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KOREA

Leveraged Buyouts in Korea Present Fiduciary Duty Issues

A leveraged buyout, or LBO, is an acquisition of a company or business by using borrowed money, which is one of the most common types of acquisition structures internationally.

However, an LBO has been met with some challenges in South Korea. One of the main issues in an LBO in Korea arises from the fiduciary duty owed by directors of a target company who participate in a decision approving the structure of an LBO. Particularly, using the target company's assets as collateral in the financing of an LBO transaction has been viewed as a breach of fiduciary duty by the directors of the target company approving such type of transaction. In such case, such directors may be subject to civil and criminal liability under Korean law, and investors (including foreign investors) who have agreed to such collateralization structure may also be held jointly liable for a breach of fiduciary duty.

In relation to the fiduciary duty issue, through the guidance that has been offered thus far, investors should note the following.

- The fact that an LBO has occurred does not, in and of itself, infer that fiduciary duties have been breached. The Korean courts have emphasized that the specific actions of the directors should be examined on a case-by-case basis to determine whether such directors have breached their fiduciary duties.

- It has been clearly established that exposing a target company to the risk of losing its assets by pledging the target company's assets without an appropriate quid pro quo or consideration for the procurement of the purchaser's acquisition loans prior to the acquisition is a breach of fiduciary duty. In case that the target company's assets are used as collateral for the purchaser's acquisition loan, directors of the target company should consider whether there will be certain gains to the target company in exchange of its agreement to collateralize its assets backing the purchaser's loan.

- There was an LBO case where the purchaser caused the target company to reduce the capital and pay dividends to the purchaser after the acquisition in order to repay its acquisition loans. In such case, dividend distributions and capital reductions were conducted for purposes of an LBO but were viewed as not violating applicable laws. So long as such dividend distributions and capital reductions do not give improper gains to the shareholders and does not result in damages to the target company, it cannot be a basis for a breach of fiduciary duty.

- Case precedents do not offer clear or sufficient guidance as to LBOs involving a reverse merger. Particularly, there is no court precedent in Korea specifically addressing the permissibility of a reverse merger structured in such a way that an SPC is merged into a target company. Despite the lack of clear guidance, it is generally accepted that Korean courts have not found the reverse merger LBO structure, in and of itself, to be in violation of Korean law. Korean courts suggested in their decisions that the relative financial conditions of the parties to a merger and resulting adverse effect or damage caused to a party should be taken into account on a case-by-case basis based on the specific factual background surrounding the particular merger.

In addition to the guidance from court precedents, based on the recommendation of legal scholars and commentators in Korea, the following should be considered in evaluating an LBO structure using a reverse merger.

LOW LEVERAGE RATIO

Legal scholars contend that the less leverage is used for an acquisition, the less harm or damage would be caused to the target company's financial soundness. In past cases, this view held true - successful reverse merger cases had relatively low leverage ratios (the amount of equity contributed by the acquiring company's shareholder(s) compared to the amount of debt to finance the acquisition), while prosecuted cases often had high leverage ratios. Most successful cases had a leverage ratio of 1:1 to 1:3. Consequently, the amount of the financing sought from a purchaser should not exceed the amount of capital contributed by the purchaser by more than 3 times at most. Market practices in Korea as to a leverage ratio do not exceed 1:1.

MAINTAIN VIABLE COMPANY

After the closing of the acquisition and the merger, the purchaser or investor should ensure that the target company retains sufficient cash or assets to continue normal operations and to pay off its monetary obligations when they become due. A drastic distribution of the target's assets after the acquisition/merger is likely garner the scrutiny of the prosecutor's office.

PURCHASE OF 100% OF THE SHARES OF TARGET

Legal scholars contend that interests of minority shareholders, among others, should be protected in the process of an LBO reverse merger. In case of an acquisition of 100% of the shares of the target company, the purchaser can ease the reverse merger process after the acquisition, since there will be no issues with protecting minority shareholders' interests.

COMPLIANCE WITH STATUTORY REQUIREMENTS

If an LBO involving a reverse merger is carried out in compliance with the statutory requirements intended to protect the shareholders and creditors of a target company, such as shareholders' appraisal rights and creditor protection measures, the risk of exposing the LBO to breach of fiduciary duty claims can be reduced.

In conclusion, as mentioned above, an LBO in Korea would not automatically result in a violation of fiduciary duty. However, although certain principles have been established, the Korean courts appear to be continuing its efforts in establishing their positions on LBOs. In this regard, foreign investors intending to structure a transaction in the form of an LBO with respect to a target in Korea are advised to proceed with caution based on legal advice from experts in Korea. ■

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