KIM & CHANG

M&A in Korea – A Year in Review and Outlook
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Korea had the strongest and most active M&A market in 2014 during the past five years with a 47% increase in announced deal volume from USD 64.8 billion in 2013 to USD 95 billion in 2014 (based on Bloomberg statistics), and Kim & Chang had the privilege of advising on transactions accounting for approximately USD 38 billion, amounting to 40%, of such total for 2014. Inbound investments into Korea were particularly active as offshore private equity funds sought to capitalize on the buyout opportunities arising from the Korean government’s efforts to restructure and ease the debt burden of selected, highly leveraged Korean conglomerates (chaebol in Korean), which resulted in many assets and businesses, including core businesses, of such conglomerates being divested and sold in 2014. The market also witnessed increased voluntary restructuring efforts by financially sound conglomerates to strengthen and focus on their core businesses (e.g., proposed sales of non-core businesses by POSCO and KT Corporation, and the recently announced Samsung-Hanwha deal), and we expect such financial restructuring and voluntary restructuring efforts by Korean conglomerates, combined with upcoming exits of maturing private equity investments, small to mid-cap cash-out transactions by controlling shareholders and private equity or venture minority investments, to continue to support a healthy and dynamic Korean M&A market in 2015. Another key recent trend is the rising competition and sophistication of domestic private equity funds, which are contributing to the vigor and enthusiasm for Korean assets as investment commitment in such domestic funds exceeded KRW 50 trillion (approximately USD 46 billion) for the first time in history in 2014, and the domestic funds are now actively searching and competing for investment opportunities in Korea alongside traditional offshore private equity heavyweights.

To briefly recap the past year and to stay abreast of key issues of interest in Korean M&A, we share below our observations on some of the material recent developments and issues widely discussed in Korean M&A circles.

M&A Regulatory Landscape. Understanding the value and contribution of healthy M&A activities to the overall economy, the Korean government continued its efforts in 2014 to promote an M&A friendly regulatory environment. In particular, the Korean government sought to alleviate regulatory hurdles restricting investments and the growth of private equity by proposing numerous deregulatory legislations, including the following which are now subject to the deliberation and vote of the National Assembly:

- Amendment of the Korean Commercial Code to permit and facilitate previously prohibited transaction structures, including triangular spin-off and triangular share exchange, and allow the board of directors of companies to definitively approve certain business and asset transfers without shareholder approval;

- amendment of the Financial Investment Services and Capital Markets Act to abolish the prior approval requirement for establishing local private equity funds thereunder and adopt an after-the-fact notice scheme to allow such funds to promptly commence operations upon establishment, and expand the scope of permitted investment targets and structures of such local private equity funds; and
The Korean government appears to be committed to its deregulation efforts, and we expect the improved legal infrastructure to facilitate and support the continued growth of M&A, and particularly private equity investments, in Korea. Nonetheless, navigating the regulatory requirements to consummate an M&A transaction in Korea is often a complex and delicate task, particularly in regulated or nationally sensitive industries, and potential investors are well advised to undertake a comprehensive analysis of potential regulatory obstacles early in their review of proposed investments in Korea.

**Withholding Tax on Capital Gains.** Korean tax on Korean source income, particularly capital gains, earned by offshore funds has been a consistent topic of interest for offshore funds and the Korean tax authorities in 2014. The issue of whether the Korean tax authorities would look through the offshore funds towards the ultimate investors of the funds in applying tax treaties to, and assessing tax on, Korean source capital gains remains unresolved as there remains a conflict between two positions respectively supported by statutory law and a line of Korean Supreme Court decisions. First, the so-called Overseas Investment Vehicle (OIV) regime, which became effective as of July 1, 2012 for Korean source passive income (e.g., dividend, interest and royalty income) and as of January 1, 2014 for Korean source capital gains, supports looking through the offshore funds, typically limited partnerships, towards the limited partners of such funds as the beneficial owners of the Korean source capital gains and affording to such limited partners the benefit of any tax treaty in effect between Korea and their resident country. This regime is consistent with the past practice of the Korean tax authorities, as well as the OECD’s position on taxation of offshore funds. On the other hand, the Korean Supreme Court, in a series of decisions since 2012, have found offshore funds themselves to have distinct business purposes and be the beneficial owners of Korean source capital gains in relation to transactions consummated prior to the effective date of the OIV regime. Currently, a request for authoritative ruling remains pending before the Ministry of Strategy and Finance, the Korean governmental body responsible for the interpretation of tax laws and treaties, to resolve this apparent inconsistency, and the Ministry is soon expected to provide official guidance on the operations of the OIV regime against the backdrop of the recent line of Korean Supreme Court decisions.

**Acquisition Financing.** On January 22, 2015, the Seoul Central District Court rendered a notable decision regarding the alleged breach of fiduciary duty in connection with a leveraged buyout (LBO) transaction in the *Hi-Mart* case. The lower court in *Hi-Mart*, with distinct factual circumstances under review, held that the directors of the target company should not be held criminally liable for breach of fiduciary duty in a “merger type” LBO (a structure whereby the acquirer would incorporate an SPC which would borrow funds for the acquisition, and thereafter merge the SPC with the target, thereby giving the creditor a direct recourse to the assets of the target) underscoring, among others, the financial soundness of the SPC, the assets of the target not being encumbered to secure the acquisition financing obligations of the SPC, and the merger being consummated in accordance with applicable laws. The lower court’s reasoning and decision in *Hi-Mart* may provide meaningful guidance on structuring of future LBO transactions. However, caution is still warranted to potential legal risks when structuring an LBO transaction of this type given that the Korean courts view the legality of an LBO transaction on a case-by-case basis and have, in fact, held LBO transactions in criminal violation of the directors’ fiduciary duty in many cases (again, the subject lower court’s
holding in Hi-Mart was rendered upon detailed review of distinct set of facts) and Hi-Mart may still be appealed to the appellate court and potentially to the Supreme Court.

**General Partner Liability.** Many private equity fund personnel have frequently inquired on the scope of fiduciary duties and liabilities of a director serving on the board of directors of a Korean portfolio company. Underscoring the need for private equity funds to exercise caution in managing their Korean portfolio companies, a Korean court recently allowed creditors of a Korean company to provisionally seize the management fees and carried interest owed by a private equity fund to its general partner in connection with a damage claim brought against the general partner. According to news reports, the creditors are claiming that the directors of the company breached their duties of loyalty and care and the private equity fund is liable as a controlling shareholder who actively participated in the management of its Korean portfolio company. Although it remains to be seen whether the court will ultimately find the directors and the general partner to be liable, this development serves as a prominent reminder of the importance of understanding the scope of fiduciary duties of directors of Korean companies and the potential liability for not only the private equity fund personnel serving as directors but also the general partner of the private equity fund.

**Compliance.** The current Korean administration has emphasized its commitment to address the potentially corrupt ties between the government and the private sector in various industries. In July 2014, Korean government agencies jointly formed the Anti-Corruption Task Force, which investigated nearly 500 cases of corruption linked to government institutions within two months of its establishment, implicating over 1,700 individuals. Further, the most significant new anti-corruption legislation to-date, namely the “Act on Prevention of Improper Solicitation and Provision/Receipt of Money and Valuables”, which is more commonly known as the “Kim Young-ran Law”, is expected to be passed and voted into law by the National Assembly in February 2015. If passed in the current form, the new law would, among others, (i) criminalize receipt of an amount or benefit of over KRW 1 million (approximately USD 920), even if not connected to the duties of the relevant public official, (ii) criminalize bribery of smaller amounts, if the aggregate value of benefits provided/received in a one-year period exceeds KRW 3 million (approximately USD 2,800), and (iii) expand the scope of the subject public officials to include individuals “deemed to perform a public function in society”, such as teachers at private schools and news reporters. Given the heightened interest by the Korean government to eradicate corrupt practices and the impending new legislation, investors in Korean corporations are strongly urged to strengthen compliance due diligence, particularly in industries with higher risks of corruption.

**Employment and Labor.** Employment and labor have long been a due diligence area of focus in Korean M&A due to the strong employment rights and protections provided under Korean law to the Korean workforce. While a number of such issues may arise in any given Korean M&A transaction based on the particular facts and circumstances, below are three of such issues frequently encountered in recent transactions.

- **Ordinary Wage.** In 2014, contingent liabilities of Korean companies arising from potential unpaid wage to their employees due to a retroactive and prospective increase in “ordinary wage” (a Korean labor term describing the base wage of an employee and used as a basis for calculating additional wage for statutory allowances, such as overtime and holiday work allowances) were extensively diligenced, and negotiated between transaction parties to allocate risks in numerous Korean M&A transactions. The landmark Korean Supreme Court decision addressing this issue (rendered in December 2013), continues to heavily influence
how parties analyze and assess risks as to unpaid wage arising from ordinary wage. In short, the Korean Supreme Court held that certain allowances and bonuses customarily excluded in calculating the ordinary wage of employees must be included and added if paid on a “regular”, “uniformed” and “fixed” basis unless certain conditions (among others, where the payment of such unpaid wage would result in an excessive financial burden on the relevant company) justify barring employees’ unpaid wage claim arising therefrom based on the principle of good faith and trust. Since the Supreme Court decision, numerous claims for unpaid wage based on the ordinary wage issue have been filed by employees (frequently led by labor unions), and lower courts have issued at times conflicting decisions in interpreting whether a certain allowance or bonus satisfies the requirement to qualify as ordinary wage or whether the requirements for the good faith and trust exception have been satisfied. We expect this issue to remain hotly contested in Korea in 2015.

- Additional Allowance for Holiday Work. Another unpaid wage issue that has received much attention in 2014 is whether employers are required to pay overtime work allowance, in addition to holiday work allowance (each of which would provide employees with an additional payment of 50% of ordinary wage), to their employees for hours worked during holidays. Until recently, based on administrative guidelines previously issued by the Ministry of Employment and Labor, most Korean companies only paid holiday work allowance, in addition to ordinary wage, to employees for less than eight hours worked on any given holiday. Employees recently started to bring lawsuits claiming entitlement to overtime work allowance in addition to holiday work allowance for such hours worked during holidays, and a majority of the lower courts have held in favor of employees and ruled that employees are entitled to receive an additional payment of a total of 100% of ordinary wage for each hour worked during a holiday. The Korean Supreme Court is expected to weigh in on this issue soon, and practitioners and commentators expect the majority lower court decisions to be upheld.

- Labor Unions. In addition to being a key diligence concern, labor unions of Korean companies have at times delayed or even derailed Korean M&A transactions by making excessive demands for employment guarantee, incentive payments (often referred to as M&A bonus) and other concessions in cases of change of control transactions. Accordingly, investors should consider preparing a game plan at the initial outset of a Korean M&A transaction to understand the characteristics and concerns of the relevant labor union.

We hope you find our discussion above helpful as you consider Korean investment opportunities. Please feel free to reach out to us if you have any Korea related issue of interest, and we would be happy to discuss and provide our input.

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