CORPORATE GOVERNANCE IN KOREA AT THE MILLENNIUM: ENHANCING INTERNATIONAL COMPETITIVENESS*

FINAL REPORT AND LEGAL REFORM RECOMMENDATIONS

to the Ministry of Justice of the Republic of Korea
15 May 2000

With an Introduction to the Report by
Bernard Black**

Abstract

The core of this article is our May 2000 Report to the Ministry of Justice of the Republic of Korea. The Report reviews South Korea's corporate governance system and recommends legal reforms to improve Korean corporate governance and protect against a repeat of Korea's governance-related financial crisis of 1997-1998. The Report's principal recommendations include enhancing the role of public company boards of directors, strengthening independent director and non-interested shareholder review of related party transactions, and requiring cumulative voting and preemptive rights for public companies. The Introduction by Bernard Black that precedes the Report discusses the ongoing transition in Korean corporate governance, and the political and economic forces behind that transition.

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* This Report can be downloaded without charge from http://papers.ssrn.com/paper.taf?abstract_id=222491 (Social Science Research Network).

** The introduction prepared by Professor Black is not part of the Report to the Ministry of Justice. The Report represents the views of the consultants to the Ministry and does not necessarily represent the views of the Ministry of Justice or the World Bank.

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INTRODUCTION *(by Bernard Black)*: KOREAN CORPORATE GOVERNANCE IN TRANSITION

The Report that follows this Introduction was prepared for the Ministry of Justice of South Korea as part of a World Bank funded project. It describes the current state of Korean corporate governance and recommends various reforms, principally through amendments to the Korean Commercial Code, which contains the Korean company law. The Report's proposals would bring Korea's company law up to world-class corporate governance standards. If fully adopted (which isn't politically likely), they would put Korea ahead, in many respects, of Japan and many Western European countries.

The Report focuses on company law. This is *not* because we believe that the company law should be a principal focus of Korea's corporate governance reform efforts. Our focus on company law reflects instead the practical reality that our "client" was the Ministry of Justice. The Ministry of Justice can propose changes to the Commercial Code, but *not* to the Securities Law (which is within the domain of the Korean Ministry of Finance and Economy), the antitrust rules, or the accounting rules. Bureaucratic turf issues like these complicate capital market reform efforts in Korea and many other countries.

Korean Corporate Governance and the Asian Financial Crisis

It's useful to put the current state of Korean corporate governance in the broader context of Korea's decades-long transition from a poor, agricultural economy to a major developed nation. In 1960, Korea was a third-world country, with per capita Gross Domestic Product (GDP) under $100. Today, it is the world's eleventh largest economy and seventh largest exporter, with per capita GDP over $10,000. Its major firms compete at world-class levels in a number of important industries, including automobiles, construction, consumer electronics, and semiconductors. Many Korean brands are household names in the United States, including Hyundai, Lucky, Goldstar, and Samsung.

Korea's political environment has also changed radically, and peacefully. In 1960, Korea was a military dictatorship. Today, it's a democracy, led by a President who was a leading dissident during the dictatorship period.

To get this far, this fast, Korea had to do many things right. Indeed, there is no more striking example of how government policies can affect economic development than the contrast between South Korea and North Korea. While South Korea flourished, North

*** The Annexes are not published with this Report, but are available on request from the authors.

Korea floundered under Communist dictatorship, and today is desperately poor, with widespread starvation during the past decade.

In corporate governance, Korea again did many things right. Its company law and securities law, after major overhauls of both laws in 1995-1996, and important incremental changes since then, provide near-world-class investor protection. Korea has a thriving stock market—both a major company market in the Korean Stock Exchange, and a small company market in KOSDAQ (a dealer-to-dealer market patterned on NASDAQ). Its government is gradually relaxing its control over the major banks, which were once state-owned, and until recently were strongly state-influenced. Its accounting rules have improved greatly in the last few years. Its regulators and judges are honest (though its politicians are not yet consistently so). Its regulators and judges are also reasonably competent, though many judges are inexperienced in commercial and securities cases. Its business lawyers, accountants, and investment bankers are rapidly improving. The best of them are very good and often Western-trained. Most insiders of large firms are reasonably honest. Self-dealing within corporate groups is widespread, but is intended more often to expand the group's economic and political influence, or shore up weak group members, than to line the controlling family's pockets.

And yet, the corporate governance structures and institutions that sustained Korea's growth for 40 years failed severely in the 1997-1998 Asian financial crisis. They do not yet allow Korean firms to become fully world-class competitors, able to achieve world scale by partnering with, and when appropriate buying, companies formed in other countries. Since the crisis, Korea's growth has been haphazard. Japan's stagnation in the 1990s, after decades of rapid growth, shows how a system that works under one set of economic conditions can fail miserably under different conditions.

Investors still distrust Korean controlling shareholders. One measure of this distrust is the premium that investors give to high-vote shares in Korean companies (owned mostly by the controlling shareholders), relative to low vote shares. Tatiana Nenova estimates that, in 1997, the voting rights conveyed by Korean high-vote shares were worth 29% of the total value of the firm. The high value of voting rights (the comparable United States value is 2%) suggests that investors discount Korean share prices to reflect self-dealing risk.[1]

Korea's growth was spurred by the growth of large conglomerate groups, called *chaebol*, each run by an autocratic founding chairman. The *chaebol* competed furiously with each other and entered wildly disparate businesses. Their growth was fueled by government-provided loans and later, after banks were privatized, government-directed loans from major banks. The *chaebol*, assured of cheap bank financing, developed debt-heavy capital structures. A 5:1 debt-equity ratio was typical. Korean company law prohibited formal holding company structures, so the *chaebol* developed as complex networks of cross-owned firms. The cross ownership ensured control by the founding chairman's family, even though the founding family's economic stake in the major group companies declined as the group grew, often down to 10% or so.[2]

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1. *See* Tatiana Nenova, *The Value of Corporate Votes and Control Benefits: A Cross-Country Analysis* (working paper 2000), *available at* http://papers.ssrn.com/paper.taf?abstract_id=237809 (Social Science Research Network).

2. For overviews of *chaebol* corporate governance practices, see Hwa-Jin Kim, *Living with the IMF: A New Approach to Corporate Governance and Regulation of Financial Institutions in Korea*, 17 BERKELEY J.

The chaebols' high debt-equity ratios made them vulnerable to economic downturns. But Korea hadn't had a major downturn for so long that no one worried much about that risk. The *chaebol* chairmen borrowed all they could, expanded as fast as they could, and lobbied for still more loans. And why not, when this strategy had brought them great wealth and prestige, and brought their country fabulous economic success?[3]

The chaebol, however, weren't especially profitable. During the 1990s, only about a third of Korean *chaebol* earned a market rate of return on invested capital.[4] The major *chaebol* typically had Tobin's q's below 1, indicating that they were turning a dollar of capital into less than a dollar of earning power.[5] Earning a below-market rate of return on invested capital is a recipe for long-run trouble, even if lenders will lend you more money in the near term.

Low profitability meant that the *chaebol* had to finance expansion with debt, rather than earnings (which they didn't have much of), or new equity offerings (which would have further diluted the controlling family's stake). As the *chaebols'* capital demands outstripped domestic capital supply (despite an enviable national savings rate), Korean banks and *chaebol* turned to foreign capital, which was readily available because everyone assumed that the government wouldn't let major banks or major *chaebol* fail. The Korean banks borrowed in foreign currency, converted the proceeds to Korean won, and relent the proceeds to the *chaebol*. Some *chaebol* also borrowed directly in foreign currency. Most of these currency exposures weren't hedged. That left the banks, and *chaebol* with foreign currency borrowings, vulnerable to a drop in the government-managed exchange rate. But no one worried much about that risk either. Korea had a large trade surplus, strong central bank reserves (so it was believed), and hadn't experienced a sharp devaluation since economic takeoff had begun. Signs that the won might be overvalued were disregarded.

The 1997-1998 Asian financial crisis exposed the weakness in these interrelated assumptions. The Korean won collapsed, and would have dropped even further but for an IMF bailout. The major banks became insolvent. Eight large *chaebol* went bankrupt in 1997 alone. One of the five huge first-tier *chaebol*, Daewoo, saw the crisis as an opportunity to expand and borrowed heavily to do so, before collapsing in 1999, thoroughly bankrupt. Daewoo alone had about $80 billion in debts, for which creditors are likely to receive back around fifty cents on the dollar.[6] To get a sense for the scale of the Daewoo collapse, relative to Korean GDP, imagine a U.S. company going bankrupt with debts of $1.6 trillion dollars, and creditor losses of $800 billion! No American bankruptcy on a remotely similar scale has ever occurred. A second "big five" *chaebol*, Hyundai, is also insolvent and is being dismembered.[7]

INT'L L. 61 (1999); YONG-DOO CHO, CORPORATE GOVERNANCE IN KOREA: ISSUES AND OPTIONS (1999) (report to the Asian Development Bank, on file with authors).

3. Curtis Milhaupt, *Property Rights in Firms*, 84 VA. L. REV. 1145 (1998), argues that *chaebol* size could be partly an endogenous response to a strong central government. The *chaebol* had an incentive to grow large enough to develop their own countervailing political clout.

4. *See* Yen Kyun Wang, *Corporate Governance and Finance* (Nov. 18, 1999) (unpublished manuscript, on file with authors).

5. *See* Kwang S. Chung, *Corporate Governance Reform in Korea* (1999) (unpublished manuscript, on file with authors). Tobin's q is a measure of the market value of a company's assets to their replacement value.

6. *See, e.g.*, Don Kirk, *For Daewoo's Founder, Pride Before the Fall*, N.Y. TIMES, Feb. 23, 2001, at W1.

7. *See, e.g.*, Michael Schuman & Hae Won Choi, *Dispute May Hasten Hyundai's Breakup*, WALL ST. J.,

The financial crisis exposed oversight weaknesses that hadn't seemed to matter as long as growth let the *chaebol* cover their sometimes poor management decisions. In hindsight, the *chaebols'* management weaknesses also likely grew over time as they continued to diversify, Korea lost its labor cost advantage over other Asian countries, and the *chaebol* chairmen aged and perhaps lost some of their energy and acuity. Perhaps too, the crisis was made more severe because accounting rules required neither consolidated accounting nor disclosure of intra-group guarantees, which many *chaebol* used to prop up weak group companies. The *chaebol* groups' true debts, and thus financial fragility, were hidden from everyone, including their creditors.[8]

Prospects for Reform

The 1997-1998 economic collapse has not persuaded the surviving *chaebol* chairmen that there is anything awry in Korean corporate governance. The *chaebol* consistently oppose legal reforms designed to increase accounting transparency. They oppose proposals to require a minimum number of outside directors and increase board oversight of management decisions, as impediments to the rapid, autocratic decision making that they now enjoy. Least of all do the *chaebol* want self-dealing rules that might stop them from selling shares (or convertible bonds) cheaply to family members to maintain family control, or shuffling money among group companies to subsidize losers and hide from outsiders which companies are profitable and which are not.

The *chaebol*, through their lobbying arm, the Federation of Korean Industries (FKI), have publicly stated that there isn't a single proposal in our entire Report that should be adopted. They believe that corporate governance reform has gone too far already, and market forces can address any corporate governance problems that some outsiders might think exist. Lest readers think that I am offering a caricature, here's an excerpt from a *Korea Herald* story on the FKI response to our Report:

> **Chaebol call for an end to state meddling in corporate governance**
>
> The Federation of Korean Industries yesterday called for a hands-off chaebol policy, denouncing the government's latest attempt to overhaul the family-controlled governance structures at leading conglomerates. Leading tycoons issued a joint statement after attending the monthly FKI chairmen's meeting in a golf club outside Seoul, urging government officials not to interfere in private firms' governance structures and other internal affairs.
>
> "Excessive state interference in the management of private companies are not desirable," said the statement. "Instead of direct interventions, the government is required to pursue market-friendly reforms . . ." it said, making clear the chaebol's intention to fight to maintain their current governance structures.[9]

July, 27, 2000, at A17.

8. *See* Joon-Ho Hahm & Frederic S. Mishkin, *The Korean Financial Crisis: An Asymmetric Information Perspective*, 1 EMERGING MARKETS REV. 21 (2000); Michael Schuman, *Big Korean Firms Sicker than Thought*, WALL ST. J., Aug. 2, 2000, at A18 (new consolidated accounting rules cause upward revisions in the *chaebols'* reported debt/equity ratios).

9. Yoo Cheong-mo, *Chaebol Call for an End to State Meddling in Corporate Governance*, KOREA

Chaebol opposition to our reform proposals is the bad news, however predictable. The good news is that Korea hasn't wasted the reform opportunity created by the financial crisis and the *chaebol*'s business reverses. Much reform in both law and business practices has already occurred despite *chaebol* resistance.[10] One big change: Lenders no longer assume that the government will bail them out if a major bank or *chaebol* group fails. More reform is possible. Indeed, early indications are that at least some of our recommendations are likely to be adopted.[11] Korea has also recently developed a serious shareholder advocacy organization, the People's Solidarity for Participatory Democracy (PSPD), which has filed a number of lawsuits, submitted shareholder proposals, and nominated outside directors to major *chaebol* companies. The PSPD also provides public support for further governance reforms, including many of the reforms we propose.[12]

Importantly, when Korean rules change, they mostly change in sensible and meaningful ways. This contrasts with Japan, which has only tinkered with its corporate governance practices, despite its decade-long economic stagnation. Both countries, for example, long required public companies to appoint a "statutory auditor"—a company employee who is supposed to scrutinize the company's books. The statutory auditor's efforts add little to those of the outside auditors—no surprise, since the outside auditors have greater expertise and far greater resources. The Japanese concluded that if one statutory auditor wasn't useful, three of them might be. Outside observers could only wonder why three ineffectual auditors would be better than one. Korea replaced the statutory auditor for its major companies with an audit committee of the board of directors, composed primarily of outside directors. To American eyes, this is a far more useful institution.

It's also promising that Korea has, mostly since the crisis, developed a vibrant venture capital industry.[13] That industry remains vulnerable to a stock market collapse,

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HERALD, Apr. 21, 2000, *available at* 2000 WL 3276470; *see also* Cho Young-sam, *Chaebol Counter Corporate Governance Reform Proposal*, KOREA HERALD, Aug. 7, 2000, *available at* 2000 WL 21234060 (FKI to submit its own reform proposal in response to the proposal in our Report; "FKI officials said the [Ministry of Justice] proposal, if enacted would suffocate companies' ability to compete in the global environment"); *The Chaebol Spurn Change*, ECONOMIST, July 22, 2000, at 59.

10. We discuss recent Korean corporate governance reforms in the Introduction to our Report, *infra*. *See also* Joongi Kim, *Recent Amendments to the Korean Commercial Code and Their Effects on International Competition*, 21 U. PA. J. INT'L ECON. L. 273 (2000). On informal changes in practices, see CORPORATE GOVERNANCE COMMITTEE (KOREA), CODE OF BEST PRACTICE FOR CORPORATE GOVERNANCE (Sept. 1999), *available at* http://papers.ssrn.com/paper.taf?abstract_id=192170 (Social Science Research Network); Hwa-Jin Kim, *Taking International Soft Law Seriously: Its Implications for Global Convergence in Corporate Governance* 1 J. KOREAN L. 1 (2001).

11. *See* Press Release, Korean Ministry of Finance and Economy, Financial Policy Bureau, Securities Policy Division, Corporate Governance Improvement Plan for Transparent Business Management (Oct. 27, 2000) (describing proposed revisions to the Korean Securities and Exchange Act); Cho Young-sam, *Seoul Decides to Phase in Class-Action Suit System*, KOREA HERALD, Oct. 28, 2000; *available at* 2000 WL 27394473. Cho Young-sam, *Activist Group Moving to Legislate Cumulative Voting, Class-Action Suits*, KOREA HERALD, Oct. 17, 2000, *available at* 2000 WL 27394157.

12. *See generally* Jooyoung Kim & Joongi Kim, *Shareholder Activism in Korea: A Review of How PSPD Has Used Legal Measures to Strengthen Korean Corporate Governance*, 1 J. KOREAN L. 51 (2001).

13. *See Entrepreneurial Fresh Air: South Korea's New Entrepreneurs: Financial and Industrial Turmoil is Leading to a Big Shake-up in South Korea's Corporate Culture*, ECONOMIST, Jan. 13, 2001, at 60.

but ranks, on a per capita basis, with other leading centers of innovation, including the United States, Israel, and Taiwan. Here too, the Korean government has resisted the temptation to do too much. Instead of funding particular startup companies, as some other countries have, it has provided rather modest tax breaks to venture capital-financed companies, and a real estate tax abatement designed to encourage clustering of venture capital-financed firms.[14]

That boldness and economic vibrancy gives reason for confidence that Korean corporate governance will continue to improve over time, and perhaps that significant portions of our Report will find their way into Korean law or practice. I'm among those who believe that the era of *chaebol* dominance is ending, and that venture capital-financed startups will form an important part of Korea's future.

The Philosophy Behind our Report

I will close this Introduction with a brief comment on the philosophy behind our recommendations. We believe strongly that reforms must fit within a country's existing laws and institutions. They cannot just be airlifted in from outside. That approach is often tried and rarely succeeds. Thus, it was important that our team included both a respected Korean law firm (Shin & Kim) and a Western lawyer with several decades of experience in Korea (Timothy O'Brien), as well as lead drafters (Barry Metzger and Bernard Black) with extensive experience in corporate governance reform in other countries.[15] We thus brought to our task significant knowledge about and respect for the corporate governance practices of many countries, not just our home country (the United States).

At the same time, we believe that many of the core problems of corporate governance are universal, and that the range of reasonable solutions is finite.[16] We believe that Korea's corporate governance, already not bad, can be improved further through incremental legal intervention. Conversely, we don't believe that Korea's supposedly autocratic, Confucian culture will simply shrug off measured efforts to

14. *See* Haksoo Ko & Hyun Young Shin, *Venture Capital in Korea? Special Law to Promote Venture Capital Companies*, 15 AM. U. INT'L L. REV. 457 (1999). For an argument that this sort of indirect support of venture capital is more promising than direct support, see THEODORE BAUMS & RONALD J. GILSON, THE LEGAL INFRASTRUCTURE OF THE GERMAN VENTURE CAPITAL MARKET: BARRIERS TO REPLICATING THE U.S. TEMPLATE (Working Paper 1999).

15. Barry Metzger was general counsel of the Asian Development Bank from 1994-1998. Bernard Black has provided company and securities law reform advice in Armenia, Brazil, Indonesia, Mongolia, Russia, Ukraine, and Vietnam, and done comparative research in Britain and the Czech Republic. *See* Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997 (1994); Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911 (1996); Bernard Black, Reinier Kraakman & Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731 (2000); Bernard Black, *Strengthening Brazil's Securities Markets*, REVISTA DE DIREITO MERCANTIL, ECONOMICO E FINANCIERO [J. COMMERCIAL, ECON. & FIN. L.] (forthcoming 2001), *available at* http://papers.ssrn.com/paper.taf?abstract_id=247673 (Social Science Research Network).

16. This theme is developed in Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001).

control self-dealing and improve oversight of corporate managers.[17] Even Confucian managers respond to incentives.

17. For such an argument, see Craig P. Ehrlich & Dae-seob Kang, *Corporate Governance Reform in Korea: A Description of Legal Changes and Suggestions for Empirical Research* 22-26 (1999) (unpublished manuscript, on file with authors). *See also* Douglas M. Branson, *The Very Uncertain Prospect of "Global" Convergence in Corporate Governance* 34 CORNELL INT'L L.J. (forthcoming 2001), *available at* http://papers.ssrn.com/paper.taf?abstract_id=244742 (Social Science Research Network) (arguing that cultural factors will sharply limit the extent of global convergence toward common corporate governance practices).

FINAL REPORT AND LEGAL REFORM RECOMMENDATIONS
to the Ministry of Justice of the Republic of Korea

INTRODUCTION TO THE REPORT

The Corporate Governance Reform Project

This is the Final Report and Legal Reform Recommendations on Corporate Governance in the Republic of Korea. This Report is being delivered to the Ministry of Justice of the Republic of Korea by the Consultants under the Financial and Corporate Restructuring Assistance Project, undertaken with assistance from the International Bank for Reconstruction and Development of the World Bank Group. The Terms of Reference for the Project are set forth in Annex *A*.*

In every country, effective corporate governance depends on a combination of regulations and market institutions. Pursuant to the Terms of Reference, this Report is devoted primarily to recommendations for reforms to Korean laws and regulations. In preparing our recommendations, we were closely attentive to the need for balance between reliance on formal rules and reliance on market institutions and market forces, and the extent to which appropriate legal rules can foster the development of supporting market institutions. Experience teaches that unregulated securities markets do not function at all. At the same time, over-regulated securities markets can make it too difficult and costly for companies to raise capital. The challenge is to find an appropriate balance between the two.

The Consultants are members of a consortium of international and domestic consultants assembled for the Project, consisting of Mr. Barry Metzger and Mr. Timothy J. O'Brien of the Coudert Brothers international law firm, Dr. Shin Young Moo of the Korean law firm of Shin & Kim, Professor Bernard S. Black of Stanford Law School, and the International Development Law Institute (IDLI). The Consultants were assisted by Professors Park Kiljun and Hong Bok Ki of the College of Law at Yonsei University, by Mr. Song Woong Soon of Shin & Kim and by other partners and associates of the Coudert Brothers and Shin & Kim law firms.

The Consultants have undertaken over the past six months extensive research and consultation on the current state of corporate governance in Korea, the corporate governance reforms initiated by the government and the private sector during the past two years in response to the Asian financial crisis, experience with these reform initiatives to date, further reforms currently under consideration, and experience in other countries dealing with similar issues.

In addition to consultations with the Ministry of Justice, other government agencies and private sector experts, the Consultants convened Roundtable Meetings in Seoul in

* The Annexes to the Report are available from the authors.

September and October 1999. These Roundtable Meetings brought together business executives, bankers, lawyers from private practice, academics from law schools, business schools and economics faculties, civic group representatives and government officials. The Roundtable Meeting discussions solicited participants' views on the current state of corporate governance in Korea, Korea's experience with earlier reform initiatives, and additional measures which might be undertaken.

The Consultants' interviews and meetings and the discussions at the Roundtable Meetings are more fully described in the Consultants' *Inception Report* dated 6 September 1999, their *First Interim Progress Report* dated 12 October 1999, their *Second Interim Progress Report* dated 12 November 1999 and their *Draft Report and Recommendations* dated 5 December 1999.

The Consultants' Draft Report and Recommendations were considered at a Workshop in Seoul on 15-16 December 1999, which brought together Korean experts on corporate governance and representatives of the legal, business and academic communities. A portion of the Workshop also was open to participation by the public and the press. On the basis of discussions at the Seoul Workshop, further consultations with the Ministry of Justice and comments from the business community,[1] the Draft Report and Recommendations was revised and this Final Report and Legal Reform Recommendations prepared for submission to the Ministry of Justice.

Certain of the Recommendations contained in the Draft Report and Recommendations have already been the subject of legislation adopted by the National Assembly and action taken by various regulatory agencies.

In addition to preparing this Report, the Consultants conducted two training workshops on Modern Corporate Governance Practices in Seoul during February 2000. The Consultants also designed a year-long overseas corporate governance training program at Stanford Law School for selected Ministry of Justice personnel, which commenced in January 2000.

Thus, this Final Report and Legal Reform Recommendations is the product of a broad and open consultative process which has provided the legal, business and academic communities numerous opportunities to convey to the Consultants their views on corporate governance reform in Korea and their views on the Consultants' recommendations. Among the subjects receiving most attention in those consultations were: (i) the role of the Board of Directors in Korean corporations and, in particular, the role of independent directors, (ii) the problem of intra-group transactions and the potential use of holding companies, and (iii) the respective roles of Government regulation, shareholder litigation and market forces in enforcing corporate governance protections.

The Need for Further Legal Reform

"Corporate governance" in Korea and elsewhere is a broad term that encompasses rules and market practices which determine how companies, especially listed companies, make decisions, the transparency of their decision-making processes, the accountability

1. Written submissions commenting on the Draft Report and Recommendations were received from the Federation of Korean Industries, the Korean Chamber of Commerce and Industry, the Korea Listed Companies Association and the Korea Association of Small and Medium Business.

of their directors, managers and employees, the information they disclose to investors, and the protection of minority shareholders. It involves issues of company law, securities laws, the listing rules of a country's stock exchanges, the accounting standards applicable to listed companies, competition or antitrust laws, and bankruptcy or insolvency laws. It includes the government regulations and regulatory agencies with which corporations and their shareholders deal and those regulators' actions to ensure compliance with applicable laws and regulations. Corporate governance involves the courts as well, as they are called upon by shareholders, directors, managers and regulators to resolve corporate governance disputes and enforce government regulations.[2]

In all countries, some corporate governance rules are the subject of binding law or regulations, while others involve market institutions or merely common practices, sometimes written down in corporate governance codes and enforced through listing or disclosure rules, and sometimes simply embodying investor expectations. Corporate governance rules are neither entirely mandatory nor entirely voluntary in nature, but a mixture of both. Any reform proposal must include judgments on which issues should be addressed by a mandatory rule, which issues should be addressed by mandatory disclosure but not a binding substantive rule, and when adoption of a practice should be purely voluntary.

With Korea's return to economic growth, there are voices expressing the view that the reform process has gone far enough for now. Some argue that Korea should allow time for the recent corporate governance reforms to work their way into corporate practice. An assessment would be made, in a few years, to see whether further reforms are needed. Some believe that Korea has gone too far already, and criticize the recent reforms as imposed by the IMF and other foreign sources and as alien to the structure and culture of Korean corporate groups. These critics believe that the reforms undertaken thus far should be quietly abandoned.

We believe that these views reflect a fundamental misunderstanding of the reasons for Korea's financial crisis, the extent to which corporate governance failures helped to create and exacerbate the crisis, and the extent to which Korean corporate governance practices remain well behind Korea's principal international competitors. For Korea to return to pre-crisis corporate governance practices or to stop the reform process now would undermine Korea's international competitiveness, place Korea at odds with prevailing standards of corporate governance among its fellow OECD members and the trend of corporate governance reforms in the more developed emerging markets, and risk repeating the crisis from which Korea is just emerging.

Korean industry, not surprisingly, argues that past legal reforms are sufficient and nothing further should be done. Let the market work, they say. And indeed, there are many areas where the market provides some of the elements of corporate governance. But there are also important areas where market forces are insufficient. For example, in every country, effective control of related party transactions requires legal rules, not just market pressure. In every country, managers will not voluntarily disclose very much

2. For discussion of the multiple legal and market institutions that are needed to support strong public securities markets, see Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781 (2001), *available at* http://papers.ssrn.com/paper.taf?abstract_id=182169 (Social Science Research Network).

about their own compensation. In every country, managers would like their control of a company to be secure against threats from outside—even a threat as mild as minority shareholders electing one or two directors using cumulative voting.

To take a pattern that is common in Korea, controlling shareholders everywhere would like to be able to cause their companies to issue shares cheaply to themselves or their family and friends (in Korea, this often occurs through issuance of convertible bonds). The controlling insiders understand that such an issuance will depress the market price of the company's shares. All too often, they go ahead nonetheless. If Korea had a well functioning corporate governance system, these abuses would not occur. But they do occur, even among the largest *chaebol.*

There are corporate governance issues on which knowledgeable people can reasonably disagree. Some of our proposals fall into that category (for example, cumulative voting, preemptive rights, and a mandatory bid requirement during a change of control). We include these proposals because we believe that they are important for Korea at the present time, but other people—whose views we respect—may disagree.

But there are many other reforms on which, we believe, knowledgeable people with an understanding of the last 150 years of worldwide corporate governance would not disagree.

- There is no dispute about whether inside directors should vote on related party transactions. They should not.
- There is no dispute about whether related party transactions, if they occur, should be disclosed to shareholders and should be on arms-length terms. They should.
- There is no dispute about whether the Board of Directors of a listed company should be a serious body that reviews and adopts decisions on major corporate actions. It should.
- There is no dispute about whether shareholders in a listed company should receive the material information that they need to vote in an informed manner at a shareholder meeting, a reasonable time in advance of the meeting. They should.
- There is no dispute about whether shareholder approval is appropriate for a limited number of major transactions that fundamentally change a company's business, or pose a special risk of harm to shareholders. It is. The only question is which transactions are important enough to require shareholder approval—how one balances the delay and cost of a shareholder meeting against the need for shareholder protection.

These proposals, about which there is no serious dispute, are at the heart of our Recommendations.

A corporate governance system, in any country, must achieve a sensible balance among company managers' need for flexibility to meet rapidly changing business conditions, companies' need for low-transaction-cost access to capital markets, large investors' need to monitor what managers do with the investors' money, and small investors' need for protection against self-dealing by managers and large investors. The ultimate goal is to provide a set of governance rules that maximize the value of companies to investors and, thus, minimize the cost of capital. Our proposals are intended to achieve that balance, against the background of Korea's current conditions.

Market forces are a critically important source of pressure for improving corporate governance. But they are not sufficient by themselves and often operate rather slowly. The core problem is that one firm cannot move very far ahead of its peers in terms of investor perception. A firm can disclose more than the law requires, but investors tend to discount these additional disclosures in the belief that such disclosures will be selective (that is, disclosures of good news rather than bad). A firm can avoid related-party transactions, but investors will know that these remain possible if the firm's managers change their minds or come under increased pressure from controlling shareholders. Moreover, investors rely partly on a particular firm's corporate governance practices and partly on a country's overall corporate governance system when deciding whether to invest and what prices to pay.

Korea has made tremendous progress in corporate governance over the last 40 years, through a combination of market forces and legal reform. In our judgment, market forces supplemented by appropriate legal reform can help Korea achieve a world-class corporate governance system within the next 10-20 years. Market forces alone might achieve the same result in the next half-century. Korea can't afford to wait that long.

A major goal of our Recommendations is to enhance the international competitiveness of Korean companies. Competition for capital in the Korean and global equity and debt markets can be expected to increase in the years ahead. Lenders now know better than blindly to expect the government to bail out the major *chaebol*. The quality of corporate governance will play an increasing role in creditors' willingness to provide loans to companies, equity investors' willingness to buy their shares, and the prices that investors will pay. Companies and countries with strong corporate governance will enjoy cheaper access to capital, and thus an enormous competitive advantage over companies and countries with weak corporate governance.

Corporate Governance in Korea at the Millennium

Structure of the Korean Economy

The growth of the Korean economy during the last 40 years is among the most dramatic stories of nation-building in modern history. Devastated by the Second World War and the Korean War, Korea in 1960 was among the world's poorest nations, with per capita Gross Domestic Product (GDP) of approximately $80. Over the next 35 years, Korea has transformed itself into the world's 11th largest industrial economy with per capita GDP in excess of $10,000, leading to its 1996 admission to membership in the Organization for Economic Cooperation and Development (OECD) as one of the world's developed economies.[3]

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3. During this period, the total economy increased in size from GDP of US$2.3 billion in 1962 to US$485 billion in 1996. The structure of the economy also changed dramatically over this period: international trade increased from 13% of GDP in 1960 to 89% in 1996; investment increased from 9% of GDP in 1960 to 39% in 1996; manufacturing increased from 11% of GDP in 1960 to 30% in 1996, with heavy and chemical industries increasing from 2% to 24% of GDP during the period; agriculture in turn decreased from 42% of GDP in 1960 to 6% in 1996. Il-Chong Nam et al., *Corporate Governance in Korea* 2 tbl. I-1 (Mar. 1999) (paper presented at conference on *Corporate Governance in Asia: A Comparative Perspective*, sponsored by OECD

The "miracle" of Korea's economic transformation has been the subject of extensive study by academics and policy-makers, and is compellingly presented in THE EAST ASIAN MIRACLE: ECONOMIC GROWTH AND PUBLIC POLICY (World Bank, 1993) and in EMERGING ASIA: CHANGES AND CHALLENGES (Asian Development Bank, 1997). That economic transformation was built upon the education and entrepreneurial energy of the Korean people; the maintenance of a generally stable macro-economic environment; high levels of public and private savings and investment; government policies which encouraged a strong private sector, industrialization, heavy industry development, a strong export orientation, and active promotion of foreign investment and technology transfer.

In the process, large corporate groups emerged which are active multinationals in the international arena and dominate the Korean private sector economy. The government's so-called HCI (heavy and chemical industries) drive in the 1970s was a major factor in the growth of these large conglomerates, known as *chaebol*. The *chaebol* have been the principal engines of private sector economic growth in the ensuing period. They have benefited in targeted sectors from low-interest loans from state-owned banks and implicit government risk-sharing in *chaebol* projects.

The term *chaebol* means "financial house" and is commonly used to refer to conglomerates consisting of many related companies, including a number of companies listed on the stock exchange, which are engaged in a broad range of industrial and service businesses. Most *chaebol* have highly centralized, autocratic management by the founder and his immediate family members. Since (until recently) the creation of holding companies was not allowed, each *chaebol* group was controlled by the founder and his family through an intricate web of cross-company shareholdings and intra-group loans and guarantees.[4]

In 1995 the thirty largest *chaebol* represented 41% of total sales in the Korean domestic economy, 40% of value added, 44% of total fixed assets, and 18% of employment. The five largest *chaebol* – Hyundai, Daewoo, Samsung, LG (Lucky Goldstar) and SK (Sunkyong) – represented 26% of total domestic sales, 27% of total value added, 26% of total fixed assets and 11% of total employment.[5]

The characteristic shareholding networks of the *chaebol* have been well-documented, both by the Fair Trade Commission and by academic studies. In 1997 family members owned 8.5% of total shares in the 30 largest *chaebol*, and group affiliates owned an additional 35% of total shares within the group; within the five largest *chaebol*,

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and the Korea Development Institute), *available at* http://www.oecd.org/daf/corporate-affairs/governance/roundtables/in-asia/1999/nam-kang-kim-joh-Korea.pdf (citing NAT'L STATISTICAL OFFICE, MAJOR STATISTICS OF THE KOREAN ECONOMY).

4. In Japan and Korea immediately after the Second World War, the creation or maintenance of holding companies was prohibited to break up Japan's conglomerates (*zaibatsu*) and prevent their re-formation. In fact the *keiretsu* system of competing groups of related companies and financial institutions in Japan and the *chaebol* system in Korea have replicated in some respects the *zaibatsu* domination of their pre-War economies. Ironically, holding companies are now proposed as a way to improve transparency and accountability within Japanese and Korean corporate groups.

5. *See* Lee Jae-Hung, Korea Development Institute and National Statistical Office, *cited in* YONG-DOO CHO, CORPORATE GOVERNANCE IN KOREA: ISSUES AND OPTIONS (1999) (report to the Asian Development Bank, on file with authors).

family members' holdings in 1997 were 8.6% of total shares within the group and group affiliates owned an additional 37%.[6]

The financial structure of the *chaebol* and other Korean firms is characterized by high levels of debt and a low proportion of equity, by international standards. Most debt financing has come from Korean commercial banks and government-owned financial institutions, though Korean companies have also borrowed in the domestic commercial paper market and from foreign banks. Korean companies in the past decade have diversified their debt financing by issuing bonds both in Korea and in the international capital markets. For example, during the first half of 1996, 12% of corporate financing in Korea came from banks, 14% from non-bank financial institutions, 17% from corporate bonds, 21% from commercial paper, 16% from foreign borrowings and only 8% from equity.[7] The debt-to-equity ratios of Korean companies significantly exceed those prevailing in Japan, Germany, Taiwan, the United States and the United Kingdom.[8] This has made Korean firms financially fragile – their interest coverage ratios are substantially lower than those prevailing in other countries.[9]

In other economies in which companies rely heavily on bank financing, such as Germany, banks significantly influence and constrain corporate decision-making. This has not been the case in Korea. Korean banks have not exercised a significant monitoring and credit control relationship with their principal corporate customers, the *chaebol*. Also, institutional shareholders have not been a significant influence or constraint on corporate decision-making. Shareholding by institutional investors in Korean companies is low compared to other developed countries, and many institutional investors are affiliated with and controlled by the *chaebol*. Foreign institutional investors have become significant investors in Korean firms, but thus far have had very modest influence on Korean corporate governance.

Only a small number of contested takeovers have taken place in Korea. Given the high aggregate shareholdings in the *chaebol* by family members and corporate affiliates (even if less than a majority of total group shareholdings), and the unavailability of takeover financing, the threat of a hostile takeover has not been a source of management discipline.

Similarly, financial press reporting of corporate governance abuses has not been a significant influence on *chaebol* behavior. The dependence of the country's leading newspapers on business advertising and the absence of a tradition of investigative journalism have contributed to the press' limited attention to corporate governance issues.

6. *See* CHO (1999), *supra* note 5, at 6 tbl. 2 (citing Fair Trade Comm'n data excerpted from Yoo (1998)).

7. *See* CHO (1999), *supra* note 5, at 8 tbl. 4 (citing BANK OF KOREA, Financial Statement Analysis (1998)). The remaining 12% of financing for Korean corporations came from diverse sources.

8. *See* Nam et al. (1999), *supra* note 3, at 6 chart I-3 (citing BANK OF KOREA, FINANCIAL STATEMENT ANALYSIS (1998); OECD, FINANCIAL STATISTICS PART 3: FINANCIAL STATEMENTS OF NON-FINANCIAL ENTERPRISES (1998)).

9. *See* Nam et al. (1999), *supra* note 3, at 6-8.

The Korean Financial Crisis 1997-1999

At the onset of the Asian financial crisis in mid-1997 the *chaebol*, and Korean listed companies more generally,[10] were characterized by low transparency of corporate decision-making, low accountability of senior managers, and higher debt-equity rates than their principal international competitors. The Asian financial crisis overtook the Korean economy in late 1997. The crisis in Korea had many causes, though it was triggered by a number of large-scale corporate failures, beginning with the failure of Hanbo Steel in early 1997. Corporate failures placed financial institutions at risk and led to a collapse of international confidence in the economy and the withdrawal of foreign investors and financiers from the Korean markets.[11] As summarized by one commentator, "the corporate insolvency problem translated into a domestic financial crisis and ultimately caused an external liquidity crisis."[12] The exchange rate fell dramatically and Korea's foreign exchange reserves were depleted. The combined effect of high leverage (and thus low interest coverage ratios), lower profits and a lower valued Won left firms and banks that had borrowed in foreign currency unable to pay their foreign debts. Much of this debt was short-term, and foreign creditors were unwilling to roll over their credit lines. Credit within the economy dried up, and the economy was thrown into an 18-month period of severe recession.

Corporate governance weaknesses were an important reason why Korea's economy collapsed while some other Asian economies didn't, and were a significant factor in explaining the recession's severity. As Simon Johnson and co-authors wrote in a recent paper:

> [T]he weakness of legal institutions for corporate governance had an important effect on the extent of [currency] depreciations and stock market declines in the Asian crisis. By "corporate governance" we mean the effectiveness of mechanisms that minimize agency conflicts [between] managers [and shareholders], with particular emphasis on the legal mechanisms that prevent [managers from expropriating] minority shareholders . . . . In the case of the Asian crisis, we find that corporate governance provides at least as convincing an explanation for the extent of exchange rate depreciation and stock market decline as any or all of the usual macroeconomic arguments.[13]

A principal focus of the government's policy response to the crisis was to reform Korea's corporate governance standards. The government undertook a series of measures to force the *chaebol* to focus their business operations on a small number of core businesses in each group, rely less on debt financing, improve transparency in corporate decision-making, and enhance the accountability of controlling shareholders and

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10. Except as otherwise specifically noted, references in this Report to "listed companies" include companies listed on the Korea Stock Exchange and companies whose shares are traded in the Korea Securities Dealers Association over-the-counter market (KOSDAQ).

11. On the actions of foreign investors prior to and during the onset of the crisis, see Choe Hyuk, Kho Bong-Chan and Rene M. Stulz, *Do Foreign Investors Destabilize Stock Markets? The Korean Experience in 1997*, 54 J. FIN. ECON. 227 (1999).

12. *See* Nam et al. (1999), *supra* note 3, at 4 and more generally for an economic analysis of the crisis.

13. Simon Johnson, Peter Boone, Alasdair Breach & Eric Friedman, *Corporate Governance in the Asian Financial Crisis*, 58 J. FIN. ECON. 141, 142 (2000).

managers. Many of the government's initiatives were based on its ability to control credit in the post-crisis period, as it recapitalized the nation's banks and secondary financial institutions, imposed higher prudential standards on their future operations, and supervised their re-negotiation of *chaebol* debt.

The most dramatic of these initiatives were the "big deals" announced by the government in October 1998, which contemplated mergers and business swaps between the largest *chaebol* to rationalize their core businesses and address over-capacity problems. Many of these transactions were presented as agreements between the government and *chaebol* leaders, or as voluntary agreements among the *chaebol* leaders mediated by government. However, only a few of the "big deals" have been completed. This underscores the reality that these were government initiatives, the implementation of which depended on the government's willingness to use its control of credit to the *chaebol* and on the impact of on-going criminal and civil investigations of the *chaebol* for violations of the Monopoly Regulation and Fair Trade Act (MRFTA) and of their controlling shareholders for tax law, foreign exchange law and other violations.

Corporate Governance Reforms Enacted

These governance initiatives were specific to the leading *chaebol.* In addition, the government undertook a series of general legal reforms. In Korea the laws most directly affecting corporate governance are the corporate laws found in Part III of the Commercial Code and, in particular, in the provisions of Chapter IV dealing with Joint Stock Companies (*chusik hoesa*); the Securities and Exchange Act, its Enforcement Decree and related regulations; the Act on External Audit of Joint Stock Companies (AEAJSC); the MRFTA and its implementing regulations; and the Bankruptcy Law.

Post-crisis amendments to the principal Korean legislation and regulations relating to corporate governance include:

- The Securities and Exchange Act was amended to require that, for all companies listed on the Korea Stock Exchange, at least one-quarter of the members of their Boards of Directors be independent, "outside directors." For the largest listed companies (with assets greater than 2 trillion Won), at least one-half of the members of their Boards of Directors must be independent, "outside directors." (Securities and Exchange Act, Article 191-16(1) and the Presidential Decree thereunder, Article 84-23(1))
- Among the top 30 *chaebol*, new intra-group guarantees have been prohibited and existing guarantees were to be eliminated by March 2000. (MRFTA, Article 10-2)
- The AEAJSC was amended to require preparation of "combined" financial statements for the 30 largest *chaebol*,[14] to increase penalties for fraudulent audit reports, and to revise selection procedures for external auditors.

14. The standards applicable to combined financial statements were promulgated by the Securities and Futures Commission in October 1998. Combined financial statements are different from consolidated financial statements, which have been required of listed firms since 1993.

- The Regulation on Securities Listing granted to the Korea Stock Exchange enhanced powers to ensure the independence of listed companies' external auditors. (Regulation on Securities Listing, Article 4(2)(5))
- Accounting standards for companies subject to the AEAJSC were revised by the Financial Supervisory Commission and the Securities and Futures Commission, to bring them into substantial compliance with International Accounting Standards (IAS) or United States Generally Accepted Accounting Principles (GAAP).
- Listed companies must file quarterly reports in addition to the annual and semi-annual reports previously required. (Securities and Exchange Act, Article 186-3)
- Shareholders may propose matters for consideration at a general shareholder meeting. (Commercial Code, Article 363-2)
- Shareholders can demand cumulative voting, unless precluded by the company's articles of incorporation. (Commercial Code, Article 382-2)
- The minimum shareholding level required for shareholders to assert rights has been reduced for (i) demanding removal of directors and auditors for wrong-doing (Commercial Code, Articles 385(2) and 415), (ii) seeking an injunction against a director who violates applicable law or a company's articles of incorporation (Commercial Code, Article 402), (iii) initiating a derivative lawsuit (Commercial Code, Article 403), (iv) convening a general shareholder meeting (Commercial Code, Article 366), (v) inspecting a company's account books (Commercial Code, Article 466), (vi) applying to court for appointment of an inspector to investigate the company's actions (Commercial Code, Article 467), and (vii) demanding the removal of a liquidator (Commercial Code, Article 539(2)). These levels were further reduced for listed companies and yet further reduced for the largest listed companies (with paid-in capital of not less than 100 billion Won). (Securities and Exchange Act, Article 191-13)
- An explicit fiduciary duty has been established, requiring directors to "perform their duties faithfully for the good of the company" in accordance with applicable law and the company's articles of incorporation. (Commercial Code, Article 382-3)
- "Shadow directors" – persons who instruct directors on the conduct of the company's business or conduct such business in the name of a director or using a senior executive title – are subject to the same duties and liabilities as directors. (Commercial Code, Article 401-2)
- The Securities Investment Trust Business Act was amended to permit securities investment trust companies to vote shares they hold in their investment trust business. (Securities Investment Trust Business Act, Article 25)
- To facilitate corporate takeovers, the requirement that a shareholder and related parties acquiring 25% of the shares of a listed company must tender for a majority of the company's shares was eliminated by an amendment of the Securities and Exchange Act.

- Companies are authorized to provide in their articles of incorporation for the granting of stock options to directors, statutory auditors and employees and standards have been established for their grant and exercise. (Commercial Code, Article 340-2)
- Shareholders may elect at each general meeting of shareholders the chairman to preside at such meeting (Commercial Code, Article 366-2) and may vote in writing at a general meeting of shareholders, without attending the meeting in person or by proxy. (Commercial Code, Article 368-3)
- Videoconference meetings of the Board of Directors have been authorized. (Commercial Code, Article 391(2))
- Standards have been established for the minutes of meetings of the Board of Directors and for shareholders to inspect and copy these minutes. (Commercial Code, Article 391-3)
- Companies may provide in their articles of incorporation for their Boards of Directors to establish committees and to delegate certain powers to such committees. Committee resolutions are to be notified to each director, and are subject to reconsideration by the full Board at the request of any director. (Commercial Code, Article 393-2)
- Companies may establish audit committees (in lieu of statutory auditors), two-thirds of whose members are to be independent. (Commercial Code, Article 415-2). Companies listed on the Korea Stock Exchange with assets of at least 2 trillion Won must have such an audit committee. (Securities and Exchange Act, Article 191-17 and the Presidential Decree thereunder, Article 84-24)
- Nominating committees for the nomination of independent directors are required for listed companies having assets of at least 2 trillion Won, and at least one-half of the members of such committees must be independent directors. (Securities and Exchange Act, Articles 191-16(3) and 54-5(2))
- Resolutions proposed by shareholders for consideration at the annual general meeting of a listed company are deemed timely if submitted six weeks before the anniversary date of the previous year's annual general meeting, even if notice of such meeting has not yet been given. (Presidential Decree of the Securities and Exchange Act, Article 84-21(2))
- Board approval and public notice are required for certain interested party transactions by a company which is a member of one of the ten largest *chaebol*. (MRFTA, Article 11-2 and the Presidential Decree thereunder, Article 17-8)

Additional corporate governance reforms have been initiated for banks and non-bank financial institutions. Consideration of these reforms is beyond the Consultants' Terms of Reference.

In March 1999, the Ministry of Finance and Economy initiated the creation of a private sector Committee on Improving Corporate Governance. In September 1999, the Committee adopted a non-binding *Code of Best Practices for Corporate Governance* (the "Best Practices Code"). It is anticipated that disclosure about a firm's compliance with the Best Practices Code will be incorporated into Korea Stock Exchange listing rules, probably in a manner similar to the incorporation of the British Combined Code in the listing rules of the London Stock Exchange.

Corporate Governance Reform Principles

These corporate governance reforms embody several principal features and policy perspectives.

First, the reforms give the Board of Directors a central role as the organ responsible for a company's major decisions, and enhance the role of independent directors in policing management actions, especially when those actions involve a potential conflict of interest. Currently, independent directors must constitute at least one-quarter of the members of the Boards of listed companies and, for the largest listed companies, banks and most non-bank financial institutions, at least one-half of the members. At least two-thirds of the members of the audit committee and at least one-half of the members of the nominating committee must be independent directors. However, Korea has no tradition of active discussion within the Board of Directors, and experience with independent directors has been limited. Most have been lawyers, accountants, academics and retired government officials. Concerns have been expressed about the effective independence of many independent directors and about their lack of business experience. Newly-appointed independent directors often complain about lack of access to the information they consider necessary for informed decision-making.

Second, the reforms have expanded shareholders' procedural rights to participate in corporate decision-making, their ability to police controlling shareholders and management, and the remedies for violations of applicable laws, regulations or a company's articles of incorporation. The effectiveness of these reforms depends on a reasonable level of shareholder activism. There are some signs of such activism in Korea in the activities of *Chamyoyundai* (the Participatory Economic Committee of People's Solidarity for Participatory Democracy), a public interest group which has initiated derivative lawsuits and obtained representation on the Boards of Directors of several listed *chaebol* companies. To date, other groups have not become involved in corporate governance issues relating to particular companies or *chaebol*, and there is little activism by individual shareholders. There has been some activism by foreign institutional investors, most visibly at SK Telecom. It remains to be seen if shareholder activism (whether based on civic group activities or on institutional investors) will give life to the shareholder voting and litigation tools which recent legislative and regulatory reforms have made more accessible.[15]

Third, the reforms have sought to increase the accountability of controlling shareholders and directors by making explicit the legal standards applicable to directors, extending those standards to shadow directors, and increasing the accountability of company executives to the Board of Directors and the accountability of executives and directors to the company's shareholders. The effectiveness of these reforms depends on the effectiveness of independent directors and the extent of shareholder activism.

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15. For a discussion of rights consciousness and the role of litigation in contemporary Korean society, see KATHARINA PISTOR & PHILIP A. WELLONS, THE ROLE OF LAW AND LEGAL INSTITUTIONS IN ASIAN ECONOMIC DEVELOPMENT, 1960-1995 (1999).

Fourth, the reforms have increased disclosures, particularly for listed companies, by upgrading accounting standards, improving audits (through the use of audit committees and procedures to enhance the independence of statutory auditors), increasing the penalties for fraudulent audit reports, and increasing the frequency of reporting to shareholders.

Fifth, the reforms have sought to decrease, and improve the fairness of, intra-group transactions.

Sixth, the reforms have sought to encourage the development of a market for corporate control by facilitating takeovers.

An Agenda for Further Reform

The process of reform is on-going. The Consultants find little to disagree with in the post-crisis corporate governance reforms. These reforms provide a solid foundation upon which greater transparency, accountability and efficiency in corporate management can be built. Our Recommendations build on that foundation.

In formulating our Recommendations, we have built upon the foundations of Korea's well established legal and judicial system, the historic patterns of its corporate, securities and competition laws, its recent corporate governance reforms and comparative experience in other OECD jurisdictions and elsewhere in Asia. Corporate governance standards are the subject of considerable law reform activity and activity to identify "best practices" in many countries. This activity has been accelerated in Asia by the regional financial crisis, but remains prominent elsewhere in the world as an evolutionary response to the increasing globalization of corporate operations and corporate financing. Despite the diversity of the countries and the legal and cultural traditions within which such reviews and reforms of corporate governance are taking place, there is a strong trend in law and "best practices" towards strong and independent boards of directors, enhanced shareholder rights and activism, fuller financial disclosure, tighter control of insider trading and self-dealing transactions, greater accountability of controlling shareholders, directors and managers, and stronger regulatory enforcement.[16]

The development of greater transparency and accountability within Korean companies will go hand-in-hand with the development of more professional management and the adoption of more efficient, technology-based management systems. In recent years, the principal multinational companies with which the *chaebol* compete in the international marketplace have expanded significantly through mergers, often financed by stock-for-stock exchanges. Today, Korean companies cannot complete comparable transactions in the American and European marketplaces. They have neither the international confidence in their corporate governance practices to persuade other companies' shareholders to accept a stock-financed acquisition, nor the unused debt capacity to pay for a major acquisition with cash.

In considering further corporate governance reforms in Korea, it must be recognized that Korea differs from most of its principal competitors in the high degree of concentration in the corporate economy, the strength of control by corporate founders and their families, and the high levels of intra-group related party transactions. Modern

16. *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. (2001).

corporate law and securities laws, whether founded on a civil law tradition or a common law tradition, focus principally on the individual company as a legal entity and lack wholly satisfactory regimes for dealing with corporate groups and intra-group related party transactions. The effort to deal with corporate groups has involved, in various jurisdictions, the development of consolidated financial accounts, broad concepts of "control" for securities law and accounting purposes, concepts such as "piercing the corporate veil" (in common law jurisdictions), and concepts such as *Konzern* (in German law, including contractual *Konzern* utilizing control agreements and profit transfer agreements and de facto *Konzern*).

As Korea considers further corporate governance reforms, it must recognize that the approaches used in other jurisdictions may be inadequate to deal with the entrenched intra-group relationships which characterize the *chaebol*. The government should be prepared to consider a limited number of reforms for which there is limited precedent elsewhere. Innovation always carries with it uncertainty, but it is also the means by which the leading edge of corporate governance reform is redefined and advanced.

The concentration of Korea's economy in a small number of *chaebol* heightens the urgency of corporate governance reform. When a company or corporate group fails elsewhere, that is not a tragedy. In contrast, when Daewoo failed, its failure became a crisis for all of Korea. Korea needs reforms that protect it against another major *chaebol* failure. A good corporate governance system provides checks against bad management, without interfering with good management. Independent directors, if well chosen, can intervene if a company gets into trouble, and exercise only gentle guidance when its prospects are bright. Shareholders will use cumulative voting to elect directors when a company is performing poorly, not when it is performing well. This is how independent directors and shareholders behave in other countries, and how Korea can expect them to behave as well.

Priorities for Further Reform

To ensure the success of the corporate governance reforms enacted over the past two years and to build further on these reforms, a number of problem areas must be addressed:

- The **role of the Board of Directors** must be strengthened. Despite the Board of Directors' theoretical role as a central decision-making body in the Korean corporation, in reality it has been a weak institution, seldom meeting, seldom openly discussing corporate strategy and policies, and dominated by controlling shareholders.
- The **role of independent directors** must be further strengthened. The success of many of the corporate governance reforms enacted to date depends on the effectiveness of independent directors. These directors' independence should be enhanced, they should be ensured effective access to corporate and financial information necessary for informed decision-making and they should have access to independent professional advice and training. Independent directors must be encouraged to be proactive in their role as directors and must have the information and resources needed to be proactive.

- The significant **expansion of shareholder rights** through legislative amendments over the past two years has resulted to date in only a modest increase in shareholder activism. Further attention is required to the corporate decisions requiring shareholder approval, the procedural rights of shareholders, and the obstacles facing shareholders who want to challenge corporate actions in the courts and before regulatory agencies.
- Despite expanded regulatory **monitoring of related party transactions**, these transactions require approval by non-interested decision-makers (independent directors and, for large transactions, non-interested shareholders) and also enhanced disclosure, to ensure their commercial reasonableness and that they do not harm minority shareholders.

These issues are the central focus of the Recommendations which follow. Those Recommendations are presented in summary form in the following section and are followed by an Explanation and Commentary.

RECOMMENDATIONS

I. Empowering Boards of Directors and Strengthening Independent Directors

A. The role of the Board of Directors should be more clearly defined by providing an explicit list of corporate actions that require a decision by the Board of Directors.

Article 393 of the Commercial Code should be amended to provide that the Board of Directors has authority to approve all matters regarding a company's business which have not been expressly reserved to the shareholders by law or the company's articles of incorporation. Without limiting that general principle, the following matters (some of which already require Board approval under the Commercial Code[17]) should require approval by the Board of Directors and may not be delegated to the company's executive management:

(i) For a listed company, adoption of a business plan specifying the major strategic directions of the company's activity, and periodic review and revision of such plan.

(ii) For a listed company, adoption of an annual budget for the company, and periodic review and revision of such budget.

(iii) The decision to convene the annual general meeting and any extraordinary shareholder meetings.

17. See the Explanation and Commentary on these Recommendations below for specific identification of current Commercial Code requirements.

(iv) The specification of the agenda of the annual general meeting and any extraordinary shareholder meetings.

(v) For a listed company, adoption of other decisions regarding shareholder meetings, including establishing a record date and approving materials for distribution to shareholders in respect of any such meeting.

(vi) Issuance of shares, bonds and other securities, including the issue and conversion prices and other material terms and conditions of these securities; approval of other financing transactions where the amount of the financing equals 5% or more of the company's assets or revenues.

(vii) Acquisition and redemption by the company of its shares, bonds and other securities.

(viii) Determination of the fair market value of shares or property and the arms-length nature of related party transactions, when required by other provisions of the Commercial Code.

(ix) The proposed amount and form of directors' compensation, for approval by the shareholders.

(x) The proposed amount of dividends, for approval by the shareholders.

(xi) Appointment and termination of the company's senior officers including the representative director and, for senior officers who are not directors, the terms of their employment and compensation.

(xii) Proposing to shareholders selection of the external auditors, and determining the terms of the external auditors' engagement.

(xiii) Approving the company's annual business report and financial statements and submitting the statements and report to the shareholders for approval.

(xiv) Adoption of internal procedural rules for the Board of Directors and its committees.

(xv) The establishment of branch offices and subsidiaries.

(xvi) Approval of corporate transactions, including acquisitions, investments, disposals, leases and mortgages, in an amount equal to 5% or more of the company's assets or revenues, approval of simplified mergers and small-scale mergers as provided in Articles 527-2 and 527-3 of the Commercial Code, and submitting to shareholders for approval transactions requiring shareholder approval pursuant to the Commercial Code or the company's articles of incorporation.

(xvii) Approval of related party transactions, and submitting large related party transactions for approval by non-interested shareholders when required by other provisions of the Commercial Code.[18]

(xviii) Other matters requiring Board of Directors approval pursuant to the Commercial Code or the company's articles of incorporation.

(xix) Proposing, for approval by the shareholders, other matters which should be determined by the Board.

B. *A limited extension of directors' fiduciary duties to shareholders should be recognized.*

Article 382-3 of the Commercial Code should be amended to provide an explicit duty on the part of directors to deal with all shareholders in a fair and equitable manner and to ensure equal treatment to all shareholders of the same class.

C. *The right of directors to access all corporate information necessary to perform their duties should be expanded and clarified.*

A new Article should be added to the Commercial Code to give directors the authority (comparable to that provided in Articles 412 and 412-4 for statutory auditors) to require the officers of the company to report on, and to investigate themselves, the affairs and financial condition of the company and its subsidiaries. The provision should explicitly guarantee to the directors full access to all business records and books of account of the company and effective access to employees.

D. *The duty of confidentiality on the part of directors, shareholders and others should be made explicit.*

A new Article should be added to the Commercial Code to impose upon a company's directors, shadow directors, statutory auditor and shareholders a duty to preserve the confidentiality of any non-public information obtained by them from the company and not to use such information for their own or their families' personal benefit.

E. *Recent amendments to the Commercial Code and the Securities and Exchange Act authorizing the establishment of Board committees, establishing procedures for their operation, and providing for audit committees at least two-thirds of whose members must be independent directors and nominating committees at least one-half of whose members must be independent directors, are commended.*

1. As further experience is gained with audit committees, consideration should be given to making use of an audit committee mandatory for all listed companies. Consideration should also be given to requiring that all members of any such audit committee shall be independent directors.

18. See the discussion of Monitoring Related Party Transactions at paragraphs III.A.1-4 below.

2. As further experience is gained with Board committees generally, consideration should be given to requiring one or more independent directors to serve on each Board committee of a listed company (unless a larger number or percentage is otherwise required by law, regulation or the company's articles of incorporation, as is now the case with audit and nominating committees).

F. The liability of independent directors should be limited in cases in which they have acted in good faith.

Articles 399 and 401-2 of the Commercial Code should be amended to provide that the personal liability of an independent director will be limited, in the case of non-willful breaches of duty not involving personal benefit to the director or the director's family, to a multiple (such as 5 times) of the director's total annual compensation from the company (including the value of non-cash compensation). This liability should not be further reduced by corporate indemnification or directors and officers (D&O) insurance.

G. Further steps should be taken to assure the effective independence of independent directors.

1. Relevant laws should be amended to unify the standards of independence for independent directors.

2. The existing standards of independence should be expanded to require the absence of "any other relationship with the company, its principal shareholders or its directors or officers which could compromise the independence of such person's judgment in respect of the company's business."

3. Independent directors should be required to certify their independence when they first stand for election as directors and annually thereafter.

H. Support should be available to independent directors to enable them to perform their duties.

The Commercial Code should be amended to permit any director to consult the company's legal, financial and other professional advisors and the right of two or more independent directors, acting together, to engage independent legal, financial and other professional advisors regarding the conduct of their corporate responsibilities. The directors' reasonable expenses to obtain this advice should be paid by the company.

II. Enhancing Shareholder Rights

A. The categories of corporate decisions requiring shareholder approval should be expanded and clarified to ensure shareholder participation in (i) large acquisition and disposal transactions by the company and its subsidiaries , (ii) large share issuance transactions by listed companies, and (iii) material related party transactions by the company or its subsidiaries.

1. Article 374(1) of the Commercial Code should be amended to require shareholder approval of the acquisition by a company or its subsidiaries of all or a part of another business, when the company's attributable interest in the acquired assets or revenues represents 20% or more of the company's assets or revenues.

2. Article 374(1) of the Commercial Code should be further amended to require shareholder approval of the disposition by a company or its subsidiaries of any part of their business or assets in which the company's attributable interest represents 20% or more of the company's assets or revenues.

3. A new Article 374-1 should be added to the Commercial Code to deal with material acquisition and disposal transactions by a company's non-subsidiary affiliates.[19] When a company's affiliate acquires or disposes of all or part of its business or assets and the company's attributable interest in the business or assets being acquired or disposed is greater than 20% of the company's assets or revenues, the company's shareholders should determine how the company and its subsidiaries vote the shares of the affiliate held by the company and its subsidiaries in any vote by the affiliate's shareholders on the transaction.

4. Shareholder approval should be required for an issuance by a listed company of ordinary shares or securities convertible into ordinary shares which represent 20% or more of the previously outstanding shares of the company, other than transactions involving (i) the public offering of shares for cash at the prevailing market price of the shares or (ii) the public offering of convertible securities with a conversion price greater than the prevailing market price of the shares.

5. As part of a comprehensive series of provisions to address material related party transactions (see Monitoring Related Party Transactions below), large related party transactions by a company should require approval by the company's non-interested shareholders. Large transactions requiring shareholder approval would be transactions, other than in the ordinary course of the company's business, exceeding in value a certain percentage (perhaps 5%) of the company's assets or revenues. Approval by the company's non-interested shareholders would also be required for related party transactions by the company's subsidiaries and affiliates where the company's attributable interest in the related party transactions exceeds this threshold.

B. Procedures for the election of directors of listed companies should be amended to (i) provide for a unified ballot for the election of directors, which includes nominees of the Board of Directors and any shareholder nominees, and (ii) strengthen cumulative voting.

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19. For a proposed definition of "affiliate" see the Explanation and Commentary to this Recommendation below.

1. Recent amendments to the Securities and Exchange Act provide that independent directors of listed companies with assets of at least 2 trillion Won shall be nominated by a nominating committee of the Board of Directors, at least one-half of whose members must be independent directors. The enactment of such provisions is commended. As experience is gained with nominating committees, consideration should be given to reducing the company size threshold for this requirement.

2. Under current law, at a general shareholder meeting at which the election of directors is an agenda item, any shareholder may nominate, and any other shareholder may second the nomination of, one or more candidates for election to the Board of Directors. In addition, shareholders of a listed company holding a designated level of shares (such as 1%) should be permitted to nominate candidates prior to such a meeting, to have the company disseminate information about these candidates at the same time as information regarding candidates nominated by the Board of Directors, and to have these candidates and those nominated by the company listed in a single unified ballot for the election and in any proxies solicited by the company for such meeting.

3. Article 382-2 of the Commercial Code should be amended to ensure that cumulative voting is available to shareholders of listed companies by removing these companies' power to preclude cumulative voting in their articles of incorporation. To give practical effect to cumulative voting, (i) all directors of listed companies should be elected annually and (ii) where a director was nominated by a shareholder and elected using cumulative voting, removing that director would require removing all directors followed by a new election, again using cumulative voting.

C. *To ensure more effective shareholder meetings, amendments to the Commercial Code should require (i) 30 days' notice of a listed company's annual shareholder meeting, (ii) more detailed notices and agendas for all shareholder meetings, and (iii) fuller disclosure by listed companies of information relating to matters to be considered at a shareholder meeting.*

1. Article 363(1) of the Commercial Code should be amended to require 30 days' notice for a listed company's annual shareholder meeting. Other shareholder meetings may be convened on 14 days notice, as presently provided.

2. Article 363 of the Commercial Code should be further amended to require that the notice and agenda for a shareholder meeting set forth in reasonable detail the matters to be considered at the meeting.

3. Article 363 of the Commercial Code should be further amended to require listed companies to timely distribute to all shareholders prior to any shareholder meeting written materials containing all material information necessary for shareholders to make an informed decision on the issues to be presented at the meeting.

a. For a meeting at which the election of directors is to occur, such information should include background information on the candidates for election as directors (whether nominated by the company or by shareholders), including their educational and professional backgrounds, their business experience, and their past and present relationships (if any) with the company and its affiliates.

b. For a meeting at which a resolution proposed by a shareholder is to be considered, the proponents of such resolution should timely provide comparable material to the company for timely distribution to shareholders prior to such meeting.

c. The materials for the annual meeting should explain the procedures for shareholders to nominate directors or to propose resolutions for consideration at a shareholder meeting.

D. *Shareholder access to information regarding the company should be enhanced, subject to an explicit obligation of shareholders to maintain the confidentiality of any non-public information so obtained (see Recommendation I.D).*

1. Article 466 of the Commercial Code should be amended to reduce the minimum level of shareholding required for a shareholder of a listed company to obtain access to company records relevant to the exercise of shareholder rights and to ensure that the records available for inspection by shareholders include the company's business records.[20]

2. Article 467 of the Commercial Code should be amended to permit any shareholder to apply to the court to appoint an inspector where there is reason to suspect that the company or its management has committed a dishonest act, or violated relevant law or the company's articles of incorporation.

3. Article 635 of the Commercial Code should be amended to provide meaningful sanctions on a company and its management for failure to comply with the provisions of the Commercial Code providing for shareholder access to company information.

4. The sanctions for failure to comply with the other disclosure requirements of the Commercial Code, Securities and Exchange Act, Enforcement Decree of the Securities and Exchange Act and the Korea Stock Exchange Listing Rules should be increased and should include the right to impose material fines on the company and management. For listed companies, the government should encourage greater use of the existing sanctions of suspension and delisting of a company's securities.

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20. Shareholders' expanded access to company records is balanced by our proposal (see Recommendation I.D above) to amend the Commercial Code to explicitly require shareholders to keep confidential any non-public information they receive from the company.

E. Shareholder pre-emptive rights for issuance of ordinary shares by listed companies should be strengthened.

1. Article 418(1) of the Commercial Code should be amended to preclude listed companies from restricting pre-emptive rights for issuance of ordinary shares in the company's articles of incorporation, other than provisions permitting annual shareholder approval for the issuance of shares, not exceeding 5% of the company's previously outstanding shares, in one or more transactions during such year. Other offerings without pre-emptive rights may be approved by special resolution of the shareholders, and mandatory pre-emptive rights should not apply to public offerings of a company's shares at or above the market price for the shares.

2. Article 418 of the Commercial Code should be further amended to include in the transactions subject to pre-emptive rights issuance of securities which are convertible into ordinary shares of the company.

3. When a listed company issues ordinary shares or securities convertible into ordinary shares, other than in a public offering, and pre-emptive rights are not applicable, the company should give fourteen days' prior notice of the issuance to shareholders, including information about the material terms and conditions of the issuance.

4. Offerings by listed companies of ordinary shares with the use of preemptive rights should be at no more than a 10% discount to the pre-offering market price, unless the independent directors determine, based on the advice of an independent financial advisor, that a larger discount is necessary to ensure the success of the offering.

III. Monitoring Related Party Transactions

A. The Commercial Code should be amended to provide more comprehensively for approval of related party transactions by non-interested directors and, for major related party transactions, by non-interested shareholders.

1. The Commercial Code should require, for each non-trivial related party transaction (a related party transaction that exceeds a *de minimis* threshold) by a listed company or its subsidiaries, approval by a majority of the company's independent directors who are not interested in the transaction. These provisions would supplement recent revisions to the Presidential Decree of the MRFTA which require Board of Directors approval and public notice of large transactions by any member company of the ten largest *chaebol* with or in favor of an interested party.

2. The Commercial Code should establish that any related party transaction by a listed company or its subsidiaries should be approved by the company's independent and non-interested directors only if they are satisfied that the transaction is on arms-length terms and at market prices. If the independent non-interested directors cannot conclude that a

proposed related party transaction is on arms-length terms and at market prices, they shall either disapprove the transaction or place the issue on the agenda of a shareholder meeting for approval by a majority vote of the non-interested shareholders.

3. In deliberating and voting on a related party transaction, the independent and non-interested directors should meet separately from other members of the Board, except that the independent and non-interested directors may request any executive director or interested director to provide them with information and answer questions about the transaction.

4. Related party transactions by the company or its subsidiaries or affiliates, other than in the ordinary course of business, should be approved by majority vote of the company's non-interested shareholders in addition to the company's independent and non-interested directors, if the company's attributable interest in the transaction exceeds a specified percentage (perhaps 5%) of the company's assets or revenues.[21]

5. For non-listed companies, the Commercial Code should provide for the approval of non-trivial related party transactions by a majority of the company's non-interested directors (if there is at least one non-interested director) and, also for large transactions, by a majority of the company's non-interested shareholders. A company with a small number of shareholders (perhaps 10 or fewer) could exclude some or all of these requirements in its articles of incorporation.

6. A "related party transaction" would be (A) any transaction between the company and (i) any member of a group of companies which includes the company and for which combined financial statements are required to be prepared pursuant to the AEAJSC or (ii) any member of an affiliated business group which includes the company, as determined by the Fair Trade Commission pursuant to the MRFTA, (B) any transaction by the company or any subsidiary or affiliate in which a director, officer or significant shareholder of the company or their affiliated persons (including their families) has an interest (as more fully set forth in the Commentary to these Recommendations), and (C) other transactions that are considered to be related party transactions or potential related party transactions in accordance with regulations to be issued by the Securities and Futures Commission. A transaction between a company and its sole shareholder (for example, a parent company and its wholly-owned subsidiary) would not be treated as a related party transaction.

B. In addition to these Board of Directors and shareholder approval requirements, the company's external auditors should review all non-trivial

21. Approval of a related party transaction by the independent and non-interested directors and, if necessary, the non-interested shareholders should be in addition to any other approvals required by the Commercial Code or other applicable laws.

related party transactions and report on these transactions annually to the shareholders.

The external auditors' report on related party transactions should identify all significant related party transactions known to them and confirm whether, to their knowledge, all of such transactions required to be submitted for approval by the company's non-interested directors and by the company's non-interested shareholders have been so approved.

IV. Enforcing Shareholder Rights

A. *Korean law provides a reasonably broad range of administrative, criminal and private litigation sanctions against violations by companies, directors and others of the corporate, securities and antitrust laws or a company's articles of incorporation. Nonetheless, the view is widely held that shareholders generally lack effective remedies for such violations.*

1. The level of fines and other penalties imposed for such violations should be increased substantially.

2. Article 405(1) of the Commercial Code (and any relevant provisions of the Civil Procedure Act) should be amended to include full reimbursement of litigation costs (including attorneys' fees) incurred by shareholders who prevail in a derivative suit.

3. Article 405 of the Commercial Code (and any relevant provisions of the Civil Procedure Act) should be amended to permit the court to award to the shareholders who prevail in a derivative suit a portion of the damages payable to the company as compensation to the shareholders for pursuing the claim and managing the litigation.

4. Further consideration should be given to the adoption of class action lawsuits to permit shareholders to pursue violations of the Commercial Code, Securities and Exchange Act and other provisions of Korean law relating to corporate governance.

5. To facilitate the resolution of matters now handled by derivative suits, the Commercial Code should be amended to permit corporations to provide in their articles of incorporation for the resolution by arbitration of a dispute between any shareholder and the company or its directors, at the shareholder's option in lieu of litigation.

B. *Enforcement of Korea's corporate governance rules requires attention to the resources of the Ministry of Justice, Securities and Futures Commission, Fair Trade Commission, other regulatory agencies and the courts.*

1. Consideration should be given to creation in Korea's major cities of a separate bench of the District Court to handle large or complex commercial and financial disputes, including shareholder litigation.

2. Consideration should be given to creating a national prosecution unit for commercial, corporate and securities matters and to creating a specialized career path within this unit.

3. A program of continuing legal education should be provided to judges and prosecutors in principles of corporate governance and in the specific provisions of Korean corporate governance law, including the extensive recent amendments.

C. Consideration should be given to encouraging the establishment of shareholder associations as exist in Germany (Vereinigungen von Aktionaeren) to protect and promote the interests of small shareholders.

V. Disclosure Requirements

A. Korea's corporate disclosure requirements under the Commercial Code, Securities and Exchange Act, Enforcement Decree of the Securities and Exchange Act and Stock Exchange Listing Rules are generally within the range of prevailing practice in other OECD jurisdictions, subject to the on-going revision of Korean financial accounting principles to conform to International Accounting Standards. The recent establishment of the Korean Accounting Standards Board is commended.

B. Each listed company should be required to report regularly to its shareholders on the extent to which its corporate governance practices conform to the standards established by the Code of Best Practices for Corporate Governance.

1. A listed company's annual report to shareholders should include a statement, approved by the company's independent directors, on the extent of the company's compliance with the Code of Best Practices for Corporate Governance.

2. A listed company's annual report to shareholders should include a report by its external auditors on the company's related party transactions during the prior year (as contemplated in paragraph III.B. above, Monitoring Related Party Transactions).

3. The Commercial Code or the AEAJSC should be amended to require listed companies to disclose to shareholders, if the company replaces its external auditors, the reasons for the change, with the auditors having an opportunity to provide their own explanation.

VI. Mergers, Acquisitions and the Market for Corporate Control

Efforts have been made to encourage mergers and acquisitions, including contested takeover bids. Some of these changes pose risks to minority investors that may outweigh their benefits. The Commercial Code or the Securities and Exchange Act should be amended to require, in the case of listed companies, (i) advance notice of the intention of any company, person or group of affiliated persons to acquire a controlling interest in a listed company by a tender offer or otherwise, (ii) restrictions on defensive measures by the company that will discourage or prevent such an intended acquisition, unless approved by the company's shareholders, and (iii) a mandatory offer for the company's remaining ordinary shares following acquisition of a controlling interest by any such company, person or group of affiliated persons, unless the obligation to make such an offer is waived by majority vote of the shareholders who would otherwise be entitled to accept the offer. A company, person or group of affiliated persons failing to comply with these requirements should be prohibited from voting the shares so acquired unless their voting rights are restored by majority vote of the other shareholders.

To balance the protection for minority shareholders provided by a mandatory bid requirement against concerns that this requirement may discourage takeover bids, the Commercial Code could allow such bids to be made at a small discount (perhaps 10%) to the price paid for the controlling shares.

VII. Encouraging Institutional Investor Involvement in Corporate Governance

Institutional investors have an important role to play in bringing Korea's new corporate governance rules into actual practice in the marketplace and in shaping the further evolution of Korean corporate governance standards. The Korean government is to be commended for measures to (i) promote the independence of the Boards of Directors of banks and other financial institutions, (ii) expand the fiduciary obligations of the directors of these institutions, (iii) encourage these institutions to exercise voting rights in companies in which they have invested (when acting with respect to securities held in trust), (iv) reduce these institutions' conflicts of interest and related party transactions and (v) increase these institutions' disclosure of information about their investments. To ensure the effectiveness of these reforms:

1. Training for financial institution executives in fiduciary standards and corporate governance should be encouraged.
2. The government must ensure that regulatory agencies that supervise financial institutions have appropriate budgetary and personnel resources, that training is made available to their personnel, and that coordination is maintained with other government agencies (in particular, with the Ministry of Justice) involved in investigating and prosecuting violations of these rules.

VIII. Other Recommendations

A. The government should establish an Institute of Directors at a public institution or encourage its establishment at a private sector institution. Such an Institute of Directors would provide training courses, practical seminars, research and technical support to company directors and should be governed by a board of directors or trustees drawn primarily from the private sector.

B. *Whether or not an Institute of Directors is established, training needs to be provided for Korean businessmen and government officials on corporate governance, including both independent directors and executive directors.*

C. *The corporate community and the securities industry (including investment managers) should be encouraged to engage in public information and education activities to promote shareholder involvement in and understanding of corporate governance.*

D. *While beyond the appropriate scope of legislation or government regulation, efforts to encourage the development of an active and independent financial press should be supported.*

E. *To improve public access to corporate information, measures should be undertaken for the rapid phase-in of the electronic filing of periodic corporate reports with the Securities and Futures Commission and for free public Internet access to these filings.*

F. *Provisions should be introduced into the Commercial Code permitting small companies to provide in their articles of incorporation for exemption from the application of selected provisions of the Code (including some of the amendments to the Commercial Code proposed here). Small companies would be defined on the basis of a pre-determined level of assets or, preferably, a maximum number of shareholders. Alternatively, consideration should be given to encouraging use of the* yuhan hoesa *form by small businesses.*

EXPLANATION AND COMMENTARY ON THE CONSULTANTS' RECOMMENDATIONS

I. Empowering Boards of Directors and Strengthening Independent Directors

A. The role of the Board of Directors should be more clearly defined by providing an explicit list of corporate actions that require a decision by the Board of Directors.

Commentary: For most Korean companies, the Board of Directors has not been an effective decision-making body. The Commercial Code should ensure that all major corporate decisions are brought to the Board of Directors for consideration and decision. Management will run the company's day-to-day business, but the Board of Directors should approve major decisions. This is the traditional division of authority between the Board of Directors and management that is followed in most other countries.

As a practical matter, even if the Board of Directors is given very broad powers (we propose that the Board of Directors should have discretion to determine which issues, in addition to those specified in the law or the company's articles of incorporation, require a Board of Directors decision), it will not micro-manage the company's business activities. The outside board members have neither the time nor the incentive to do so.[22]

In order to change the culture of Korean boardrooms, the Commercial Code should list the matters requiring Board of Directors approval, rather than merely state in general that a Board decision is required for all material matters not reserved to the shareholders. We expect that larger companies will make use of Board committees to streamline Board decision-making and to develop directors' expertise in specialized areas on which Board decisions may be required.

Under the Commercial Code, matters to be decided by the Board may be delegated to committees of the Board, subject to the right of any Board member to bring any committee decision to the Board for reconsideration. In some cases, Boards will find it efficient to adopt general resolutions to address certain matters: for example, the annual budget, adopted by the Board, may include approval for capital raising transactions within defined limits.

Article 393 of the Commercial Code should be amended to provide that the Board of Directors has authority to approve all matters regarding a company's business which have not been expressly reserved to the shareholders by law or the company's articles of incorporation. Without limiting that general principle, the following matters (some of which already require Board approval under the Commercial Code) should require approval by the Board of Directors and may not be delegated to the company's executive management:

(i) For a listed company, adoption of a business plan specifying the major strategic directions of the company's activity, and periodic review and revision of such plan.

(ii) For a listed company, adoption of an annual budget for the company, and periodic review and revision of such budget.

(iii) The decision to convene the annual general meeting and any extraordinary shareholder meetings.[23]

(iv) The specification of the agenda of the annual general meeting and any extraordinary shareholder meetings.[24]

(v) For a listed company, adoption of other decisions regarding shareholder meetings,[25] including establishing a record date[26]

22. *See* MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 139-48 (1976) (explaining why, even if the Board of Directors is instructed by statute to manage the business (as was often the case in the United States), it cannot do so as a practical matter and can review only major decisions).

23. *See* REPUBLIC OF KOREA, COMMERCIAL CODE art. 362.

24. *See id.*

25. *See id.*

26. *See id.* art. 354.

and approving materials for distribution to shareholders in respect of any such meeting.[27]

(vi) Issuance of shares,[28] bonds and other securities,[29] including the issue and conversion prices and other material terms and conditions of these securities;[30] approval of other financing transactions where the amount of the financing equals 5% or more of the company's assets or revenues.

(vii) Acquisition and redemption by the company of its shares, bonds and other securities.[31]

(viii) Determination of the fair market value of shares or property and the arms-length nature of related party transactions, when required by other provisions of the Commercial Code.

(ix) The proposed amount and form of directors' compensation, for approval by the shareholders.[32]

(x) The proposed amount of dividends, for approval by the shareholders.[33]

(xi) Appointment and termination of the company's senior officers including the representative director[34] and, for senior officers who are not directors, the terms of their employment and compensation.

(xii) Proposing to shareholders selection of the external auditors, and determining the terms of the external auditors' engagement.[35]

(xiii) Approving the company's annual business report and financial statements and submitting the statements and report to the shareholders for approval.[36]

(xiv) Adoption of internal procedural rules for the Board of Directors and its committees.

(xv) The establishment of branch offices[37] and subsidiaries.

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27. *See id.* arts. 362 & 363.
28. *See* REPUBLIC OF KOREA, COMMERCIAL CODE art. 416.
29. *See id.* arts. 469, 513 & 516-2.
30. *See id.* arts. 416, 469, 513 & 516-2.
31. Under the Commercial Code, the acquisition by a company of its shares is not permitted except in certain exceptional cases. However, Article 189-2 of the Securities Exchange Act and Article 84-3(1) of the Presidential Decree thereunder permit listed companies to acquire their shares through the Korea Stock Exchange, KOSDAQ, or by tender offer pursuant to a resolution of the Board of Directors.
32. *See* REPUBLIC OF KOREA, COMMERCIAL CODE arts. 362 & 388.
33. *See id.* arts. 447 & 462.
34. *See id.* art. 389(1).
35. *See* REPUBLIC OF KOREA, ACT ON EXTERNAL AUDIT OF JOINT STOCK COMPANIES art. (4)(2) [hereinafter AEAJSC].
36. *See* REPUBLIC OF KOREA, COMMERCIAL CODE arts. 447 & 447-2.

(xvi) **Approval of corporate transactions, including acquisitions, investments, disposals, leases and mortgages, in an amount equal to 5% or more of the company's assets or revenues, approval of simplified mergers and small-scale mergers as provided in Articles 527-2 and 527-3 of the Commercial Code, and submitting to shareholders for approval transactions requiring shareholder approval pursuant to the Commercial Code or the company's articles of incorporation.**[38]

(xvii) **Approval of related party transactions,**[39] **and submitting large related party transactions for approval by non-interested shareholders when required by other provisions of the Commercial Code.**

(xviii) **Other matters requiring Board of Directors approval pursuant to the Commercial Code or the company's articles of incorporation.**

(xix) **Proposing, for approval by the shareholders, other matters which should be determined by the Board.**[40]

Commentary: This list of major decisions to be made by the Board of Directors is consistent with practice in other countries that have active Boards of Directors. Consideration should be given to whether small companies with a modest number of shareholders should be exempted from some of these requirements.

For a presentation of comparative practice, see Annex *B*, para. III.A.

B. A limited extension of directors' fiduciary duties to shareholders should be recognized.

Article 382-3 of the Commercial Code should be amended to provide an explicit duty on the part of directors to deal with all shareholders in a fair and equitable manner and to ensure equal treatment to all shareholders of the same class.

Commentary: The corporate and securities legislation of most comparator jurisdictions defines the duties of a director as duties *to the company*. However, judicial interpretation of such duties has introduced, in certain situations, an element of responsibility to deal equitably with all shareholders. For example, it is universally understood that the Board of Directors may not pay higher dividends to some holders of ordinary shares than to other holders of the same class of shares, and that a company should not selectively disclose material information to some shareholders and not others, thus permitting

37. *See id.* art. 393(1).
38. *See id.* arts. 362 & 363.
39. See REPUBLIC OF KOREA, COMMERCIAL CODE art. 398 with respect to Board approval of transactions between the company and a director.
40. *See id.* arts. 362 & 363.

better-informed shareholders to profit by trading in the market with less-informed shareholders.

We believe that the explicit statutory recognition of an obligation of the Board of Directors, as part of its fiduciary duty, to treat all shareholders fairly and equitably, and to treat shareholders of the same class equally, would be an appropriate response to widespread concern about the inadequate protection of minority shareholder rights in Korea. This duty is intended to ensure that directors do not approve transactions which discriminate between shareholders of the same class (and, especially, in favor of controlling shareholders) or which discriminate between different classes of shares in a manner unrelated to the legal rights of the different classes. For example, an acquisition or disposal transaction which allocated almost all of the economic benefit of the transaction to the voting ordinary shares and little or none of the economic benefit to the holders of non-voting ordinary shares could constitute a breach of the directors' fiduciary duty to treat shareholders fairly and equitably.

The fiduciary duty of directors to shareholders is expressed in general terms. This is characteristic of the statutory description of the fiduciary duties of directors in Korea and other civil law jurisdictions and the description of fiduciary duties developed by courts in common law jurisdictions. Over time the scope of this duty to shareholders will be clarified by judicial interpretation.

For a presentation of comparative practice, see Annex *B*, para. III.D.1.

C. The right of directors to access all corporate information necessary to perform their duties should be expanded and clarified.

A new Article should be added to the Commercial Code to give directors the authority (comparable to that provided in Articles 412 and 412-4 for statutory auditors) to require the officers of the company to report on, and to investigate themselves, the affairs and financial condition of the company and its subsidiaries. The provision should explicitly guarantee to the directors full access to all business records and books of account of the company and effective access to employees.

Commentary: A continuing theme in our discussions with independent directors of Korean companies is the difficulty they encounter in obtaining the corporate and financial information that they need for informed decision-making. Though directors' rights to this information may be inherent in their status as directors, the Commercial Code should recognize such rights explicitly. The access provided to statutory auditors under Commercial Code Articles 412 and 412-4 is an appropriate starting point for such a provision, though these Articles should be expanded to give both directors and statutory auditors full access to all of a company's business records and books of account and to all company employees.

For a presentation of comparative practice, see Annex *B*, para. III.F.

D. The duty of confidentiality on the part of directors, shareholders and others should be made explicit.

A new Article should be added to the Commercial Code to impose upon a company's directors, shadow directors, statutory auditor and shareholders a duty to preserve the confidentiality of any non-public information obtained by them from the company and not to use such information for their own or their families' personal benefit.

Commentary: The obligation to maintain the confidentiality of non-public corporate and financial information obtained by a director, shadow director (as defined in Article 401-2 of the Commercial Code) or statutory auditor and the obligation not to use such information for their personal benefit may be implicit in their duty of loyalty to the company, it would be desirable explicitly to recognize such a duty by directors and statutory auditors. This duty should also be extended to shareholders who receive non-public information from the company.

For a presentation of comparative practice, see Annex *B*, para. III.F.

E. **Recent amendments to the Commercial Code and the Securities and Exchange Act authorizing the establishment of Board committees, establishing procedures for their operation, and providing for audit committees at least two-thirds of whose members must be independent directors and nominating committees at least one-half of whose members must be independent directors, are commended.**

Commentary: Board committees have an important role to play in corporate practice. The use of such committees, particularly by larger companies, reflects a recognition internationally that such committees can contribute to more efficient Board decision-making and to the development within the Board of expertise relevant to particular areas of a company's management and operations.

Recent amendments to Article 391-3 of the Commercial Code authorize Boards of Directors to establish Board committees, provide that each director should receive notice of committee decisions, and permit each director to require the full Board to reconsider any committee decision. The right of the Board to reconsider any matter considered by a committee is appropriate. Consideration should be given, however, to creating strict time limits following a committee decision during which that decision is communicated to directors and a director can request reconsideration by the full Board. Otherwise, third parties cannot rely on the finality of the committee's decision and can be expected to insist upon full Board consideration to ensure finality.

For a presentation of comparative practice, see Annex *B*, para. III.C.1.

1. **As further experience is gained with audit committees, consideration should be given to making use of an audit committee mandatory for all listed companies. Consideration should also be given to requiring that all members of any such audit committee shall be independent directors.**

   Commentary: Article 415-2 of the Commercial Code now provides that a company may establish an audit committee in lieu of statutory auditors, that such audit committee shall consist of three or more directors and that at least two-thirds of such directors shall meet enumerated standards of independence. Article 191-17 of the Securities and Exchange Act and the February 2000 amendments to the Presidential Decree of the Securities and Exchange Act have made such audit committees mandatory for companies listed on the Korea Stock Exchange and having assets of at least 2 trillion Won.

Audit committees are an important means for ensuring the integrity of the external audit process and the adequacy of internal control systems. The external auditors should present their periodic audit reports to the audit committee and should report to the audit committee any irregularities encountered in their audits or as a result of other work for the company. Once potential irregularities are reported to the audit committee, the committee must determine how the matter should be investigated and what remedial action to take. More generally, major accounting policies and material accounting items requiring interpretation are matters on which the audit committee should be consulted and, as appropriate, decisions taken by the audit committee or the entire Board.[41]

As experience is gained with audit committees, they should be made mandatory for all listed companies. We also believe that the audit committee should be composed wholly of independent directors. A central role of the audit committee is to serve as a place for auditors to go if they discover or suspect that the company has provided them with false or misleading financial information. For the audit committee to serve that role effectively, it must be composed exclusively of independent directors. Irregularities identified by the company's external auditors often involve actions taken by executives of the company or the failure of such executives to provide adequate supervision. Auditors (or others wishing to bring matters to the attention of the audit committee) should not have to report such matters to a group composed, even in part, of company executives. A requirement that the audit committee be composed exclusively of independent directors is not feasible in Korea at this time, but we believe that such a requirement should be introduced as the number of independent directors grows, beginning with the largest listed firms.

For a presentation of comparative practice, see Annex *B*, para. III.C.2.

2. **As further experience is gained with Board committees generally, consideration should be given to requiring one or more independent directors to serve on each Board committee of a listed company (unless a larger number or percentage is otherwise required by law, regulation or the company's articles of incorporation, as is now the case with audit and nominating committees).**

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41. On the role of audit committees, see *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, 54 BUS. LAW. 1057 (1999).

Commentary: Independent directors should play similar roles on Board committees as they play at the full Board, since committees are exercising delegated authority from the Board. Accordingly, it would be desirable for all Board committees to include at least one independent director. The involvement of independent directors on Board committees serves two purposes. First, participation by independent directors can enhance the objectivity and transparency of committee decision-making. Second, participation by independent directors in the work of Board committees enables the independent directors to develop expertise in technical and complex areas (through participation, for example, on a finance committee or an audit committee) and on the company's operations (through participation, for example, on a management or executive committee or a compensation committee), which can help them perform their overall oversight duties.

Concerns have been expressed in Korea that independent directors will not have the expertise to function on such committees nor the time to serve on committees. Concerns about expertise will diminish over time, and do not recognize that one purpose of including independent directors on Board committees is to enable them to acquire expertise which will make them more effective in general. Experience with independent directors in other countries confirms that the time needed for service on committees of the Board of Directors is not excessive. Also, companies generally pay additional compensation to independent directors who serve on Board committees in addition to their service on the main Board.

For a presentation of comparative practice, see Annex *B*, para. III.B.2.

Commentary: In exercising delegated authority from the Board, committees should be subject to the same record-keeping standards as the full Board. Minutes of committee meetings should be open to inspection by shareholders to the same extent as minutes of full Board meetings, to ensure the transparency of corporate decision-making. The standards applicable to the minutes of Board of Directors meetings are addressed in Article 391-3 of the Commercial Code, which requires that such minutes include the agenda, the procedures followed and the actions taken at the meeting, the identity of the directors who objected to a resolution and the reasons for their objections. Any shareholder may inspect and copy the minutes during business hours. While the company may reject a demand for inspection, it must state the reasons therefor and the shareholder may seek a court order to compel the company to permit such inspection and copying. This seems an appropriate balancing of interests that can be reviewed, if necessary, in the light of experience.

F. The liability of independent directors should be limited in cases in which they have acted in good faith.

Articles 399 and 401-2 of the Commercial Code should be amended to provide that the personal liability of an independent director will be

limited, in the case of non-willful breaches of duty not involving personal benefit to the director or the director's family, to a multiple (such as 5 times) of the director's total annual compensation from the company (including the value of non-cash compensation). This liability should not be further reduced by corporate indemnification or directors and officers (D&O) insurance.

Commentary: There is a risk that qualified individuals may be reluctant to serve as independent directors because of the potential liability to which they may be exposed. We consider it appropriate to limit independent directors' liability for breaches of duty where those breaches are not intentional and involve no personal benefit to the director or the director's family.[42] The proposed limitation of liability – to a meaningful multiple of the director's annual remuneration from the company (including the value of non-cash compensation) – will still impose a sanction on the director for such breach of duty, but prevents the catastrophic losses to which a director might be exposed without a limitation of liability. This proposal is a compromise between the traditional position, followed in many jurisdictions, that directors are fully liable for damages caused by a breach of their fiduciary duty, and the position, recently adopted in the United States, that a corporation can eliminate all liability of directors for breach of the duty of care through a provision in the articles of incorporation.[43]

At the same time, once an independent director's liability is limited in this way, such liability should not be further limited by indemnification or insurance. Under our proposal, directors could be indemnified, or covered by directors and officers insurance, for legal and other expenses incurred in defending a lawsuit, and for amounts paid to settle a lawsuit, but would be responsible for paying any actual award of damages.

For a presentation of comparative practice, see Annex *B*, para. III.D.5. In the United States, concern over the deterrent effects of catastrophic personal liability on directors has resulted in limitations on liability which go much further than the Consultants' recommendations in the Korean context. For example, the Delaware General Corporation Law (Del. Code sec. 102(b)(7)) permits a Delaware corporation effectively to eliminate director liability for breach of the duty of care, and almost all listed companies incorporated in Delaware have chosen to do so.

G. Further steps should be taken to assure the effective independence of independent directors.

1. Relevant laws should be amended to unify the standards of independence for independent directors.

42. Directors would remain liable to third parties for their gross negligence pursuant to Article 401 of the Commercial Code.

43. A similar proposal to limit the directors' liability to a multiple of their compensation can be found in AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.19 (1994).

For a presentation of comparative practice, see Annex *B*, para. III.B.

2. **The existing standards of independence should be expanded to require the absence of "any other relationship with the company, its principal shareholders or its directors or officers which could compromise the independence of such person's judgment in respect of the company's business."**

3. **Independent directors should be required to certify their independence when they first stand for election as directors and annually thereafter.**

   Commentary: This annual certification is intended to formalize the procedure for confirming a director's independence, including continuing independence over time.

H. Support should be available to independent directors to enable them to perform their duties.

The Commercial Code should be amended to permit any director to consult the company's legal, financial and other professional advisors and the right of two or more independent directors, acting together, to engage independent legal, financial and other professional advisors for advice in regard to the conduct of their corporate responsibilities. The directors' reasonable expenses to obtain this advice should be paid by the company.

Commentary: Independent directors need access to legal and other professional advice regarding the conduct of their corporate responsibilities. Such assistance will often be available from the company's staff or from its outside advisors. However, in some cases such advice will not be readily available from the company and its advisors or, if provided by the company or its advisors, may lack independence or objectivity. Suppose, for example, that the independent directors must consider a proposal for a large related party transaction. They may want to obtain independent financial advice as to whether the transaction is in the interests of the non-interested shareholders. Such advice cannot be obtained from management, which may be interested in the transaction. As a practical matter, it cannot be obtained from the company's customary financial advisors, who will be anxious to remain on good terms with management in order to receive future business from the company.

Access to independent advice is particularly important during the current, formative period in the use of independent directors in Korea. To minimize the possibility that independent directors will overuse the right to obtain outside advice and incur expenses which must be paid by the company, we propose that the right to hire independent advisors can only be invoked by two or more independent directors rather than by one independent director acting alone. We include this restriction in order to meet objections that we heard in Korea, not because we believe that overuse of independent advisors will be a significant problem. Experience in other countries suggests that independent directors hire their own advisors infrequently. If there are cases when this right has been overused, we are not aware of them.

For a presentation of comparative practice, see Annex *B*, para. III.B.3.

II. Enhancing Shareholder Rights

A. The categories of corporate decisions requiring shareholder approval should be expanded and clarified to ensure shareholder participation in (i) large acquisition and disposal transactions by the company and its subsidiaries; (ii) large share issuance transactions by listed companies, and (iii) material related party transactions by the company or its subsidiaries.

Commentary: Shareholders should be entitled to approve large transactions that can fundamentally affect the company's business and large related party transactions. Objective standards should be established for which transactions require shareholder approval. To prevent companies from evading the rules by conducting transactions through subsidiaries, the approval requirement must also apply to a transaction by a subsidiary. Within an affiliated corporate group, the shareholder approval requirements should also extend to affiliated companies within the group. In addition, shareholder approval should be required for large share issuance transactions, other than public offerings for cash at prevailing market prices.

A core issue, in adopting shareholder approval requirements, is balancing the shareholder protection that the approval requirement provides against the delay and cost the requirement will impose. A larger threshold (we propose 20% of assets or revenues) is appropriate for transactions that do not involve a conflict of interest on the part of the company's directors and controlling shareholders. A lower threshold (we propose 5% of assets or revenues) is appropriate for related party transactions, because these involve a greater risk of harm to non-interested shareholders. In both cases, we believe that these thresholds are high enough to ensure that only a rare transaction, of unusual importance to the company, will require shareholder approval. The approval requirements will not affect the company's ordinary activities. At these threshold levels, the cost of the occasional need for shareholder approval should be offset by the additional protection of shareholders' interests.

The 20% threshold is found in United States practice for stock-for-stock acquisitions pursuant to New York Stock Exchange requirements for shareholder approval of the issuance of 20% or more of a company's previously outstanding shares to acquire another company. The Russian Law on Joint Stock Companies uses a threshold for shareholder approval of major acquisition transactions involving 25% of the book value of the company's assets. The OECD *General Principles of Company Law for Transition*

Economies[44] recommend a threshold for large acquisition and disposition transactions, while leaving to national legislatures the determination of the appropriate thresholds expressed as a percentage of the company's assets (as valued in the most recent balance sheet available at the time that the company's Board of Directors approves the transaction). The OECD Principles speak of such a threshold as a minimum protection for minority shareholders and contemplate that companies could provide for lower, stricter thresholds in their charters.

1. **Article 374(1) of the Commercial Code should be amended to require shareholder approval of the acquisition by a company or its subsidiaries of all or a part of another business, when the company's attributable interest in the acquired assets or revenues represents 20% or more of the Company's assets or revenues.**

   Commentary: This approval requirement would apply to all types of acquisition transactions (whether by the acquisition of shares, the purchase of assets or in any other form) and to any series of inter-related transactions. For the purposes of this provision (and the related provisions which follow), a company's "attributable interest" in the assets or revenues of the business being acquired should be the value of such assets or revenues or, if the business is being acquired by one or more subsidiaries of the company, the value of such assets or revenues multiplied by the successive shareholding percentages of the company and each intervening subsidiary.

   Consider an example. Company X owns 60% of Company Y. Company Y acquires all of the business of Company Z. Company X's attributable interest in the assets and revenues being acquired will equal 60% (Company X's ownership share in Company Y) of Company Z's assets and revenues. This transaction will require approval by the shareholders of Company X if Company X's attributable interest in the acquired assets or revenues exceeds 20% of Company X's assets or revenues.

   To consider a more complicated example, assume that Company B and Company C are each 80% owned by Company A. Each of Company B and Company C acquires 50% of the shares of Company D, a company having assets of 100 billion Won and revenues of 1,000 billion Won. The attributable interest of Company B and Company C in the acquisition will be 50% of Company D's assets and revenues. Approval by the shareholders of Company B and Company C will be required if this attributable interest is greater than 20% of their respective assets and revenues—that is, if 50% of 100 billion Won (Company D's assets) is greater than 20% of the assets of Company B or Company C, or if 50% of

44. Organisation for Economic Co-operation and Development, *General Principles of Company Law for Transition Economies*, 24 J. CORP. L. 190 (1999), *available at* http://papers.ssrn.com/paper.taf?abstract_id=126539 (Social Science Research Network).

1,000 billion Won (Company D's revenues) is greater than 20% of the revenues of Company B or Company C. Company A's attributable interest in the transaction will be the sum of (i) 80% (its shareholding percentage in Company B) multiplied by Company B's 50% interest in the assets and revenues of Company D, and (ii) 80% (its shareholding percentage in Company C) multiplied by Company C's 50% interest in the assets and revenues of Company D. Approval by Company A's shareholders will be required if Company A's attributable interest in the transaction is greater than 20% of Company A's assets or revenues (that is, if [0.80 x 0.50 x 100 billion Won + 0.80 x 0.50 x 100 billion Won] is greater than 20% of Company A's assets or if [0.80 x 0.50 x 1,000 billion Won + 0.80 x 0.50 x 1,000 billion Won] is greater than 20% of the revenues of Company A.

For a presentation of comparative practice, see Annex *B*, para. I.E.1.

2. **Article 374(1) of the Commercial Code should be further amended to require shareholder approval of the disposition by a company or its subsidiaries of any part of their business or assets in which the company's attributable interest represents 20% or more of the Company's assets or revenues.**

Commentary: This shareholder approval requirement would apply to all types of disposal transactions (whether by sale, lease or in any other form) and to any series of inter-related transactions. The company's "attributable interest" in the assets or revenues of the business being disposed of would be determined in the same manner as for acquisition transactions. Any such transaction would require approval by special resolution of a general meeting of shareholders.

For a presentation of comparative practice, see Annex *B*, para. I.E.2.

3. **A new Article 374-1 should be added to the Commercial Code to deal with material acquisition and disposal transactions by a company's non-subsidiary affiliates. When a company's affiliate acquires or disposes of all or part of its business or assets and the company's attributable interest in the business or assets being acquired or disposed is greater than 20% of the company's assets or revenues, the company's shareholders should determine how the company and its subsidiaries vote the shares of the affiliate held by the company and its subsidiaries in any vote by the affiliate's shareholders on the transaction.**

Commentary: In extending the shareholder approval requirements for large acquisition and disposal transactions to transactions by affiliates, Korea would be establishing an important precedent in providing shareholder protection within affiliated corporate groups. As a practical matter, situations in which a parent company will have a 20% attributable interest in a transaction by an affiliate (that is not a subsidiary) will be rare. Transactions of this size are rare to begin with, and shareholder votes on transactions by affiliates will be even rarer because the attribution rules will reduce the effective transaction size from the perspective of the parent company. Thus, the principal effect of this rule will be to block intentional evasion of the basic rules set forth above governing large acquisition and disposition transactions.

For the purpose of these provisions, an "affiliate" would include all other companies in which the company or any of its subsidiaries has a shareholding and which, with the company, (i) are required to be included in the combined financial statements of the same group pursuant to the AEAJSC, (ii) are treated as affiliated companies within the same business group for purposes of the MRFTA, or (iii) meet a new, general definition of affiliation, which might be as follows.

"Affiliated persons" with respect to each other are deemed to be (a) a group of persons who by force of a contract, including an oral contract, or another transaction have the ability to determine the decisions adopted by a company; (b) a company and a person (including a group of persons) who by force of a contract, including an oral contract, or another transaction have the ability to determine the decisions adopted by a company; (c) a predominant company (defined as a company that owns 20% or more of another "dependent" company) and its dependent company; (d) two or more dependent companies of the same predominant company; (e) two or more companies if a person (including a group of persons) has the ability to determine the decisions adopted by both or all of them; (f) a company and its director or officer, other than an independent director; (g) a company and a person who is an affiliated person of an affiliated person of the company; and (h) family members (suitably defined) of any such person.[45]

The "attributable interest" of a company in an acquisition or disposal transaction involving an affiliate will be determined in the same manner as for transactions involving a company and its subsidiaries as set forth above.

Thus, take the example of Company A, its 80% subsidiary Company B and its affiliated Company C, in which Company B holds a 15% interest. Company C intends to acquire Company D, which has assets of 100 billion Won and revenues of 1,000 billion Won. The transaction requires (we will assume) the approval of Company C's shareholders. Companies A, B and C have been determined by the Fair Trade Commission under the MRFTA to be members of an affiliated business group. The attributable interest of Company B in the acquisition will be 15% of Company D's assets and revenues. If Company B's attributable interest is greater than 20% of its assets or revenues (that is, if 0.15 x 100 billion Won is greater than 20% of Company B's assets or if 0.15 x 1,000

45. This definition is adapted from the *Model Law on Joint Stock Companies*, *in* BERNARD BLACK, REINIER KRAAKMAN & ANNA TARASSOVA, GUIDE TO THE RUSSIAN LAW ON JOINT STOCK COMPANIES app. I (1998).

billion Won is greater than 20% of Company B's revenues) then a vote of Company B's shareholders is required to determine how Company B will exercise its right (as a shareholder of Company C) to vote on this transaction. Company A's attributable interest in the transaction will be 80% (its shareholding percentage in Company B) multiplied by 15% (Company B's interest in Company C) of the value of Company D's assets and revenues. If Company A's attributable interest is greater than 20% of its assets or revenues (that is, if 0.80 x 0.15 x 100 billion Won is greater than 20% of Company A's assets or if 0.80 x 0.15 x 1,000 billion Won is greater than 20% of Company A's revenues) then a vote of Company A's shareholders is required to determine how Company A will exercise its right (as a shareholder of Company B) to vote on the transaction. This vote, in turn, will determine how Company B will exercise its right to vote on the transaction as a shareholder of Company C.

For a presentation of comparative practice, see Annex *B*, para. I.E.1 and I.E.2.

4. **Shareholder approval should be required for an issuance by a listed company of ordinary shares or securities convertible into ordinary shares which represent 20% or more of the previously outstanding shares of the company, other than transactions involving (i) the public offering of shares for cash at the prevailing market price of the shares or (ii) the public offering of convertible securities with a conversion price greater than the prevailing market price of the shares.**

Commentary: A large issuance of ordinary shares or securities convertible into ordinary shares, other than a public offering for cash at prevailing market prices, is a material event in the life of a company and could result in significant changes in the composition of the company's shareholders. Such a transaction should be subject to approval by the shareholders, and the articles of incorporation of the company should not be permitted to provide otherwise.

Shareholder approval of share issuance transactions and shareholders' pre-emptive rights are intimately linked. Even if a share issuance does not require shareholder approval, preemptive rights can protect existing shareholders from dilution. Another of our Recommendations would expand the scope of pre-emptive rights. The current Recommendation for shareholder approval of large share issuance transactions is intended to work together with such expanded pre-emptive rights. If the Commercial Code is not amended to expand the application of pre-emptive rights, the need to require shareholder approval of large issuances of shares and convertible securities will become even more important.

For a presentation of comparative practice, see Annex *B*, para. I.E.3.

5. **As part of a comprehensive series of provisions to address material related party transactions (see Monitoring Related Party Transactions below), large related party transactions by a company should require approval by the company's non-interested shareholders. Large transactions requiring shareholder approval would be transactions, other than in the ordinary course of the company's business, exceeding in value a certain percentage (perhaps 5%) of the company's assets or revenues. Approval by the company's non-interested shareholders would also be required for related party transactions by the company's subsidiaries and affiliates where the company's attributable interest in the related party transactions exceeds this threshold.**

Commentary: Shareholder approval is an important protection for related party transactions because these transactions create a large risk of harm to minority shareholders. Requiring shareholder approval only for large transactions other than in the ordinary course of the company's business ensures that the required approvals should not be frequent.

Only non-interested shareholders would be permitted to vote on such transactions. Thus, in related-party transactions between companies within a single *chaebol*, the *chaebol*'s controlling shareholders would be interested in the transaction and, as interested shareholders, would not be permitted to vote for approval of the transaction. The concept of a shareholder being interested in a transaction on which a shareholders vote is required is already addressed in Article 368(4) of the Commercial Code.

Under a recent amendment to the Presidential Decree of the MRFTA, Board of Directors approval and public notice are required for a company which is a member of the ten largest *chaebol*, for certain types of transactions with or in favor of interested parties which have a value greater than 10% of the company's paid-in capital or ten billion Won. These requirements should help to reduce related party transactions within these groups on non-market terms. It would be desirable, nonetheless, to adopt general principles that apply to all Korean corporate groups. First, related party transactions remain a problem in company groups well beyond the ten largest. Second, even within the ten largest groups, only independent directors should be permitted to vote to approve a related party transaction, and for large transactions, shareholder approval should be required (in addition to Board of Directors approval).

For a presentation of comparative practice, see Annex *B*, para. II.B.

B. Procedures for the election of directors of listed companies should be amended to (i) provide for a unified ballot for the election of directors, which includes nominees of the Board of Directors and any shareholder nominees, and (ii) strengthen cumulative voting.

1. **Recent amendments to the Securities and Exchange Act provide that independent directors of listed companies with assets of at least 2**

trillion Won shall be nominated by a nominating committee of the Board of Directors, at least one-half of whose members must be independent directors. The enactment of such provisions is commended. As experience is gained with nominating committees, consideration should be given to reducing the company size threshold for this requirement.

Commentary: Nominating committees provide transparency in the process by which a company nominates directors for election to the Board of Directors by the company's shareholders. They also provide accountability, since nominating committees (particularly when composed principally of independent directors) make choices on the basis of objective criteria related to the qualifications of the candidates and the particular needs of the company. Recent amendments to the Securities and Exchange Act requiring the nomination of independent directors at the largest listed companies to be made by a nominating committee at least one-half of whose members must be independent directors are to be commended. Ultimately, all candidates for election as directors of the company should be proposed to the shareholders by a nominating committee of the Board of Directors consisting of at least a majority of independent directors. Such a nominating committee would be expected to make nominations in the best interests of the company, involving a mixture of executive directors and independent directors appropriate to the business and management structure of the company.

Shareholders (including controlling shareholders) who may be dissatisfied with such nominations may nominate other candidates for election as directors, in accordance with the shareholder nomination procedures available to all shareholders.

For a presentation of comparative practice, see Annex *B*, para. III.B.1 and III.C.1.

2. **Under current law, at a general shareholder meeting at which the election of directors is an agenda item, any shareholder may nominate, and any other shareholder may second the nomination of, one or more candidates for election to the Board of Directors. In addition, shareholders of a listed company holding a designated level of shares (such as 1%) should be permitted to nominate candidates prior to such a meeting, to have the company disseminate information about these candidates at the same time as information regarding candidates nominated by the Board of Directors, and to have these candidates and those nominated by the company listed in a single unified ballot for the election and in any proxies solicited by the company for such meeting.**

Commentary: Shareholders and company executives often are unaware of the right of shareholders under current law to nominate directors. The Commercial Code should set out more fully the procedures for shareholders to nominate directors. These procedures should include notice to all shareholders of the candidates for election, whether nominated by the company or by shareholders. A unified ballot will avoid any advantage which might arise from company-nominated directors appearing on an "official" ballot.

For a presentation of comparative practice, see Annex *B*, para. I.A.1.

3. **Article 382-2 of the Commercial Code should be amended to ensure that cumulative voting is available to shareholders of listed companies by removing these companies' power to preclude cumulative voting in their articles of incorporation. To give practical effect to cumulative voting, (i) all directors of listed companies should be elected annually and (ii) where a director was nominated by a shareholder and elected using cumulative voting, removing that director would require removing all directors followed by a new election, again using cumulative voting.**

Commentary: Cumulative voting is an important mechanism for providing large minority shareholders, especially institutional investors, with an effective voice at the Board of Directors, and greater access to information about the company's activities than they could obtain from the company's public disclosures.[46] There is empirical evidence that companies that eliminate cumulative voting suffer a decline in share price as a result.[47]

It is true that cumulative voting has fallen out of favor in some developed countries, including the United States. However, the principal reason that many companies do not use cumulative voting is the same reason that it is important: it enhances the ability of large minority shareholders to monitor the actions of managers. Managers and controlling shareholders dislike cumulative voting for the same reason. When managers and controlling shareholders are politically strong, they are often able to eliminate cumulative voting as a legal requirement.

Experience teaches that if cumulative voting can be eliminated by a provision in a company's articles of incorporation, it will usually be eliminated and will have little practical effect. Thus, the current Korean rules permitting cumulative voting do not provide any significant benefit to shareholders, because very few large companies in fact permit cumulative voting. The reforms that introduced this rule were cosmetic only—they produced no actual change in corporate practices.

Cumulative voting provisions can be diluted by reducing the size of the Board of Directors (thus increasing the number of votes required to elect a single director) or using staggered terms of office (thus reducing the number of directors being elected at any time and, therefore,

46. *See* Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1947-49 (1996); Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124 (1994).

47. *See* Sanjai Bhagat & James A. Brickley, *Cumulative Voting: The Value of Minority Shareholder Voting Rights*, 27 J.L. & ECON. 339 (1984).

increasing the number of votes required to elect a single director). Experience also indicates that cumulative voting is most effective when institutional investors are active in the market, because they have larger shareholdings and greater ability to mobilize other institutional investors than individual shareholders and shareholder groups. The recommended amendments to the Commercial Code (including an amendment to Article 383-2 to give effect to the annual election of directors) are intended to enhance the effectiveness of cumulative voting in Korea, and also to enhance the influence of institutional investors.

As a practical matter, even if cumulative voting is available, it will rarely be used. When a company is performing well, shareholders will not oppose the company's own nominees. When the company is not doing well, and a large minority shareholder credibly threatens to demand cumulative voting and run an election campaign, the company will often agree voluntarily to include the shareholder's nominee in its own slate of candidates, thus avoiding the expense and embarrassment of an election campaign.

For a presentation of comparative practice, see Annex *B*, para. I.C.2-3.

C. To ensure more effective shareholder meetings, amendments to the Commercial Code should require (i) 30 days' notice of a listed company's annual shareholder meeting, (ii) more detailed notices and agendas for all shareholder meetings, and (iii) fuller disclosure by listed companies of information relating to matters to be considered at a shareholder meeting.

Commentary: If shareholder approval rights are to be meaningful, shareholders must have enough information to make informed decisions and adequate notice of shareholder meetings to consider the matters to be decided and, if they so wish, to consult with other shareholders and organize common positions.

1. Article 363(1) of the Commercial Code should be amended to require 30 days notice for a listed company's annual shareholder meeting. Other shareholder meetings may be convened on 14 days notice, as presently provided.

Commentary: Fourteen days notice is reasonable for most general shareholder meetings and may sometimes be necessary to ensure that business transactions requiring shareholder approval can be consummated quickly. However, the annual general meeting is of particular importance to minority shareholders. It is at the annual general meeting that directors and auditors are elected, financial statements are approved, dividends declared, and most shareholder resolutions are presented.

In our judgment, 30 days' notice is appropriate for the annual general meeting of a listed company. This period is needed to allow shareholders to receive information about the meeting and voting ballots by mail, to review the materials, and to determine the action which they wish to take (including, possibly, communicating with other shareholders about the meeting) and to return their votes (also by mail).

As a practical matter, it is usually not hard for companies to prepare the agenda for the annual shareholder meeting a month in advance of the meeting.

Related time periods addressed in the Commercial Code (Article 354 dealing with "Suspension of Entry in Shareholders' Register" and Article 447-3 dealing with "Submission of Financial Statement" to a company's statutory auditor) should not require amendment on the basis of the modest extension of the notice period for the annual shareholder meeting which is recommended here.

For a presentation of comparative practice, see Annex *B*, para. I.A.1.

2. **Article 363 of the Commercial Code should be further amended to require that the notice and agenda for a shareholder meeting set forth in reasonable detail the matters to be considered at the meeting.**

   Commentary: Concerns were expressed during our consultations that the materials provided to shareholders often do not provide enough information for shareholders to make informed decisions on the matters on the agenda for a shareholder meeting.

   For a presentation of comparative practice, see Annex *B*, para. I.A.1-2.

3. **Article 363 of the Commercial Code should be further amended to require listed companies to timely distribute to all shareholders prior to any shareholder meeting written materials containing all material information necessary for shareholders to make an informed decision on the issues to be presented at the meeting.**

   Commentary: Shareholders need to receive all written materials for a shareholder meeting in sufficient time to review them and, if appropriate, consult with other shareholders.

   a. **For a meeting at which the election of directors is to occur, such information should include background information on the candidates for election as directors (whether nominated by the company or by shareholders), including their educational and professional backgrounds, their business experience, and their past and present relationships (if any) with the company and its affiliates.**

      Commentary: Background information on directors proposed for election is necessary for shareholders to make informed decisions, whether or not the election is contested.

   b. **For a meeting at which a resolution proposed by a shareholder is to be considered, the proponents of such resolution should timely provide comparable material to the company for timely distribution to shareholders prior to such meeting.**

Commentary: The need for shareholders to receive the information they need to make informed decisions applies equally to resolutions proposed by shareholders as to those proposed by management. The company should provide to shareholders such corporate information as is reasonably necessary for the preparation of such materials, and the company should print and distribute all materials provided to shareholders and bear the associated cost.

c. **The materials for the annual meeting should explain the procedures for shareholders to nominate directors or to propose resolutions for consideration at a shareholder meeting.**

Commentary: For listed companies, shareholders should be reminded annually of the procedures to be followed to nominate directors or propose shareholder resolutions, including the deadlines for these actions.

For a presentation of comparative practice, see Annex *B*, para. I.B.1-2.

D. Shareholder access to information regarding the company should be enhanced, subject to an explicit obligation of shareholders to maintain the confidentiality of any non-public information so obtained (see Recommendation I.D).

Commentary: Concerns were expressed during our consultations that shareholders often had trouble in obtaining information about corporate affairs which they considered relevant to the exercise of their rights as shareholders. Strengthening shareholders' rights to obtain information appears warranted, subject to the shareholders' obligation to keep confidential any non-public information that the shareholder receives from the company.

1. **Article 466 of the Commercial Code should be amended to reduce the minimum level of shareholding required for a shareholder of a listed company to obtain access to company records relevant to the exercise of shareholder rights and to ensure that the records available for inspection by shareholders include the company's business records.**

Commentary: It would be appropriate to lower the current shareholding thresholds (which range from 0.5% to 3.0% depending on the company's size and whether it is listed) for the exercise of rights of access to account books and related documents pursuant to Article 466 and to make clear that such rights of access to other business records of the company. The right of access to business records other than the company's account books and related documents could be subject to the shareholder's demonstration of a proper purpose for the requested access to such records.

For a presentation of comparative practice, see Annex *B*, para. I.D.1.

2. **Article 467 of the Commercial Code should be amended to permit any shareholder to apply to the court to appoint an inspector where**

there is reason to suspect that the company or its management has committed a dishonest act, or violated relevant law or the company's articles of incorporation.

Commentary: To persuade a court to appoint an inspector, a shareholder must satisfy a court that there is reason to suspect serious misconduct. The court can filter out frivolous petitions. Accordingly, it is appropriate to permit any shareholder to make such an application to court.

For a presentation of comparative practice, see Annex *B*, para. I.D.2.

3. **Article 635 of the Commercial Code should be amended to provide meaningful sanctions on a company and its management for failure to comply with the provisions of the Commercial Code providing for shareholder access to company information.**

Commentary: Shareholders' effective access to corporate information is essential to their exercise of their rights of approval. We have heard complaints from shareholders that their requests for information are often not complied with, and that sanctions against companies are so low that company insiders can easily afford to pay the fine, instead of complying with the information request. The sanctions must be strong enough to ensure that companies provide shareholders with information that the shareholders are entitled to obtain. The sanctions set forth in Article 635 of the Commercial Code should extend to violations of disclosure rights granted to shareholders under Article 466. For violations of shareholder rights under Articles 396 and 466, sanctions should be increased (possibly to 10 million Won) and be assessable against the company and any director or senior corporate officer specifically responsible for refusing an appropriate shareholder request for information. The liability of the relevant director or officer should not be subject to indemnification by the company.

For a presentation of comparative practice, see Annex *B*, para. VIII.A.1.

4. **The sanctions for failure to comply with the other disclosure requirements of the Commercial Code, Securities and Exchange Act, Enforcement Decree of the Securities and Exchange Act and the Korea Stock Exchange Listing Rules should be increased and should include the right to impose material fines on the company and its management. For listed companies, the government should encourage greater use of the existing sanctions of suspension and delisting of a company's securities.**

Commentary: A general upward revision of the sanctions for failure to comply with disclosure requirements under other provisions of the Commercial Code and related legislation appears warranted. For the reasons stated above, liability should extend to the company and any director or senior corporate officer specifically responsible for the disclosure violation. Greater use should be made of the existing sanctions of the suspension or delisting of a listed company for violations of such disclosure requirements, particularly when such violations are unremedied or repeated.

For a presentation of comparative practice, see Annex *B*, para. IV.G and VIII.A.1-2.

E. Shareholder pre-emptive rights for issuance of ordinary shares by listed companies should be strengthened.

Commentary: Pre-emptive rights are an important mechanism for protecting the interests of minority shareholders. Pre-emptive rights continue to play an important role in the corporate law regimes of a number of the most developed corporate and capital markets, including most European countries.

1. Article 418(1) of the Commercial Code should be amended to preclude listed companies from restricting pre-emptive rights for issuance of ordinary shares in the company's articles of incorporation, other than provisions permitting annual shareholder approval for the issuance of shares, not exceeding 5% of the company's previously outstanding shares, in one or more transactions during such year. Other offerings without pre-emptive rights may be approved by special resolution of the shareholders, and mandatory pre-emptive rights should not apply to public offerings of a company's shares at or above the market price for the shares.

Commentary: Under Article 418(1), companies can eliminate or restrict shareholders' pre-emptive rights by provisions of the company's articles of incorporation. Many large companies have done so, and thereby deprived shareholders of an important protection against dilution. We believe that listed companies should be required to provide pre-emptive rights to shareholders when they issue ordinary shares, or securities convertible into ordinary shares, with only limited exceptions. One exception would be that shareholders could approve, each year, issuance during the year of up to 5% of the company's shares without pre-emptive rights. Specific transactions for the issuance of shares without pre-emptive rights could also be approved by a shareholder vote on a case-by-case basis. Pre-emptive rights also should not be required for public offerings of a company's shares at the market price of such shares; such public offerings provide to existing shareholders a reasonable opportunity to purchase shares (in the public offering or in the market) if they want to retain their proportionate interest in the company's shares. Exceptions would also be permitted for shares allocated to employees pursuant to applicable legal requirements and for stock option grants to management that have been approved by the shareholders.

Comparable (indeed even stronger) pre-emptive rights provisions work satisfactorily in England and continental Europe and have not significantly restricted companies' ability to raise capital. In addition, the short-term inconvenience of pre-emptive rights must be weighed against the protection they provide to minority shareholders, which can improve the prices that shareholders will pay for a Korean company's shares, and expand the pool of investors willing to invest in Korean companies.

For a presentation of comparative practice, see Annex *B*, para. I.E.3.

2. **Article 418 of the Commercial Code should be further amended to include in the transactions subject to pre-emptive rights issuance of securities which are convertible into ordinary shares of the company.**

Commentary: Pre-emptive rights should apply to securities which are convertible into ordinary shares to the same extent as they apply to ordinary shares. In the past convertible bonds have been issued in Korea in a number of transactions to dilute the position of minority shareholders. Commonly, such convertible bonds have been issued at a large discount to the market value of the ordinary shares into which the bonds can be converted, and are intended to convey share ownership to members of the company's founding family (often of a younger generation) at a bargain price. The company issues convertible bonds instead of ordinary shares in order to avoid the pre-emptive rights that would apply to an issuance of ordinary shares.

Unless pre-emptive rights apply to convertible securities, the loophole that Korean companies use today to avoid the pre-emptive rights that apply to ordinary shares will remain wide open. Pre-emptive rights for convertible securities would be subject to the same exceptions as pre-emptive rights for ordinary shares.

For a presentation of comparative practice, see Annex *B*, para. I.E.3.

3. **When a listed company issues ordinary shares or securities convertible into ordinary shares, other than in a public offering, and pre-emptive rights are not applicable, the company should give fourteen days' prior notice of the issuance to shareholders, including information about the material terms and conditions of the issuance.**

Commentary: Such a prior notice provision will further protect against abuses which have arisen in the use of convertible instruments, by providing potentially disadvantaged shareholders the opportunity to challenge any such proposed transaction either internally within the company or in the courts.

For a presentation of comparative practice, see Annex *B*, para. I.E.3.

4. **Offerings by listed companies of ordinary shares with the use of pre-emptive rights should be at no more than a 10% discount to the pre-offering market price, unless the independent directors determine, based on the advice of an independent financial advisor, that a larger discount is necessary to ensure the success of the offering.**

Commentary: Even if pre-emptive rights are available, an offering of shares at a large discount to market, as in the SK Telecom scandal of last year, can coerce shareholders into buying additional shares to avoid being diluted, and can dilute shareholders who can't afford the additional investment or don't timely respond to the share offer. There is no valid business reason for a company to coerce its shareholders into buying additional shares by offering them at an abnormally large discount to market.

Experience with pre-emptive rights in other countries shows that there is rarely a business reason for a discount exceeding 10% of the pre-offering market price. Our proposal permits discounts of up to 10%, and also gives companies the flexibility to employ a larger discount if this is genuinely necessary to ensure the success of the offering.

III. Monitoring Related Party Transactions

A. The Commercial Code should be amended to provide more comprehensively for approval of related party transactions by non-interested directors and, for major related party transactions, by non-interested shareholders.

Commentary: Related party transactions within Korean corporate groups are a major concern for minority shareholders and government regulators. Prohibitions exist on certain types of related party transactions for certain companies (such as prohibitions on intra-group guarantees under the MRFTA), notice requirements to the Financial Supervisory Commission and the Korea Stock Exchange exist for certain transactions between listed companies and their largest shareholder, and notice and board approval requirements exist for intra-group transactions within the ten largest *chaebol.* But these constraints are, for the most part, relatively weak. Related party transactions, often not on market terms, remain common.

There is no single greater problem for Korea's capital markets than the widespread belief, justified by ongoing abuses, that minority shareholders are systematically disadvantaged and that there are no effective legal constraints on related party transactions and other forms of self-dealing that transfer wealth from minority shareholders to controlling shareholders. Korean companies routinely engage in intra-group transactions, or issue shares at a discount to insiders, in ways that do not occur in countries with strong capital markets. These practices adversely affect the share price of all Korean companies, even those that have not misbehaved recently. Investors know that all companies can misbehave, and discount the share prices of all companies to reflect that risk.

To address this problem, related party transactions generally should be subject to approval by non-interested directors and, for the largest transactions, by non-interested shareholders. These approval requirements will provide more assurance than currently exists as to the fairness of these transactions and will discourage related party transactions on less than arms-length terms. At the same time, these rules will permit intra-group transactions to proceed, when the non-interested decision-makers (independent directors and, where appropriate, shareholders) are persuaded that the transaction will benefit the company.

1. **The Commercial Code should require, for each non-trivial related party transaction (a related party transaction that exceeds a *de minimis* threshold), by a listed company or its subsidiaries, approval by a majority of the company's independent directors who are not interested in the transaction. These provisions would supplement recent revisions to the Presidential Decree of the MRFTA which require Board of Directors approval and public notice of large transactions by any member company of the ten largest *chaebol* with or in favor of an interested party.**

2. **The Commercial Code should establish that any related party transaction by a listed company or its subsidiaries should be approved by the company's independent and non-interested directors only if they are satisfied that the transaction is on arms-length terms and at market prices. If the independent non-interested directors cannot conclude that a proposed related party transaction is on arms-length terms and at market prices, they shall either disapprove the transaction or place the issue on the agenda of a shareholder meeting for approval by a majority vote of the non-interested shareholders.**

3. **In deliberating and voting on a related party transaction, the independent and non-interested directors should meet separately from other members of the Board, except that the independent and non-interested directors may request any executive director or interested director to provide them with information and answer questions about the transaction.**

4. **Related party transactions by the company or its subsidiaries or affiliates, other than in the ordinary course of business, should be approved by majority vote of the company's non-interested shareholders in addition to the company's independent and non-interested directors, if the company's attributable interest in the transaction exceeds a specified percentage (perhaps 5%) of the company's assets or revenues.**

5. **For non-listed companies, the Commercial Code should provide for the approval of non-trivial related party transactions by a majority of the company's non-interested directors (if there is at least one non-interested director) and, also for large transactions, by a majority of the company's non-interested shareholders. A company with a small number of shareholders (perhaps 10 or fewer) could exclude some or all of these requirements in its articles of incorporation.**

6. **A "related party transaction" would be (A) any transaction between the company and (i) any member of a group of companies which includes the company and for which combined financial statements**

are required to be prepared pursuant to the AEAJSC or (ii) any member of an affiliated business group which includes the company, as determined by the Fair Trade Commission pursuant to the MRFTA, (B) any transaction by the company or any subsidiary or affiliate in which a director, officer or significant shareholder of the company or their affiliated persons (including their families) has an interest (as more fully set forth in the Commentary to these Recommendations), and (C) other transactions that are considered to be related party transactions or potential related party transactions in accordance with regulations to be issued by the Securities and Futures Commission. A transaction between a company and its sole shareholder (for example, a parent company and its wholly-owned subsidiary) would not be treated as a related party transaction.

Commentary: We propose Board of Directors approval of all related party transactions that exceed a *de minimis* threshold (whether or not in the ordinary course of business) by the company's independent and non-interested directors. In considering the transaction such independent and non-interested directors should meet separately from the other directors, to ensure their deliberations, even in subtle ways, are not influenced by the presence of inside directors. The independent directors can ask inside directors to be present for part of their deliberations for the limited purpose of explaining the proposed transaction and answering questions about it.

In approving a related party transaction, the independent and non-interested directors should satisfy themselves that the transaction is on arms-length terms and at market prices. If they believe that a proposed related-party transaction is not on arms-length terms, the independent directors cannot approve it. Our proposal provides a safety valve – if the independent directors believe that the transaction, even though not on arms-length terms, is still advantageous to the company, they can submit the transaction to the non-interested shareholders for approval. In practice, we expect cases where the independent directors submit a non-arms-length transaction to shareholders for approval will be rare. More often, the directors will either reject the transaction, or insist that it be renegotiated on arms-length terms.

For listed companies, inside directors, even if they are not personally interested in a particular transaction, should not vote on the transaction because they cannot be expected to vote in a non-interested manner. For non-listed companies, which may not have independent directors, approval of related party transactions should be by the non-interested members of the Board of Directors (whether or not they are independent directors).

For large related party transactions which are not in the ordinary course of the company's business, approval should also be required by the company's non-interested shareholders.[48] A shareholder vote provides much stronger assurance that a transaction is in fact fair to the company. Experience in other countries teaches that even independent directors are not always as vigorous as they might be in defending the interests of minority shareholders when a transaction is proposed by a controlling shareholder (who also controls re-election of the Board of Directors). In choosing the threshold level for when a shareholder vote is required, one must balance the need to protect minority shareholders against the nuisance, delay and cost of a shareholder vote. Our proposed threshold of 5% of a company's revenues and assets is high enough so that shareholder votes should be infrequent. For transactions between members of a corporate group, these will often be transactions in the ordinary course of business for which no shareholder approval is required.

A "related party transaction" would be (A) any transaction between the company and (i) any other company which is part of a group (including the company) for which combined financial statements are required to be prepared, or (ii) any person, company or other legal entity within an affiliated business group (including the company) as determined by the Fair Trade Commission under the MRFTA, and (B) any transaction by the company or any subsidiary or affiliate in which a director, officer or significant shareholder of the company or any of their affiliated persons (including their families) has an interest. Such related party transactions would include a transaction by a company or its subsidiary or its dependent company (dependency arising at a 20% shareholding level) in which a director, officer or major shareholder (a shareholder who possesses together with affiliated persons 20% or more of the company's shares), or an affiliated person of any such director, officer or major shareholder:

(a) is a party to such transaction or participates in it as a representative or intermediary;

(b) is a director or officer, or possesses together with his affiliated persons 20% or more of the shares of a company that is a party to the transaction or participates as a representative or intermediary;

(c) acquires, directly or indirectly, as a result of such transaction, property, property rights or other rights having monetary value; or

(d) receives in another way a personal benefit from the transaction.

For the purpose of these definitions, the term "subsidiary" would have the same meaning as provided in Article 342-2 of the Commercial Code,

48. *See* REPUBLIC OF KOREA, COMMERCIAL CODE art. 368(4).

which defines a parent-subsidiary relationship on the basis of a 40% shareholding in the subsidiary.

See as well the definition of "affiliated persons" in the Commentary to paragraph II.A.3 above. Consideration should be given to whether the 20% shareholding level used in the definition of "affiliated persons" and "related party transactions" should be reduced given the shareholding patterns currently prevailing in Korean corporate groups.

The definitions of related party transactions which are recommended are complex but build upon the substantial experience accumulated by Korean regulatory agencies in dealing with corporate groups under the MRFTA, AEAJSC and the SEA. Such definitions are more detailed than those normally contained in the Commercial Code, and it may be appropriate to consider granting to an appropriate government agency or regulatory authority the right to promulgate regulations addressing definitional and related issues within a broad statutory standard established by amendments to the Commercial Code.

Comparable provisions requiring Board of Directors and shareholder approval of such transactions are found in the corporate law of a number of other jurisdictions. The United States does not formally require approval of related party transactions by only independent directors, but case law strongly encourages this practice by imposing a heavy burden on a company to prove the entire fairness of a transaction *unless* it is approved only by independent, non-interested directors.

For a presentation of comparative practice, see Annex *B*, para. I.E.1, II.A, II.B and VII.B.

B. In addition to these Board of Directors and shareholder approval requirements, the company's external auditors should review all non-trivial related party transactions and report on these transactions annually to the shareholders.

The external auditors' report on related party transactions should identify all significant related party transactions known to them and confirm whether, to their knowledge, all of such transactions required to be submitted for approval by the company's non-interested directors and by the company's non-interested shareholders have been so approved.

Commentary: The company's external auditors should review annually all non-trivial related party transactions and provide to the shareholders a report identifying all significant transactions and confirming that, to their knowledge, all transactions required to be submitted for approval by the company's non-interested directors and by the company's non-interested shareholders have been so approved. Ideally, the external auditors should also report on whether, in their judgment, any non-trivial related party transactions were not on arms-length terms. As a practical matter, such a requirement would ensure that the auditors were consulted prior to the completion of the transaction, to ensure that they were satisfied with its terms. This would provide a further check on the fairness of the transactions.

We have been advised that the Korean accounting profession is not yet ready to assume this additional obligation. This is, therefore, a recommendation for implementation when feasible, rather than immediately.

For a presentation of comparative practice, see Annex *B*, para. IV.C and IV.D.

IV. Enforcing Shareholder Rights

A. Korean law provides a reasonably broad range of administrative, criminal and private litigation sanctions against violations by companies, directors and others of the corporate, securities and antitrust laws or a company's articles of incorporation. Nonetheless, the view is widely held that shareholders generally lack effective remedies for such violations.

1. **The level of fines and other penalties imposed for such violations should be increased substantially.**

2. **Article 405(1) of the Commercial Code (and any relevant provisions of the Civil Procedure Act) should be amended to include full reimbursement of litigation costs (including attorneys' fees) incurred by shareholders who prevail in a derivative suit.**

Commentary: The absence of full reimbursement of litigation costs in a derivative suit is a strong disincentive to such litigation, even when there has been a clear breach of duty or violation of applicable law or the company's articles of incorporation. The core problem is that the shareholder who brings the derivative suit must pay his own expenses, while benefiting only through his fractional ownership of the company, which receives the actual recovery. Derivative suits, while they benefit the injured company and its shareholders, also involve the public interest in ensuring compliance with legal standards applicable to business entities, and can also be valuable in providing an opportunity for the courts to explain the scope of directors' fiduciary duties, which are phrased quite generally in the Commercial Code.[49] Accordingly, we believe that a shareholder prevailing in a derivative suit should be fully reimbursed by the company for the litigation costs incurred. Such coverage already exists with respect to listed companies pursuant to Article 191-13(5) of the SEA, and such coverage should be expanded to all companies by addressing the subject in the Commercial Code.

3. **Article 405 of the Commercial Code (and any relevant provisions of the Civil Procedure Act) should be amended to permit the court to award to the shareholders who prevail in a derivative suit a portion of the damages payable to the company as compensation to the shareholders for pursuing the claim and managing the litigation.**

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49. On the value of litigation in giving meaning to uncertain company law rules, see Ehud Kamar, *Shareholder Litigation Under Indeterminate Corporate Law*, 66 U. CHI. L. REV. 887 (1999).

Commentary: A challenge facing Korea is to motivate shareholders to take action to enforce their rights. The initiation and pursuit of a shareholder derivative action, even with the full reimbursement of litigation costs, involves costs to the shareholders involved, especially the shareholders' time. In contrast, the economic benefit of the litigation goes to the company. The shareholder who brings the derivative action will receive only a relatively small, indirect benefit.

It would be appropriate to permit the courts to award a portion of the damages recoverable by the company as a result of a successful derivative suit (including a suit that is settled by the company) to the initiating shareholders as compensation for their efforts. The court can exercise its discretion to ensure that direct payment is awarded only when the shareholder has brought a meritorious action and that the payment amount reflects the value contributed by the shareholder.

4. **Further consideration should be given to the adoption of class action lawsuits to permit shareholders to pursue violations of the Commercial Code, Securities and Exchange Act and other provisions of Korean law relating to corporate governance.**

Commentary: Legislation introduced into the last session of the National Assembly to permit class action lawsuits for violations of the securities laws did not gain passage. If, after several years' experience with the enhanced derivative suit procedures suggested here, shareholder litigation remains infrequent, the government should reconsider whether to permit class action lawsuits. We believe that a class action procedure, or another way to aggregate the claims of shareholders, is an essential component of a well functioning corporate governance system.

For a presentation of comparative practice, see Annex *B*, para. VIII.A.4.

5. **To facilitate the resolution of matters now handled by derivative suits, the Commercial Code should be amended to permit corporations to provide in their articles of incorporation for the resolution by arbitration of a dispute between any shareholder and the company or its directors, at the shareholder's option in lieu of litigation.**

Commentary: Korean judges are generalists, with little or no experience as practicing lawyers. This creates a risk that they will not fully understand complex corporate or securities cases. In contrast, arbitrators can be chosen for their expertise in a particular area. Arbitration provides the prospect of a lower cost and speedier alternative to derivative suits and other forms of shareholder litigation. Experience with the use of arbitration in corporate governance matters is limited, but extensive experience with commercial arbitration suggests that arbitration of corporate disputes has promise as a way to obtain a decision by an expert arbitrator, at lower cost and more expeditiously than a court trial. Such an approach is worthy of consideration. The use of such arbitration procedures would be available only when provided in a company's articles of incorporation and when the complaining shareholder is agreeable to the use of arbitration.

B. Enforcement of Korea's corporate governance rules requires attention to the resources of the Ministry of Justice, Securities and Futures Commission, Fair Trade Commission, other regulatory agencies and the courts.

Commentary: Even the best laws and regulations must be complemented by adequate financial and personnel resources for relevant government regulatory and enforcement agencies. The government should undertake a comprehensive review of the resources available to the principal agencies responsible for implementing and enforcing Korea's corporate governance regime, in light of the important amendments to corporate governance laws and regulations over the past several years.

1. **Consideration should be given to creation in Korea's major cities of a separate bench of the District Court to handle large or complex commercial and financial disputes, including shareholder litigation.**

   Commentary: It is common in many jurisdictions for the courts in the major cities to have a specialized "bench" or court which handles commercial, corporate and financial disputes, often involving at least a threshold monetary amount. The judges on such a court hear a continuing stream of cases involving commercial, corporate and financial issues and develop expertise in adjudicating these often technical matters. Specialized courts also tend to have fewer backlogs than courts of general jurisdiction, permitting speedier disposition of time-sensitive commercial, corporate and financial matters.

2. **Consideration should be given to creating a national prosecution unit for commercial, corporate and securities matters and to creating a specialized career path within this unit.**

   Commentary: The value of specialized units handling the investigation and enforcement of corporate and securities laws relating to corporate governance (including both criminal prosecutions and civil enforcement proceedings) has been demonstrated in many jurisdictions. Such work requires specialized knowledge not only of the relevant law, but of commercial practices in a marketplace which is constantly changing. For example, prosecuting a securities case generally demands knowledge of finance and accounting. Consideration should be given to creating a specialized national unit for such work and developing a career path for prosecutors permitting them to specialize in corporate, securities and financial cases.

3. **A program of continuing legal education should be provided to judges and prosecutors in principles of corporate governance and in**

the specific provisions of Korean corporate governance law, including the extensive recent amendments.

Commentary: The laws and regulations relating to Korean corporate governance have changed significantly in the last several years, and are likely to continue to do so, as Korea catches up to world standards. Continuing legal education in the laws and practice of corporate governance for judges, prosecutors and other government legal personnel working in the area should be given a high priority by the Government.

C. Consideration should be given to encouraging the establishment of shareholder associations as exist in Germany (*Vereinigungen von Aktionaeren*) to protect and promote the interests of small shareholders.

Commentary: In Germany, "shareholders associations" (*Vereinigungen von Aktionaeren*) are groups which exist to promote and enforce shareholders' rights. They are usually organized as a registered association and either concentrate on a specific corporation or take a more general approach. The two largest associations of this type are the *Deutsche Schutzvereinigung fuer Wertpapierbesitz e.V.* (German Protection Association for Securities Ownership) with some 20,000 members and the *Schutzgemeinshaft der Kleinaktionaere e.V.* (Protection Association of Small Stockholders). These associations represent their members at shareholders meetings, are a channel of communication for corporate information, and may take legal action against the company or its officers to protect the interests of its members.

V. Disclosure Requirements

A. Korea's corporate disclosure requirements under the Commercial Code, Securities and Exchange Act, Enforcement Decree of the Securities and Exchange Act and Stock Exchange Listing Rules are generally within the range of prevailing practice in other OECD jurisdictions, subject to the on-going revision of Korean financial accounting principles to conform to International Accounting Standards. The recent establishment of the Korean Accounting Standards Board is commended.

B. Each listed company should be required to report regularly to its shareholders on the extent to which its corporate governance practices conform to the standards established by the Code of Best Practices for Corporate Governance.

Commentary: Such an annual report on corporate governance practices has been developed in the United Kingdom, based upon a set of standards (comparable to the Code of Best Practices for Corporate Governance in Korea) known as the Combined Code. The requirement for such a report allows shareholders to assess their company's practices against "best practice" standards. It also serves as an incentive to corporate management to adopt "best practice" standards.

1. **A listed company's annual report to shareholders should include a statement, approved by the company's independent directors, on the extent of the company's compliance with the Code of Best Practices for Corporate Governance.**

2. **A listed company's annual report to shareholders should include a report by its external auditors on the company's related party transactions during the prior year (as contemplated in paragraph III.B. above, Monitoring Related Party Transactions).**

3. **The Commercial Code or the AEAJSC should be amended to require listed companies to disclose to shareholders, if the company replaces its external auditors, the reasons for the change, with the auditors having an opportunity to provide their own explanation.**

VI. Mergers, Acquisitions and the Market for Corporate Control

Efforts have been made to encourage mergers and acquisitions, including contested takeover bids. Some of these changes pose risks to minority investors that may outweigh their benefits. The Commercial Code or the Securities and Exchange Act should be amended to require, in the case of listed companies, (i) advance notice of the intention of any company, person or group of affiliated persons to acquire a controlling interest in a listed company by a tender offer or otherwise, (ii) restrictions on defensive measures by the company that will discourage or prevent such an intended acquisition, unless approved by the company's shareholders, and (iii) a mandatory offer for the company's remaining ordinary shares following acquisition of a controlling interest by any such company, person or group of affiliated persons, unless the obligation to make such an offer is waived by majority vote of the shareholders who would otherwise be entitled to accept the offer. A company, person or group of affiliated persons failing to comply with these requirements should be prohibited from voting the shares so acquired unless their voting rights are restored by majority vote of the other shareholders.

To balance the protection for minority shareholders provided by a mandatory bid requirement against concerns that this requirement may discourage takeover bids, the Commercial Code could allow such bids to be made at a small discount (perhaps 10%) to the price paid for the controlling shares.

Commentary: Under a "mandatory offer" regime, any shareholder obtaining a shareholding level in the company which is deemed to be a controlling interest is required to tender for the remaining shares in the company on comparable terms to the most recently acquired shares. A limited "mandatory offer" regime existed in Korea until recently (whereby a shareholder acquiring a 25% interest was then required to bid on comparable terms for a majority of the shares), but that scheme was abolished in order to encourage takeover bids.

We believe that the decision to eliminate the mandatory bid requirement was mistaken. It moves Korea away from the dominant worldwide trend. It is true that the mandatory bid requirement may sometimes discourage a takeover bid. But international experience suggests that this effect is a small one. The fraction of takeovers worldwide in which an acquiror acquires only partial control is tiny. Many of the most active takeover jurisdictions, including the United States and the United Kingdom, have such a requirement, either as a matter of law or as a matter of almost universal practice. The European Community is likely soon to adopt a mandatory bid requirement for all member states.

The principal reason for the trend toward a mandatory bid requirement is that the mandatory bid provides important protection for minority shareholders, against a change of control that they do not have the opportunity to participate in, which may introduce a new controlling shareholder who will profit by taking advantage of the vulnerable position that minority shareholders are inevitably in.

The value of a mandatory bid requirement is especially great for Korea, given its current combination of inadequate protection of minority shareholder interests and the common practice among controlling shareholders of giving little weight to minority shareholder interests when engaging in transactions of all kinds.

Concerns about whether the mandatory bid requirement will chill takeover bids can be addressed by allowing the bid to be at a slightly lower price than the price paid for the controlling shares – say 90% of the highest price paid by the new controlling shareholder. Allowing offers to be made at a small discount will reduce the cost of making the bid to the acquiring shareholder, while still protecting minority shareholders against significant expropriation.

For a presentation of comparative practice, see Annex *B*, para. V.A.2.

VI. Encouraging Institutional Investor Involvement in Corporate Governance

Institutional investors have an important role to play in bringing Korea's new corporate governance rules into actual practice in the marketplace and in shaping the further evolution of Korean corporate governance standards. The Korean government is to be commended for measures to (i) promote the independence of the Boards of Directors of banks and other financial institutions, (ii) expand the fiduciary obligations of the directors of these institutions, (iii) encourage these institutions to exercise voting rights in companies in which they have invested (when acting with respect to securities held in trust), (iv) reduce these institutions' conflicts of interest and related party transactions and (v) increase these institutions' disclosure of information about their investments. To ensure the effectiveness of these reforms:

1. **Training for financial institution executives in fiduciary standards and corporate governance should be encouraged.**

2. **The government must ensure that regulatory agencies that supervise financial institutions have appropriate budgetary and personnel resources, that training is made available to their personnel, and that**

coordination is maintained with other government agencies (in particular, with the Ministry of Justice) involved in investigating and prosecuting violations of these rules.

VIII. Other Recommendations

Commentary: Reforming legislation and regulations is not enough to ensure the success of corporate governance reforms in Korea. Measures must be undertaken to foster the work of independent directors and to encourage shareholder activism. While such initiatives can in large part be left to the private sector, the government should play an active, early role in launching some of the "infrastructure" to support such reforms. Initiatives are needed for training, research and technical support for the work of Board directors (particularly outside directors), for public information campaigns to foster popular understanding of corporate governance issues, and for encouraging development of an active financial press.

A. The government should establish an Institute of Directors at a public institution or encourage its establishment at a private sector institution. Such an Institute of Directors would provide training courses, practical seminars, research and technical support to company directors and should be governed by a board of directors or trustees drawn primarily from the private sector.

B. Whether or not an Institute of Directors is established, training needs to be provided for Korean businessmen and government officials on corporate governance, including both independent directors and executive directors.

C. The corporate community and the securities industry (including investment managers) should be encouraged to engage in public information and education activities to promote shareholder involvement in and understanding of corporate governance.

D. While beyond the appropriate scope of legislation or government regulation, efforts to encourage the development of an active and independent financial press should be supported.

E. To improve public access to corporate information, measures should be undertaken for the rapid phase-in of the electronic filing of periodic corporate reports with the Securities and Futures Commission and for free public Internet access to these filings.

Commentary: Internet access to company filings with the Securities and Exchange Commission in the United States (under the EDGAR program) has vastly expanded the effective public availability of corporate and financial information about listed companies. The rapid expansion of Internet utilization in Korea warrants expedited implementation of electronic filing with the SFC and arrangements for the public to obtain immediate electronic access to such materials.

F. Provisions should be introduced into the Commercial Code permitting small companies to provide in their articles of incorporation for exemption from the application of selected provisions of the Code (including some of the amendments to the Commercial Code proposed here). Small companies would be defined on the basis of a pre-determined level of assets or, preferably, a maximum number of shareholders. Alternatively, consideration should be given to encouraging use of the *yuhan hoesa* form by small businesses.

Commentary: The debate in Korea over issues of corporate governance has focused principally on problems in large corporate groups and with listed companies. As corporate law becomes more complex in its application to such larger scale businesses, and appropriately so, it is necessary to assess whether the Commercial Code's requirements can be streamlined for small companies with a limited number of shareholders. We have addressed this concern throughout this Report. Many of our recommendations are specifically limited to listed companies. However, it would be also be valuable to review more generally the desirability of exemptions from the Commercial Code requirements for small companies. Alternatively, measures should be considered to promote the use of alternative legal forms by smaller businesses, particularly the *yuhan hoesa.*