Foreign bidders welcome Korean takeover changes

Woong-Soon Song, Tong-Gun Lee and Robert Young explain how a bitter takeover battle brought about changes to takeover rules that will soon come into force

To attract foreign capital during and after the 1997/1998 Asian financial crisis, the Korean government lifted many of the foreign investment restrictions on Korean companies. This resulted in a steady increase of foreign ownership of Korean companies. Based on the latest data from the Korea Stock Exchange (KSE), foreign investors hold an estimated 42.5% of the total value of the shares in the Korean stock market, and a majority of the shares of certain Korean blue chip companies, such as Samsung Electronics, Hyundai Motor, Posco, Kookmin Bank and SK Corporation.

This trend, however, has also stoked fears of hostile takeover bids by foreigners. Korean conglomerates (*chaebols*) have been critical of the steps taken by President Roh Moo Hyun's administration to curb abuses by the *chaebols*, contending that such legislation will result in hostile takeovers of Korean blue chip companies by foreigners. Korean scholars and economists, on the other hand, have been more supportive of takeovers by foreigners. Based on a recent survey by the Institute of Global Management, 65% of the polled economists believed that hostile takeovers by foreigners would stimulate the Korean economy and improve governance structure and transparency.

Although there has been much debate about the possibility of a hostile takeover by foreigners, there has been only one such attempt. In mid-2003, SK Corporation, the virtual holding company of the nation's third largest conglomerate, was the target of an unsuccessful hostile takeover by a Monaco-based private investment fund. However, given the continuing trend of foreign investments in Korean companies, new legislation aimed at curbing abuses by the *chaebols* and the government's initiative to promote more activity by private equity funds, the possibility of more attempts by foreigner investors, as well as domestic investors, to enact a hostile takeover of a Korean company will probably increase.

In Korea, hostile takeovers rarely take the form of a public tender offer, but are instead carried out through secretive block purchases of shares or through a coalition with friendly shareholders. In this context the need for fair rules in hostile takeovers has far outpaced the actual development of such rules in the short history of hostile takeovers in Korea. However, amendments of two rules concerning hostile takeovers (the 5% reporting rule and the tender offer rule) were recently enacted, which bring Korean rules more in line with global standards.

The genesis of change

The new amendments to the 5% reporting rules and the tender offer rules arose as a result of Kumgang Korea Chemical Co (KCC)'s attempt to takeover Hyundai Elevator Co, the virtual holding company of the Hyundai Group (Korea's 15th-largest chaebol).

The new amendments should provide a better framework of fair and transparent rules for takeovers of Korean companies

Under Korea's disclosure rules, an investor purchasing a stake of more than 5% in a listed company must report such purchase to the Financial Supervisory (FSC) and the KSE within five business days of the transaction. In addition, any change in the ownership interest subsequent to the report that equals or exceeds 1% of the total equity of the company is required to be reported within five business days from the date of change.

In the Hyundai Elevator case, KCC accumulated control of a 20% stake in Hyundai Elevator through direct acquisitions and acquisitions through a number of mutual funds and a private investment trust fund. Although KCC properly reported its direct acquisition of the additional shares of Hyundai Elevator, it neglected to report the acquisition through the funds until two weeks after the transaction.

In this regard, the FSC discovered that KCC failed to timely report its acquisition of the Hyundai Elevator shares through the mutual funds and the private investment fund, and issued a disposal order. The FSC, however, also held that KCC's direct acquisition itself did not violate the 5% disclosure requirement. Hyundai Elevator filed suit, contending that KCC's direct acquisition also violated the 5% disclosure requirement on the grounds that it concealed its intention to take over the company and did not include the portion which was acquired through the funds and, therefore, KCC should be prohibited from voting those shares at the upcoming shareholders meeting. One day before the shareholders meeting, the court ruled in favour of Hyundai Elevator.

Moreover, in response to the hostile takeover attempt by KCC, Hyundai Elevator announced that it would issue 10 million new shares, which would have resulted in dilution of KCC's ownership to below 20%. KCC filed suit to stop the issuance of the new shares. The court ruled in favour of KCC that the issuance of the new shares to thwart the takeover did not satisfy the requirement under the Korean Commercial Code that the issuance of new shares must be to promote the managerial objectives of the company (such as improving management or financial status of the company, or introducing technology and foreign investment). However, in doing so, the court articulated the principle of a *modified business judgment rule*, which stated that the requirement for promoting the managerial objectives of the company to issue new shares may be satisfied if, in the judgment of the directors of the company, the takeover will harm the interests of the company and its shareholders.

In response to the FSC's disposal order, KCC initially launched an offer to acquire a number of shares equal to the shares acquired through the mutual funds (which were ordered by the FSC to be disposed of). KCC attempted to amend its tender offer proposal by increasing the number of shares it desired to purchase to include the shares acquired through the private investment trust fund (which were also ordered by the FSC to be disposed of). The FSC did not accept the amendment on the grounds that it would result in a delay on the date of the payment to the shareholders for the tendered shares. Under the regulations governing tender offers, the tender offer period is deemed to be restarted on the date of the amendment, and the offeror can amend the offer as long as it does not have a negative impact on the tenderers such as lowering the price, decreasing the number of shares it desires to acquire or delaying the payment date. Therefore, KCC's attempt to takeover Hyundai Elevator eventually ended in failure.

As a result of KCC's attempted hostile takeover and various court rulings that were made in connection with the attempt, two rules concerning hostile takeovers (the 5% reporting rule and the tender offer rule) were amended and will take effect March 29 2005.

Amendment to the 5% reporting rule

Previously, under the Korean Securities and Exchange Act, any person who has direct or beneficial ownership of shares having voting rights in a company, whether in the form of common shares, convertibles or other equity-related securities and is acting in concert with a related party or other owner of equity securities in the company is required to report the status of the holdings to the FSC and the KSE within five business days of reaching the 5% threshold of ownership of a company's shares.

In addition, the parties must report within five business days from the date of change any change in the ownership interest subsequent to the initial report that equals or exceeds 1% of the company's total issued equity securities. Violation of these reporting requirements could subject a person to criminal sanctions such as fines or imprisonment, and could result in a loss of voting rights with respect to the equity securities in question. Furthermore, the FSC may issue an order to dispose of such violating equity securities. The scope of the violating portion was an issue in Hyundai Elevator case.

The amendments made three changes:

- The reporting shareholder is required to specify the intention of the acquisition (that is, whether it is for investment purposes or to influence the management of the company) and any subsequent change of such intention. Depending on the intention of the acquisition, the shareholder is required to submit a long form report (if the intention is to influence management) or short form report (if the intention is for investment purposes).
- The violating portion that is subject to loss of voting rights or disposal order from the FSC is defined to include not only that portion of the shares that were not timely reported, but may include the portion that was timely reported if the reporting shareholder submitted a false report or omitted material factors (which was an issue in the Hyundai Elevator case).
- Introduced a cooling period of five days in which the reporting shareholder cannot exercise its voting rights or acquire any additional equity securities from the date it filed the report of its change in intention of the acquisition from investment purposes to influencing the management of the company.

Amendment of the tender offer rule

Pursuant to the Korean Securities and Exchange Act, if a person, together with any related persons, intends to make an acquisition that will result in such person holding 5% or more of a company's total equity securities during a six-month period, the Securities and Exchange Act requires such a person to make a public tender offer. This so-called 5% mandatory tender offer rule also applies to additional purchases of equity securities the six-month period. Failure to comply with the tender offer rule may result in criminal sanctions. Further, the violating party may lose all voting rights attached to the shares purchased in violation of the tender offer rule. In addition, the FSC may issue an order compelling the sale of the equity securities purchased in violation of the tender offer rule.

Under the previous rules, the tender offer becomes effective after three business days have elapsed from the date of the publication of the public notice. Amendments to the tender offer are permitted, provided that it does not materially harm the tenderers. As such, once the tender offer has been made, the offeror would not be permitted to decrease the tender price or the number of shares to be tendered or lengthen the payment date. If an amendment is filed during the tender offer period, the tender offer statement becomes effective three business days after the date of the public notice of this amendment. The offeror may proceed with a tender offer as stated in the tender offer statement only after this three-day period has elapsed. This became an issue in the KCC tender offer, because the tender offer period was deemed have restarted on the date KCC amended its offer and therefore the amendment resulted in a delay to the payment date.

After the effective date of the tender offer, the offeror and its related persons are prohibited from purchasing shares from outside the tender offer process during the period of the tender offer, except for in certain prescribed cases. Repetitive tender offers are prohibited. In that regard, a tender offer is not allowed if the offeror purchases shares of the target company through a tender offer within a six-month period before the filing of the tender offer statement, except for in cases prescribed in the Securities and Exchange Act, such as a counter tender offer. Issuance of new equity securities by the target company is also prohibited during the tender offer period.

The notable amendments to the tender offer rule are as follows:

- The restriction on issuance of new equity securities during the tender offer period was deleted (however, the requirement that the issuance of new equity securities must promote the management objectives of the company remains, provided that the modified business judgment rule as previously explained is applicable).
- The three-business-day waiting period was deleted. Therefore, the tender offer becomes effective on the date of the public announcement of the tender offer.
- The prohibition on repetitive tender offers within six months was deleted.
- Also deleted was the provision that if an amendment is filed, the tender offer period shall be deemed to have commenced on the date of the amendment (which was an issue in the KCC tender offer). Instead, if the amendment is filed at least 10 days before the end of the tender offer period, the initial tender offer period will remain unchanged. If the amendment is filed within 10 days of the end of the tender offer period, the tender offer period shall expire 10 days from the date of the amendment.

The new amendments to the 5% reporting rule and the tender offer rule adjust and balance the conflicting interests of the party attempting a takeover and the party defending the takeover by increasing the monitoring system of takeovers while eliminating some restrictions on tender offers. The new amendments should provide a better framework of fair and transparent rules for takeovers of Korean companies, instead of takeover attempts that lead to a war of attrition in the courts. ■

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