



Recent Amendments to the Korean Commercial Code - Mitigation or Exemption of Directors' Liability

I. Purpose of Amendment

Currently, Article 400 of the Korean Commercial Code (the "KCC") provides that a director may be released from liability to the company by the consent of all shareholders of the company. In other words, the current law only acknowledges the release of director liability under the very strict condition of unanimous shareholder consent and the policy stems from considerations such as (i) the fact that shareholders of a stock company, who are in an equity-based relationship with each other, bear the loss when they surrender a claim for damages against the company's directors, and (ii) the deterrent effect such a strict requirement would have against unlawful conduct in business management.

As it is practically impossible to gain the consent of all shareholders (particularly for a listed company), and recent director liability cases have involved large amounts of damages, there has been wide consensus that the existing provisions have failed to properly protect directors and have disproportionately focused on toughening the obligations and liabilities of directors. KCC Article 450's provision on the release of directors' liability regarding the approval of financial statements is an example of a provision mitigating the situation but it lacks effectiveness in protecting directors because the scope of the release of liability is too narrow – it is limited to matters which are actually described in the financial statements or may be known from such matters described.

Accordingly, there has been a general call for a new system with relaxed requirements to effectuate the mitigation or exemption of directors' liability. Furthermore, such a system would be in line with the global trend of mitigating or exempting directors' liability for purposes of encouraging proactive business management by attracting talented individuals to serve as directors and ultimately helping to increase the profits of the company through their contribution. Under Supreme Court precedents, the Court has decided on multiple occasions that the liability of directors to their company may be limited (Supreme Court October 11, 2007 Sentence 2007Da34746 Decision and others). In the end, a new provision with more relaxed requirements for the mitigation or exemption of directors' liability was included in the amended Commercial Code and it is "expected to help clear the way for a broader intake of talented

business managers by companies and encourage forward-looking management by directors.”

II. Key revisions

It is permitted under Article 400, Paragraph 2 of the amended KCC to partially exempt directors from liability under the articles of incorporation of a company in addition to the release of directors' liability by the consent of all shareholders. In this regard, there has been debate in academic circles regarding whether a threshold of negligence is required to find a director liable to his company under KCC Article 399 for his violation of any laws or the company's articles of incorporation. In the amended KCC, since the requirement of “intentionally or negligently” was inserted in the language of KCC 399, it is now clear that a director must at least have been negligent to be liable under KCC 399. Under the new standards for mitigation or exemption of directors' liability, the company, through its articles of incorporation, may exempt a director from liability for amounts in excess of six times (three times for an outside director) his remuneration (including bonuses and gains from the exercise of stock options, etc.) for the year immediately preceding the date of the acts leading to such liability. However, the amended Article 400 also states that in case (i) the director caused losses intentionally or by gross negligence or (ii) violated (a) the provision on the prohibition of competitive business for directors (KCC Article 397), (b) the provision on the prohibition of misappropriation of business opportunities (KCC Article 397-2), or (c) the provision on the prohibition of transactions between companies and their directors (KCC Article 398), the liability of the director shall not be mitigated or exempted. That is, a director may have his liability mitigated or exempted only in the case of negligence which does not rise to the level of gross negligence and does not involve a violation of the provisions related to the prohibition of competitive business, misappropriation of business opportunities and transactions between companies and their directors. Particularly noteworthy is that the amendments differentiate between the limitations on liability for inside directors and for outside directors based on the reality that the latter is inferior to the former in terms of legal status and access to the company's internal information. The different treatment incentivizes outside directorship as a result. The amended KCC provisions regarding the mitigation or exemption of directors' liability applies *mutatis mutandis* to auditors, members of the audit committee, and executive officers (KCC Articles 415, 415-2 paragraph 6, and Article 408-9).

Some argue that the connection between adopting a system for the mitigation or exemption of directors' liability and the ability to attract talented directors is exaggerated in light of the practice of appointing directors in Korea. However, in academic circles, it is generally expected that limitations on directors' liability will produce the effects of increasing a preference for attaining directorship in Korea where the US-oriented principles of the “business judgment rule” are not yet fully acknowledged. Such limitations on liability are also expected to bring about other positive effects such as reducing insurance premiums which companies have had to pay for liability compensation insurance.

III. Implications

The amendments to the KCC which have relaxed requirements for the mitigation or exemption of directors' liability have been met with fierce opposition during legislative debate concerning the revisions. Critics have also raised issues regarding the detailed standards and procedures as will be discussed below. In consideration of such opposition to the amendments, a company is advised to exercise great caution when mitigating or exempting their directors' liability under the amended KCC.

1. Procedure for determination of the mitigation or exemption of the liability of directors

Under the amended KCC, the mitigation or exemption of directors' liability may be provided for in the articles of incorporation of the company. That is, a system for the mitigation or exemption of directors' liability may be adopted upon establishment of the company through its articles of incorporation or through the process of modification of the articles of incorporation by a special resolution of the general meeting of shareholders. However, the amended KCC fails to provide for standards regarding the extent of conditions and/or procedures to be specifically set forth in the articles of incorporation when providing for the mitigation or exemption of directors' liability. In this regard, some argue that simply providing for the exemption of directors' liability in the articles of incorporation is not enough for the exemption to apply to all cases in which directors' liability is at issue. Such reasoning stems from the risk that incomplete provisions in the articles of incorporation can lead to issues of determining who may decide to mitigate or exempt directors' liability and of what procedural steps should be taken. Based on our review, it is certainly possible for one to argue that provisions of the articles of incorporation are insufficient to determine whether to mitigate or exempt directors' liability under the amended KCC because such determinations constitute the execution of the company's business and such determinations must be made by a resolution of the board of directors based on the provisions of the articles of incorporation. However, in case where the directors whose liability is the point at issue make up the entire board itself, a resolution of the board of directors may be impossible due to the exclusion of directors having conflicts of interest with the matter at hand. Further, even in cases where the subject director(s) do not comprise the entire board, a resolution by the remaining directors may again lead to liability for the resolving directors. Thus, the purpose of the KCC amendments, which are to help the company attract talented directors through the mitigation or exemption of directors' liability, is not achieved if the exemptions themselves require a resolution of the board of directors again to determine whether or not to mitigate or exempt directors' liability. We believe, therefore, that provisions of the articles of incorporation providing for the mitigation or exemption of directors' liability should be deemed effective for such purposes. However, as there is still room for dispute about this issue, it is desirable for the company to include detailed provisions on the mitigation or exemption directors' liability in its articles of incorporation based on consultation with its legal counsel so as to prevent disputes in the future when the company decides to introduce a system for the mitigation or exemption of directors' liability.

2. Establishment of the standard for the amount of remuneration for the previous year

The amended KCC provides that “The company may exempt a director from liability for the amounts in excess of six times (three times for an outside director) his remuneration (including bonuses and gains from the exercise of stock options, etc.) for the year immediately preceding the date of the acts leading to such liability.” Pursuant to existing precedents, “remuneration” as used in the provision above is interpreted to include all things that a director receives from the company in exchange for the execution of his duties (Supreme Court December 10, 2004 Sentence 2004Da25123Decision). However, some point out that the scope and the standards for the calculation of the amount of remuneration for the immediately preceding year “including bonuses and gains from the exercise of stock options” are unclear based on the provisions of the amended KCC (for example whether this should also include an evaluation of unexercised stock options) and thus the resulting amount of remuneration is difficult to predict. Regarding this issue, we expect that the Enforcement Decree of the amended KCC and other provisions will include more detailed instructions.

3. Protection of shareholders and creditors

Some critics argue that the system for the mitigation and exemption of directors’ liability under the amended KCC may neutralize derivative lawsuits and harm the interests of shareholders and creditors due to the passive reduction of property to which the company has a non-exemptable claim. That is, even if shareholders file a derivative lawsuit for the liability of a director to the company, if the company mitigates or exempts directors’ liability to the maximum amount, shareholders will only see compensation made to the company up to the amount of six times (or three times) the remuneration of such director for one year. For this reason, some critics have insisted on the establishment of procedures, and other safeguards for the disclosure of matters regarding the mitigation or exemption of directors’ liability and for shareholders or creditors to file complaints against the mitigation or exemption of liability so as to prevent unfair mitigation or exemption of directors’ liability. As the above criticisms regarding the new regime have consistently been brought up, and because the protection of shareholders from such issues are not reflected in the amended KCC, a company introducing a system for the mitigation or exemption of directors’ liability under the amended KCC should establish its articles of incorporation with the assistance of its legal counsel in order to ensure the procedural legitimacy of the system, to protect against abuses which could harm the interests of parties such as the stockholders, and to prevent possible legal disputes.

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