunneling, and fraud.[34] Nonetheless, unlike investors in public corporations, VC investors cannot easily exit their investments due to the illiquid nature of startup shares.[35] Thus, VC investors safeguard their rights through protective provisions in investment contracts.

However, the ways in which investment contracts work within Korea's corporate law framework differ from the contractual arrangements in Delaware, where most US startups are incorporated. The Delaware General Corporation Law (DGCL) is widely known for permitting an extensive scope of private ordering with a default rule-based legal framework.[36] Based on the nexus-of-contract approach in corporate law, the DGCL authorizes corporations to establish governance structures that fit their needs through charters and bylaws.[37] Except for a few mandatory provisions, those provisions are amendable through charters or bylaws.[38] Accordingly,

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33) William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 Mich. L. Rev. 891, 892-893 (2002).

34) On startup entrepreneurs' agency problems and fraudulent behaviors, see Donald C. Langevoort & Hillary A. Sale, *Corporate Adolescence: Why Did "We" Not Work?*, 99 Tex. L. Rev. 1347 (2021); John Carreyrou, Bad Blood: Secrets and Lies in a Silicon Valley Startup (2018); Elizabeth Pollman, *Private Company Lies*, 109 Geo. L. J. 353 (2020).

35) Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. Corp. L. 913, 916 (1998).

36) Jens Dammann, *The Mandatory Law Puzzle: Redefining American Exceptionalism in Corporate Law*, 65 Hastings L. J. 441, 448 (2014) ("United States corporate law consists largely of default rules.").

37) 84 Del. Laws §102(b)(1) (corporate charters may contain "any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders…if such provisions are not contrary to the laws of this State."); Del. Laws §109(b) (bylaws may address any subject "not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers of its stockholders, directors, officers or employees.").

38) Fisch, Jill E., *Governance by Contract: The Implications for Corporate Bylaws*, 106

startup boards can design preferential rights for investors in various forms based on corporate charters and bylaws and grant them to VC investors through shareholder agreements.[39] Combined with charters and provisions, shareholder agreements have been actively used by Delaware startups to govern the rights and interests of VC investors.[40] While the Delaware courts generally respect contractual arrangements associated with VC investors, boards of directors are subject to ex post judicial review of certain corporate decisions or transactions that have been carried out according to the charters, bylaws, or contracts through the lens of fiduciary duty.[41]

On the other hand, in the Korean legal framework, preferred shares and investment contracts are two separate regimes with different effects: class rights for preferred shareholders are effective at the governance level, while investment agreement arrangements are only contractual in nature.[42] Under the dichotomous framework, the additional rights of VC investors only have contractual effects against counterparties to the extent permitted by the KComC.[43] Although Korean VC investors commonly enter into a

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California L. Rev., 373, 379 (2018), ("By virtue of its largely enabling structure, Delaware corporate law is consistent with the private ordering approach. The Delaware statute contains relatively few mandatory provisions. Instead, most of the statute provides default rules that can be modified through an appropriate charter or bylaw provisions.").

39) Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 Brook. L. Rev.113, 1171 (2013) ("No single feature or set of features is found in every issuance of preferred stock that could be said to define it. Instead, the rights that accompany ownership of any particular share of preferred stock are simply those that are set forth in the issuing corporation's charter. As a result, preferred stock comes in a bewildering variety.").

40) Rauterberg, *supra* note 6, at 1126 ("Shareholder agreements-contracts among the owners of a firm and sometimes the firm itself- are a central instrument of corporate law and at the core of private company governance.").

41) Bratton & Wachter, *supra* note 5, at 826 ("Contract law privileged preferred fixed claims and reinforced barriers, while corporate law facilitated the barrier's removal."); Rauterberg, *supra* note 6, at 1132.

42) The dichotomous distinction between preferred shares and contractual rights is quite similar to the legal framework in Japan, which also distinguishes class rights for preferred shareholders granted based on the articles of incorporation and contractual rights for preferred shareholders in a strict manner. Okubo Kei et al., Kabunushikan Keiyaku · Goben Keiyaku No Jitsumu [Shareholders' Agreement · Joint Venture Agreement] 10-11 (Fujiwara Soichiro ed. 2021) (In Japanese).

43) Choong-kee Lee, *Jujugangyeyagui hoesagyubeomseonggwa geu hangye: sajeogjachiwa bochungseongui wonchig, gyeyage gihan teugjeongihaengcheongguuigabuleul jungsimeulo* [*Role of Share Agreements as Supplementary Constitutional Document and the Limitation of their*

single investment agreement with entrepreneurs and startups that includes their rights as preferred shareholders and additional contractual rights, class rights attached to preferred shares have legal effect at the corporate level, while contractual provisions do not.[44)]

As a result, investors' contractual rights under the Korean legal framework are restricted in several aspects. Primarily, the contractual provisions cannot preempt mandatory provisions in the KComC, and any arrangements in breach of such mandatory provisions or principles are invalid. Whereas VC investors in the United States also need to preserve mandatory provisions in the DGCL, that law is basically structured as an enabling document that is amenable to private ordering, with few mandatory provisions.[45)] By contrast, the KComC is a mandatory rule-based law that only permits exceptions in articles of incorporation when explicitly permitted by the law.[46)] Therefore, the authorized scope of contractual protections for investors is vastly more limited in Korea.

This situation means that despite the importance of mitigating risks in startups through protective provisions, Korean VC investors cannot reallocate corporate authority through investment contracts. Since the KComC specifically prescribes a number of corporate decisions that require shareholder resolutions, it is not feasible for VC investors and entrepreneurs to arbitrarily redistribute decision-making authority between shareholder resolutions by the GMS and board of directors, even if supported by the amended articles of incorporation.[47)] With respect to a shareholder agreement that imposes one of the duties of a shareholder as a director, the Korean

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Organisational Law Effect], 20(2) Hongik L. Rev. 359, 373, (2019) (In Korean).

44) Chun, *supra* note 9, at 76 (explaining that while the protective provisions in investment contracts are essentially similar to the shareholder agreements that US-based corporations frequently use, they are often included in investment agreements rather than being concluded as separate shareholder agreements in Korea); Junyoung Jun, *Yagjeonge uihan jujuui sajeondonguigwone gwanhan geomto [Shareholder's consent rights by contracts between firm and shareholders]*, 42(1) Korean Com. L. Ass'n, 47, 49-50, (2023) (In Korean).

45) Rauterberg, *supra* note 6, at 1128.

46) Song, *supra* note 23, at 739-740 (explaining that the majority opinions construe corporate law to be mandatorily applicable in Korea, although the author views it necessary to assess the mandatory feature of each provision in the KComC).

47) Such resolutions that violate the KComC are subject to litigations invalidating their effect. Sangbeob [Commercial Act] art. 380 (S. Kor.).

Supreme Court has ruled that it is invalid.[48] In the context of this reasoning, shareholders cannot contractually dictate the performance of directors' duties outside the statutory mandates, and any contractual arrangements among shareholders regarding corporate governance outside the KComC may be invalid.[49] According to Rauterberg's classification of shareholder agreements into horizontal and vertical dimensions, with the former referring to arrangements among shareholders and the latter to agreements between corporations and shareholders, contractual arrangements in the vertical dimension are of virtually no effect in the Korean corporate law framework.[50]

2. Investors' Consent Rights

VC investors in Korea contractually acquire consent rights to control a startup's important corporate decisions.[51] By compelling startups to obtain investors' consent in advance of making essential decisions, VC investors aim to prevent entrepreneurs from taking arbitrary steps on matters that may significantly affect their interests, including transfer of material assets, increase in corporate capital, incorporation of subsidiaries, sales of corporate control, and filing for bankruptcy or rehabilitation procedures. When VC investors have more bargaining power, they require startups to obtain prior approval from investors for operational decisions, such as increasing employee compensation levels or entering into contracts with third parties over a specified threshold amount.

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48) Daebeobwon [S. Ct.], Sept. 13, 2013, 2012Da80996 (S. Kor.); On the analysis of the decision, *see* Hyeokjoon Roh, *Jujuin isae daehan jujugan gyeyagui gusoglyeog, [A Shareholder Agreement and Its Binding Effect on a Shareholder-Director],* 42(1) HUFS L. Rev. (2018) (In Korean).

49) Sukjong Baek, *Jujugan gyeyaggwa gacheobun [Shareholders' agreements and injunctive order],* 88 BFL 98 (2018) (In Korean); Ok-rial Song, *Jujugan gyeyagui hoesae daehan hyoryeok - hoesabeobe isseo sajeok jachiui hwakdaeui gwanjeomeseo [A Thought on Enforcement of Shareholder Agreement - Enhancing Private Ordering in Corporate Law]*, 178 The Justice 328, 360 (2020) (In Korean).

50) Rauterberg, *supra* note 6, at 1130.

51) On VC investors' consent rights, see Karen A. Chesley, *Not Without Consent: Protecting Consent Rights Against Deliberate Breach*, 80 Md. L. Rev. 95, 100 (2021) ("Generally, venture capitalists make investments through the purchase of preferred stock accompanied by a set of consent rights, commonly referred to collectively as 'protective provisions.'").

Although the consent rights of Korean VC investors appear to be similar to those of Silicon Valley investors, there are two differences. First, Korean VC investors' consent rights only have contractual effect; they do not carry veto authority. In other words, despite the contractually arranged consent rights, VC investors in Korea can only seek monetary damages from startups and entrepreneurs if their consent rights are violated. Startups' corporate decisions that violate VC investors' consent rights are valid without being affected by the breach of contract. Accordingly, VC investors in Korea can neither directly control startups' corporate decisions in advance nor challenge the validity of corporate decisions that violate their consent rights after those decisions have been made. By contrast, VC investors in the United States can structure veto rights that are effective at the corporate governance level, with the authority to prevent startups from making decisions without investors' prior consent.[52)]

Second, the consent rights of Korean VC investors are generally the rights of individual investors rather than of VC investors as a collective.[53)] Each VC investor can exercise contractual consent rights based on his or her respective interests, but there is no collective decision-making process. However, even VC investors who have invested in the same startup often have conflicting interests regarding corporate decisions subject to their consent rights.[54)] In particular, when a startup is undergoing a moderate downside, each VC investor may have different interests in whether the startup is sold or makes subsequent down-round investments, depending on the terms of their investments, even though they are all treated as the preferred shareholders of the same class.[55)] Thus, if VC investors with consent rights on the same corporate matters have conflicting interests, they may exercise their rights differently, leading to hold-up problems in startups.[56)] Under these circumstances, entrepreneurs and startups are

52) Rauterberg, *supra* note 6, at 1130; Jill E. Fisch, *Stealth Governance: Shareholder Agreements and Private Ordering,* 99 Wash. U. L. Rev. 913, 930, (2021); Chesley, *supra* note 51, at 100; Robert P. Bartlett, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation,* 54 UCLA L. Rev. 37, 53-54 (2006).

53) Chun, *supra* note 9 at 91, 95.

54) Bratton & Wachter, *supra* note 5, at 1875-1876.

55) *Id.*

56) Bartlett, *supra* note 52, at 99.

vulnerable to the legal risk of violating certain VC investors' consent rights when making corporate decisions, which may lead VC investors to seek remedies against them. By contrast, the consent rights of US investors are commonly structured as collective rights of all VC investors who have invested in the same series of investment rounds and/or as board-level veto rights that require the approval of VC investor-nominated directors to implement corporate decisions.[57]

3. Investors' Contractual Appraisal Rights and Liquidated Damages

Primarily because of the tenuous effect of consent rights, most VC investors' rights are accompanied by rigid contractual appraisal rights or put options that VC investors can exercise against startups and/or entrepreneurs in Korea.[58] Since VC investors are unable to invalidate corporate actions or transactions undertaken without their consent, VC investors use a contractual measure to protect their consent rights by arranging penalties for such violations in advance. By imposing a high level of penalty for a breach, Korean VC investors indirectly pressure startups and entrepreneurs to protect their consent rights. Typically, VC investors define the contractual appraisal price or put option exercise price as their principal investment amount plus additional interest. In the event that such contractual appraisal rights or put options are found to be illegitimate, most VC investors also include liquidated damages provisions in the contracts in amounts equal to the principal investment plus interest as a precautionary measure. By including liquidated damages in the contracts, VC investors avoid the difficulty of proving the amount of damages caused by a startup's breach of contract.

Alternatively, some VC investors include put options or liquidated damages exercisable against entrepreneurs in the contracts. These provisions give VC investors the right to recover their invested capital and interest from entrepreneurs who intentionally or grossly negligently fail to compel

57) *Id*; In section 5.5 of the NVCA Investors' Rights Agreement (2021 version) (stipulating matters requiring preferred director approval) and section 3.3 of the NVCA Certificate of Incorporation (2020 version) (promulgating Preferred Stock Protective Provisions requiring the majority of series A preferred shareholders).

58) Park, s*upra* note 31, at 406-407.

startups to comply with their duties, including the duty to protect VC investors' consent rights. Thus, it is common for VC investors to simultaneously claim damages from both startups and entrepreneurs for breaching their consent rights. This type of VC investment practice has been criticized by scholars, who argue that the potential risk of personal liability may discourage entrepreneurs from establishing innovative businesses in the first place and from taking risks to scale up.[59)]

These types of strict contractual remedies reflect the limited exit opportunities for Korean VC investors. Despite the importance of securing exit options from startup investments, Korean VC investors have very few such options, as there is a high bar for startups to go public through an IPO, including profit levels above a threshold in principle.[60)] In addition, startup M&A markets are not active enough to provide exit opportunities for VC investors, and deemed liquidation preference provisions are not available.[61)] Even if many VC investors have statutory redemption rights, they are rarely able to exercise these rights due to the stringent requirements for doing so.[62)] Under these circumstances, many VC investors prefer to acquire additional exit options through contractual appraisal rights and put options in the event that startups and entrepreneurs breach their duties. Therefore, when no alternative exit options are available, VC investors may choose to exercise their contractual appraisal rights or liquidated damages against startups and entrepreneurs for breach of rights and require them to repay the investment amounts.

Contrary to these practices, VC investors in the United States rarely include redemption rights or put options exercisable against startups in

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59) Park, s*upra* note 31, at 413.

60) KOSDAQ (Korean Securities Dealers Quotations), where many startups aim to list their shares, evaluates corporations' revenue and/or profit level over the threshold as one of the essential elements unless corporations are certified to possess highly advanced technologies by a professional institution. Koseudagsijangsangjanggyujeong [KOSDAQ Market Listing Regulation] art. 28 para. 1 subpara. 2 (S. Kor.).

61) Press release by affiliated administrative agencies, M&A HWALSEONGHWAREUL WIHAN BENCHEOJIJUHOESA JEDOGAESEON BANGAN [REFORMING VENTURE HOLDING CORPORATIONS TO ENCOURAGE M&A TRANSACTIONS], Aug. 2, 2018 (explaining that only 3% of VC investments had exited through M&A in Korea while 89% had exited in the US as of 2016).

62) III. A. 2. of this article below.

their agreements.[63] Just as US VC investors can exert direct control over startups through consent or veto rights, they can also guarantee a return of the invested capital by exercising deemed liquidation preferences upon a startup's M&A or sale of control. The active M&A markets in the United States provide VC investors with ample chances to effectively exit from startup investments by exercising deemed liquidation preferences.[64] In this sense, it is rare for US VC investors to hold entrepreneurs personally accountable for corporate failures to protect investors' rights, unless they breach their duty of loyalty as directors or controlling shareholders in transactions or decisions involving conflicting interests.[65]

III. Legal Issues Associated with Investors' Contractual Rights

While VC investors in Korea typically receive the contractual rights outlined above, it is often argued that granting additional rights only to VC investors may conflict with the mandatory principles of Korean corporate law. This issue has best been illustrated in recent litigation between investors and entrepreneurs over two fundamental principles in the KComC: the principle of equal treatment of shareholders and the principle of maintenance of capital. Concerning these controversies, the Korean Supreme Court has provided standards for evaluating the validity of investors' rights in its recent decisions. Thus, this part of the paper delves into the controversies over the conflicts and analyzes the court's decisions.

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63) Whereas section 6 of the model certificate of incorporation by the NVCA (2020 version) includes VC investors' redemption rights against startups, the entailed footnote 69 mentions that it is rare for VC investors to acquire redemption rights in practice and rarer for them to exercise such rights in practice.

64) Brad Feld & Jason Mendelson, Venture Deals 41 (2021).

65) Regarding the approaches of VC investors in Silicon Valley to startups' failure, *see* Elizabeth Pollman, *Startup Failure*, 73 Duke L. J. 327, 365-372 (2023); In the case of the breach of the duty of loyalty as directors or controlling shareholders, *see* Stephen Bainbridge, Corporate Law, 177, 206 (4th ed. 2020).

A. Conflicts with the Mandatory Principles in Corporate Law

1. The Principle of Equal Treatment of Shareholders

The principle of equal treatment of shareholders has been understood as one of the most fundamental principles of Korean corporate law. Primarily, this principle prohibits corporations from treating shareholders disproportionately, except for differences in the number of shares they own.[66] In assuming that the interests and rights of shareholders are homogenous, this principle requires corporations to treat shareholders equally in order to protect minority shareholders and prevent corporations from arbitrarily granting benefits to controlling shareholders while depriving minority shareholders of their rights.[67] Despite the lack of a statutory basis in the KComC, this principle has been recognized as mandatory in judicial decisions and academic discussion in the extrapolation of the statutory provisions in the KComC that mandate a one-share-one-vote approach (Article 369(1)) and the equal distribution of dividends (Article 464) and remaining assets upon liquidation (Article 538).[68]

Although this principle appears to be straightforward, controversy has arisen as to how and to what extent it should be applied. From a formalistic point of view, this principle permits only statutory exceptions, such as class rights, so as to invalidate any corporate activity that results in discriminatory treatment of shareholders other than those based on the statutory exceptions.[69] However, this interpretation is at odds with the diverse needs of companies to develop flexible governance structures for raising capital. Particularly in the context of startups and in the absence of alternative financing options, firms need to raise funds from VC investors in exchange

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66) Chung, *supra* note 9, at 216.

67) Reinier Kraakman, John Armour et al., Anatomy of Corporate Law, 81 (3rd ed. 2017); Taewon Sohn, *Jujupyeongdeungui Wonchiggwa Jujue Daehan Chadeungjeog Chwigeubui Yeoejeog Heoyong Ganeungseong [The principle of equal treatment of shareholders and plausibility of permitting discriminatory treatment to shareholders]*, 121 BFL, 104 (2023) (In Korean).

68) Kyunghoon Chun, *Hoesawa sinjuinsuin ganui tujajabohoyagjeongui hyolyeog [Validity of Investor Protection Arrangements between the Corporation and the Investor]*, 40(3) Korean Com. L. Ass'n, 71, 81-83 (2021) (In Korean).

69) Kraakman & Armour, *supra* note 67, at 81.

for additional protections beyond the scope of statutory class rights for those investors.[70] If the additional rights that startups provide to VC investors are found to be invalid because they treat certain shareholders more favorably than other shareholders, it may limit the options that startups can use to raise capital. Given that raising capital is inextricably linked to the survival and growth of startups, the principle that purports to protect minority shareholders may inadvertently cause startups to fail, thereby harming the interests of all shareholders.

Thus, several scholars have begun to argue against the unqualified application of the principle to all corporate decisions and activities. In addition to the growing need for corporations to diversify their financing options through contractual arrangements, the hybrid nature of RCPS justifies the call for a qualified application of the principle. While equity and debt are two distinct financing options for corporations, the preferred stock used by VC investors, especially RCPS, is an amalgamation of equity and debt that defies any sharp distinction between the two.[71] As shareholders, RCPS holders enjoy upside gains by exercising conversion rights to common stock if startups are successful while having downside protection to recoup their investment by exercising redemption rights like creditors if a startup struggles.

More specifically, since RCPS are on a par with convertible bonds (CBs) in terms of cash flow rights of the holders, a strict application of this principle only to RCPS may result in a situation where CB holders have more governance rights than preferred shareholders. Like RCPS, CB holders can convert their bonds into shares when the company's growth potential appears to be high while protecting themselves from downside risk by ensuring payment of the debt if a company is in a negative situation.[72] Notably, CB holders can obtain additional protection through covenants and keep companies under control by preventing them from

70) Darian M. Ibrahim, *Debt as Venture Capital,* 2010 U. Ill. L. Rev. 1169, 1175 (2010) (explaining difficulties of startups to get funded through debt).

71) Bratton & Wachter, *supra* note 5, at 1819 ("Stockholders are corporate, lenders are contractual, and a well-understood wall separates their legal treatments. Preferred stock straddles the wall.")

72) Korsmo, *supra* note 39, at 1175.

engaging in certain activities through contractual arrangements.[73] If covenants are breached, CB holders can accelerate the principal and interest due on the bonds and reclaim their loans from the companies. If investors' contractual rights with RCPS are interpreted as invalid due to the stringent application of the principle, an ironic situation may arise in which bondholders have more governance rights in startups than those firms' shareholders.[74] This discrepancy may prevent VC investors and entrepreneurs from negotiating appropriate investment measures among various options, including CBs and RCPS.

2. The Maintenance of Capital Principle

The maintenance of capital principle is established as mandatory for the protection of corporate creditors. Although this principle is not statutorily enshrined in the KComC, it is recognized by scholars and judicial decisions that extrapolate from the statutory provisions that limit the dividends, share repurchases (Article 341(1)), redemption of shares (Articles 345(3), 462), and reduction of capital (Articles 438, 439). The main purpose of this principle is to prevent companies from arbitrarily reducing their own capital and to serve as a standard for assessing the validity of corporate decisions that reduce a company's capital.[75]

While the KComC abolished the statutory minimum legal capital rule for corporations in 2011, it strictly regulates the remaining occasions that may reduce the corporate treasury, which serves as a cushion to guarantee loan repayment to creditors.[76] For example, statutory distributable profits have been widely used as a control mechanism to prevent corporations from siphoning funds from a corporate treasury. While it is common in corporate law in other jurisdictions to limit the distribution of profits to

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73) Although the corporate law in the US does not authorize bondholders to exercise control over corporate matters, it is not the case under the Korean corporate law (Korsmo, *supra* note 39, at 1175; Bratton, *supra* note 33, at 915); On the disparities in contractual control rights between creditors and shareholders, Chung, *supra* note 9, at 230-232.

74) *Id.*

75) Sunil Gwon et al., Ju-seog sang-beob [Annotated Korean Commercial Code] 102 (6th ed. 2021) (In Korean).

76) *Id*; Regarding the purpose of regulating corporate capital, Louise Gullifer & Jennifer Payne, Corporate Finance Law 127 (1st ed. 2011); Kraakman & Armour, *supra* note 67, at 124.

shareholders to some extent, the KComC narrowly defines statutory distributable profits by subtracting several elements, including statutory capital, capital reserve, and earned surplus from net assets as reported on the balance sheet.[77] This is considered a higher standard for distributable profits than Delaware law, which allows dividends to be paid from surplus, defined as the excess of net assets over capital.[78] Within the limits of statutory distributable profits, corporations may distribute dividends to shareholders and repurchase shares in accordance with the statutory procedures under the KComC (Article 341(1)).

Furthermore, preferred shareholders with statutory redemption rights are interpreted as able to exercise them only when corporations actually have statutory distributable profits.[79] Although the KComC only states that shareholders' redemption rights are exercisable against corporations if there are sufficient corporate profits to redeem shares, most scholarly opinions strictly require corporations to have statutory distributable profits as a condition for shareholders to exercise redemption rights.[80] Accordingly, granting non-statutory redemption rights to shareholders without the condition of the corporations' statutory distributable profits may be invalid, even if they are based on the articles of incorporation or contracts between corporations and shareholders.

In the context of VC investments, this principle, if strictly applied, could potentially conflict with contractual appraisal rights, put options, and liquidated damages of VC investors. If VC investors exercise contractual appraisal rights or liquidated damages against startups that violate investors'

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77) To be precise, the statutory distributable profits are computed by subtracting i) the amount of legal capital, ii) the total amount of capital reserve and the earned surplus reserve that has been accumulated by the settlement period, iii) the earned surplus reserve that should be accumulated during the settlement period, and iv) unrealized benefits and so on from the net assets in the balance sheets. Sangbeob [Commercial Act] art. 462 para. 1 (S. Kor.).

78) 8 Del. Laws § 170(a) and §154; Soon-Suk Kim, *Jabongeumjedosang chaegwonjabohoui beobjeoggwaje [Legal Issues Regarding the Protection of Creditors under the Legal Capital System]*, 2 Business L. Rev. 9, 43 (2012) (In Korean).

79) Young Shim, *Jusighoesaui baedangganeungiig gyesangwa misilhyeoniig [Distributable Profits and Unrealized Profits]*, 33(3) Korean Accounting Association 79, 46-47 (2014) (In Korean); Konsik Kim et al., Hoesabeob [Corporate Law] 167 (4th ed. 2020) (In Korean); Hongki Kim, Sangbeobgangui [Commercial Law] 387 (5th ed. 2020) (In Korean).

80) *Id.*

consent rights, questions may arise as to whether the return of capital to the investors from the company's treasury based on contractual rights may violate the maintenance of capital principle.[81] The return of investment capital and interest to VC investors by startups upon the exercise of contractual rights may seem similar to a situation in which corporations return invested amounts only to certain shareholders from the corporate treasury in a manner not prescribed by the KComC, which is a typical case of violation of the maintenance of capital principle.

Two features of the court's review of the maintenance of capital principle are noteworthy. First, court decisions often conflate this principle with the principle of equal treatment of shareholders, as relevant disputes arise over whether corporations should or could return invested capital only to certain shareholders, such as VC investors.[82] Since the principle of equal treatment of shareholders is established as an overarching principle that governs all corporate activities, the court examines the principle of equal treatment of shareholders prior to the maintenance of capital principle.[83] Thus, in cases where companies have returned invested capital to only a few shareholders, the court invalidated those actions based on the principle of equal treatment of shareholders rather than the maintenance of capital principle.[84] Second, in disputes, the legitimacy of contractual appraisal rights or liquidated damages under the maintenance of capital principle is asserted as an alternative to the issue of the validity of consent rights. Since contractual remedies can only be exercised if such contractual rights are valid, the legitimacy of the contractual remedies is examined after the validity of the contractual rights is affirmed.

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81) Chun, *supra* note 9, at 85-88.

82) Chun, *supra* note 9, at 110-112 (suggesting that those two issues should be segregated, and the maintenance of capital principle should be prioritized to the principle of equal treatment of shareholders).

83) *Id*.

84) For example, regarding a company's payback of invested capital to several shareholders who participated in a capital increase in accordance with provisions for investment return guarantee in a contract, the Supreme Court decided it to be invalid in breach of the principle of equal treatment of shareholders. Daebeobwon [S. Ct.], Aug. 13, 2020, 2018Da236231 (S. Kor.).

B. The Korean Supreme Court's Decisions On Investors' Rights

The controversies over investors' contractual rights described above have culminated in recent Supreme Court decisions that have limited the unqualified application of the mandatory corporate law principles to investors' contractual rights and elucidated the scope of these principles. However, there is room for a critical assessment of these decisions, as discussed below.

1. Overview of the Cases

The Supreme Court decided three cases on investors' contractual rights in July 2023. The first case was brought by an investor who claimed liquidated damages from a company in which he had invested for issuing new shares without the investor's consent.[85] The defendant argued that such contractual consent rights were invalid due to a breach of the principle of equal treatment of shareholders, so the company was not obliged to pay damages to the investor. In the alternative, the defendant denied any obligation to pay liquidated damages to investors, alleging a breach of the maintenance of capital principle.

In the second case, a plaintiff sought the return of invested capital and interest as liquidated damages for breach of consent rights.[86] Despite the plaintiff's consent rights regarding a petition for rehabilitation of the company, the company just filed such a petition to the court without the plaintiff's prior consent. Once the rehabilitation court notified the company's shareholders of the company's application, the plaintiff claimed liquidated damages caused by the defendant's breach of its consent rights as legitimate receivables to the rehabilitation court. However, that court ultimately rejected the plaintiff's claim for liquidated damages as receivables. Therefore, the plaintiff eventually sued the defendant to officially confirm the liquidated damages as receivables.

The third case also addressed investors' prior consent rights of the investee company to submit an application for initiating the rehabilitation

85) Daebeobwon [S. Ct.], Jul. 13, 2023, 2021Da293213 (S. Kor.).

86) Daebeobwon [S. Ct.], Jul. 13, 2023, 2023Da210670 (S. Kor.).

process.[87] However, one of the investee company's minority shareholders, who was not bound by the investment agreement, submitted an application to the rehabilitation court without the plaintiff's prior consent. As a result, the plaintiff filed a lawsuit against the company, claiming liquidated damages for the breach of consent rights. As in previous cases, the defendant claimed that the investors' consent rights were invalid due to the violation of the principle of equal treatment of shareholders and, alternatively, that the liquidated damages were invalid due to the maintenance of corporate capital principle.

Prior to the Supreme Court's decisions in these cases, the appellate courts had issued inconsistent rulings regarding investors' contractual rights. Specifically, regarding the first case, the Seoul High Court ruled in 2021 that consent rights granted only to certain shareholders were invalid as a violation of the principle of equal treatment of shareholders.[88] This decision raised serious concerns among VC investors, as it could disrupt the widespread use of control mechanisms through consent rights and their remedies in practice. Some academics criticized the decision for its crude application of the equal treatment principle without examining the specific circumstances in which these rights had been employed.[89]

2. Decisions of the Supreme Court on Investors' Contractual Rights

a. Concerning the Principle of Equal Treatment of Shareholders

The Supreme Court provided a standard for assessing the validity of investors' consent rights in light of the principle of equal treatment of shareholders. Rather than applying the principle broadly, the court has adopted a qualified approach, allowing exceptions to the principle beyond the scope prescribed by the KComC. The Supreme Court articulated three requirements for assessing whether consent rights granted only to certain shareholders are valid:[90] plaintiff investors should (1) demonstrate a clear and compelling business need for companies to raise capital through exceptional arrangements that grant additional rights to investors, (2) show that

87) Daebeobwon [S. Ct.], Jul. 13, 2023, 2022Da224986 (S. Kor.).

88) Seoul Godeungbeobwon [Seoul High Ct.], Oct. 28, 2021, 2020Na2049059 (S. Kor.).

89) Chun, *supra* note 9, at 117; Chung, *supra* note 9, at 249; Jun, *supra* note 44, at 62-64.

90) Daebeobwon [S. Ct.], Jul. 13, 2023, 2021Da293213 (S. Kor.).

no actual or potential harm has been caused to other shareholders in the company and that other shareholders also benefit from the additional rights granted to investors, and (3) prove that investors' consent rights do not override or violate the statutory rights of shareholders through the GMS.

However, applying these context-specific standards to startups and VC investors is not straightforward. The first criterion, which requires a compelling business reason for providing preferential rights to certain shareholders when raising capital, is relatively easy to meet in the startup and VC investment context. It is similar to the compelling business reason test in minority shareholder oppression cases regarding the discriminatory treatment of minority shareholders by majority shareholders proposed by the Massachusetts Supreme Court.[91] Most startups in financial distress find it difficult to raise funds through typical financing mechanisms due to the high risks and uncertainties involved.[92] Therefore, it is relatively easy for VC investors to demonstrate startups' compelling need to raise funds in exchange for granting additional rights to investors.

The second and third criteria are quite complicated in the context of startups and VC investors. More specifically, the second criterion leaves uncertainties in its practical application due to the potential conflict of interest among startup shareholders. Because startups are composed of different classes of shareholders, they inherently involve conflicts of interest between VC investors and other shareholders.[93] While VC investors generally have interests aligned with other shareholders, there may also be conflicts with other shareholders in the exercise of their consent rights with respect to material corporate decisions.[94] Therefore, depending on the specific circumstances of a given company, each shareholder may have different interests in the same corporate decision requiring investors' consent.

For example, consider investors' consent rights to the issuance of new shares by an investee company for subsequent rounds of investment. If the

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91) Wilkes v. Spingside Nursing Home, 353 N.E.2d 657 (Mass. 1976); James D. Cox, *Equal Treatment for Shareholders: An Essay*, 19 Cardozo L. Rev. 615, 632 (1997).

92) Paul Gompers & Josh Lerner, The Venture Capital Cycle 6-7 (2nd ed. 2004).

93) On the complexities concerning the conflict of interests among shareholders in startups, Pollman, *supra* note 12, at 188; On the conflict of interests among preferred shareholders, Bartlett, *supra* note 52, at 71.

94) *Id.*

company is on an appropriate growth trajectory, VC investors may have aligned interests with other common shareholders in exercising their consent rights for new rounds of investment. Suppose, however, that the company is on a moderate downward trajectory and has little potential for further growth. In this case, VC investors' interests may diverge from those of other common shareholders in exercising their consent rights for the company's issuance of new shares.[95] If the company undertakes a down-round investment with less enterprise value than a previous investment round, the VC investors' stakes in the startup could increase, subject to the conversion rates embedded in the RCPS, while the common shareholders' stakes could be significantly diluted.[96] Thus, whether the VC investors' consent rights benefit other shareholders could change for reasons specific to the investee company that are not foreseeable at the time those consent rights are contracted, and the application of the second criterion may be more complicated in practice in the context of VC investments.

This complexity is compounded by the third criterion, as most matters subject to investors' consent rights may overlap with corporate decisions that require statutory shareholder resolutions by the GMS under the KComC. Modeled on the United Kingdom's pro-shareholder company law, the KComC provides for a fairly broad range of shareholders' rights to participate in corporate decisions by the GMS.[97] Corporate decisions requiring ordinary or special shareholder resolutions range from the appointment of directors (Article 382) to internal operations such as granting stock options to employees (Article 340-2) and major corporate transactions such as the transfer of substantial corporate assets (Article 374).[98] Ordinary or special shareholder resolutions prescribed by law are

95) Bratton & Wachter, *supra* note 5, at 1875-1876; Abraham J. B. Cable, *Opportunity-Cost Conflicts in Corporate Law*, 66 Case W. Res. L. Rev. 51, 60-61 (2015).

96) Jeffrey M. Leavitt, *Burned Angels: The Coming Wave of Minority Shareholder Oppression Claims in Venture Capital Start-up companies*, 6 N. C. J. of L. & Tech. 223, 269-270 (2005).

97) Kyung-Hoon Chun, *Understanding Korean Corporate Law and Governance*, 21 J. Korean L. 253, 281 (2022) (holding that shareholders, at least according to the statutory law, have a strong set of rights, close to the UK model of pro-shareholders).

98) Shishido also identified the strong shareholders' rights under the Japanese corporate law as one of the causes of the lack of VC investors' participation in startup governance in Japan. Zenichi Shishido, *Does Law Matter to Financial Capitalism? The Case of Japanese Entrepreneurs*, 37 Fordham Int'l L. J. 1083, 1115 (2014).

interpreted as mandatory requirements for the implementation of corporate activities or decisions that cannot be amended by the articles of incorporation without statutory justification.[99] As the scope of corporate decisions subject to shareholder resolutions under the KComC is quite extensive, most matters subject to investors' contractual rights are highly likely to require such a resolution at the GMS at the same time. As a result, investors' consent rights are inclined to be invalid under the third criterion because they infringe on the rights of other shareholders to make corporate decisions through GMS resolutions.

However, in the cases at hand, the court did not elaborate on the circumstances under which investors' consent rights would be interpreted to preempt shareholders' rights, especially whether investors' consent rights are automatically invalid merely because the corporate decisions subject to consent require ordinary or special shareholder resolutions at the GMS under the KComC. In the above cases, the disputed corporate decisions that violated investors' consent rights were not subject to shareholder resolutions under the KComC, which alleviated the court's burden in deciding whether shareholders' statutory rights were infringed. The first case concerned an investor's prior consent to a company's issuance of new shares, which is within the authority of the board under the KComC (Article 418(1)). In the second and the third cases, the investors' consent rights at issue related to the company's applications for rehabilitation, which is not subject to a shareholder resolution at the GMS.[100]

b. Concerning the Maintenance of Capital Prinicple

The Korean Supreme Court explicitly distinguished investors' contractual remedies for breaches of their consent rights from other contractual provisions that aim to ensure the return of invested capital only to certain shareholders without resorting to legitimate procedures. Since investors

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99) Gwon, *supra* note 75, at 30 ("It is not authorized to delegate matters subject to GMS in the KComC to the board of directors or executive directors through articles of incorporation or board resolutions, unless the statutory law permits such delegation.").

100) In the case of corporations, not only debtor company but also creditors with loans equivalent to more than 10% of the corporate capital and shareholders with more than 10% of stakes can file for an application to commence a rehabilitation process. Chaemuja hoesaeng mich pasane gwanhan beoblyul [Debtor Rehabilitation and Bankruptcy Act] art. 34 (S. Kor.).

can exercise contractual remedies only when corporations or entrepreneurs breach their contractual obligations, these remedies are exercised based on separate contractual grounds. Therefore, the mere fact that liquidated damages are equal to the investors' invested capital does not necessarily indicate that the company violated the maintenance of capital principle. At the same time, with regard to the decision on the amount of damages to be awarded to the investors, the court exercised its discretion to reduce the amount of damages in accordance with the civil law provision that grants courts the authority to reduce the amount of damages to less than the amount of the liquidated damages if the court deems that latter amount excessive (Article 398(2) of the Civil Code).

c. Diverging Court Decisions on Investors' Rights

Based on these requirements, the Supreme Court has taken a case-by-case approach, resulting in divergent decisions on investors' claims for contractual remedies. While the court upheld investors' claims for liquidated damages in the first and second cases, it rejected those claims in the third case. In the first and second cases, the court found that the investors' consent rights were valid because the defendant companies were in financial distress, which satisfied the first criterion, and that the investors' consent rights were compatible with the interests of other shareholders, which satisfied the second criterion. Concerning the third criterion, the corporate decisions subject to the investors' consent rights did not overlap with matters subject to shareholder resolutions. As the defendant violated the investors' legally valid consent rights, the Supreme Court held that the investors were entitled to receive liquidated damages for that violation.

In the third case, however, the Supreme Court took a cautious approach and ruled that investors' consent rights had not been infringed. This was partly due to the ambiguous provisions in the agreement, which loosely defined a breach of investors' consent rights as an occasion when a corporate rehabilitation process is initiated or an application for the rehabilitation process is filed without the consent of the investors. The contract did not specify which party was prohibited from filing for a rehabilitation process and thus did not fully consider the possibility that the process could be initiated by any shareholder or creditor meeting the statutory requirements, other than the startup entrepreneurs or the

company itself.[101] The plaintiff argued for a broad application of this provision to accommodate this case, in which a minority shareholder filed an application for the rehabilitation process as a breach of consent rights.

However, the court rejected this argument based on the principles of equal treatment of shareholders and the maintenance of capital. According to the court's decision, investors' consent rights granted to certain shareholders to hold a company accountable for an outcome beyond the control of entrepreneurs are invalid and violate the principle of equal treatment of shareholders. Given that other minority shareholders could file a petition to initiate a rehabilitation process beyond the control of the entrepreneurs when a company is in a distressed financial situation, upholding the plaintiff investor's claim for liquidated damages in this case might have resulted in a company being held accountable for corporate mismanagement that caused the financial distress. If only a few investors were to recoup their investments due to a management failure, it would amount to a textbook case of violating the equal treatment of shareholders, which guarantees the return of invested capital to certain shareholders under all circumstances. However, the court's reasoning in the third case is unclear, because it conflates the principle of equal treatment of shareholders with the maintenance of capital principle. The court invoked the principle of equal treatment of shareholders for a situation more pertinent to the maintenance of capital principle, which involved a return of invested capital to certain shareholders.[102]

Notably, the Court in the first two cases upheld investors' claims for contractual damages against entrepreneurs in a straightforward manner, in contrast to the limited possibility of exercising valid remedies against corporations. Because the mandatory principles of corporate law do not apply to entrepreneurs' personal liability, there is no restriction on their liability to investors for corporate conduct or decisions, as contractually agreed. As a result, there remains an undue burden on entrepreneurs, which may ultimately have a chilling effect on entrepreneurship due to the

101) *Id*.

102) In the same manner denoted in the court's previous decisions as shown in III.A.2. of this article.

potential for legal liability.[103)]

3. Critical Analysis of the Decisions

Significantly, the Supreme Court decisions have partially resolved uncertainties associated with investors' contractual rights in light of the mandatory principles in the KComC by applying a qualified approach based on the specific circumstances of companies granting such rights. However, there are several limitations in these decisions regarding the incorporation of investors' contractual rights into the corporate law framework.

First, the court's decisions have taken a context-specific approach, requiring circumstantial evidence to assess the validity of investors' consent rights, which makes it difficult to predict the legality of an investor's consent rights ex ante due to the abstract nature of those rights. For example, as explained above, the determination of the second criterion may vary depending on the circumstances of the investee company. This is because the interests of preferred shareholders may differ from those of other shareholders in a number of ways. It is difficult to carry out a comprehensive assessment of whether the second criterion is met without identifying the shareholder structure and the specific circumstances of the investee company. The third criterion exacerbates the uncertainties regarding the validity of contractual rights. The guidance provided by the court's decisions is not clear enough about the extent to which contractual rights are permissible. While the decisions may provide some guidance for assessing the legality of such rights ex post, they do not provide any clear standards for investors and entrepreneurs on the valid scope of contractual arrangements between them. If investors and entrepreneurs cannot predict the validity of investors' rights in a given context, it is difficult for investors to enforce their rights as contractually agreed.

Second, from a technical perspective, the court failed to properly consider the contractual nature of the investors' consent rights in assessing their validity, especially regarding the third criterion. If the investors' consent rights were veto rights, as is the case with US investors, it might be

103) Park, s*upra* note 31, at 413.

reasonable to examine whether they preempt the rights of shareholders to approve corporate decisions through ordinary or special shareholder resolutions. However, as explained above, Korean investors' consent rights differ from veto rights in that they cannot directly affect the validity of corporate decisions taken in violation of those consent rights. Investors' consent rights are additional contractual requirements that merely trigger contractual remedies in the event of a breach of such rights.[104] Furthermore, contractual arrangements cannot substitute for the statutory requirement to obtain shareholder approval for corporate actions on such matters. Thus, even if some issues subject to investors' consent rights overlap with decisions requiring shareholder resolutions under the KComC, that does not necessarily mean that shareholders' statutory rights are infringed by investors' consent rights. However, the court decisions have treated investors' contractual rights as if they had veto authority over corporations.

Third, the court's proposed exceptions to the principle of equal treatment of shareholders are restrictive with respect to the reallocation of control through contractual arrangements. The court's decisions offer uniform standards for assessing the validity of the exceptions without taking into account structural differences in the shareholders and boards of directors of the companies involved. In addition, the standards offered by the courts are quite limited in scope in granting additional rights to specific shareholders. For example, if the third criterion is applied strictly, only trivial internal management decisions that do not require ordinary or special shareholder resolutions under the KComC would be subject to investors' consent rights, while important corporate decisions would not face that same hurdle. As a result, investors would end up exerting control over internal corporate decisions that do not substantially affect them but be unable to exercise control over important corporate decisions. This result is inconsistent with the original intention of investors to contractually arrange consent rights as a mechanism to mitigate risk in startups by reallocating control in investee companies.[105]

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104) II.C.2. above.

105) Gilson, *supra* note 5, at 1078; Broughman & Wansley, *supra* note 15, at 1309.

IV. Reshaping Investors' Contractual Rights for Startups

As demonstrated above, uncertainties associated with investors' contractual rights remain despite recent decisions by Korea's Supreme Court. Therefore, extending the previous discussion on the mandatory principles of corporate law, this part of the paper explores the root causes of the discrepancies between investors' rights and Korean corporate law and proposes suggestions for incorporating investors' rights into the corporate law framework. The suggestions focus primarily on the development of investors' rights in startups at the governance level through private ordering, accompanied by reinforcement of ex post review of investors' rights in light of fiduciary duty and the enhanced role of startup boards. Given that the discussion of startups and VC investment in Korea remains in its infancy, this part aims to analyze the fundamental problems underlying investors' rights from a broader perspective and to make a few proposals that need further research, rather than offering suggestions that can be implemented immediately.

A. The Root Causes of the problems

At the root of controversies over investors' consent rights is the fundamental mismatch between the Korean corporate law framework and VC investment arrangements in the United States. When adopting VC investment approaches from that country, the underlying discrepancies in the corporate law frameworks have not been properly examined. US VC investment has developed on the basis of free contractual arrangements between VC investors and entrepreneurs. Whereas these arrangements have been a key driver of the unprecedented growth of the startup ecosystem in the United States, they are not well suited to a mandatory law-based corporate law framework with a low degree of private ordering.[106] Even though Korean VC investors have adopted contractual mechanisms to

106) Dammann, *supra* note 36, at 443 ("Internationally, this U.S.-style libertarianism in corporate law is the exception rather than the rule. Most foreign corporate law systems rely strongly on mandatory corporate law.").

allocate control in startups, they cannot control startup decision making at the governance level through contractual rights, which are constrained by the principle of equal treatment of shareholders under Korea's corporate law framework.

Despite several attempts to promote startups in Korea, such as the Act on Special Measures of the Promotion of Venture Businesses (1997) and the Act on the Promotion of Technology Innovation of Small and Medium Enterprises (2001), little attention has been paid to the unique governance structure of startups in that country.[107] Although the KComC was revised in 2011 to meet the demand for diverse class rights and less stringent corporate capital regulations, that was only a piecemeal legislative intervention. It was not comprehensive enough to encompass the distinctive corporate governance of startups, which is shaped by contractual mechanisms.[108] However, without recognizing the unique governance structure of startups in the course of VC investment, it is difficult to resolve the controversies involving the conflicts between investors and entrepreneurs, as illustrated by the disputes over investors' rights.

The existence of common challenges faced by civil law countries that adhere to mandatory rule-based corporate law underscores the misalignment between VC investment and the mandatory legal framework.[109] In European countries, despite efforts to promote the growth of startups,

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107) Haksoo Ko & Hyun Young Shin, *Venture Capital in Korea? Special Law to Promote Venture Capital Companies*, 15 Am. Univ. Int'l L. Rev. 457, 470 (1999) ("The law as enacted, however, was aimed at emulating only the results of the United States venture capital market, without implementing the necessary contractual schemes or the social and economic infrastructure.").

108) After several revisions of the Special Act and the Law to Promote Small and Medium Size companies, the promotion initiatives and the legal requirements to establish venture capital companies and funds have been integrated into the Venture Investment Promotion Act in 2020. Min Hyuk Choi & Min Chul Kim, *Bencheotuja chogjine gwanhan beoblyului geomtowa hyanghu gwaje [Review of 'Act on the Promotion of Venture Investment' and Future Tasks]*, 42 Soongsil L. Rev. 105, 109-111 (2018) (In Korean) (summarizing the history of VC-related laws in Korea).

109) Paolo Giudici & Peter Agstner, *Startups and Company Law: The Competitive Pressure of Delaware on Italy (and Europe?)*, 20 Eur. Bus. Org. L. Rev. 597, 626 (2019) ("Accordingly we propose a rule of construction stating that if a provision is not explicitly identified as mandatory, it has to be treated as a default one, allowing the contracting parties to amend it as they wish.").

inflexible corporate law regimes restrict startups from developing governance structures through contractual arrangements.[110] The corporate law frameworks in these countries are simply not flexible enough to accommodate the allocation of authority and the redesign of board structures through contractual arrangements.[111] Some countries have responded to these challenges by special legal entity forms for startups with different legal frameworks from corporations. For example, Germany has enacted a separate law for a special type of close corporation for innovative businesses (Mini GmbH, Unternehmergesellschaft haftungsbeschränkt, UG).[112] By forming a UG, startups can benefit from more lenient capital regulations and design flexible governance structures through private ordering.[113] Italy also reformed its Società a responsabilità limitata (SRL) law in 2012 to allow for a flexible governance structure for innovative startups, modeled on the US limited liability company (LLC).[114]

However, these options may not be effective in Korea. Although other forms of business organization, such as LLCs or limited partnerships, are available under the KComC, more than 95% of companies in Korea are registered as corporations.[115] On top of the social reputation and credibility

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110) Giudici & Agstner, *supra* note 109, at 606.

111) Kraakman & Armour, *supra* note 67, at 87 ("In general, civil law jurisdictions-and particularly those that have been heavily influenced by German law- tend to view equal treatment as a broad principle (or source of law) that suffuses all aspects of corporate law.").

112) Sebastian Mock, *The Mini-GmbH (Unternehmergesellschaft haftungsbeschrankt [UG] in Germany), in* Modelli di Impresa Societaria fra Tradizione e Innovazione nel Contesto Europeo, 153-164 (P. Montalenti ed., 2016).

113) Janne Grote, Ralf Sanger, Kareem Bayo, *Attracting and Supporting International Start-ups and Innovative Entrepreneurs in Germany* 15 (Fed. Of. for Migration and Refugees, Working Paper No. 988, 2020); Miller, Sandra K., *Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French Close Corporation Problem*, 30 Cornell Int'l L.J. 381, 393-396 (1997) (the differences between AG and GmbH in the German law).

114) Giudici & Agstner, *supra* note 109, at 600.

115) Soo Jung Choi, *Changeopsaengtaegye Hwalseonghwa Gwanjeomeseoui Hoesabeop Juyo Jaengjeom [Key Issues of the Corporate Law to be Considered in Order to Build Start-up Friendly Environment]*, 30(2) Chungnam L. Rev. 47, 48 (2019) (In Korean); Soo-Seok Maeng, *Jungsobencheogieobe Jeokapan Hoesabeopjeui Ipbeop Piryoseong Geomto -Daetpjungsohoesa Gubunipbeobeul Jungsimeuro- [Review on the Necessity to Legislate Company Act Systems suitable to Small and Medium Venture Companies -Focusing on Legal Divisions of Small and Large Companies]*, 30(2) Chungnam L. Rev. 11, 12 (2019) (In Korean).

associated with the corporate form, most startups that want to grow into public companies through an IPO prefer to establish themselves in that form. Under these circumstances, it is unlikely to be effective to force entrepreneurs to choose business forms other than corporations for their new businesses. Therefore, developing a more accommodating corporate law framework for startups while retaining the corporate form is more promising than developing new business forms for Korean startup governance.

B. Embracing Private Ordering for Startups

1. Accommodating Private Ordering through Articles of Incorporation

As a desirable way to accommodate the rights of VC investors within Korea's corporate law framework, this paper proposes that the country adopt private ordering for startups through shareholder agreements based on articles of incorporation.[116] To raise funds from VC investors, startups need to accommodate unique ownership and board structures through flexible governance structures.[117] Startup entrepreneurs and common shareholders are better off being funded by VC investors than left unfunded due to their high risk and uncertainty. However, in the absence of protective measures, VC investors may refrain from investing in early-stage startups with high risks, preferring instead to invest in mature-stage startups with less risk and uncertainty. This may make it difficult for early-stage startups to raise funds from VC investors, leading to unintended consequences that undermine the government's policy of encouraging startups.

Therefore, startups should be allowed to devise a flexible governance structure in response to their financing needs through contracts based on articles of incorporation to meet the need for deviations from the governance structure suitable for financing while preserving the rights of other shareholders. Since both the principle of equal treatment of shareholders and the maintenance of capital principle are not rooted in statutory law, courts can

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116) Discussions associated with arguments about whether corporations, in general, should be subject to private ordering are beyond the scope of this article.

117) An argument for permitting different corporate governance structures for small and medium-sized companies under the Korean corporate law, *see* Maeng, *supra* note 115, at 27-29; Choi, *supra* note 115, at 74.

take the specific situations and distinctive ownership and board structures of startups into account when examining the validity of contractual arrangements that reallocate control between startup entrepreneurs and VC investors. While the court decisions discussed above have reviewed contractual arrangements in startups as deviation from the standards denoted by these principles, the suggestion here is to change perspectives by considering these principles only as guiding principles that allow for reallocation of corporate control by contracts.

Some may ask why this proposal needs to treat startups differently from Korea's conventional corporate governance structure. However, it is not necessary to treat all types of companies under the same rule, as there is no one-size-fits-all governance structure. While some Korean scholars have suggested that the country needs to diversify its governance structure for companies based on their size, some legal systems govern non-listed companies under a separate law from listed companies.[118] In this sense, the present study argues that given the unique ownership and governance structure resulting from the financing mechanisms used by VC investors, startups need to be governed by a different set of rules than other companies.

With respect to appropriate measures for private ordering in startups, shareholder agreements based on articles of incorporation can be used to allow startup entrepreneurs and VC investors to customize the governance structure of a startup. As Fisch has noted, articles of incorporation are a more appropriate measure for private ordering in corporations than contractual measures in terms of protecting common shareholders.[119] Since the articles of incorporation are accessible to all shareholders, other common shareholders can identify any deviations contained in the articles of incorporation.[120] However, under the KComC, the articles of incorporation alone cannot serve as a measure for private ordering. Given that a

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118) Regarding the discussion in Korea, *see* Maeng, *supra* note 115, at 28; Regarding the legal system that governs non-public companies differently from public companies, Paolo Giudici & Peter Agstner, *Startups and Company Law: The Competitive Pressure of Delaware on Italy (and Europe?)*, 20 Eur. Business Org. L. Rev. 597, 608-610 (2019).

119) Fisch, *supra* note 52, at 946 (holding that charters and bylaws should be deployed for private ordering instead of shareholder agreements, as they are transparent, appropriate to standardization and can be overseen by shareholders).

120) *Id*.

special resolution that requires no less than two-thirds of the shares present at the GMS is necessary for amendments to articles of incorporation (Article 434), it is not feasible for entrepreneurs and VC investors to take steps to amend them on every occasion that calls for reflecting specifics regarding investors' rights. Furthermore, the structuring of a more lenient quorum for the amendment than the statutory requirements is not permissible, although a stricter quorum is allowed, according to the scholarly interpretation in Korea, despite the lack of an explicit provision in this regard in the KComC.[121] Therefore, startups should be allowed to use contractual measures according to the articles of incorporation to structure flexible governance structures for startups.[122]

Under the framework proposed in this article, VC investors and entrepreneurs can enter into shareholder agreements to reallocate authority among themselves based on the process and conditions set forth in the articles of incorporation. While startups can determine the basic standards and process for granting additional rights to specific types of investors, including VC investors, through the articles of incorporation, VC investors can negotiate specific features of the rights that they intend to exercise over startups through shareholder agreements, followed by notification to other shareholders of the specific rights granted to VC investors. As a result, VC investors and entrepreneurs can structure flexible governance based on their needs within the confines of the articles of incorporation. At the same time, common shareholders will remain informed about the types of rights and controls exercisable by VC investors. In this framework, the arrangements and reallocation of rights and controls granted to VC investors under shareholder agreements within the scope of the articles of incorporation not only have contractual effects but also impact startups at the governance level.

Most importantly, however, it is necessary to clarify the interpretation of Korean corporate law regarding the use of private ordering for startups

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121) Kim, Roh & Chun, *supra* note 79, at 885.

122) Song, *supra* note 51, at 360 (arguing that concerning the corporate law framework in general, voting agreements to appoint a director should be acknowledged as legally binding to let minority shareholders with the right to nominate a director by directly compelling the counterparty to consent to the appointment of such a director through court orders).

through shareholder agreements on the basis of the articles of incoporation. Private ordering through articles of incorporation is one of the most underexplored areas in the KComC; although it prescribes certain specific criteria that are compulsory to include in the articles of incorporation (Article 289), there has been little discussion on the scope of permissible deviations in the governance structure through articles of incorporation under the mandatory rule and principle-based legal framework. Since the concept of articles of incorporation serving as a governing contract is not widespread in Korea, companies tend to adopt boilerplate articles of incorporation without review or adjustment; this is especially true of under-resourced startups.[123] In addition, the extent of deviations permitted by articles of incorporation has not been rigorously tested in court.

Therefore, it is imperative to clarify the relevant uncertainties regarding the scope of permissible private ordering for startups through two measures. First, it should be clarified that startups may deviate from the mandatory structure prescribed by the KComC based on the articles of incorporation unless explicitly prohibited.[124] Since the KComC recognizes the possibility of including additional content in the articles of incorporation, courts can clarify that the deviations from the conventional corporate law governance can be included in the articles of incorporation to the extent they are not prohibited by the KComC. If the permissible scope of private ordering is clarified, VC investors and entrepreneurs may choose to use articles of incorporation to shape a flexible governance structure.

Second, with respect to the deviations provided by the articles of incorporation, the principle of equal treatment of shareholders should be applied as a guiding principle that requires corporations to treat shareholders fairly in proportion to their stakes in corporations.[125] Given the lack of a statutory basis for the principle, there is no compelling reason to apply

123) Regarding the legal nature of the articles of incorporation, most scholars construe them as self-governing laws rather than contracts. *See* Kwon (eds), *supra* note 75, at 145.

124) On the necessity to expand the scope of private ordering through shareholders agreements based on the articles of incorporation for corporations in general, *see* Song, *supra* note 51, at 352.

125) Chun, *supra* note 9, at 245 (arguing that formalistic review standard of equal treatment of shareholders should be replaced by a standard of corporations' fair treatment of shareholders).

the principle in a uniform manner to every corporation. Thus, startups that treat shareholders differently based on the process and content of the articles of incorporation could be considered to be treating shareholders fairly and not an automatic violation of the principle.

From a comparative point of view, Japanese scholars have attempted to tackle the challenges of adopting VC investment arrangements within that country's corporate law framework by using articles of incorporation, particularly for deemed liquidation preference rights. Japanese corporate law has a similar structure to the KComC, as demonstrated by the statutory mandate of the principle of equal treatment of shareholders (Article 109(1)).[126] Similar to the KComC, Japanese corporate law limits the scope of class rights to those provided by the law, although they are more extensive than those permitted by the KComC, encompassing shares with the right to appoint or remove directors (Article 108(1)(9)) and veto rights (Article 108(1)(8)) as class rights after a 2005 revision of the law.[127] However, the deemed liquidation preference rights, despite their frequent use by VC investors, is not one of the types of class rights permitted by the law.

To bridge the gap between the law and practice, many Japanese scholars argue that although deemed liquidation preference rights are not class rights, they can have legal effects on companies based on the articles of incorporation.[128] Since Japanese corporate law allows companies to include additional corporate governance arrangements in the articles of incorporation (Article 29), deemed liquidation preference based on the articles of incorporation can be recognized as one of these additional arrangements to coordinate rights among shareholders in the case of M&A transactions (Articles 749(2), 753(3)).[129] Thus, VC investors may exercise deemed

126) Tanaka Wataru, Kaisha-hō [Corporate Law] 88 (3rd ed. 2022) (In Japanese) (explaining that the purpose of this principle is to encourage stock investments by protecting shareholders' odds of earning profits from stock investments).

127) Kanda Hideki, Kaisha-hō [Corporate Law] 79-80 (23rd ed. 2021) (In Japanese).

128) Tanaka Wataru, Hamada Matsumotohōritsujimusho, Kaisha Kabunushi-kan Keiyaku No Riron To Jitsumu: Gōben Jigyō Shihon Teikei Sutātoappu Tōshi [Theory and practice of corporate and shareholder agreements: Joint ventures, capital alliances, and startup investments] 187 (2021) (In Japanese) (explaining that majority of scholars and practitioners in Japan acknowledge the legitimacy of deemed liquidation preferences based on article 29 of the Japanese corporate law).

129) Wataru & Matsumotohōritsujimusho, *supra* note 128, at 384.

liquidation preference rights in the case of corporate M&A transactions if those rights are based on the articles of incorporation. This type of proactive interpretation of the use of articles of incorporation provides guidance to Korean corporate law in terms of private ordering for startups.

2. In the Case of VC Investors' Consent Rights

By applying the above suggestion to investors' consent rights, startups may be allowed to include investors' consent rights as a legitimate element of their articles of incorporation. The scope of corporate decisions that may be subject to investors' consent and the effect of such rights shall be prescribed in the articles of incorporation. Based on the framework set out in the articles, VC investors and entrepreneurs can define specific details of the consent rights through shareholder agreements. If VC investors acquire consent rights that are directly enforceable against startups, they can protect those rights by challenging corporate decisions that violate them. As a result, VC investors may no longer need to arrange additional layers of contractual remedies for breaches of their rights.[130] This may prevent uncertainties related to investors' contractual rights and controversies about excessive remedies for VC investors.

The focus of the discussion needs to shift from the validity of VC investors' consent rights to the appropriate ways to establish those rights. Three ways should be considered to delineate the legitimate consent rights of investors using the articles of incorporation. First, they should be structured as a collective decision-making process among VC investors to avoid hold-up problems caused by the conflicting exercise of individual consent rights. For example, the articles of incorporation may require investors to decide whether to consent to certain decisions by majority vote if they have different opinions. By taking these steps, startups can avoid deadlocks that may be caused by the individual consent rights of VC investors with differing interests. Second, startups' articles of incorporation should require that investors exercise their consent rights in a reasonable manner for the overall benefit of the startup and its shareholders. If VC investors withhold consent only to delay corporate decisions without

130) Baek, *supra* note 49, at 98; Song, *supra* note 49, at 360; Chesley, *supra* note 51, at 118-119.

reasonable justification, startups may choose to carry out those decisions despite that refusal. Finally, the articles of incorporation must establish procedures to inform common shareholders of the essential aspects of VC investors' consent rights in a straightforward manner.[131] Since the articles of incorporation provide a brief outline of the rights granted to VC investors, common shareholders should be informed of the actual scope of those rights.

3. Restructuring the Board Based on the Articles of Incorporation

From a broader perspective, for startups to have flexible governance through private ordering, they need to be permitted to reallocate decision-making authority between the board and shareholders and to reinforce board-centered governance structures. It is costly and time-consuming for startups to take steps for shareholder resolutions through the GMS at the same level and to the same extent required for public corporations. In addition, because common shareholders often lack sufficient resources to voice their opinions or monitor corporate decisions through the GMS, most startups take steps for them as a legal formality rather than as a mechanism for shareholders to exert control over corporate decisions. Thus, it may not fundamentally change shareholders' rights if startups can delegate a specific range of decisions to the board of directors based on the articles of incorporation.[132] By allowing the board to make a wide range of decisions based on the articles of incorporation, startups can speed up the decision-making process and enhance the accountability of directors. In addition, since board members can represent shareholders' interests, with VC investors nominating director(s) and entrepreneurs themselves serving as directors, the conflicting interests of shareholders can be resolved through board

131) Regarding information asymmetry problems of common shareholders, the majority of whom are startup employees, and the necessity to disclose essential aspects of the VC investors' rights to common shareholders, *see* Alon-Beck, *Unicorn Stock Options-Golden Goose or Trojan Horse?* 2019 Columbia Business L. Rev. 107, 184-186 (2019); Yifat Aran, *Making Disclosure Work for Start-up Employees*, 2019 Columbia Business L. Rev. 867, 952-955 (2019).

132) Similar to the broad scope of delegation to the board according to §141(a) of Del. Laws ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.").

deliberation processes.[133]

Consistent with the heightened board-centered governance in startups, VC investors' consent rights may be incorporated into a board approval process by incorporating deviations into the articles of incorporation.[134] Startups can tailor board approval processes for certain corporate decisions to require the approval of a VC-nominated director. As an alternative to VC investors' contractual consent rights as preferred shareholders, this proposal suggests structuring investor control at the board level. This draws on the National Venture Capital Association model agreement of investor rights, which provides for investors' consent rights for board approval.[135] If VC investors' consent rights are incorporated into the board approval process, it will be easier for other shareholders to assert breaches of fiduciary duty owed by VC-nominated directors.[136]

As a prerequisite for the adoption of this type of private ordering, the scope of permissible deviations from board approval procedures should be clarified. According to the KComC, the approval of the board of directors requires the consent of both a majority of directors present at a meeting and the majority of outstanding directors (Article 391(1)). Although the extent of permissible deviations from the quorum for board approval has not been tested in court, many scholars believe that increasing the threshold for quorum may be legitimate.[137] Nevertheless, there is no uniformity of scholarly opinion on whether the quorum for board approval can be increased to a level that gives a particular director veto authority.[138] Therefore, it needs to be clarified that startups are authorized to change a quorum for board approval in a way that requires the approval of a VC-nominated director for certain corporate decisions, based on the articles of

133) Pollman, *supra* note 12 at 183 ("In startups, the board is not only the site of value-adding managerial guidance, but also one of the key arenas in which conflicts are resolved and investments are protected.").

134) Chun, *supra* note 9, at 78 (arguing that it is desirable to structure consent rights by heightening the quorum for board approval and resolutions of the GMS instead of devising them as contractual rights).

135) Section 5.5 of the NVCA Investors' Rights Agreement (2021 version).

136) Part IV. C. of this article.

137) Song, *supra* note 23, at 1010.

138) *Id*.

incorporation.

C. Enhancing Fiduciary Duties

The above proposals to expand private ordering in startups should be accompanied by an enhancement of the fiduciary duties owed by VC investors as controlling shareholders and VC investor-nominated directors. This section examines the Delaware courts' decisions regarding the fiduciary duties owed by VC investors and VC investor-nominated directors to common shareholders and explores the direction in which fiduciary duties under the KComC should evolve.

1. Delaware Courts' Decisions

The Delaware courts have addressed numerous disputes associated with agency problems and conflicts of interest in startups through the lens of the fiduciary duties of directors and controlling shareholders.[139] While most decisions are made by the board of directors, VC investors in the United States have a role in startup decision making through VC investor-nominated directors. In addition, as the ownership structure of startups changes, the class of shareholders controlling the startup board gradually shifts from entrepreneurs to VC investors.[140] Accordingly, the Delaware courts have assessed board decisions on corporate matters involving conflicting interests between common and preferred shareholders in terms of the fiduciary duties of directors and controlling shareholders.

One leading case on this issue is *In re Trados Inc*. Simply put, the board of directors of Trados, which was controlled by VC investors, decided to sell the company for USD 60 million, which resulted in a situation where USD 52.2 million, the vast majority of the consideration of the transaction, being distributed to the VC investors on a deemed liquidation preference basis and USD 7.8 million to a professional management team as a manage-

139) Korsmo, *supra* note 39, at 1181.

140) Brian Broughman & Jesse M. Fried, *Do Founders Control Startup Firms that Go Public?*, 10 Harvard Business L. Rev. 49, 55-57 (2020) (explaining the shifting control in the startup board).

ment incentive plan, leaving nothing for the common shareholders.[141] Those shareholders filed suit against the directors, alleging that they had breached their fiduciary duty to the shareholders in the sale. On the issue of VC investors-nominated directors' fiduciary duties, the Delaware Chancery Court held that they owed a fiduciary duty to the common shareholders, but not to the preferred shareholders.[142] The court ruled that to the extent that preferred shareholders exercise their contractual rights against a corporation as explicitly provided in contracts, the directors do not owe them a fiduciary duty.[143] The court evaluated the directors' decisions under the entire fairness standard and determined that the transaction price was fair to common shareholders.[144] While this decision was controversial among practitioners and scholars, it did provide a standard for assessing directors' fiduciary duty to shareholders when preferred and common shareholders have conflicting interests.[145]

With respect to investors' consent rights, the *Basho* case is representative in that the court upheld breaches of fiduciary duty by VC investors and VC-nominated directors as controlling shareholders and directors, respectively.[146] In this case, a VC investor called Georgetown LLC acquired a class consent right from a startup called Basho when it invested in a Series G round. Because of this class consent right, Basho was prohibited from issuing new shares without the prior approval of a majority of Series G

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141) *In re* Trados Inc., Shareholder Litig., 73 A.3d17 (Del. Ch. 2013) *33.

142) *Id.* *41 ("it is the duty of directors to pursue the best interests of the corporation and its common shareholders if that can be done faithfully with the contractual promises owed to the preferred.").

143) *Id.* *39 [8] ("A board does not owe fiduciary duties to preferred stockholders when considering whether or not to take corporate action that might trigger or circumvent the preferred stockholders' contractual rights. Preferred stockholders are owed fiduciary duties only when they do not invoke their special contractual rights and rely on a right shared equally with the common stock.").

144) *Id.* *43 [9], *55, *78. While distinguishing its judgment on fair dealing from a fair price of the transaction, the court rejected that the sales transaction that granted nothing to the common shareholders was unfair.

145) For previous discussions criticizing the decision, *see* Bratton & Wachter, *supra* note 5, at 1885-1887; Bartlett, *supra* note 15, at 294-296; Sepe, *supra* note 19, at 342-345.

146) Basho Technologies Holdco B LLC v. Georgetown Basho Investors LLC, C.A. No. 11802-VCL (Del. Ch. July 6, 2018).

shareholders.[147] When Basho, in dire financial straits, subsequently raised funds in a Series F round, Georgetown LLC, which held a majority of the Series G shares, used its class consent rights to refuse to consent to a third-party financing offer. With no alternative financing options, Basho had no choice but to accept an investment offer from Georgetown LLC that was less favorable to the company than the previous offer.[148] After Georgetown LLC gained control of Basho's board of directors through the Series F investment, Basho was eventually liquidated due to the deteriorating financing conditions, caused primarily by several self-dealing transactions by Georgetown LLC. As a result, Basho's former shareholders filed suit against Georgetown LLC and Georgetown LLC-nominated directors for breach of fiduciary duty.

In this case, the Delaware Chancery Court found that the plaintiffs' claims had merit. Concerning the Series F investment round, the Court held that Georgetown LLC had control over the funding decision, even though it was not a majority shareholder of Basho at the time. Relying on well-established case law regarding the fiduciary duties of controlling shareholders, the court found that Georgetown LLC's control stemmed from several factors, one of which was its consent rights over the issuance of new shares by Basho.[149] Since the financing transaction involved conflicting interests between Georgetown LLC and its nominated director with other shareholders, the court applied an entire fairness standard and held that both Georgetown LLC and the director breached their fiduciary duties to the common shareholders.[150] Thus, while US startups incorporated in Delaware have broad discretion to design flexible governance structures in negotiations with VC investors, ex post review of the fiduciary duties of directors and controlling shareholders prevents exploitation by VC investors.

2. Fiduciary Duties of Controlling Shareholders and VC-Nominated Directors

Based on the theories of fiduciary duties developed in Delaware, Korean

147) *Id.* at 10.

148) *Id.* at 26, 44 (regarding the new money raised by the company and the liquidation preferences).

149) *Id.* at 86.

150) *Id.* at 101.

corporate law should apply well-theorized fiduciary duties to VC investors and VC-nominated directors. As shown by the above decisions, those duties can be used as an effective measure to prevent VC investors from exploiting their control over startups.[151] By incorporating the fiduciary duties of controlling shareholders into corporate law, the abuse of control rights by VC investors can be subject to fiduciary duty review as to whether the decisions were fair to the companies and shareholders when VC investors have de facto control startups through consent rights or board approval.

However, the fiduciary duty of directors and controlling shareholders is an under-researched area in Korean corporate law. Although directors' fiduciary duty was added to the KComC in 2008 (Article 382-3), neither case law nor academic theories have been developed to address the complexities associated with VC investment and startups in Korea.[152] While the KComC explicitly mandates the directors' duty of loyalty, there has been debate regarding the ultimate meaning of the statutory duty and whether it should be characterized as separate from the duty of care, as established by the Delaware case law.[153] Furthermore, since the KComC specifies that directors owe a duty of loyalty to corporations, it has been debated whether directors are construed to owe such a duty to shareholders as well.[154] The fiduciary duty of controlling shareholders to remaining shareholders is an unfamiliar concept under the KComC.[155]

Therefore, theories of fiduciary duty should be developed through

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151) Tae-Jin Kim, *Jujupyeongdeungwonchige Gwanhan Sogo [Review of the Principle regarding the Equal Treatment of Shareholders]*, 22(3) Bus. L. Rev. 9, 39 (2008) (In Korean) (explaining an argument to develop fiduciary duty theories in exchange for flexibly interpreting the principle of equal treatment of shareholders).

152) While the duty of loyalty had been adopted in the KComC in 1998, the KComC was revised again in 2011 to incorporate concrete duties associated with the duty of loyalty, which are the duties not to expropriate corporate opportunity or usurp corporate assets (Sangbeob [Commercial Act] art. 397-2 (S. Kor.)), and none-compete duties and legitimate process for the self-dealing transactions (Sangbeob [Commercial Act] arts. 397, 398 (S. Kor.)).

153) Kim, Roh & Chun, *supra* note 79, at 408; Song, *supra* note 23, at 1039-1041.

154) Song, *supra* note 23, at 1041; Kim, Roh & Chun, *supra* note 79, at 409-410.

155) Kim, Roh & Chun, *supra* note 79, at 409 (explaining that because the fiduciary duty under the Korean corporate law arises from the contractual relationship, as opposed to the fiduciary duty in Delaware that derives from the fiduciary relationship, it is difficult to apply the fiduciary duty to controlling shareholders under the Korean law).

scholarly discussions and court decisions in accordance with the expanded scope of private ordering in startups. Three suggestions can be made in this regard. First, the duty of loyalty should be characterized as the duty to maximize shareholders' value in self-dealing transactions, which serves as a separate standard of review for directors from the duty of care. Clarifying the scope and extent of the duty of loyalty is a prerequisite to further developing directors' fiduciary duties. Second, it is necessary to clarify that directors owe fiduciary duties not only to corporations but also to shareholders. Accordingly, in the event of a conflict between the interests of common and preferred shareholders, the interests of common shareholders should prevail as the residual claimants, as determined by the *Trados* decision. By combining these two suggestions, the fiduciary duties owed by VC-nominated directors to startups can be clarified and enhanced.

Finally, the concept of controlling shareholders' fiduciary duty, according to which shareholders or a group of shareholders who have control rights over companies owe fiduciary duties to shareholders as a whole, needs to be introduced into Korean corporate law. Applying the fiduciary duty of controlling shareholders to the context of VC investors in startups, VC investors can be considered controlling shareholders of startups if they have acquired controlling stakes in startups through multiple rounds of investment. Even if VC investors do not hold controlling stakes in startups, they still may owe fiduciary duties to other shareholders and to the startups themselves if they have consent rights or approval rights that can be exercised at the corporate level. Accordingly, VC investors may have liabilities to other shareholders and startups in proportion to their exercise of control over those firms.

Recently, the Korean Supreme Court shed light on the possibility of extending fiduciary duty to shadow directors; that is, parties who exercise control over the decisions of directors without assuming director positions.[156] In its decision, the court held that the statutory liability of shadow directors toward corporations and third parties (Article 401-2) is essentially the same in nature and effect as the fiduciary duty of directors. Based on this reasoning, it is plausible to adopt the notion of fiduciary duty for controlling

156) Daebeobwon [S. Ct.], Oct. 26, 2023, 2020Da236848 (S. Kor.).

shareholders such as VC investors with additional control rights over startups, as the Delaware Court did in the *Basho* case.

V. Conclusion

The Korean startup ecosystem has achieved remarkable growth over the past 30 years by adopting VC investment models from the United States, which were designed to provide VC investors with protections to mitigate the high risks and uncertainties associated with startups. While Korean startups have adopted the distinctive ownership and board structures of US startups, little attention has been paid to the specifics of startup governance from a corporate law perspective in Korea. Although Korean VC investors typically use preferred shares and obtain additional rights from startups through contractual arrangements similar to those in the United States, the validity of investors' contractual rights has remained uncertain, largely due to the mandatory principles of Korean corporate law, including the equal treatment of shareholders and the maintenance of capital. Despite the protective provisions such as the right to consent to major corporate decisions, these rights may be invalidated if the mandatory principles of corporate law are strictly applied. Recent decisions by the Korean Supreme Court on the validity of investors' consent rights have resolved some of the uncertainties by suggesting a qualified application of the principle of equal treatment of shareholders. However, it is difficult to apply the standards suggested by the Supreme Court to assessing the validity of investors' contractual rights in practice because those standards are highly context-specific. Moreover, the permissible scope of investors' contractual rights is insufficient to meet the need to mitigate risk by controlling important corporate decisions.

Therefore, this article proposes ways to expand the scope of private ordering for startups beyond the mandatory principles of corporate law to accommodate diverse financing needs within governance structures. Since it is essential for VC investors to be involved in startups' decision making to mitigate high risks and uncertainties, startups should be allowed to structure flexible governance in combination with articles of incorporation and shareholder agreements. Under the proposed framework, VC investors

and entrepreneurs can negotiate VC investors' consent rights through shareholder agreements within the limits of the articles of incorporation. If they agree to grant VC investors consent rights over corporate decisions and conduct, those rights need to be recognized as valid, provided that they are grounded in the articles of incorporation. Furthermore, as an alternative to contractual consent rights, VC investors can be involved in startup decision making at the board level using flexible quorums for board approval. As a response to the expanded private ordering for startups, any exploitation or abuse of VC investors' rights can be controlled and monitored through ex post review in light of the fiduciary duties of directors and controlling shareholders, which can be developed in Korea based on Delaware case law.

By allowing VC investors and entrepreneurs to establish governance structures that meet their needs through articles of incorporation, startups can facilitate active fundraising from VC investors. If they are equipped with control measures to engage in startup decision making at the governance level, VC investors may be less wary about investing in early-stage, high-risk startups. Furthermore, VC investors do not have to design excessive remedies against startups and entrepreneurs for breaching their rights. This may reduce the potential personal liability of entrepreneurs with respect to startup management. Since startup governance is an interim governance structure that will change with a startup's IPO or M&A involvement, the extended scope of private ordering may cause little harm to other common shareholders.[157] Once the issues related to the rights of investors are resolved under the extended scope of private ordering, the discourse on startups and VC investment can move on to more advanced discussions of vertical and horizontal agency problems in startups and conflicts of interest among shareholders.[158]

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157) *Supra* note 14.

158) Bartlett, *supra* note 52, at 71-80 (analyzing horizontal agency problems, which refer to the conflicts of interests among preferred shareholders on top of vertical agency problems regarding management and shareholders in a traditional manner); Pollman, *supra* note 12, at 176-196 (exploring vertical and horizontal agency problems that are unique to startups at a comprehensive view).