

The New Corporate Governance Structure of Korean Conglomerates: Reorganization into Holding Companies

Beginning with the 2002 reorganization of LG Group and continuing with this year's reorganization of SK Group, South Korea has seen a trend of conglomerates reorganizing as holding companies. With at least 10 of the largest *chaebol* either in the process of or considering reorganization, it is crucial that investors understand the reorganization procedures and how controlling shareholders use the process to strengthen their positions.



By Sang Gon Kim
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Korean conglomerates (*chaebol*) have traditionally maintained a cyclical investment structure whereby the controlling shareholder is able to control numerous affiliates despite having a very small shareholding. This structure has been criticized for being counter to the principles of capital adequacy and corporate governance (having control of affiliates by the controlling shareholder despite that shareholder having a very small equity holding). In addition, this structure has been vulnerable to hostile takeover bids by third parties.

Recently, there has been an increase in the number of *chaebols* reorganizing their corporate governance structure to that of a holding company in order to increase corporate governance transparency and strengthen corporate control. The wave of reorganization began in 2002 with LG Group, the second-largest *chaebol* in terms of assets. SK Group (the fourth-largest *chaebol*) underwent reorganization this year, and we understand that roughly 10 or more of the 30 largest *chaebol* are in the process of or considering reorganization.

In this context, it is crucial that investors with interests in Korean

chaebol understand the reorganization procedures and how the existing controlling shareholders are able to strengthen their position through this process.

Reorganization procedures

There are two ways to establish a holding company: through in-kind contribution (method one) and spin-off (method two).

Under method one, the controlling shareholders would use their shares as an in-kind contribution into a new company. Since most of the new company's assets would be the shares of other companies, the company would be a holding company whose business would consist of investing in, governing and maintaining other companies under its control. The controlling shareholders would control the company.

Under method one, except for the fact that a company is created to govern a *chaebol* instead of individual shareholders, there are no material differences from a situation where the controlling shareholders govern the *chaebol*. Therefore, there have not been any cases where method one has been used for reorganization.

Under method two, a company within a *chaebol* whose corporate structure is most similar to that of a holding company would undergo a spin-off. The spun-out company (NewCo) would continue to carry on its pre-spin-off business and the parent company (HoldCo) would transfer most of its remaining business to NewCo. HoldCo would then be left with shares of other companies and securities.

Under Korean law, spin-offs are categorized into (i) vertical spin-offs, where HoldCo owns 100% of the shares of NewCo, and (ii) horizontal spin-offs, where HoldCo and NewCo have the same controlling shareholders. So far, only horizontal spin-offs have been used for reorganization purposes.

In this regard, a question may arise as to how HoldCo would control NewCo if they share the same controlling shareholders. It is in the process of finding an answer to this question that the means of strengthening the shareholders' position has been found; this solution constitutes the core know-how of the ongoing reorganization efforts by the *chaebol*.

The role of treasury shares in the process of reorganization

As explained above, because the only type of spin-off used in connection with establishing a holding company is a horizontal spin-off, in principle there cannot be a superior-subordinate relationship between HoldCo and NewCo. However, if a company which reorganized through a spin-off holds treasury shares, a the result is quite different.

If the company which reorganized through a spin-off (method two) holds treasury shares, during the spin-off process such treasury shares would be divided into shares of HoldCo and NewCo. Since both of these shares were created from the treasury shares of HoldCo, they would remain under the title of HoldCo. As a result, HoldCo would end up possessing NewCo shares proportional to the number of treasury shares it held prior to the spin-off, and consequently it would control NewCo to the extent of its shareholding.

As such, companies planning to reorganize into holding companies almost without exception possess substantial treasury shares. Although the *Korean Commercial Code* (KCC) had prohibited a company from holding its own shares because of the principle of capital adequacy, the *Securities Exchange Act* (SEA) provides an exception for listed companies, allowing them to possess treasury

shares within the scope of their disposable profits. The KCC also provides for an exception, allowing the acquisition of treasury shares through a merger with a subsidiary. Thus, a company is able to acquire treasury shares, and because of such shares, HoldCo, following a horizontal spin-off, is able to control NewCo to the extent of its holding ratio of treasury shares.

Tender offer with new shares as consideration

Procedures

As discussed above, HoldCo is able to control NewCo to the extent of its treasury-shareholding ratio. However, because the acquisition of treasury shares is an exception to the rule, no company would be able to acquire more than 20% of its total issued and outstanding shares. Yet, the *Monopoly Regulation and Fair Trade Act* (MRFTA) requires that a holding company hold at least 20% of the shares of its listed subsidiaries and at least 40% of the shares of its unlisted subsidiaries. These requirements must be satisfied within two years of undergoing a reorganization. As such, HoldCo would need to acquire additional NewCo shares within two years of the spin-off in order to meet shareholding thresholds under the MRFTA.

Here, HoldCo would be able to acquire additional NewCo shares through a tender offer with new shares as consideration. In other words, HoldCo would make a tender offer to the shareholders

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of NewCo for their NewCo shares, but instead of money, HoldCo would offer its new shares as consideration. The tender offer would need to follow relevant regulations under the SEA as well as KCC regulations regarding in-kind contribution since HoldCo would be making an in-kind investment into NewCo by offering new shares.

Strengthening control

When making a tender offer, taking into account the fact that there is no need to hold excessive NewCo shares but simply meet the 20% threshold (for listed companies), HoldCo would ordinarily aim for a shareholding of roughly 30% to 50% of its subsidiaries.

Among NewCo's shareholders, those who believe that the value of NewCo shares will go up would not accept the tender offer, and the likelihood of such refusal would increase the lower the Tender Offer price. At this point, all of the shareholders would accept the tender offer and use their NewCo shares (obtained from the spin-off) as an in-kind contribution to HoldCo and, in exchange, obtain HoldCo shares. As a result, HoldCo would be able to strengthen its control over NewCo by adding the NewCo shares obtained through the tender offer to its existing treasury shares. In addition, the shareholders would be able to substantially increase their shareholding in HoldCo by exchanging their NewCo shares for HoldCo shares. If HoldCo were to retire its treasury shares, the shareholders' control over HoldCo would be additionally strengthened.

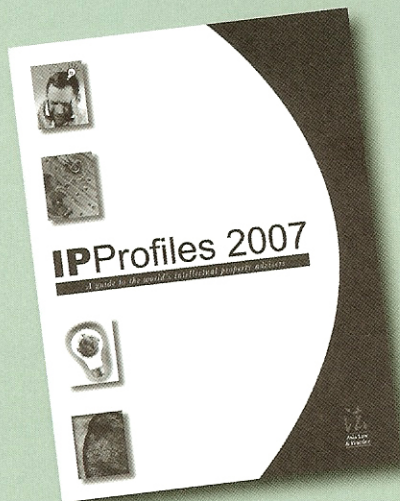
In practice, there have been several cases where the shareholders' control over a holding company increased at least two-fold through a split of treasury shares, in-kind contribution and share exchange through a tender offer and subsequent retirement of treasury shares. These benefits are proving to be incentives for *chaebols* to undergo reorganizations.

Conclusion

As discussed above, numerous *chaebol* have either undergone or are considering a reorganization because it would strengthen the shareholders' control over their respective companies. Because in the long run, transparency in corporate governance would increase substantially through a reorganization, the government has been encouraging such efforts, even though it may result in some distortion in corporate control. Further, it appears that a reorganization may help improve the corporate governance structure of Korean companies in the long run.

About the author

Sang Gon Kim is a partner in Lee & Ko's corporate practice. Kim received his LL.B from Seoul National University College of Law in 1992. He went on to attend the Judicial Research and Training Institute, Supreme Court of Korea, from 1992-1994 before receiving a LL.M from the University of Minnesota Law School in 2001. Kim is admitted to the Bar in Korea and New York. He speaks Korean and English.



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