Taking shape in Korea

New developments alter the role of independent directors and the nature of executive compensation packages, explain Dr Chang-Hyun Song and Byung Tae Kim of Shin & Kim

The recent financial crisis has prompted new developments in corporate governance globally, and Korea is no different. Over the last several years, the country's laws have changed to provide greater corporate transparency and accountability and reign in executive compensation for financial institutions. We have also seen several landmark decisions by the Supreme Court of Korea further defining the fiduciary duties of directors.

Independent directors

The supervisory regulations and enforcement decrees of the Financial Holding Companies Act were amended to reduce conflict of interest issues and to strengthen the independence of independent directors. On January 25 2010 the Korea Federation of Banks publicly announced guidelines of best practice for corporate governance. The best practice guidelines aim to strengthen the role and responsibility of independent directors and improve the soundness and transparency of the management of banks and bank holding companies. Financial institutions are now required to amend their internal regulations and comply with the guidelines, or explain the reason for non-compliance. The adoption of these guidelines is likely to significantly alter the role of independent directors in the management of financial institutions in Korea.

As of 2008, independent directors constituted up to 70% of the directors of financial institutions in Korea. Thus, it would seem that independent directors dominate the boards of directors in financial institutions. The reality is that, in some instances, independent directors lack the necessary independence and expertise to sufficiently affect the decision making process of the board of directors. Furthermore, because independent directors usually have a majority presence on the board of directors of financial institutions, they have had a tendency to focus on matters such as nomination of independent directors, term of office and remuneration of independent directors, which pose conflicts of interest and moral hazards. The guidelines were made to improve the role of independent directors in the board of directors of financial institutions.

The best practice guidelines expanded the list of required qualifications for independent directors. New standards include restrictions on major shareholders from becoming independent directors and requirements for independent directors to be professional practitioners in finance, economics, law or other area. The stricter qualifications seek to promote the appointment of independent directors with diverse specialties and increase systematic use of their expertise and increase sound management.

In light of the fact that many independent directors in Korea are nominated by the management or the government, the guidelines require that the company publicly disclose, at a general meeting of shareholders, the relationship between the persons nominating the independent directors and the nominees, the reasons for their nomination, whether all qualifications required under law and the guidelines are fulfilled and the basis for deeming such qualifications fulfilled.

The term of an independent director must be no longer than two years, and a subsequent, consecutive term may be no longer than one year. Additionally, an independent director cannot serve for longer than five years in aggregate. These restrictions serve to allow independent directors enough time to sufficiently familiarise themselves with the state of the financial institution in order to make effective decisions while monitoring the financial institution, while preventing independent directors from entrenching themselves and establishing a comfortable relationship with the management that could affect their independent role. In addition to restrictions on the term of the independent directors, the guidelines require one fifth of a financial institution's independent directors to be replaced every year so as to prevent any one group of independent directors from having consolidated control and preserve their independence.

To strengthen the ability of the independent director to provide an effective counterbalance to management, the guidelines separate the offices of the CEO and the chairman of the board of directors. Where one individual holds both offices of the CEO and chairman of the board of directors, the guidelines require the appointment of an independent director to chair meetings among independent directors and be responsible for communicating with management.

The guidelines require the board of directors and employees to evaluate the independent directors' activities and for companies to pay remuneration to independent directors. The total amount of the remuneration and other benefits of the independent directors must be publicly announced, and the amount of the remuneration should not be linked to business performance.

While the guidelines are carefully designed to enhance transparency and effective monitoring of financial institutions, it may take years for financial institutions to fully accommodate and settle down with these rules.

Model guidelines

In January 2010, the Korean government introduced model guidelines for executive compensation for financial institutions (the Compensation Guidelines) which will apply to banks, bank holding companies, financial investment companies and insurance companies. According to the announcement, the recommendations and guidelines from international institutions such as the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) were reflected in the Compensation Guidelines.

The Compensation Guidelines were prepared in accordance with a basic principle: executive compensation packages for those engaged in investment banking, foreign exchange trading, stock and derivative trading and other fields of work that pose potential high risk to the stability of financial institutions, must be linked to such risks. They specify that compensation packages must be set up to restrain irrational risk-taking activities, and that payment of executive compensation must not hamper the capital stability of financial institutions. Under such principles, the compensation guidelines provides as follows:

(1) Financial institutions must set up a compensation board (under the board of directors) consisting of directors, a majority of whom are independent directors. The

compensation board will establish compensation policies, review their implementation and prepare and submit an annual compensation review report to the shareholders and government for their review and supervision.

(ii) Variable compensation (eg, payments linked to performance) must be subject to claw-back in the event of the financial institution not meeting its performance targets or reporting financial loss.

(iii) Approximately 40-60% of an executive's variable compensation must be deferred for a period of at least three years.

(iv) Approximately 50% of an executive's variable compensation must be paid in the form of stock or other stock-related commodities such as stock options, restricted stock or performance shares, that are interlocked with the long-term performance of financial institutions. A retention policy must be applied to variable compensation through minimum vesting periods (including the deferral period) of such stock or stock-related commodities.

(v) A guaranteed bonus is not an acceptable form of compensation, and for severance pay (retirement package), the principles of adding long-term value to the company and sound risk-taking should be considered.

(vi) Financial institutions must post an annual report on their compensation policy and implementations.

Notwithstanding that the Compensation Guidelines were drafted by the Korean Financial Supervisory Commission as reference guidelines, they are expected to have a de facto effect of law. Under the relevant Korean law, compensation schemes and their implementation by financial institutions are annually reported to the financial supervisory bodies and disclosed to the public. Many financial institutions have shareholders consisting of government entities or funds such as the Deposit Insurance Corporation, and there will therefore be increasing public and political pressure for financial institutions to comply. In fact, in the first half of 2010, major bank holding companies were reported to have already modified, or be in the process of modifying, their internal compensation regulations based on the Compensation Guidelines.

There is criticism from the financial sectors regarding the effectiveness of the Compensation Guidelines, pointing out that they may not effectively reflect the structure and timing of profit and loss realization and the performance of long-term projects. However, the significance of the Compensation Guidelines can be found in the fact that it provides an institutional scheme that restrains irrational high-risk investments incentivized by short-term compensation and gambling for redemption activities that are suspected to be widespread in the financial sector. The effectiveness and ripple effects of the Compensation Guidelines are expected to become apparent during the course of their implementation by each financial institution.

Director liability

Another notable development in Korea's corporate governance relates to recent judicial rulings on director liability. The Supreme Court of Korea has rendered several landmark decisions in recent years involving the breach of fiduciary duties by directors. Most of these cases made headlines as they all involved directors of major Korean conglomerates.

One notable feature of these cases is that the minority shareholders generally sought enforcement through criminal proceedings rather than civil proceedings. Minority shareholders preferred filing criminal charges against controlling shareholders or directors who breached their fiduciary duties rather than recovering damages by civil action. While there may be several reasons for this, one reason appears to be due to the near absence of class actions in Korea. Some shareholder-activists even commented that criminal sanction would serve as the best tool to reprimand wrong-doers in fiduciary-violation cases.

In one landmark case, Samsung SDS and Samsung Everland, which acts as a *de facto* holding company of the Samsung group, had issued convertible bonds (CB) and bonds with warrants (BW) at discount prices to family members of the controlling shareholder and CEO of the Samsung group, Mr Keun-Hee Lee. The key issue here was whether the issuance of CBs and BWs by the companies at discount prices harmed their own interests. The Supreme Court decision is important in that it distinguished the issuance of discounted securities to existing shareholders from the issuance of the same to a third party. It held

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that while the issuance of CBs and BWs at discount prices would harm the interests of the companies if they were issued to a third party, they would not harm the interests of the companies if issued to existing shareholders as such issuance is comparable to the offering of bonus issues. Therefore, this type of issuance should not be deemed to harm the interests of the companies. With regard to this ruling, many scholars and practitioners question whether it was necessary to discern between issuing securities to existing shareholders and issuing to a third party. Despite ongoing debates, this case clearly showed that the issuance of securities at discount prices may result in fiduciary violations of directors.

The Supreme Court also rendered a landmark decision involving the sale of treasury stock. In this case, Dongbu Corporation sold 35% of its treasury stock in a block sale to its controlling shareholder, who was also its representative director, at market price without adding any controlling premium. The Supreme Court ruled that the sale price should have included the controlling premium and therefore, the directors that approved the sale violated their fiduciary duties. The Court also added that in calculating the controlling premium, factors such as the present and future value of the company, the resulting effect from acquiring control and the cost needed to acquire such shares on the stock exchange should be taken into account, although the detailed terms would be entirely up for negotiation between the parties.

Until recently, many corporate acquisitions were structured as a leveraged buy-out (LBO), an acquisition heavily financed by debt collateralized and serviced by assets and cash flows of the target companies. Despite the popularity of LBOs, their validity under Korean law was not a settled matter of law. However, two Supreme Court rulings, one issued in 2006 and one recent case in 2010, seem to have removed much of the ambiguity in the law.

In 2006 the Supreme Court held in a seminal case that the directors of the target company were liable for breach of their fiduciary duties in an LBO transaction where the assets of the target company were provided to secure financing extended to the acquirer without commensurate consideration, thereby exposing the target company's assets to potential foreclosure in the event the acquirer failed to repay the acquisition loan. Since then, LBOs took on a tripartite structure involving an acquirer, a target company and a special purpose vehicle (an acquisition entity) which eventually merged into the target company at the closing of the LBO. The special purpose vehicle was used as a conduit to procure acquisition financing and was done without collateralizing the assets of the target company. In this way, directors of the target company would not be exposed to any breach of fiduciary duties. However, the validity of this tripartite structure under Korean law was unsettled until the Supreme Court in April of 2010 issued a ruling with respect to the LBO of Hanil Synthetic Fiber (a cash-rich target company, Hanil) by Tong Yang Major (the parent holding company of Tong Yang Conglomerate that was extended acquisition financing for the acquisition, Tong Yang). The Supreme Court held that while an inquiry on the validity of an LBO must be made on a case by case basis, the tripartite structured LBO of Hanil was not *per se* illegal because the directors had complied with all legal requirements for acquiring Hanil and its subsequent merger with Tong Yang, and no assets of Hanil were unjustly used to secure acquisition financing by Tong Yang. Though not all LBO-related legal concerns are clear, this ruling will greatly help reduce uncertainty in structuring an LBO in Korea.

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