국제학석사학위논문

The developments of Shareholder and Creditor Protection in Korea

- "Law and Finance" Revisited -

한국의 주주와 채권자의 보호 변화
-"법과 금융" 재고-

2015 년 2 월

서울대학교 대학원

국제학과 국제통상전공

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Abstract

The developments of Shareholder and Creditor Protection in Korea – "Law and Finance" Revisited

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Poor corporate governance is widely viewed as one of the structural weaknesses that were responsible for the outbreak of the 1997 Asian financial crisis. While several factors accounted for the poor corporate governance, the most important one was the failure to establish appropriate rules for managing corporations that were built up with funds provided by multiple investors. Good corporate governance is needed to prevent the expropriation of shareholders by managers and to ensure the efficient management of a company that has multiple owners. Before Asian financial crisis, legal infrastructure to regulate corporate governance was incomplete and inadequate, leaving firms vulnerable to expropriation by managers and dominant shareholders. Furthermore, laws and regulations were not rigorously enforced, so that such expropriations were frequently ignored and were rarely penalized.

The extensive reform measures introduced since 1998 have led to significant improvements in the corporate governance in Korea. This paper aims to document and evaluate a contemporary corporate governance reform by using LLSV's measures of shareholder and creditor protection for Korea for the period 1998 to 2014. Corporate governance scores based on LLSV's indices show that shareholder protection in Korea has been strengthened whereas creditor protection has been weakened.

Keywords

Investor protection, Corporate Governance, Law and Finance, Korea

Student ID: 2012-23830

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1. Introduction

Korea's sustained economic growth, which averaged around 8% a year over a span of 35 years since the early 1960s, came to an abrupt end by the financial crisis of late 1997. With the substantial depreciation of the Korean Won and the economic setback, per capita GDP, which exceeded US $10,000 several years ago, slid back to the 1991 level at a little over US$6,800. The 1997 financial crisis exposed a wide range of structural weaknesses in Korea's economy. International organizations such as the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank), in particular, criticized Korea's corporate sector and blamed ineffective corporate regulation as a major cause of the crisis.[1] Other scholars also believe that 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. In return for receiving their financial assistance, Korea enacted extensive amendments to its corporate

[1] See BALINO & UBIDE, *supra* note 7, at 7 ("[L]ack of transparency in financial and corporate sectors, weak governance, and poor regulator systems hampered the efficient functioning of markets in disciplining the Korean economy."). In its "Letter of Development Policy" concerning the Second Structural Adjustment Loan from the World Bank, the Korean government admitted that "[t]o restore, and sustain, financial viability and competitiveness, Korean firms need both financial and real restructuring. The latter requires improvements in the governance of firms and increased exposure to competitive pressures." Letter from Kyu-Sung Lee, Minister of Finance and Economy, to James D. Wolfenshon, President, International Bank for Reconstruction and Development, para. 7 (Sep. 24, 1998)

governance standards beginning with December 28, 1998 (1998 KCC). Among various regulatory reforms, increasing recognition of the rights of noncontrolling shareholders was in part due to the increase in foreign shareholders who were now perceived as having the potential to play positive roles in bringing Korean firms in line with international standards. Bankruptcy-related laws were amended in February 1998 to facilitate both easier exit and entry to an industry. The amendment simplified legal processes for bankruptcy filing and corporate rehabilitation, and gave a greater role and voice to creditor banks in the resolution process.

I particularly focus on the effectiveness of protection for minority shareholders and creditors by using 18 indices, developed by La Porta, Lopez-de-Silanes, Shelifer, and Vishny (hereafter, LLSV) (1997, 1998) for measuring investor protection in Korea for the period 1998-2014. LLSV(1998) discuss a set of key legal rules protecting shareholders and creditors, and document their prevalence in 49 countries around the world. To measure investor protection, they also create shareholder and creditor rights indices for each country.

Investor protection turns out to be crucial because, in many countries, expropriation of minority shareholder and creditors by the controlling shareholders is pervasive. When outside investors finance firms, they face a risk, and sometimes near certainty, that the returns on their investments will never materialize because the controlling shareholders or managers simply keep them. Also, related work shows that stronger investor protection results in larger and more efficient capital markets (LLSV, 1997), higher equity values (LLSV 2002, Claessens te al.2002), and faster economic growth (Demiguc-Kunt Maksimovic, 1998; Levine, 1999; and Wugler, 2000).

But what determines the control rights of investors? LLSV argue that the legal rules and effectiveness of their enforcement shape these rights. When the rules – such as the voting rights of the shareholders and reorganization and liquidation rights of the creditors – are extensive and well enforced by regulators or courts, investors are willing to finance firms. When the rules do not protect investors, corporate governance and external finance do not work well.

In this paper, I discuss the changes in shareholder and creditor rights in Korea between 1998 and 2014 based on LLSV'S indices and address important lessons Korea has derived from comparative corporate governance. Also, I figure out LLSV's indices are adequate to evaluate investor protection in Korea.

The structure of the paper is as follows. Following this section, section II discusses regulatory reform efforts in relation to better corporate governance in Korea since the Asian crisis. Section III provides the evolution of shareholder protection between 1998 and 2014 in Korea. Section IV outlines the changes of creditor protection between 1998 and 2014 in Korea. Section Ⅴ presents overall conclusions and policy implications.

2. Corporate Governance Reform in Korea

Poor corporate governance has been widely viewed as one of the structural weaknesses that were responsible for the onset of the 1997 Asian financial crisis. Family-controlled large businesses have indeed inadequately supervised or monitored by outside shareholders, board of directors, creditor banks, or markets for corporate control. In managing their firms and business groups, controlling family owners have been able to pursue their private interests relatively easily, often at the expense of minority shareholders and their firms' profits. Without strengthening corporate governance, economic growth is unlikely to be sustainable and may be vulnerable to another crisis in the future.

Good corporate governance is needed to prevent the expropriation of shareholders by managers and to ensure the efficient management of a company that has multiple owners. It is also needed to attract the capital needed to pursue large and worthwhile projects. Korea succeeded in building up many large firms that their countries needed for economic development, however, they failed to put it place a sound governance mechanism that could effectively solve the problems that arose from the divergence of ownership and control. Legal infrastructure to regulate corporate governance was incomplete and inadequate, leaving firms vulnerable to expropriation by managers and dominant shareholders. Furthermore, laws and regulations were not rigorously enforced, so that such expropriations were frequently ignored and were rarely penalized.

One crucial cause of the poor performance of many corporations in Korea was inability to prevent dominant shareholders from making key decisions single-handedly. Consequently, reform efforts emphasized giving greater decision making power to other shareholders. Laws and regulations were amended to facilitate the participation of minority shareholders in decision making on important issues and to force managers to provide more accurate information to shareholders so that they could make better decisions. Furthermore, reform measures enabled shareholders to seek stronger remedies when their rights were violated.

3. The Evolution of Shareholder Protection

A shareholder is granted a shareholder's right which is one of the rights given to the members of a company and becomes the basis of individual rights to the company. Shareholder protection refers to the protection provided by the corresponding Corporate Law or the Commercial code to the shareholders of a company. Those in control of the corporation, whether managers or controlling shareholders, may use their power to expropriate private benefits of control. Without effective shareholder protections, managers may pay themselves exorbitant salaries.

LLSV examine various rights from company laws which they consider to be central to the protection of minority shareholders. These include the "one share – one vote" principle and six other rights, which they refer to as "Anti-director" rights, because they measure if minority shareholders are protected against dominant shareholder or the management. The last shareholder rights measure is the right to a "Mandatory dividend." In some countries, companies are mandated by law to pay out a certain fraction of their declared earnings as dividends. This variable was downplayed even in LLSV(1998, 1128) and hardly exists anywhere anyway. So I skipped this variable. For other variables, if a country requires or provides for a certain right a score of one is assigned, otherwise zero is assigned. The source for shareholder protection is commercial code.

Concerning shareholder protection, the Korea achieved three out of seven points (criteria 1, 5, 7). The original scores for Korea are summarized and depicted in Table 1 below.

Variables	South Korea
One share-One vote	1
Anti-director Index	
Proxy by mail allowed	0
Shares not blocked before meeting	0
Cumulative voting/ proportional representation	0
Oppressed minority	1
Preemptive right to new issues	0
% of share capital to call an ESM	1
Score	**3**

Table 1: Shareholder protection score for Korea
(Source: LLSV, “Law and Finance”, 1998)

3.1 One share One vote index of LLSV(1998) and extensions

A voting right is the right of a shareholder to participate and cast a vote in resolutions at a shareholder's general meeting. Shareholders can participate in the management of a company by exercising their voting rights. The right to vote in the general meeting to elect directors and make major corporate decisions guarantees shareholders that management will channel the firm's cash flows to shareholders through the payment of dividends rather than divert the funds to give themselves higher compensation, undertake poor acquisitions, or adopt other measures not in the interest of the shareholders.

Because shareholders exercise their power by voting for directors and on major corporate issues, experts focus on voting procedures in evaluating shareholder rights. They include voting rights attached to shares, rights that support the voting mechanism against interference by the insiders, and what we call remedial rights. To begin, investors may be better protected when dividend rights are tightly linked to voting rights, that is, when companies in a country are subject to one-share-one-vote rules (Grossman and Hart 1988; Harris and Raviv 1988). When votes are tied to dividends, insiders cannot have substantial control of the company without having substantial ownership of its cash flows, which moderates their taste for diversion of cash flows relative to payment of dividends.

The principle of 'one share, one vote' was indeed derived from the equality of proportionate interests that shareholders have as to corporate governance. The principle of shareholder equality may be excluded or limited by special provisions in the law. For example, there are some provisions exclusive from the principle of shareholder equality, including ‘different classes of shares’, ‘non-voting shares’. LLSV grant one point for a legal system if the Company Law or Commercial Code of the country requires that ordinary shares carry one vote per share or when the Law prohibits the existence of both multiple-voting and nonvoting ordinary shares and does not allow firms to set a maximum number of cotes per shareholder irrespective of the number of shares owned, and zero otherwise (LaPorta et al., 1998, 1122).

According to the LLSV(1998), South Korea received 1 point for this condition. Article 369(1) (Voting Rights) (1984) prescribes that a shareholder shall have one vote for each share, claiming the principle of ‘one share, one vote’ which is one of the few provisions forming the basis of corporate governance in the Korean corporations.[2] There was no deviation from one share-one vote rule in Korea. However, because of the recent law revision, a legal basis that enables firms to issue common stocks without voting rights is established. In other words, after the revision of commercial act, if the company includes in the articles of incorporation, issuing common stock without voting rights is allowed.[3] The revised Commercial Act also adopted

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[2] Article 369(1) (Voting Rights) ① A shareholder shall have one vote for each share.

[3] Article 344(Different Class of Shares) (2011 amended)

(1) A company may issue different classes of shares which are different in respect of their particulars as to the profit dividends, distribution of the surplus assets, exercise

the restricted exercise of voting rights.[4] Thus, in theory, when voting rights are restricted or excluded under the matters such as merger or election of directors, this could be used as a defense mechanism for hostile M&A. Even though Korea has yet to approve issuing dual class stock, it is certain that one share one vote of Korea has been damaged over the last 15 years. Therefore, the score for this variable has changed from" 1" to" 0."

3.2 Antidirector index of LLSV (1998) and extensions

The "Antidirector Rights Index" from La Porta et al.'s "Law and Finance"(1998) has been used as a measure of shareholder protection in almost 100 published studies. The ADRI was defined in LLSV (1998) as the sum of six indicator variables counting the existence, in a country's laws, of six legal rules favorable to shareholders. For each of the first five antidirector rights measures, a country gets a score of 1 if it protects minority shareholders according to this measure and a score of 0 otherwise. LLSV also give 1 if the percentage of share capital needed to call an extraordinary shareholder meeting is at or below the world median of 10 percent. Finally, LLSV add up these six antidirector rights scores into an aggregate score.

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of voting rights at a general meeting of shareholders, repayment, conversion, etc.

[4] Article 344-3(Different Classes of Shares concerning Exclusion/Limit of Voting Rights)
When a company issues a class share without voting right or a class share with a restricted voting right, it shall mention in the articles of incorporation when it is not allowed to exercise voting right, and the conditions of exercising voting right or reinstatement.

The last shareholder rights measure, which we treat differently from others, is the right to mandatory dividend. In some countries, companies are mandated by law to pay out a certain fraction of their declared earnings as dividends. I don't consider this variable because Korea never adopted mandatory dividend policy.

3.2.1 Proxy by mail allowed

In some countries, shareholders must show up in person or send an authorized representative to a shareholders' meeting to be able to vote. In other countries, in contrast, they can mail their proxy vote directly to the firm, which both enables them to see the relevant proxy information and makes it easier to cast their votes. According to LLSV a point is assigned if the company law or commercial code allows shareholders to mail their proxy vote to the firm (LaPorta et al. 1998, 1127). The objective behind proxy by mail and proxy voting in general is to provide shareholders with the possibility to vote without personal attendance and exercise their right without much "*time, money and effort*".

Before 1999, Korean law doesn't allow shareholders to mail their proxy vote to the firm.[5] After 1999 amendment, the commercial Act

[5] Article 368(Method of Adopting Resolutions and Exercise of Voting Rights) (Amended 1995)
(1) Unless otherwise provided by this Act or articles of incorporation, resolutions shall be adopted at the general meetings by affirmative votes of a majority of the voting rights of shareholders present threat and representing at least 1/4 of the total

recognized a shareholders' voting by physically attending the meeting or using a proxy in addition to the vote exercise by way of a written means.[6] Moreover, the commercial Act amended in 2009 provides for another means, electronic voting.[7] Although the company may determine whether to use mail and or electronic voting, mail voting requires a provision in the articles of incorporation, whereas electronic voting may be used by the resolution of the board of directors without any provision in the articles of incorporation. Now, Korea clearly gets "1" point. Shareholders are able to exercise their votes without attending the general meeting.

In April 2011, among 199 listed subsidiaries from 35 groups (belonging to the large business groups with the same person), 25 companies introduced exercise of voting right in writing in their charter while none had introduced electronic voting.

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issued and outstanding shares.

[6] Article 368-3 (Exercise of Voting Rights by Writing) (1999)

(1) Shareholders may exercise their voting rights in writing, without attending a general meeting of shareholders, pursuant to the articles of incorporation.
(2) Any notice of convocation of a general meeting of shareholders shall be accompanied by documents and reference materials necessary for shareholders to exercise their voting rights pursuant to paragraph

[7] Article 368-4 (Exercise of Voting Rights by Electronic Means) (Amended 2009)

(1) A company may determine that a shareholder may exercise an absentee vote by electronic means, through a resolution of the board of directors.

	Groups with the same person	Groups without the same person	Total
No. of groups	35	8	43
No. of listed companies	199	19	218
No. of companies allowing proxy by mail	21	4	25
No. of companies allowing electronic voting	0	0	0

Table 2: Exercise of voting rights listed companies in the large business groups (2011.04.30)
(Source : Korea Fair Trade Commission's Disclosure of Large Business Groups)

3.2.2 Shares not blocked before meeting

In some countries, law requires that shareholders deposit their shares with the company or a financial intermediary several days prior to a shareholder meeting. The shares are then kept in custody until a few days after the meeting. This practice prevents shareholders from selling their shares for several days around the time of the meeting and keeps from voting shareholders who do not bother to go through this exercise. LLSV assign a point if the company law does not allow firms to require the deposit of their shares prior to a meeting, and otherwise zero is assigned (LLSV, 1998, 1122).

Before considering this variable in more detail, it is necessary to look at the different stick classes provided for in Company law. Companies may issue shares in two forms, namely bearer or registered. While bearer shares are traded without any keeping of ownership records and the physical possession is sole evidence of ownership, registered shares are issued under keeping of records of the shareholder. In many Civil law countries, including Austria and Germany, bearer shares are widely used, whereas in Common law countries as the UK, Ireland or the US, registered shares are predominant. In the case of Korea, although bearer shares are adopted in 1963 in Korea, it has never been issued. Korean corporations only offer registered shares instead of bearer.

Before 1998, the deposit is permitted by law.[8] But, this provision is only restricted to bearer share.[9] As of 2014, these articles are deleted which leads to bearer share repealed with only registered share being used. Considering the fact that most of the traded stocks in Korea are registered, this revision is not practically meaningful. Regardless of effectiveness, the score has changed from “0” to “1” point.

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[8] Article 358(Exercise of Rights by Shareholders Holding Bearer Share Certificates) The holder of a bearer share certificate may not exercise his/her rights as a shareholder unless he/she deposits his/her share certificate with the company.

[9] Article 368(Methods of Adopting Resolutions and Exercise of Voting Rights)
(2) Persons holding bearer share certificates shall deposit them with the company one week prior to the date set for the meeting.

3.2.3 Cumulative voting/ proportional representation

The level of influence granted to minority shareholders is of a very limited scope, in particular in regard to the right to vote for directors. Without special mechanisms, any attempts of minority shareholder to be represented in the board of directors would fail or at least be hampered. While regular voting requires shareholders to vote for a different candidate for each available sear, cumulative voting is a voting mechanism which permits minority shareholders to elect at least one director on the board, even if one shareholder or a group of shareholders control an absolute majority of the voting rights. With cumulative voting, there is no deviation from one share on vote in the sense where some shareholders carry voting rights greater than their cash flow rights. Proportional representation is another voting method and allows shareholders to give multiple seat votes to the same candidate. The effect of either rule, in principle, is to give more power for minority shareholders to put their representatives on boards of directors and it is expected to improve corporate governance structure ultimately.

LLSV assign a point if the Company Law or Commercial Code allows shareholders to cast all their votes for one candidate standing for election to the board of directors (cumulative voting) or if the Company Law or Commercial Code allows a mechanism of proportional representation in the board by which minority interests may name a proportional number of directors to the board, otherwise zero is given (LaPorta et al., 1998, 1122).

Cumulative voting can be optional, through a clause in the articles of incorporation of the company, or mandatory by special provision in the Companies Act or the Securities Act. Countries where the procedure is optional include Canada, Finland, Italy, Latvia, the UK, the U.S., Bulgaria and Croatia. Sometimes, shareholders representing a minimum percentage of the voting rights, can demand it. Russia is one example where cumulative was made mandatory by the law makes. Under Article 66 of the Joint Stock Company Law, open joint stock companies with more than 1,000 shareholders must: (1) have at least seven members of the board of directors and (2) use cumulative voting in the election of their directors. Companies with more than 10,000 shareholders must have at least nine members and must also use cumulative voting. Other companies may have fewer board members and may use either proportional or cumulative voting. The use of cumulative voting has been important in fostering equitable treatment in Russia, particularly since the procedure was combined with a requirement that some key decision need unanimous approval of the board of directors.

In Korea, a cumulative voting system was first introduced in 1998 when the Commercial Code was revised. Unfortunately, the Commercial Code contains an opt-out provision that enables companies to exclude cumulative voting by amending the articles of incorporation. While a cumulative voting system was actually adopted in 1998, most Korean companies have avoided its implementation through an amendment to their articles of incorporation at shareholders' general meetings. [10] According to a recent study of 734 Korean listed companies, only 7.4% of listed companies had introduced the cumulative voting system, and most of them are small KOSDAQ listed firms. Also, in the firms which introduced cumulative voting, due to director's staggered terms, cumulative voting is not applicable, or even if it is applicable, at least 25% of shares are required. Thus, it is nearly impossible for the minority shareholders to recommend and elect outside director in the companies where cumulative voting is introduced, and the cumulative policy which appears successful in the improvement of corporate governance structure is actually for a decoration purpose. As the cumulative voting is well identified to be non-effective, the government should think of other ways to complement or replace this policy.

According to the recent announcement of the Ministry of Justice concerning the revision of the Commercial Act, if a company's asset size exceeds a minimum threshold, the company will be required to adopt a cumulative voting system. The applicable minimum threshold and other specific provisions will be determined in its related Enforcement Decree. Starting with 2014 general meetings, shareholders can expect to elect directors by cumulative voting in Korea.

Cumulative voting is an important mechanism for providing large

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[10] Article 382-2 (Cumulative Voting) (Amended in 2001)

(1) Where a general meeting of shareholders of a company is convened to appoint two or more directors, shareholders who hold less than three percent of the total issued and outstanding shares excluding nonvoting shares may request the company to appoint directors based on cumulative voting, except as otherwise provided for by the articles of incorporation.

minority shareholders, especially institutional investors, with an effective voice at the Board of Directors, and great access to information about the company's activities than they could obtain from the company's public disclosures. There is empirical evidence that companies that eliminate cumulative voting suffer a decline in share price as a result. [11] 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 produced no actual change in corporate practices. Based on LLSV measure, despite the lack of effectiveness, a point is justified if the Law provides for the possibility – not obligation – to introduce cumulative voting in corporations.

3.2.4. Oppressed minority

Oppressed minorities mechanisms are remedies for minority shareholders against perceived oppression by directors. LLSV assign a point if a countries' company law grants minority shareholders either a judicial venue to challenge the decisions of the management or of the assembly or the right to step out of the company by requiring the company to repurchase their shares when they object to certain fundamental changes in the company structure, such as mergers, asset sales or changes in the statutes, zero otherwise (LaPorta et al., 1998, 1122). Minority is defined as shareholders holding equal or less than 10% of the share capital.

The clear objective of those mechanisms is to ensure means by which shareholders can protect themselves from abuses or oppression by the majority. Since they are likely to deprive managers of money, prestige, or even their jobs, these suits serve an important threatening or disciplinary function that can deter the management from engaging in wrongdoings.

Theoretically, an auditor or audit committee should file a suit against a company on behalf of the company, but it is unrealistic due to the special connection between auditors/audit committees and directors. This may result in harm to the interests of a company and shareholders. Thus, the Korean Commercial Act has the provisions that allow minority shareholders questioning the liability of directors by filing a law suit, which is the derivative suit system.[12] After the revision of commercial act, a plaintiff would be a shareholder who holds not less than 1/100 of the total issued and outstanding share of a company.[13] The requirement share decreased from 5/100 to 1/100 which implies strengthening shareholder protection. However,

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[12] Article 403 (Derivative Suit by Shareholders)
(1) Any shareholder who holds no less than 5/100 of the total issued and outstanding shares may demand that the company file an action against directors to enforce their liability.

[13] Article 403 (Amended 1998) (Representative Suits by Shareholders)
Any shareholder who holds no less than one percent of the total issued and outstanding shares may request that the company file an action against directors to compel them to perform their obligations

gradation is not considered in LLSV. Also, after 1998, new article was inserted, which stated the liability of instructor.[14] In many cases, instructor is controlling shareholders who instruct director to conduct business.

Derivative lawsuits are very rare in Korea. Fewer than 10 derivative suits have been filed since the late-1990s, and the class action has never been filed since its adoption in 2005. The derivative lawsuits were not initiated by shareholders or entrepreneurial lawyers, but rather they were filed by an NGO called "People's Solidarity for Participatory Democracy (PSPD)." Chances are, however, such derivative suits may be poorly tuned up from the efficiency point of view, because they are filed not for the pecuniary reason, but rather with a mission to cure Korean corporate governance system. Due to lack of financial and human resources, the PSPD was only able to bring a few lawsuits against the limited number of large corporate groups like Samsung or Hyundai. Thus, although the derivative lawsuits that the PSPD filed attracted much attention, little threatening function was achieved.

The reason behind the inactive derivative lawsuit against listed corporations is thought to be the difference in legal system among countries. While the United States and Japan designates the derivative lawsuit system as an independent shareholder′s right, in Korea it is a minority shareholder′s

[14] Article 401-2 (Liability of Person who Instructs Another Person to Conduct Business, etc.) (1998)
(1) Any person who falls under any of the following subparagraphs shall be a director for the purposes of Articles 399, 401, and 403 regarding the duties hw/she instructs or perform:
1. A person who instructs a director to conduct business by using his/her influence over the company…

right with the requirement of holding minimum 0.01% of the company's stock. Another reason is that shareholders tend to file for other kinds of suits due to derivative lawsuit's structural weakness: low economic incentive for the shareholders. The shareholders, as the plaintiff, file a suit on behalf of the company. If shareholders win, the damages are paid to the company, not to the shareholders; therefore, there is no direct economic gain of the lawsuit for the shareholders.

In order to ease the standing to sue, double (multiple) derivative suit should be adopted. In the current Commercial Act and the precedents, the standing to file derivative suit is given only to the shareholder of the corporation, not to the shareholder of the parent company. Because the double (multiple) derivative suit is not acknowledged, the pursuit of private benefits using unlisted subsidiaries by controlling shareholders and the management is not effectively regulated, leading to the listed subsidiaries' shareholders' loss. In the October 2006's revision of Commercial Act, the double (multiple) derivative suit was included, but it was deleted under the pressure of business group.

Second point of oppressed minority is the right to force the company to repurchase shares of the minority shareholders. Before 1998, for transfer, takeover or lease of business and merger, repurchasing right is guaranteed.[15]

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[15] Article 374-2 (Appraisal Rights of Opposing Shareholders) (1995)
Opposing to resolutions for transfer, takeover, or lease of business
Article 522-3 (Appraisal Rights of Shareholders Dissenting Merger) (1995)

Korean law has guaranteed the right to force the company to repurchase share of minority shareholder who object to certain fundamental decisions of the management or the shareholders since 1998. After 1998, repurchasing right can be guaranteed when there is contract for share swap.[16] For oppressed minority, Korea got '1' point before 1998 and now still gets '1' point.

3.2.5. Preemptive right to new issues

Preemptive rights grant existing shareholders the right to buy new issues of stock before they are issued to the public. Preemptive rights secure that the management is not able to *"issue shares (...) to third parties, especially at a discount to the market price"*. The underlying goal is to protect shareholders from dilution, whereby shares are issued to favoured investors at below-market prices which in turn decreases the power of existing shareholders. As early as 1932, Adolf Berle stated that "*the doctrine arose (...) to impose an equitable limitation on an apparently absolute power of directors to issue stock*". In sum, there seems to be wide agreement within the jurisprudence that preemptive rights are an important tool for shareholder protection. LLSV assign a point, if shareholders are granted the first opportunity to buy new issues of stock and this right can only be waived by a shareholders' vote, zero otherwise.

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[16] Article 360-5 (Appraisal Rights of Opposing Shareholders) (2001)
Opposing to resolution for Contracts for Share Swap

Before 1998, under Article 418(1), companies can eliminate or restrict shareholders' preemptive rights by provisions of the company's articles of incorporation.[17] Many large companies have done so, and thereby deprived shareholders of an important protection against dilution. After 1998, denying the preemptive right was limited to cases necessary for the achievement of the company's operational objectives, which means denying the preemptive right becomes very hard and almost impossible.[18] Therefore, for this variable, Korea got "0" point before 1998 and now gets "1" point.

3.2.6. % of share capital to call an extraordinary shareholders' meeting

LLSV look at the percentage of share capital needed to call an extraordinary shareholders' meeting. Presumably, the higher this percentage is, the harder it is for minority shareholders to organize a meeting to challenge or oust the management. A point is assigned if the percentage is less or equal to

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[17] Article 418(Contents of Preemptive Rights, Designation and Public Notice of Record Date for Allotment),
(1) Unless otherwise provided by the articles of incorporation, each shareholder shall be entitled to the allotment of new shares in proportion to the number of shares which he holds.

[18] Article 418 (Amended in 2001)
(1) Each shareholder shall be entitled to the allotment of new shares in proportion to the number of shares which he/she holds.
(2) A company may make an allotment of new shares to other persons than shareholders, as provided for in the articles of incorporation, notwithstanding the provisions of paragraph (1): Provided, that in such cases, it shall be limited to cases necessary for the achievement of the company's operational objectives, such as introduction of new technology, improvement of financial structures, etc.

10%, and zero otherwise. This percentage varies around the world from 3 percent in Japan to 33 percent of share capital in Mexico.

Before 1998, Article 366(Calling an extraordinary meeting by small shareholders) states that shareholders who hold no less than 5/100 of the total outstanding shares can request an extraordinary shareholder meeting. According to amended Article 366, shareholders who hold no less than 3/100 of the total issued and outstanding shares may demand the meeting. Percentage of share capital needed to call an extraordinary shareholder's meeting has lowered from 5% to 3%. Because for both time, the percentage is lower than 10, Korea got "1" point before 1998 and now still gets "1" point.

4. The Evolution of Creditor Protection

Creditor rights are of paramount importance for lenders in determining their basic legal protections against borrower expropriation. When creditors finance firms, they face a risk that the returns on their investments may never materialize because the controlling shareholders or managers simply keep them and default on debt contracts. Protection of creditors through the legal system constitutes the most effective way to limit expropriation. Creditors finance firms to a significant extent because their rights are protected by the law. When reorganization and creditors' liquidation rights are extensive and well enforced by regulators or courts, creditors will finance firms. When the rules and their enforcement do not protect investors, corporate governance and external finance fail to work. Effective bankruptcy procedures may also be essential to allow banks to exercise their creditor rights appropriately. Furthermore, in a corporate debt crisis, the inability to repossess collateral may trigger a cascade effect of debtor defaults, deepening the economic crisis.

To measure overall creditor rights, I start with 4 indices developed by LLSV (1997, 1998). The index consists of four measures of creditors' role in bankruptcy and reorganization: (1) "no automatic stay on assets", meaning that secured creditors could seize collateral even through bankruptcy proceedings had commenced; (2) "secured creditors first paid," which established the rule of absolute priority among creditors, assuring that secured creditors would be paid in bankruptcy proceedings before unsecured creditors; (3) "restrictions for going into reorganization," which referred to statutory provisions assuring that management could not start reorganization proceedings without the consent of creditors; and (4) "management does not stay in reorganization," which refers to a rule automatically ousting management from their positions up on the commencement of the proceedings.

Concerning creditor protection, the Korea achieved three out of four points (criteria 1, 5, 7). The original scores for Korea are summarized and depicted in Table 3 below. In the past, there were various separate laws on bankruptcy and insolvency in Korea: the Corporate Reorganization Act, the Composition Act and the Bankruptcy Act. Such separate laws consolidated into the Debtor Rehabilitation and Bankruptcy Law ("DRBL"), which took effect in April 2006. The DRBL provides for proceedings for bankruptcy and rehabilitation either for a legal entity or an individual as well as a separate rehabilitation proceeding for an individual.

Variables	As of 1998
No automatic stay on assets	1
Secured creditors first paid	1
Restrictions for going into reorganization	0
Management does not stay in reorganization	1
Score	3

Table3: Creditor protection score for Korea
(Source: LLSV, "Law and Finance", 1998)

4.1 No Automatic Stay on Assets

In some countries, bankruptcy law may come with an automatic stay of assets and discharge some portion of debt. An automatic stay upon the start of bankruptcy proceedings means that creditors must cease debt collection efforts and move claims to the court (Alexopoulos and Domowitz, 1998). The firm continues to operate while creditors and firms negotiate (Kaiser, 1996). Before deciding whether the firm should be liquidated or not, an automatic stay allows time for managers to communicate with creditors (Franks et al., 1996). LLSV find that nearly half of the 49 countries they study do not have an automatic stay on assets. While automatic stay is allowed in the United States in the case of reorganization bankruptcy (such as Chapter 11), countries such as Germany, United Kingdom, and Japan do not guarantee automatic stay of assets (Alexander, 1999; Hashi, 1997).

It prevents secured creditors from gaining possession of the proceeds that result from the disposition of the assets of a bankrupt firm if reorganization petition is filed. LLSV gives value of 1 if reorganization procedure does not impose an automatic stay on the assets of the firm on filing the reorganization petition. If there is such provision, it gets value of 0.

In Korea, even today 'automatic stay on assets' is not allowed as was in 1998.[19] The newly enacted DBRL introduced individual stay and comprehensive stay for the business reorganization.[20] Comprehensive stay order could be issued only if individual stay order does not realize its goal to protect debtors. However, this stay order is very different from the U.S. counterpart in the scope of affected action. Comprehensive stay only block foreclosure, lawsuit related to the debtor's property, tax related seizure and administrative agency process concerning debtor's property. Stay against secured creditors is only available to the Business Reorganization which happens less than 100 cases annually, which is not automatic procedure. Therefore, Korea gets '1'point in both period.

[19] According to the Company Reorganization Act of 1963 (revised in 1993),
Article 37 (Suspension Order)
In case of filing petition for rehabilitation, the court can suspend other on-going legal procedures over the company, including bankruptcy, composition, execution, provisional attachment, injunction, etc.
Article 67(Suspension of other Procedures)
After the deciding initiation of rehabilitation procedure, bankruptcy, composition, execution, provisional attachment, injunction, auctioning company's asset are prohibited.

[20] According to Debtor Rehabilitation and Bankruptcy Act of 2006 (revised in 2013)
Article 44 (Order Given to Suspend Other Procedures)
In case of filing petition for rehabilitation, the Court may order the discontinuation of the procedures over the company, including provisional attachment, injunction, execution of security right (right over collaterals) etc.
Article 45 (General Order Given to Prohibit Compulsory Execution)
In case of filing petition for rehabilitation, the Court can order comprehensive prohibition order prohibiting execution of creditors' rights including security right if it is concerned that achieving goals of reorganization is impossible.

4.2 Secured Creditors first paid

Who gets paid first when a company goes bankrupt? When a company goes bankrupt, it sells off its remaining assets to pay off as much of its debts as possible. In the eyes of bankruptcy law, not all debts are equal in priority. The bankrupt company must pay off its creditors and shareholders according to an order set by federal laws. In some countries, after the company handles its bankruptcy costs, it starts paying off its business creditors. The company first pays off its secured creditors. Secured creditors get their money back first, usually by taking back their property. In other countries, secured creditors get in line behind the government and workers, who have absolute priority over them. In the Philippines, for example, various social constituencies must be repaid before the secured creditors, often leaving the latter with no assets to back up their claims.

LLSV gives 1 point if secured creditors are ranked first in the distribution of the proceeds that result from the disposition of the assets of a bankrupt firm. If non-secured creditors such as the government and workers are given absolute priority, 0 point is given.

Carrying out a rehabilitation proceeding incurs certain administrative expenses. Also, payment of expenses that provide for the common benefit serves the interest of all relevant parties. In recognition, the DBRL adopted the concept of ‘common benefit claims’ wherein such claims may be satisfied irrespective of the rehabilitation plan and entitled to payments whenever disposable cash is retained. Paragraph 2 of the Article 180 states that payment of common benefit claims shall 'take preference' over the satisfaction of rehabilitation claims or secured rehabilitation claims. The language used in this provision can be translated to mean that creditors with common benefit claims shall be paid before any other creditor participating in the proceeding. Nevertheless, this interpretation does not signify that common benefit claims can be paid in full from the proceeds of the collateral for secured rehabilitation claims before paying the secured rehabilitation creditor. Various provisions in the DBRL sets out common benefit claims in addition to Article 179, which provides a list of common benefit claims.[21] As Article 179 is same as Article 208 of 1994's act, Korea should get '0' in both in the past and the present.

4.3 Creditors' consent in Reorganization

In some countries such as Thailand and the Republic of Korea, management can seek protection from creditors unilaterally by filing for reorganization, without creditor consent. Such protection is called Chapter 11 in the United States, and gives management a great deal of power, because, at

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[21] Article 179 (Claims that Become Public-Interest Claims)
Following rights of claim are classified as the claim for the common benefit.
8. The claim of the opponent party in a supply contract. (Supplier)
9. Tax authority's some qualifying tax claim. (Government)
10. Employees' wages and severance pays. (Workers)

best, creditors can get their money or collateral only with a delay. In contrast, in other economies like Hong Kong or the United Kingdom, filing for reorganization requires creditor consent and, hence, managers cannot escape easily creditor demands. LLSV gives '1' point if reorganization procedure imposes restrictions, such as creditor consent, to file for reorganization.

Before 1998, firm or shareholder can file reorganization without creditors' consent under the Article 30 of Company Reorganization Act.[22] After 1998, the rehabilitation plan also approved without the consent of creditor rights.[23]

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[22] Company Reorganization Act (1994)
Article 30 (Initiation of rehabilitation Procedure)

1) Firm can petition a reorganization procedure in case of financial distress or there is a concern for bankruptcy.
2) If there is a concern for bankruptcy, the shareholder who has shares over 10% of equity or the creditor who has bond equivalent to 10% or over of equity can petition a reorganization procedure.

[23] Article 34 (Application Filed for Commencing rehabilitation Procedure)

1) Obligor (the Firm) can petition a rehabilitation procedure
    1. In case of financial distress, or
    2. If there is a concern about bankruptcy.
2) In case of above #2, the followings can petition rehabilitation procedure.
    1. If obligor is a corporation or LLC, the shareholder who has shares over 10% of equity or the creditor who has bond equivalent to 10% or over the equity, or
    2. If obligor is not a corporation or LLC, the shareholder who has shares over 10% of equity or the creditor who has bond over 50 million won.

4.4 Management does not stay in Reorganization

In countries like the Philippines, management stays pending the resolution of the reorganization procedure, whereas in other countries, such as Malaysia, a team appointed by the court or the creditors replaces management. This threat of dismissal may enhance creditors' power. LLSV assign '1' point when an official appointed by the court, or by the creditors, is responsible for the operation of the business during reorganization.

In Korea, after having reviewed the positive and negative requirements of the case, the court issues the commencement order of rehabilitation proceeding within one month after filing. At the time of issuing the commencement order, the court appoints, in principle, a receiver with the power and authority to operate the debtor company and an examiner who investigates the financial conditions of the debtor company. Before 1998, Korea had third type of custodian under the Article 94 of Company Reorganization Act.[24] After amendment, the incumbent representative director of the debtor is usually appointed as receiver unless financial distress of the debtor can be ascribed to misappropriation, concealment, or mismanagement of the debtor's assets by the management or the Council of

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[24] Article 94(Appointment)

(1) The custodian shall not have any interest with the firm,
(2) The previous clause may not be applied to one specific custodian if several custodians are appointed

Creditors makes a request to discharge the incumbent representative director for a reasonable cause.[25] However, in case where the debtor is an individual, small-and-medium-sized enterprise or other types of persons set out in the Supreme Court Regulations, the court may not appoint the receiver. And if no receiver is appointed by the court for the said debtor that is not an individual, current representative director of such debtor is deemed as receiver and can continue to operate the company under the court's supervision.

[25] Article 74(Selection and Appointment of Custodian)
The reason of enactment- introducing incumbent management as custodian policy
(1) Excluding the incumbent representative from management of the firm made the management avoid petitioning rehabilitation early enough.
(2) So in principle, appoint the incumbent the representative as custodian and appoint a third party as custodian exceptively in case of embezzlement, concealment, poor management with significant responsibility or being requested by creditors committee.
(3) Efficiency of reorganization is expected to be improved by active use of rehabilitation procedure and expertise of incumbent managers.

5. Conclusion

The extensive reform measures introduced since 1998 have led to significant improvements in the corporate governance in Korea. Table 4 below summarizes and depicts the shareholder and creditor protection for Korea after reconsideration as of 2014 and displays score 3:6, 3:1. The result shows that the reform has treated shareholders and creditors unequally. Shareholder protection has been strengthened while creditor protection has been weakened considerably.

Much progress has been made toward improving the corporate governance system: strengthening shareholder protection. After the crisis, Korea attempted to reduce shareholders' costs of participating in the decision making process by allowing voting by mail, and shareholders can now cast their votes on the agenda items of shareholders' meeting by mail if their companies adopt the new voting system. And, Korea introduced cumulative voting in an attempt to correct this asymmetry between cash flow rights and control rights. Cumulative voting can lead to improvements in the governance of a firm that has a dominant shareholder if the dominant shareholder agrees to its adoption. However, few firms actually adopted cumulative voting even after legal reforms had made it possible, and it is unlikely to be adopted in companies in which dominant shareholders face the possibility of losing their power over the appointment of directors. In other words, cumulative voting is a good example of a reform measures that has the potential to promote minority shareholders' rights, but has little chance of actually being implemented. Korea also substantially relaxed the minimum threshold shares needed to make it easier for minority shareholders to exercise their rights. For instance, the threshold shares needed to exercise the right to call for an extraordinary meeting was lowered from 5% to 3%.

Regarding creditor rights, it is necessary to understand differences in financial transaction environment. Contrary to the U.S., the financial environment surrounding Korea is under direct influence from the government regulation. This direct regulation displaced the role of bankruptcy in the past. This situation makes the role of bankruptcy trivial, which means LLSV creditor measures focusing on bankruptcy procedure are not adequate to Korean environment.

Variables	As of 1998	As of 2014
One share-One vote	1	0
Anti-director Index		
Proxy by mail allowed	0	1
Shares not blocked before meeting	0	1
Cumulative voting/ proportional representation	0	1
Oppressed minority	1	1
Preemptive right to new issues	0	1
% of share capital to call an ESM	0.05	0.03
Score	2	5
Total Score	3	6

Variables	As of 1998	As of 2014
No automatic stay on assets	1	1
Secured creditors first paid	1	0
Restrictions for going into reorganization	0	0
Management does not stay in reorganization	1	0
Score	3	1

Table 4: Reevaluation of Korea's score based on LLSV's measures

LLSV criteria seem appropriate to provide investor protection. However, this criterion measures the legal system on paper, not in practice. While the Korean government has adopted various measures into the law, from which we calculate the scores, one can argue that a more important measure would be law enforcement. Besides, the design and wording of some criteria is very much US-oriented. For example, cumulative voting is a common practice in the United States to elect the member of the board of directors. Deposit of shares before the meeting and cumulative voting are such points where LLSV stick to US-oriented criteria without giving Civil Law countries the opportunity to reach the intention of the criteria with other means. In Korea, the deposit of shares is not forbidden – it is simply not practiced. Furthermore, the binary evaluation of legal systems according to “0” or “1” is a very simplifies method to judge the extent of investor protection. It is a system without reflecting gradation or weighting effect. Considering oppressed minority, percentage of share capital to call a meeting criterion, Korea performs much better in practice

A policy implication of the research is that the on-going corporate governance reform efforts should be continued to encourage firms to pay more attention to substance than to form. While the reforms since the mid-1990s are extensive and have resulted in significant improvements in corporate governance practices within firms and in firm’s performance, enforcement of the new measures, as well of measures that had existed before the economic, is still weak. As a practical matter, even if cumulative voting is available, it has rarely been used, as well as derivative suits. For these reasons, one of the key challenges in Korea is the effective enforcement of legal standards. Improving the judicial means of enforcement should be viewed as a policy step that reinforces legal reform. One crucial important factor underlying weak legal enforcement is the shortage or absence of stakeholders who have strong incentives to ensure that participants adhere to the rules of the corporate governance. Minority shareholders or managers who receive their salaries from dominant shareholder are unlikely to have strong incentives to do so. For example, in the oppressed minority variable, 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.[26] Accordingly, fully reimbursement by the company for the litigation costs incurred should be made to a shareholder prevailing in a

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[26] On the value of litigation in giving meaning to uncertain company law rules, see Ehud Kamark, *Shareholder Litigation Under Indeterminate Corporate Law*, 66 U.CHI.L.REV.9887 (1999)

derivative suit. Another important factor behind the weak enforcement is the overall state of the legal system in Korea. Securities exchange authorities, financial regulators, prosecutors' offices, and even the courts appear to be far less active in detecting and penalizing those who seriously violate the rules of the corporate governance than counterparts in more advanced countries.

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국 문 초 록

성명: 박은영

학과 및 전공: 국제학과 국제통상전공

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1997년 발발된 아시아 금융위기의 주요 원인 중 하나로 불안정한 기업지배구조가 공통적으로 꼽힌다. 투자자들의 자금으로 만들어진 회사의 관리에 적합한 규칙을 확립하는데 실패했을 때 불안정한 기업지배구조가 형성된다. 안정적인 지배구조란 경영자로부터 주주의 권리와 효율적인 기업의 경영을 보장받을 수 있는 환경을 말한다. 아시아 금융위기 이전에는 기업 지배구조를 규제할 법적 인프라가 완전하게 갖추어지지 못했고, 회사는 경영자와 대주주들로부터 자유롭지 못한 상황이었다. 더군다나, 법적 규제 역시 강력 법적 조치가 이뤄지지 못했고, 소주주들의 권리는 보장받지 못하였다.

1998년 이래로 시행된 금융 개혁은 한국의 지배구조의 변화에 초점을 맞추어 많은 변화를 이루었다. 본 연구는 1998년과 2014년 사이 시행된 개혁 중 지배구조의 변화를 살펴보고자 LLSV(1998)논문에서 사용된 변수들을 이용하여 한국의 주주와 채

권자의 보호 변화를 조사하였다. LLSV 지표에 근거하여 살펴본 결과, 한국의 주주의 권리는 큰 폭으로 향상되었고, 채권자의 권리는 약화되었다.

주요어: 투자자보호, 기업지배구조, 법과 금융, 한국

학번: 2012-23830