

MERGERS AND ACQUISITIONS IN THE REPUBLIC OF KOREA

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Korea has traditionally had few mergers or acquisitions, and there has never been a single merger or acquisition by tender offer of a publicly listed company. The country nonetheless does have a set of rules and regulations that apply to tender offers as well as to other means of acquisition. This article will introduce Korea's legal and regulatory restrictions on share acquisition and ownership by domestic and foreign persons. Although the courts have the power to interpret those rules and regulations, they are in practice largely interpreted by the Securities and Exchange Commission ("SEC") in the course of application and enforcement.

Korea's relative lack of mergers and acquisitions has resulted from a combination of cultural aversion to the selling of a company, substantial government discretion to control the conduct of private companies, the vested interests of company founders and a general reluctance to permit foreign ownership of domestic businesses. In spite of such reluctance, by the end of 1994 certain legislative changes are expected to begin to change the existing situation. Among the highlights are the allowance for the first time of acquisition by a company of its shares as treasury stock effective in 1994, and the abolition of the rule limiting any single domestic (and foreign) shareholder to 10% of the shares of a listed company to be effective in 1997.

I. GENERAL RESTRICTIONS

The following provisions, applicable to both foreign and Korean shareholders, are significant to the subject of mergers and acquisitions in Korea.

A. Domestic Ten Percent Rule: This rule was created to encourage the public listing of privately owned companies by enabling pre-listing owners to retain and transfer control of listed companies. Under the domestic ten percent rule, no person may acquire beneficial ownership of ten percent or more of the shares of a listed company except for single blocks of shares that were a) owned by a single person at the time the company went public, b) acquired through a public tender offer, or c) otherwise acquired pursuant to SEC approval ("Exempt Blocks").

An Exempt Block may be transferred to another owner, who may in turn transfer it to a third owner. However, the transfer

of a portion of an Exempt Block has the effect of dividing it into two smaller Exempt Blocks. Any attempt to consolidate separate Exempt Blocks under the same ownership is fully subject to the domestic ten percent rule.

Virtually every listed Korean company is controlled by an Exempt Block of shares, usually retained by the original, pre-listing owner. Additionally, tender offers are effectively impossible because of various restrictions discussed further below. Therefore, control of a listed Korean corporation can only be acquired by acquiring a controlling Exempt Block of shares from a previous controlling shareholder through a private transaction.

Acquisition of shares in violation of the domestic ten percent rule will result in the loss of voting rights of shares exceeding the ten percent limit. Criminal penalties also exist.

Although the Domestic 10% Rule has been a clear roadblock to the possibility of a hostile takeover, the National Assembly has recently passed legislation which will abolish the Domestic 10% Rule as of January 1, 1997, as mentioned above.

However, in the case of a public company, defined to mean a company designated by the Ministry of Finance in which the government or government-invested company owns 30% or more of the equity, the articles of incorporation of such company may contain a restriction that no shareholder may own in excess of 3% of the shares, provided that a shareholder holding in excess of 10% of the shares at the time of SEC registration of the company may retain such shares. For companies adopting this rule, a hostile takeover is effectively precluded without regard to the abolition of the domestic 10% rule.

B. Treasury Stock Restrictions: Although Korean corporations, whether listed or not, are not presently permitted to buy back or to own their own shares except as a temporary step incident to a reduction of their paid-in capital or in other special situations, in connection with the abolition of the Domestic 10% Rule, the National Assembly has passed legislation effective January 1, 1994 which is intended to ease the restriction with the intent to aid in warding off hostile takeovers.

According to the new law, a listed corporation will be permitted to purchase in the stock market as treasury shares a percentage of outstanding voting shares as determined by Presidential Decree, but not to exceed 10% in any case. The percentage established by existing Presidential Decree would limit

the percentage to 5% of total outstanding shares. Furthermore, such purchases of treasury shares are subject to prior report to the SEC. Treasury shares to be acquired may only be paid for out of the amount which may legally be paid out as dividend by the acquiring corporation. The amount which may be legally paid out as dividend is to be determined by the SEC pursuant to a formula established under Presidential Decree. However, it is clear that a corporation which is in a negative profit position will not qualify for acquisition of treasury shares for such purpose.

Although the new law purports to discourage hostile takeovers, whether it will be effective for the purposes intended is unclear. The acquisition limits, both in terms of percentage of outstanding shares and the dividend equivalents available for funding an acquisition appear to limit its effectiveness. Moreover, since treasury shares are not entitled to vote under the Korean Commercial Code, such shares cannot be effective in regard to action by the general meeting of shareholders.

C. No Cross-Holdings: Where one ('parent') of any Korean corporation owns forty percent or more of the shares of a second ('subsidiary') corporation, the subsidiary cannot own any shares in the parent. Any contract to acquire shares in violation of this rule is null and void. Any shares held in violation of this rule are deemed not to have voting rights, and they must be promptly sold by the subsidiary. Where the parent owns ten percent or more but less than forty percent of the subsidiary, the subsidiary is permitted to own shares in the parent but is not permitted to exercise the voting rights of such shares.

In addition to the foregoing, a listed company is generally precluded from engaging in cross-shareholding by agreement with any other listed company, except where the shares held amount to less than 1% of the outstanding shares of a listed company.

D. Monopoly Regulation: Restrictions are provided on mergers, acquisitions and business combinations in restraint of trade, which apply to any company whose paid-in capital is at least one billion Korean won or whose net assets are at least five billion Korean won ("Subject Company"). The Subject Company must report to the Fair Trade Commission if it intends to acquire twenty percent or more of the shares in another company, or to merge with or acquire the business of another company. The Subject Company may not consummate the intended transaction until thirty days after it has filed such report. If the Commission finds that the proposed transaction may jeopardize competition, the Commission may

order the Subject Company not to consummate the transaction or to take any other corrective measures.

According to the Commission, in regard to regulation of horizontal business combinations, there are 3 factors to consider: (i) whether the difference in market share will be substantially increased after the merger; (ii) the status of competition in the market (e.g. how many competitors or practical barriers to new market entrants); and (iii) whether the transaction will create a market-dominating power. In regard to factor (iii) in particular, there are 4 cases of market-dominating power as follows:

- (1) either one of the companies involved or both companies together hold a market share ratio of 50% or more;
- (2) Even if a 50% or more market share ratio is not held under (a), if one of the companies or both together constitute the biggest player in the market, and there is a substantial difference in market ratio of the second and third players;
- (3) either one of the companies involved or both companies together constitute any of the first, second or third largest players by market ratio, and the market ratio of the largest three players, taken together, is 70% or more;
- (4) any other competitor except the companies involved is very small.

Corrective measures and administrative penalties as well as civil and criminal liability are prescribed for failure to file such a report or to follow an order of the Commission.

E. Holding Company Restriction: Also, no company may control other companies as its principal business or acquire or own shares in other companies where such shares have a book value exceeding fifty percent of the book value of the acquiring company, unless such control and acquisition or ownership is expressly approved. Although rare, such approval may be obtained for holding companies whose sole purpose to pool the shareholdings of domestic investors in Foreign-Invested Enterprises (discussed further below).

F. Disclosure: Since April 1, 1992, any person whose shareholding in a listed company (1) reaches or exceeds five

percent, or (2) rises or falls by one percent or more must report to the SEC within five days on the existence of and purpose of the transaction which caused the change in shareholding. As of January 1, 1994, related persons are treated as one person for the purposes of the disclosure requirement discussed above. The definition of related persons has been amended to include (i) in case of an individual, the lineal ascendants or lineal descendants of such individual, and (ii) in the case of a corporation, a natural or juridical person who owns at least 35% of the corporation or whose shares are at least 35% owned by such corporation. Furthermore, large group companies, as designated by the government pursuant to the Monopoly Regulation and Fair Trade Act, are automatically treated as related companies and therefore are subject to the disclosure requirements as well.

G. Insider Trading Restrictions on Large Shareholders: A person with ten percent or more of the shares of a listed company is considered an insider, and as such is subject to the following restrictions: (i) Short-Selling: Such person is prohibited from "short selling" of such company's shares; (ii) Short-term Trading: Any profits made by such person on any purchase and sale (or sale and purchase) of such company's shares within a period of six months must be transferred to such company. This rule was amended at the end of 1991 so that it applies regardless of whether any inside information was used in making the decision to buy or sell shares.

II. REGULATIONS AFFECTING TENDER OFFERS

Although there has not yet been an acquisition by tender offer, there are several established rules under the Securities and Exchange Act that would govern any tender offer. Matters not directly governed by the following rules are subject to the near-total discretion of the SEC.

A. Report to SEC: A report of any intended tender offer must be filed with the SEC ten days or more before shares can be purchased. Notice of the intended tender offer must be given to the target company when the report is filed with the SEC, so the target's management will have a minimum of ten days' advance warning before the offer is made to shareholders. The report must include terms and conditions of the offer to purchase shares, including the offer price and duration. The SEC may order changes to any term or condition.

B. Financing: The acquirer must attach to the report a certificate from a bank evidencing the existence of deposited funds

sufficient to complete the offered purchase of shares. This requirement has the effect of requiring that financing must be completed relatively early and makes it difficult to arrange a leveraged buyout.

C. Other Means of Share Purchase: As in most countries, during the tender offer period, the offering party may not purchase any shares through any method other than the tender offer.

D. Licensed Agent: The acquirer must designate a licensed Korean securities company as its agent for the transaction. Since, the licenses of such companies permit them to act as agents only for friendly tender offers, not hostile tender offers. It is practically impossible to acquire a company through a hostile tender offer.

E. No Mandatory Offer or Compulsory Acquisition: Korea has no rule which requires that an offer be extended to all the remaining shareholders after control is acquired by a private transaction or which empowers a successful public tender offerer or to acquire the shares of minority shareholders against their will.

III. REGULATIONS CONCERNING PROXY VOTING

Although no detailed regulations exist, if a proxy is requested pursuant to a general meeting of shareholders of a listed company, the proxy form should be delivered to the shareholder. The form should specify the way in which the voting right is to be exercised in regard to each agenda item listed. Additionally, reference documents explaining the relevant agenda item should be provided to the shareholder. A general proxy is therefore prohibited. The proxy should be reported to the SEC simultaneously with delivery to the shareholders.

IV. RESTRICTIONS APPLICABLE TO ACQUISITIONS BY FOREIGNERS

Acquisition of shares by foreigners is subject not only to the general restrictions described above but also to the following additional restrictions.

A. Open Market Purchase: At present any foreigner may purchase shares through the Korean Stock Exchange, without any prior approval or reporting requirement, subject to the following restrictions:

1. Registration: Any prospective purchaser must first register with the SEC and obtain an identification number, and use this number when buying or selling shares.

2. Three Percent Rule: Shareholding by any single foreign person in any Korean public corporation is limited to three percent of each class of issued shares. Affiliated foreign companies will be treated as separate and distinct foreign persons, provided they are independent legal entities which are not formed for the sole purpose of investing in Korean companies.

3. Foreign Ten Percent Rule: Combined shareholding by all foreign persons in any listed company is limited to ten percent of each class of issued shares. (This combined limit may be raised to twenty-five percent if special authorization is received from the SEC).

4. Minority Rights: Although many barriers exist to the acquisition of a controlling block of shares, minority shareholders are not completely excluded from management of Korean companies. The Korean Commercial Code does reserve certain rights to minority shareholders holding ten percent or, in some cases, even five percent of the total outstanding shares of a Korean company. For example, a shareholder holding ten percent of shares may, under certain circumstances, petition the court for reorganization or dissolution of the company. Shareholders holding five percent of shares have the right to inspect the books and accounts, demand the convening of a general meeting of shareholders and petition the court for cessation of illegal acts by, and removal of, directors of the company.

B. FCIA Investment: Foreign persons may acquire a controlling interest in listed or non-listed corporations subject to Ministry of Finance ("MOF") or other designated competent authority approval pursuant to the Foreign Capital Inducement Act ("FCIA"). Such an acquisition usually takes the form of a joint venture or creation of a wholly owned subsidiary. Acquisition by foreign persons of shares in a Korean company under FCIA ("FCIA Investment") causes such company to be treated as a Foreign-Invested Enterprise which is subject to several restrictions described below.

1. Engagement in Business: FCIA Investment is approved only when each foreign investor is or plans to be actively engaged in the business to be invested.

2. New Shares: The Ministry of Finance has generally

not permitted FCIA Investment by means of acquisition of outstanding shares already held by other shareholders in an existing company. Instead, the Ministry of Finance has generally required that such investment be made by means of subscription to new shares. This requirement effectively prevents a foreign investor from acquiring one hundred percent ownership of a pre-existing company. However, the Ministry of Finance has recently softened this restriction by allowing acquisition of existing shares in case of additional (not initial investment).

3. Prohibited Projects: The Ministry of Finance is not authorized to approve FCIA Investment in companies participating in projects in which foreign participation is prohibited. This prohibition applies to projects that are public in nature (including waterworks, sewage, postal or telegraph services, railways or mining), projects that cause harm to health, sanitation or the environment, projects that violate public policy (including gambling), or that are otherwise prescribed by Presidential Decree (including newspaper publishing, radio broadcasting and grain mill business).

4. Shareholdings by Foreign-Invested Enterprise:

(a) A Foreign-Invested Enterprise may not acquire any shares of other Korean companies without prior approval of the Ministry of Finance. Such approval will be granted only if the other company is a customer or supplier of, or otherwise has significant business relations with, the Foreign-Invested Enterprise.

(b) No Foreign-Invested Enterprise may acquire shareholdings in other Korean companies if the book value of such shareholdings exceeds forty percent of the value of the net assets of such Foreign-Invested Enterprise.

(c) The purchase of shares by any Foreign-Invested Enterprise in a listed Korean company is permitted only if such purchase does not exceed the limits of the three percent rule and the foreign ten percent rule discussed above.

C. Shareholdings in Land-Owning Companies: Foreigners, defined to include Korean companies owned fifty percent or more by foreigners, are generally prohibited from acquiring any ownership or leasehold interest in real property in Korea without the prior approval of the Ministry of Construction. Such approval is also required before any foreign acquisition of fifty percent or more of the shares of a Korean company that owns real property in Korea.

However, if the acquisition of land by a Foreign-Invested Enterprise is part of a project that has been previously approved by the Ministry of Finance pursuant to the FCIA, the necessary approval from the Ministry of should be obtained without difficulty in most cases.

D. Shareholdings in Restricted Industries: Special permission is also required for foreign acquisition of shares in a bank or an insurance or securities company.

V. TAXATION OF SHARE TRANSACTIONS

Tax treatment of proceeds from the sale of shares varies according to the status of the taxpayer and the shares.

A. Corporate Taxpayers: Gains from the sale of shares by a corporate shareholder are subject to the ordinary corporate tax.

B. Individual Taxpayers: Gains from the sale of shares in unlisted companies are taxed as capital gains. However, gains from the sale of shares in a listed company are generally exempt from taxes except where one person or a group of related persons sells fifty percent or more of the shares of a company and the value of real property holdings of such company amount to fifty percent or more of the entire value of such company.

C. Foreign Taxpayers: Foreign individuals and corporations that sell shares in listed or unlisted Korean companies are subject to certain Korean taxes. Subject to any applicable tax treaties, capital gains made by a non-resident without permanent establishment in Korea from the sale of shares of a Korean company to a non-resident (other than to their permanent establishments in Korea) is exempt from Korean tax unless the seller owned, together with the shares held by any entity which has a certain special relationship with such non-resident, 10 percent or more of the total issued and outstanding shares of the Korean company at any time during the five years before the year within which the transfer occurs or the seller sells such shares through a securities company in Korea.

VI. ACQUISITION BY ASSET PURCHASE

An alternative to share acquisition is to acquire the assets of a target company.

E. Shareholder Approval: The sale of substantially all the

assets of a listed or unlisted company must be approved by a shareholder's meeting of both the selling company and the buying company. Where a listed company is selling substantially all its assets, dissenting shareholders have the appraisal right.

F. Liabilities: Liabilities of the selling company will generally not pass with the assets with the following exceptions:

C. Tradenname: An asset buyer who continues to use the tradenname of the seller succeeds to the liabilities of the seller unless a judicial registration is made of the buyer's intent not to so succeed.

D. Taxes: The buyer of substantially all the assets of a company becomes secondarily liable for any corporate tax of the seller arising from the ordinary business of the seller.

E. Employee Obligations: The buyer of substantially all the assets of a company may succeed to such company's liabilities to its employees, such as severance payment obligations and other accrued rights. The law on this point is, however, unsettled.

F. Prior Approval for a Foreign-Invested Enterprise: Before acquiring the assets of another Korean company, a Foreign-Invested Enterprise must first obtain the approval of the Ministry of Finance.

VII. TRENDS

A variety of trends in the Korean economy are pushing the government towards reducing restrictions on mergers & acquisitions by Koreans and foreigners. These trends include growing interest in encouraging equity investment by foreigners and growing pressures to restructure industries in response to changing international conditions.

VIII. CONCLUSION

Despite the likelihood of continuing liberalization, there is little prospect that mergers and acquisitions by means of hostile tender offers will take place in the near future. The various restrictions on domestic and foreign shareholdings will continue to constitute an effective defense against any unwelcome takeover bid. In the mean time, with the approval of the Ministry of Finance, foreign investors can make direct investments, can acquire

the assets of Korean companies or can acquire large or controlling blocks of shares via private transactions. Continued liberalization of rules affecting company ownership can be expected to ease the approval process and increase the opportunities for domestic and international mergers and acquisitions.