South Korea

Financial Assistance

IBA Corporate and M&A Law Committee 2022

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INTRODUCTION

This guide sets out an overview of the regulations dealing with the concept of financial assistance in South Korea, primarily in the context of M&A transactions and with a particular focus on leveraged buyouts (LBOs). It also considers grants of credit under the Korean Commercial Code (KCC), the Monopoly Regulation and Fair Trade Act, and the Banking Act.

GENERAL OVERVIEW

Concept and types

An LBO is a type of share deal financing method where the purchase price to be paid by a buyer to acquire the shares in a target company (the target) is sourced from a third party by way of a loan (or otherwise) that is secured/guaranteed by the assets of the target (standard LBO).

In most cases in South Korea, a slightly modified financing structure is used as opposed to the traditional LBO method, whereby:

- the buyer establishes a special purpose vehicle (SPV);
- the SPV receives a loan from a third-party lender (or a lending syndicate) with a commitment to the lender that the SPV will merge into the target;
- the SPV purchases the shares in the target; and
- the SPV merges into the target.

Eventually, the loan will become a debt owed by the target (the so-called 'debt push down') to the third-party lender. As a result, the loan will be secured by the general/overall assets of the target. This is commonly referred to as a merger-type LBO.

In some LBOs, capital reduction of the target is used for financing, whereby:

- the buyer establishes an SPV;
- the SPV receives a loan from a third-party lender (or a lending syndicate) with a commitment to the lender that the target will undertake a capital reduction;
- the SPV purchases the shares in the target;
- the target carries out the capital reduction;
- the SPV is paid a certain amount of consideration resulting from the capital reduction of the target; and
- the SPV repays the loan to the third-party lender with the consideration received from the target in the course of the capital reduction.

This structure (a capital reduction-type LBO) can be understood as the assets (mostly cash) of the target being used for the funding of the purchase price to acquire the target.

Irrespective of the form undertaken, an LBO in South Korea carries the feature of financial assistance by the target to the buyer/acquirer (eg the SPV) in one way or another.

Enforceability

As the South Korean legal regime honors the principle of private autonomy, LBO financings (including the merger-type LBOs and the capital reduction-type LBOs) are contractually valid, effective and enforceable as long as the general contracts law requirements are met. In other words, there are no

direct mandatory rules in South Korea that prohibit an LBO financing from being carried out.

Court rulings

Although LBO financings are contractually enforceable, it must be noted that the directors of the target (and/or directors of the buyer/SPV as a joint principal offender) may be subject to criminal liability (and/or monetary damages to the target) upon breach of their fiduciary duties.

Standard LBOs

The authoritative case is the landmark 2006 *Shinhan* case (Supreme Court Case No. 2004-Do-7027, 9 November 2006) in which the Supreme Court upheld the conviction of the representative director (akin to a CEO in South Korea) of the target (as well as the head of the SPV as a joint principal offender) for criminal breach of fiduciary duty.

In *Shinhan*, immediately after the SPV acquired the majority of the shares in the target, the head of the SPV and the target's representative director conspired to collateralise and otherwise pledge most of the target's assets in favor of the SPV's lenders. The Supreme Court held that, in causing the target to pledge its assets without receiving adequate compensation from the SPV in exchange, the target's representative director acted in breach of his fiduciary duty owed to the target with the intention of realising pecuniary interest for a third party (the SPV), causing economic harm to the target. The decisive factor in the Supreme Court's ruling was the lack of adequate consideration or compensation from the SPV, which was interpreted to be risking the forfeiture of the target's assets in case the SPV defaulted on the loans. The question of what would be deemed 'adequate' enough to shield the LBO financing from criminal consequences was left unanswered.

Merger-type LBOs

The risk in these LBOs is apparent from the fact that the debts and liabilities of the SPV are effectively pushed down to the target through the merger. The target therefore will be left with a substantial increase in debt post-merger.

The notable court precedent on point is the Busan District Court's decision in the 2009 *Tong Yang* case (Busan District Court Case No. 2009-Gohap-482; 2008-Gohap-516 (consolidated); 2008-Gohap-656 (consolidated), 10 February 2009). It was the first ruling on criminal liability of directors in a merger-type LBO; the Busan District Court's decision was upheld by the Busan High Court (Case No. 2009-No-184) and ultimately by the Supreme Court (Case No. 2009-Do-6634).

In *Tong Yang*, the Court rejected charges of breach of director's fiduciary duty in an LBO using a two-stage merger between the target, the acquiring vehicle (the SPV) and a large parent holding company (Tong Yang Major Corp or Holdco), whereby the SPV's acquisition loans were pushed down to the target level and repaid with the target's cash. In this case, the Court denied the criminal breach of fiduciary duty of the target's directors. In refuting the prosecutor's reference to the *Shinhan* case, the Court:

- observed that the prosecutor inferred 'criminal intent' solely from the ultimate economic effects of the merger (ie, shifting loan repayment obligations to the target);
- determined that, by doing so, the prosecutor neglected to acknowledge that South Korean legislation has institutionalised a merger; and
- held that a merger should be recognised as legitimate so long as the procedural requirements provided in the KCC (such as dissenting shareholders' appraisal rights and creditors protection procedure) are satisfied.

As a general principle, a determination as to what constitutes a director's breach of fiduciary duty in the context of a merger-type LBO should essentially be based on an assessment of the satisfaction of the procedural requirements for a merger under the KCC; evaluation of the economic harm resulting from the merger plays a minimal role. In *Tong Yang*, in fact, the prosecutor could not even demonstrate the economic harm on the target resulting from the merger.

Since the landmark *Tong Yang* case, there have been conflicting court rulings on the conviction of the representative director of the target for breach of fiduciary duty in the context of a merger-type LBO. Notably, the *Hi-mart* case is currently pending before the Supreme Court (Seoul High Court Case No. 2020-No-1872) on this issue, and the final and non-appealable determination has not yet been rendered. it is noted that, although *Hi-mart* involves the merger-type LBO, the factual backgrounds of the transaction thereunder deviate from the pure merger-type LBO which the *Tong Yang* case falls under. In the Hi-mart case:

1. the buyer established an SPV;
2. the SPV received a loan from a third-party lender with a commitment to the lender that the SPV would merge into the target;
3. the target also borrowed money from the lender for the purpose of refinancing its own debts owed to other financial institutions and established, for the benefit of the lender, a 'comprehensive mortgage' (a so-called *keun*-mortgage) on its real properties to secure its obligations to repay its own borrowing from the lender;
4. the SPV purchased the shares in the target; and
5. the SPV merged into the target.

Eventually, the loan owed by the SPV to the lender under item (2) above will become a debt owed by the target to the lender. As a result, such loan will be secured by:

- the general/overall assets of the target; and
- the comprehensive mortgage established on the target's real properties.

Under South Korean law, the comprehensive mortgage secures 'any and all' obligations of the debtor toward a specific creditor. *Hi-mart* is different from a pure merger-type LBO in terms of the italicised items above, which are the core components of the standard LBO. Thus, *Hi-mart* can be categorised as a hybrid LBO involving both the standard LBO and the merger-type LBO. The Seoul High Court decision that the target's representative director breached its fiduciary duty seems to have focused more on the aspect of the standard LBO in *Hi-mart*.

Capital reduction-type LBOs
In the *Daesun Jujo* case, the Supreme Court ruled that the capital reduction-type LBO in this case would not constitute the target directors' breach of fiduciary duty so long as the procedural requirements (including the creditors' protection procedure) of the capital reduction under the KCC are met. The Court reasoned that the South Korean legislation has institutionalised the capital reduction (Supreme Court Case No. 2011-Do-524). The Supreme Court's ruling and grounds are similar to those in the aforementioned *Tong Yang* case.

Procedural requirements and mitigating factors
As discussed above, South Korean regulations and court precedents do not unilaterally approve or disapprove of financial assistance in the M&A or LBO context, but instead determine on a case-by-case basis as to whether the target's director has breached their fiduciary duty during an LBO.

A series of court decisions implies that an LBO involving a statutory corporate action (such as a merger or capital reduction) would not likely cause the target directors' breach of their fiduciary duties, insofar as the relevant statutory requirements for such corporate action under applicable laws (including the KCC) are fully complied with and satisfied.

In other words, an LBO which constitutes, or contains the key components of, the standard LBO may result in the target directors' breach of fiduciary duties, as the standard LBO does not involve any procedural measures (ie, statutory requirements) to protect the target, its shareholders and/or its creditors.

In contemplating an LBO financing, a potential buyer may need to create and design a structure

involving a corporate action that requires statutory protective measures for the target, its shareholders and/or its creditors, to mitigate the risk of the target's directors being charged with breach of fiduciary duty.

OTHER RELATED MATTERS

General Rule for Grant of Credit under the KCC
The concept of financial assistance is not defined under the KCC. Instead, it provides for the 'grant of credit' which is defined as:

> 'the leasing of property (including money) with economic value, guarantees for the performance of obligations, purchase of securities intended for supporting funds, or other direct or indirect transactions determined by Presidential Decree accompanying credit risks on the transactions' (KCC Article 542-9(1)).

Also, Article 35(1) of the Presidential Decree of the KCC supplements that the following constitute a grant of credit:

- provision of an asset as security;
- endorsement of a promissory note;
- a commitment to make an investment;
- a transaction falling under any item of Article 38(1), paragraph 4 of the Enforcement Decree of the Financial Investment Services and Capital Markets Act, the purpose of which is to avoid restrictions on grant of credit to the persons listed in Article 542-9(1) of the KCC; and
- a transaction falling under Article 38(1), paragraph 5 of the Enforcement Decree of the Financial Investment Services and Capital Markets Act.

While the KCC provides for certain regulations and restrictions on the grant of credit by a listed public company, no such regulations exist for private companies. However, if a private company grants credit to a third party (including its affiliates) on terms and conditions unfavourable to the company, the directors of the company may be subject to criminal penalties or damage compensation to the company due to breach of their fiduciary duties.

For a public company listed on the Korea Exchange:

- There are no particular regulations/restrictions applicable if a listed public company grants credit to an independent third party. In the event such grant of credit is made on terms and conditions unfavourable to the public company, the directors of the public company may be subject to criminal penalties or damage compensation due to breach of their fiduciary duties.
- A listed public company is prohibited from granting credit to its affiliates, except in the event of
  - business necessity;
  - approval of the board directors; and
  - the beneficiary affiliate's majority shareholder being a company (not an individual).

Regulations under the Monopoly Regulation and Fair Trade Act
The Monopoly Regulation and Fair Trade Act **(**MRFTA) is also relevant to financial assistance, specifically from an antitrust law perspective.

MRFTA stipulates that a domestic Korean company within an 'intercompany contribution-restricted group' may not provide a guarantee for the repayment of the loans provided by a domestic financial institution to its affiliates within such group for the benefit of such affiliates. A group whose aggregate assets is KRW 10tn or more is designated as an 'intercompany contribution-restricted group' by the Korea Fair Trade Commission (KFTC). Two notable points on this restriction are:

- this restriction applies only if all parties involved (ie, the guarantor, obligor and creditor) are domestic entities; and
- this restriction applies only to the guarantee to repay the loans provided by the financial institution. It does not apply to the guarantee for the loans provided by a non-financial institution third party.

To circumvent this restriction in practice, a so-called ‘contract for supplementing funds’ is commonly used. This sees the domestic company make a commitment to the financial institution extending the loan to an affiliate of the company; if the affiliate falls short of cash to repay the loan, the company will contribute a capital amount or lend money to the affiliate, and have the affiliate repay the loan by using the contributed capital amount or borrowed money. Ultimately, this arrangement has the same effect as a guarantee. Nonetheless, the KFTC does not consider such arrangements as a violation of the MRFTA.

Regulations under the Banking Act
With respect to a bank extending credit or a loan to a third party (including its customers), it is worthwhile to note that, under Articles 35, 35–2 and 35–3 of the Banking Act, a bank may not:

- extend credit/loans exceeding 25 per cent of the bank's equity capital to the same individual or corporation;
- extend credit/loans to its large shareholder (or its affiliate) in excess of 25 per cent of the bank's equity capital, or an amount equivalent to the ratio of any contribution by such large shareholder to such bank, whichever is less; or
- acquire shares in its large shareholder (or its affiliate) in excess of 1 per cent of the bank's equity capital.