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Issuance of New Shares as a Takeover Defense and Countermeasures

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Abstract

In the face of a hostile takeover bid, the best defense is to acquire more friendly shares than the bidder. The problem here is that once the takeover bid becomes known in the market, share prices may increase drastically so as to render it difficult to purchase shares in the market. A solution in this case is to issue new shares to a white knight, and there have been several attempts to do so.

Under the Commercial Code of Korea, the general rule with respect to the issuance of new shares is to offer them to existing shareholders in proportion to their existing shareholding. As an exception to these preemptive rights principle, the Commercial Code allows for third-party offerings, but this is limited to where it is necessary to achieve the managerial goals of a company such as the introduction of new technologies or improvement of the financial structure.

Much debate has centered on the question of whether a third-party offering as a defense to a hostile takeover bid falls under the above exception to preemptive rights under the Commercial Code. The courts have consistently held that it does not, and so in order to achieve the same result as a third-party offering, companies have used the method where they first issue a massive number of new shares and then allocate to third parties any new shares which were not subscribed by shareholders.

The courts have ruled that since the shareholders were given the opportunity to acquire the new shares, allocation of unsubscribed new shares to third party is lawful. However, critics have pointed out that if the original purpose of issuing new shares was to induce forfeited shares, in substance it is no different from a third-party offering and so it should be unlawful. The courts have yet to rule on this matter.

I. Introduction

In a hostile takeover situation, the most important issue for both the bidder and target is securing friendly shares. This is because, in order for a hostile takeover to succeed, the bidder's designees must be elected as the directors of the target and such election is decided by votes at the meeting of shareholders.

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Generally speaking, there are 3 ways of securing friendly shares in a hostile takeover situation: (i) proxy contest, (ii) sale of treasury shares to friendly shareholders and (iii) issuance of new shares to friendly shareholders.

Proxy contests in listed companies are regulated by the Financial Investment Services and Capital Markets Act ("FSCMA").[1] There are numerous legal problems regarding the methods for soliciting proxies and for validating power of attorneys at meetings of shareholders. Furthermore, there still remain concerns of proxy contests being handled in favor of existing shareholders who have the power to call meetings of shareholders.[2]

Regarding the sale of treasury shares and issuance of new shares, since they are subject to approval of the target's board, in practice they are used only as defensive measures by the controlling shareholder in contrast to proxy contests which can be used as offensive tools.

We discuss below the legality of the issuance of new shares as a takeover defense, which is one of the aforementioned ways to secure friendly shares, as well as countermeasures in response thereto. We also discuss briefly the similarities and differences between the sale of treasury shares and issuance of new shares.

II. Legal Assessment of Takeover Defense Measures by Directors

The issuance of new shares is subject to board approval, thus as a general matter we first discuss whether directors' takeover defense measures are lawful.

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1) The Securities and Exchange Act ("SEA"), which was the relevant law, was abolished with the promulgation of the FSCMA on February 4, 2009. The special provisions under the SEA relating to listed companies have been incorporated in the Commercial Code and the rest have been incorporated in the FSCMA. As such, certain provisions under the abolished SEA (as referred to herein) are equally applicable under the FSCMA.

2) Sang Gon Kim, *Issues Relating to Shareholders' Meeting of Listed Companies involving Proxy Contests for a Hostile Takeover Bid*, 52 Korea Listed Companies Association Research (2005) (in Korean).

1. The Activist Thesis

Under this view, directors must actively defend against hostile takeover efforts for a variety of reasons, including the following: Hostile takeovers do not increase the overall wealth of society; the target's share value increases during a takeover defense and so serves the interests of shareholders; directors have a duty to protect not only shareholders but the target's employees, customers, creditors, etc. Directors' defensive actions must be respected under the business judgment rule.

This line of argument has been set forth by Lipton of the US and Martens Wiedrmann of Germany and is known to be the majority position of the public and the courts in the US and the minority position in Germany.[3)]

2. The Passivity Thesis

Under this view, directors must remain passive in the face of hostile takeovers for a variety of reasons: Hostile takeovers have the effect of increasing the overall wealth of society by transferring the target's assets to more competent management; although the target's share value may increase during the course of the takeover defense, such defense may in the long run harm shareholder interests by decreasing the motivation for the takeover bid; since directors owe a duty only to shareholders to maximize the target's interests, there is no need for directors to consider other parties' interests.

This line of argument is known to be the majority position in Germany and the minority position in the US courts.

3. Compromise Thesis

Under this view, directors in general are to remain passive in the face of hostile takeovers but may engage in defensive actions such as persuading shareholders or arranging for a public offering as long as they do not preclude

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3) Wook Rae Lee, *Legal Assessment of Defensive Action of Directors against a Hostile Takeover*, 12 BFL 12 (2005); Jong Joon Song, *Key Defense Measures against M&A*, 14-1 STUDY ON COMMERCIAL LAW 190 (1995) (in Korean).

or impede shareholders from making decisions.[4)]

4. Conclusion

Where management engages in takeover defenses, there is the issue of shareholder discrimination in that they may act friendly towards the existing controlling shareholder while behaving antagonistically with respect to the bidder. Furthermore, considering that a takeover bid is essentially a dispute between shareholders, one may wonder if the reasonable thing for directors to do in a takeover situation is to keep neutral.

However, since a director, as an appointee of the target, owes fiduciary duties thereto, it seems reasonable to argue that a director may undertake takeover defenses if he reasonably determines that such actions are necessary to protect the target's interests.[5)] For example, assuming that a certain bidder's goal is to sell off the assets of the target and dissolve it, if the director reasonably determines that the long-term business outlook is good and that the target's business will improve if operations are maintained so as to increase shareholder wealth, then it would be reasonable to engage in takeover defenses. In light of a director's fiduciary duties, it may even be argued that such actions are required by law. In a lower-court case where the directors of a company undertook a large-scale capital increase with consideration to defend against a hostile takeover bid,[6)] the court ruled that "the question of whether such action is permissible must take into account the totality of circumstances, including the motivation or purpose behind the defense and the reasonableness of the defense tactics, and must also consider the interests of the target and the shareholders that are being protected by such actions as well as the adequacy of the procedures by which such actions are implemented." This ruling seems to be recognizing that the determination of whether takeover defenses undertaken by a director are permissible rests on how "fiduciary duty" is interpreted.

When considering the above, the issuance of new shares by a director as a takeover defense does not appear to be forbidden for the reason that it violates

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4) *Id*.

5) Wook Rae Lee, *supra* note 3, at 13.

6) 2003Kahap369 (Suwon District Court, Yeoju Branch Court, Dec. 12, 2003).

a director's duty to keep neutral or loyal. However, the determination of whether such issuance is permitted does appear to require a case-by-case assessment of whether applicable provisions under relevant laws such as the Commercial Code and FSCMA have been observed. We discuss in detail below.

III. Legality of Third-Party Allocation of New Shares as a Takeover Defense

Allocating new shares to shareholders in proportion to their shareholdings is called a "shareholder offering" and any other method of allocating new shares is generally referred to as a "third-party allocation." This allocation can be divided into two types: private offering to designated third parties and public offering to non-designees undertaken pursuant to applicable provisions under the FSCMA. Each of these has a different legal basis for issuance and we discuss them in turn.

1. Private offering

1) Interpretation of Article 418 Paragraph 2 of the Commercial Code

Article 418 Paragraph 2 of the Commercial Code ("Clause") states that "a company may, notwithstanding Paragraph 1, allocate shares to persons other than shareholders in accordance with the articles of incorporation; provided, however, that such allocation shall be limited to situations where it is necessary to achieve the managerial goals of the company, including introduction of new technologies or improvement of financial structure." This provision was introduced when the Commercial Code was amended on July 24, 2001. Before such amendment, the Commercial Code simply read that "unless provided for otherwise in the articles of incorporation, a shareholder shall be entitled to receive new shares in proportion to its shareholding."

However, numerous legal commentaries had argued that even before the above amendment, in addition to applicable provisions under the articles of incorporation, requirements similar to those contained in the proviso of the Clause ("Proviso") had de facto been applicable to third-party allocations.[7] It was in acceptance of such argument that the Clause was created at the time of the Commercial Code's amendment on July 24, 2001.

Thus, if the strengthening of control in a takeover situation does not fall within the "managerial goals" provided under the Clause, then we would have to conclude that third-party allocation of new shares as a takeover defense is not permitted.

2) Legal commentaries and court rulings

Examples of "managerial goals" that legal commentaries have propounded (other than the introduction new technology and improvement of financial structure specified under the Commercial Code) have been limited to those necessary for the business operations of a company, including: expeditious capital raising,[8)] corporate restructuring, joint venture or strategic partnership with foreign companies,[9)] injection of foreign capital, securing of upstream/downstream markets and any other goals in furtherance of its development and which cannot be obtained through a shareholder offering.[10)] Therefore, it appears that legal commentaries do not find the "managerial goals" under the Proviso to include the defense and strengthening of control by controlling shareholders or the maintaining of existing management. In particular, some legal commentaries have expressly stated that, irrespective of "managerial goals," preemptive rights cannot be restricted for the purpose of expelling a particular shareholder or wresting control away from another party.[11)]

Courts in general appear to hold the same position as the above legal commentators. One Supreme Court ruling held that in the face of an imminent or actual battle for corporate control, the issuance of convertible bonds for the sole purpose of causing or impeding a change of control can

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7) JONG JOON SONG, KOREA COMMERCIAL LAW ADMINISTRATIVE SOCIETY, ANNOTATED COMMERCIAL CODE (CORPORATIONS III) 450-451 (Joo Chan Son & Dong Yoon Jung eds., 2003); KI SOO LEE, CORPORATE LAW 502 (Pakyoungsa, 1997); TAE RO LEE & CHUL SONG LEE, LECTURES ON CORPORATE LAW 632-634 (Pakyoungsa, 1992); Dong Seung Lee, Study on Preemptive Rights of Shareholders—Focus on Exclusion Factors 243-245 (Ph.D. Thesis, Korea University, 1998); Joon Sub Lee, *Exclusion of Preemptive Rights of Shareholders*, 13 STUDY ON COMMERCIAL LAW 228-230 (1994) (in Korean).

8) DONG YOON JEONG, CORPORATE LAW 504 (Bubmoonsa, 2003) (in Korean).

9) KI BUM KWON, MODERN THEORY ON CORPORATE LAW 801 (Samjiwon, 2005) (in Korean).

10) CHUL SONG LEE, LECTURES ON CORPORATE LAW 694 (Pakyoungsa, 2006) (in Korean).

11) JONG JOON SONG, *supra* note 7, at 451.

constitute a cause for nullification.[12] In another case of dispute for corporate control, the court held that the third-party allocation of shares despite the absence of any real managerial need to deprive the shareholders of their preemptive rights (and whose main purpose was to serve as a takeover defense) was null and void.[13] Another court dealing with a similar case stated that preemptive rights serve to help existing shareholders maintain their control over the company in a takeover situation, thus in order for the company to undertake a third-party allocation at the expense of preemptive rights, the purpose for raising capital thereby must coincide with the company's interests and the necessity to quickly and flexibly raise funds to meet such purpose at the exclusion of preemptive rights must be established. If a third-party allocation by a company were to result in the substantial weakening of the existing shareholders' control over it, then such allocation would be valid only if there existed a managerial need that rendered it imperative to preclude preemptive rights even before the conclusion of corporate control dispute. This last court decision[14] appears to make it all the more clear what the general position of the courts is.

However, in the corporate control dispute case between KCC and Hyundai Group where Hyundai Elevator tried a public offering of "Kukmin" shares,[15] the court held that where "maintaining the control of the existing shareholders or the management powers of the existing management serves the interests of the target and general shareholders or is warranted by a special social necessity, and where the opinion of general shareholders and neutral experts on the issuance of new shares has been heard," then such issuance may found to be necessary to meet a "managerial goal" under the Clause. This ruling is different from the conclusions reached by the aforesaid courts and it almost appears as if in certain circumstances defending against a takeover

12) 2000Da37326 (Supreme Court, June 25, 2004). Although this decision is in regards to the issuance of convertible shares of Samsung Electronics, since Article 513 Paragraph 3 of the Commercial Code provides for the application of the Provision for the issuance of convertible bonds, it can be argued that the logic behind issuing convertible bonds applies equally to the issuance of new shares.

13) 2005Gahap71241 (Seoul Central District Court, Jul. 7, 2006).

14) 2005Kahap744 (Seoul Central District Court, May 13, 2005).

15) 2003Kahap369 (Suwon District Court, Yeoju Branch Court, Dec. 12, 2003).

may fall under "managerial goal" of the Clause. However, this judicial position is very uncommon, and considering that the Supreme Court ruling and lower court opinions in the above paragraph have all been issued after this rare decision, it seems safe to say that the court's stance is that defending against takeover bids do not fall under "managerial goal" of the Clause.

3) Subconclusion

As seen above, it appears that legal commentators and the courts are in agreement that, in a hostile takeover situation, issuing new shares to the controlling shareholder or a white knight friendly thereto violates the Clause and is thus not permitted.

In particular, considering the ruling in case no. 2005 Kahap 744, Seoul Central District Court (May 13, 2005), which held that even where the managerial need to undertake a third-party allocation is recognized, such issuance is illegal unless it can be established that there existed circumstances that made it impossible to delay such issuance until after the conclusion of the dispute for corporate control, the position of the courts on this matter seems very clear. In practice, the courts seem to prohibit third-party allocation of shares in hostile takeover cases without exception.

2. Public offering

1) Issue

A public offering differs from a private offering in two major ways.

First, in contrast to a private offering, in a public offering it is not determined in advance who will participate in the capital increase to become a shareholder and so the issuance of new shares by itself does not immediately render to a particular third party the effect of a change in control.

Secondly, Article 165-6 of the FSCMA (Article 189-3 of the abolished SEA), which permits a listed company to undertake a public offering, does not provide for compliance with the Clause and so it is unclear whether the "managerial goal" requirement for third-party allocation as discussed above is applicable to a public offering.

Should a large-scale public offering take place, the equity of the existing shareholders would be substantially diluted, and although this would not lead to a particular third party's acquiring control over the company, it would have the effect of causing loss of control by the controlling shareholder. As such, in the case where the shares acquired by the bidders already exceed the equity interest of the controlling shareholder, the existing management would try for share dilution through a public offering instead of a private offering (which would most likely be forbidden), and if the public offering succeeds, then control over the company will ultimately be decided through a proxy contest. This renders a public offering a meaningful takeover defense.

2) Legal commentaries and court rulings

Legal commentators agree that the Proviso applies to public offerings[16)] and there do not appear to be any opposing views in this regard.

The basis for this position is that the nature of preemptive rights is such that they cannot be arbitrarily restricted by majority vote, and only where the interests of the company or all of the shareholders are served should they be limited.[17)]

The only case precedent on this issue seems to be the court decision in the aforesaid dispute between KCC and Hyundai Group (Suwon District Court, Yeoju Branch Court, case no. 2003 Kahap 369, Dec. 12, 2003). In this case, the court stated that the legislative history behind the FSCMA's providing for public offerings by listed companies indicated the goal to achieve the division of ownership and management by encouraging and inducing the widespread ownership of shares. Also, public offerings were made available to listed and registered companies to enable expeditious and efficient capital raising. Considering the above, the court held that it was difficult to find the Clause as being more than a standard by which to determine whether the issuance of new shares was abused and to find that it was directly applicable. Thus, the court ruled that the Clause does not apply to public offerings.[18)]

16) Hyun Tae Kim & Yong Joon Yoon, *Study on Practical Issues Regarding Preliminary Injunctions against the Issuance of New Shares*, *in* HOSTILE TAKEOVERS AND DEFENSES 109-110 (Hwa-Jin Kim & Ok-Rial Song eds., 2007); KI BUM KWON, *supra* note 9, at 800; Choong Myung Jeong, *Legal Study on Hostile Takeover Defenses – Focus on Third Party Allocation of Shares*, 25 STUDY MATERIALS ON ADMINISTRATION OF JUSTICE 433-434 (Supreme Court Library of Korea 1999); Eung Jin Kim, Study on Restrictions on Shareholder Preemptive Rights 42-43 (Masters Thesis, University of Seoul, 2004) (in Korean).

17) TAE RO LEE & CHUL SONG LEE, *supra* 7, at 633.

18) Article 9 Paragraph 2 of the articles of incorporation of Hyundai Elevator provided that

3) Subconclusion

Although the rationale behind the above ruling is unclear, it appears that the court took into account the fact that Article 84-5 Paragraph 1 of the Enforcement Decree of the SEA (currently Article 176-8 Paragraph 1 of the FSCMA) defines “public offerings” as excluding preemptive rights and as having unspecified masses subscribe to new shares and that the SEA (currently FSCMA) is considered a special law of the Commercial Code.

However, considering the factors listed below, the Proviso should apply to public offerings as legal commentaries argue.

First, public offerings were introduced on Jan. 13, 1997 when the SEA was amended (the same provisions are incorporated in the FSCMA) and the Clause was newly created when the Commercial Code was amended on July 24, 2001. As discussed in Section III.1.A above, most legal commentators recognized that even before such amendment of the Commercial Code certain requirements needed to be met in order to preclude preemptive rights, and such views were incorporate to create the Clause. To the extent that public offerings are a way of increasing capital at the exclusion of preemptive rights, considering the purpose of the Commercial Code amendment, it appears reasonable to conclude that public offerings should also meet the requirements under the Commercial Code.[19]

Also, the reason that the FSCMA (now-abolished SEA) is generally seen as a special law of the Commercial Code is because it provides for special provisions regarding listed companies, and where restrictions in addition to those under the Commercial Code are to be applied to listed companies, such special provisions are then applicable. It is in this sense that the FSCMA (now-abolished SEA) takes on the form of a special law, and it is not the case that whenever a matter is addressed by both the FSCMA (now-abolished SEA)

“new shares may be allocated to non-shareholders by a board resolution under the following subparagraphs where it is necessary to achieve the managerial goals of the company, including introduction of new technologies or improvement of financial structure,” and Subparagraph 2 of the same Paragraph specified “issuance of new shares through a public offering in accordance with the provisions of the SEA.” The court interpreted the above to mean that the necessity to achieve managerial such as the introduction of new technologies or improvement of financial structure applied to public offerings and prohibited the issuance of new shares.

19) Hyun Tae Kim & Yong Joon Yoon, *supra* note 16, at 112.

and the Commercial Code, the former prevails.[20] Therefore, arguing that the FSCMA (now-abolished SEA), which provides for public offerings, is a special law and thus the Clause should not be applicable seems to be a logical leap.

Finally, the reasonable conclusion from a practical perspective also seems to be that the Proviso is applicable to public offerings. For public offerings, all that is prescribed by law is the minimum issuing price and the board is free to decide the issuance price, number of shares and disposal of forfeited stocks. Therefore, if the board sets a high issuing price and undertakes a massive public offering so as to induce a large number of forfeited shares, the board would be able to dispose of such shares at its discretion. The effect would be to allow the new shares to be allocated to specified third parties in circumvention of the Clause, which clearly contravenes the legislative purpose behind promulgating it.

As such, it seems reasonable to conclude that the Proviso is applicable to public offerings, thus they should be treated the same way as private offerings. Some legal commentaries argue that the Clause embodies requirements recognized under German law, i.e. principles of equal treatment of shareholders and benefit to the company, and that the former does not have any significant implications in a public offering which involves numerous unspecified persons. Similarly, with respect to the latter, in the absence of any special purpose of the public offering such as a change in or maintenance of control, its scale is not large and issuance is at near-market price, it is recognized not pose a problem.[21] Based on this rationale, these legal commentaries argue the Proviso requirements are presumed to be met in public offerings.[22]

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20) For example, with respect to the relationship between Article 366 of the Commercial Code, which requires minority shareholders to hold 3% or more shares in order to demand the convocation of a meeting of shareholders, and Article 191-13 Paragraph 5 of the SEA (currently Article 542-6 Paragraph 1 of the FSCMA), which requires a 3% or 1.5% shareholding (depending on the size of the company) for the same, the Supreme Court (2003Da41715, Dec. 10, 2004) has ruled that since the above SEA provision cannot be seen as a special law of the Commercial Code, a shareholder that meets either of the above requirements may demand the convocation of a meeting of shareholders.

21) Dong Seung Lee, *supra* note 7, at 222.

22) Yong Ho Hong, Issuance of Securities for the Defense of Hostile Takeover (Maters Degree Thesis, Seoul National University, 1998) (in Korean) at 52; Choong Myung Jeong, *supra* note 16, at 434.

However, as discussed earlier, the fact that there is a high risk of a public offering circumventing the Clause appears to render it dangerous to presume that the Proviso requirements are satisfied in public offerings. It seems that even in this case a strict assessment should be made as to whether the Proviso requirements are actually met.[23)]

3. Third-party allocation through contribution in kind

1) Legal commentaries and case rulings

Two opposing views are held on this matter: One view argues that since a contribution in kind is a means of receiving a third-party allocation, there must be a basis therefor provided under the articles of incorporation in accordance with the Clause or a special shareholder resolution (which has the same effect).[24)] The other view argues that a contribution in kind is an exception to preemptive rights, thus it is permitted through a board resolution pursuant to Article 416 Paragraph 4 of the Commercial Code without any basis in the articles of incorporation.[25)] These two views are pitted against each other.

In a Supreme Court case, although the main issue was tax-related, the court held that preemptive rights are not applicable to contributions in kind, thus new shares for a contribution in kind can be issued solely based on a board resolution.[26)]

Logically speaking, it would be reasonable to state that those who view contributions in kind as a means of a third party allocation will argue that the Clause applies and those that say that contributions in kind are an exception to preemptive rights will argue that the its does not. In reality, it appears that contributions in kind are seen as an exception to preemptive rights but nonetheless are found to be subject to the Proviso requirements.[27)] This position seems reasonable when considering that the nature of preemptive

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23) Hyun Tae Kim & Yong Joon Yoon, *supra* note 16, at 114.

24) Chul Song Lee, *supra* note 10, at 690-692; Kon Sik Kim, *Contribution in kind and Preemptive Rights*, 31 Jurisprudence (Seoul National University 1990) (in Korean).

25) Gi Won Choi, New Principles of Corporate Law 730-73 (Pakyoungsa 2005) (in Korean); Ki Bum Kwon, *supra* note 9, at 798-799; Dong Yoon Jeong, *supra* note 8, at 504-505.

26) 88Nu889 (Supreme Court, Mar. 14, 1989).

27) Dong Yoon Jeong, *supra* note 8, at 504-505.

rights is such that they cannot be arbitrarily restricted even by majority vote.[28)]

2) Restrictions on contributions in kind as a takeover defense

As seen above, even where the Proviso requirements are recognized as being applicable to contributions in kind, since such contributions by nature would most likely be necessary for the company's business operations, it appears that the Proviso requirements would be easily met. If so, when defending against a takeover, would there any way for a controlling shareholder to prevent the bidder from increasing its equity stake by contributing assets necessary for the operations of the target?

The case that sheds light on this point is the aforementioned 2005 Kahap 744 case. Here, the court held that even if the issuance of new shares is in line with the managerial goals of the company, issuance thereof at the preclusion of preemptive rights before the conclusion of the corporate control dispute would be justified only if there existed managerial needs that made it compelling to do so. The court's point was that, even if the issuance met the Proviso requirements, considering that a corporate control dispute was ongoing, the main purpose of the issuance can be said to have been to defend against the takeover. Thus, unless there is no other justification for the timing of the issuance, then such issuance is unlawful. It appears that this reasoning can be equally applied to issuance of new shares for contributions in kind.[29)]

4. Shareholder offerings

1) Issue

Shareholder offerings grant preemptive rights to shareholders in proportion to their respective shareholdings, thus in principle they do not infringe upon their rights. Also, even if a shareholder waives its preemptive

28) Hyun Tae Kim & Yong Joon Yoon, *supra* note 16, at 127.

29) A same decision was reached by the court in a Seoul Central District Court case (2005Gahap71241, Jul. 7, 2006). In this case, the court held that where a third party allocation is undertaken in the special situation of a corporate control dispute in order to bring about a change in control or to impede such change, then even if such issuance conforms in some way with the company's managerial goals, the need to attain such goals will need to be negated and ultimately such issuance of shares will need to be seen as invalid.

rights, such waiver is of a right already bestowed, thus it can be argued that the disposition thereof by the board is not problematic. However, in reality, in the context of a takeover situation, where a significant number of shareholders waive their preemptive rights and if the board allocates the forfeited shares to a particular third party, then the result would be the same as if a third party allocation occurred. Therefore, even with shareholder offerings, if the board has the power to dispose of forfeited shares and where no restriction is placed thereupon, then there is a risk that through the setting of certain prices and number of shares to be issued, the board will be able to induce forfeited shares and thus bring about the same result as a third party allocation. As such, the issue of whether a shareholder offering whose purpose is to bring about a large number of forfeited shares is unfair (and thus should be outlawed) is a very important issue for discussion.

2) Legal commentaries and case rulings

In cases involving shareholder offerings, those seeking a preliminary injunction to prevent such issuance have argued that (i) a large-scale capital increase with consideration is being undertaken in the absence of any dire and immediate need for funds, (ii) the issuing price[30] is high as the discount rate[31] is lower than usual and (iii) the share offering aims to induce a large number of forfeited shares by forbidding the transfer of preemptive rights and allowing the board to dispose of forfeited shares, the result being an infringement of shareholder rights.

In response, the courts have rejected most of the above claims, stating that (i) the need for a capital increase is a matter that requires a high degree of business judgment and (ii) since shareholders' preemptive rights are recognized, the board resolutions themselves cannot be seen as bringing about

30) According to Article 5-18 of the Regulation on Securities Issuance and Disclosure, the base share price for the issuance of new shares is calculated using the higher of (i) the arithmetic average of 1-month average closing price, 1-week average closing price and base date closing price (the base date for third-party allocation being 3 days prior to the subscription date and for a public offering, 5 days prior to the subscription date. The issuing price for a shareholder offering can be freely determined) and (ii) the base date closing price.

31) Article 5-18 of the Regulation on Securities Issuance and Disclosure states that base price shall be discounted up to 30% for public offerings and up to 10% for third-party allocations to set the issuing price.

a change in shareholdings.[32] In particular, in response to the argument that forfeited shares were induced, one ruling stated that "even if the exceedingly high issuance price rendered a large number of forfeited shares, and the disposal thereof was delegated to the board so as to give rise to the possibility that the current management of the debtor will increase the number of friendly shares, if such disposal and the discount rate are determined in accordance with the law and articles of incorporation, it cannot be found that such disposal method is materially unfair."[33] On the other hand, no cases were found in which the court forbid shareholder offerings in the contest of a takeover situation.

By contrast, although not a preliminary injunction case to prevent the issuance of new shares, one lower case court[34] held that "an issuance of new shares found to be materially unfair by both legal commentators and the courts is … where new shares are intentionally issued at high prices by the board in order to induce a large number of forfeited shares … so as to discriminate among shareholders and harm the interests of certain shareholders." This is in direct contrast to the above ruling.

There is also a view among legal commentaries that where share prices are below par value, if new shares are issued at par value or at a price substantially higher than market value so as to induce a large number of forfeited shares, such issuance is materially unfair.[35] No views in opposition to the above were found.

Thus, it appears reasonable to conclude that "the issuance of new shares at exceedingly high prices so as to induce large numbers of forfeited shares" can become the target for a claim to prevent the issuance of new shares.

On the other hand, even if new shares are issued at an adequate price, what happens where too many shares are issued? In this regard, lower courts have held, without exception, that in a shareholder offering the timing and

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32) 2004Kahap2046 (Busan District Court, Oct. 5, 2004); 2005Kahap2904 (Seoul Central District Court, Aug. 25, 2005); 2007Kahap247 (Suwon District Court, Jun. 25, 2007); 2008Kahap138 (Seoul Central District Court, Jan. 24, 2008); 2005Gahap1588 (Cheju District Court, Feb. 16, 2006).

33) 2005Kahap823 (Suwon High Court, Nov. 17, 2005).

34) 2005Noh2371 (Seoul High Court, May 29, 2007). This is the case sometimes referred to as the "Everland Convertible Bond Issuance Case."

35) CHUL SONG LEE, *supra* note 10, at 710.

scale of the capital increase requires a high degree of business judgment and so they have denied relief to the plaintiffs. In a case where a shareholder offering was undertaken in the course of a corporate control dispute, one lower court even held that "the argument that there is a problem with the capital procurement for the reason that the capital increase is on a massive scale and there is a short time interval between the disclosure date and record date cannot be a factor in the consideration of whether the issuance of new shares is materially unfair as long as the determination of the scale and timing of the capital increase is in compliance with the provisions of the Commercial Code and articles of incorporation."[36)]

3) Subconclusion

As seen above, the position of the courts is to permit shareholder offerings in takeover situations, and they are reluctant to forbid them even in situations where a large number of forfeited shares are induced so as to have an effect similar to a private offering and thus render the result unfair.

However, in some of the aforesaid cases where a claim for preliminary injunction to prevent the issuance of new shares was denied, the court stated that "there was insufficient evidence to support a finding of inducement of large-scale forfeiture …," which also means that if sufficient support had been provided, the court may have granted the injunction.[37)] Also, in the aforementioned Everland convertible bond case, the Seoul High Court held that the issuance of new shares by directors with the aim of inducing large-scale forfeiture was materially unfair. Taking these into account, it would be reasonable to conclude that issuance new shares at a high price so as to induce forfeited shares and to allocate such shares to particular shareholders is unlawful.

In practice, it is very difficult to establish that shares were issued at a high price for the purpose of inducing forfeiture for the following reason: A listed company conducting a shareholder offering determines the issuing price pursuant to Article 57 of the Regulation on Securities Issuance and Disclosure (a subordinate law under the SEA prior to the promulgation of the FSCMA),

36) 99Kahap1747 (Seoul District Court, Jul. 7, 1999).
37) 2004Kahap2046 (Busan District Court, Oct. 5, 2004).

whereby it uses the third trading day prior to the subscription date as the base date and takes the arithmetic average of (i) 1-month average closing price, (ii) 1-week average closing price and (iii) base date closing price. It then compares this calculated number against the base date closing price, takes the lower of the two and applies a 30% discount to determine the issuing price.[38] The problem here is that the share price at this point in time is several times higher that usual as it has increased in a short interval due to the takeover bid, so acquiring new shares at the issuing price calculated using the increased share price is not easy for minority shareholders. This means that even if the issuing price was calculated in accordance with the law, it is likely that a large number of forfeited shares will result.[39] Nonetheless, as discussed above, the courts have held that if the disposition of forfeited shares and discount rate are determined in accordance with the law and articles of incorporation, it is difficult to find that the share issuance is materially unfair.

In addition, in cases where shares are issued at a 30% market-price discount (i.e. at a low price) but issuance is on a massive scale so as to induce share forfeitures, the courts have even held that the fact that a massive issuance occurred cannot be considered in the determination of whether the issuance was materially unfair.

Therefore, where a shareholder offering is undertaken in the face of a share price bubble caused by a corporate control dispute, there is the problem that share forfeiture can be induced with relative ease and they can then be allocated to friendly shareholders.

Taking into account the position of the courts, the issuance of new shares as a takeover defense is generally thought to be difficult. However, this is due to the fact that the courts have almost completely forbidden the issuance of new shares to specified third parties, i.e. controlling shareholder or white

38) Under the FSCMA, the Regulation on Securities Issuance and Disclosure has been amended to do away with the issuing price restrictions in a shareholder offering. This means that now a company undertaking a shareholder offering can set the issuing price at its discretion as long as it is at least equal to par value.

39) Even if there are no restrictions on the issuing price of shares in a shareholder offering, it appears that listed companies will continue to issue shares either at market price or with a certain percent discount in order to minimize the effect on share price. Therefore, the possibility of mass forfeited shares seems to continue to be significant and so this discussion appears to remain pertinent.

knight. In fact, with respect to the inducement of forfeited shares through a shareholder offering, the courts have almost always permitted this for the convenient reason that insufficient evidence has been provided. As such, the issuance of new shares as a takeover defense still seems to remain as a viable takeover defense. Personally, my hope is that further study will be conducted regarding the takeover defense of using forfeited shares arising out of a shareholder offering, and also that continuous challenges will be made to the court's prevailing attitude in this regard so as to bring about changes thereto.

IV. Countermeasures against the Issuance of New Shares as a Takeover Defense

1. Overview

As discussed in section III above, issuing new shares to defend against a takeover may be found illegal. So how would the bidder prevent such issuance?

The first countermeasure that can be considered is a preliminary injunction to prevent the issuance ("Preliminary Injunction"). However, if the subscription payment is made and the new shares are issued before filing for such injunction or before the court grants the injunction after the motion is filed, then this would no longer be a viable countermeasure. In this case, one would need to file a motion to provisionally suspend the validity of the issuance ("Provisional Suspension"). These measures are provisional in nature so ultimately the main action would need to be instituted to obtain a final resolution. However, in practice, considering that offensive and defensive measures are quickly instituted in these situations and that the party filing for the above provisional dispositions is usually satisfied with the result thereof, most of the time the main action is not instituted and the dispute typically ends at the provisional stage of litigation. This is the reason why most cases involving a battle for corporate control do not end up at the Supreme Court level and are mostly concluded at the lower courts. In consideration of the above, we limit our discussion below to the legal practice of filing for Preliminary Injunctions and Provisional Suspensions.

2. Preliminary Injunctions

The typical order granting a Preliminary Injunction reads "The issuance of [ ] common stock with par value of [ ], which the debtor is preparing to issue pursuant to the board resolution adopted on [ ], shall be prohibited."[40)]

As can be seen above, a Preliminary Injunction case involves several issues.

1) Rights protected by a Preliminary Injunction

Article 424 of the Commercial Code states that where shares are issued (i) in violation of law or the articles of incorporation or (ii) in a severely unfair manner so as to harm shareholder interests, shareholders may demand the issuing company to desist from such issuance ("Share Injunctive Right").

Therefore, generally speaking, the Share Injunctive Right is the right being protected by the Preliminary Injunction. Looking at each type of issuance of new shares discussed above, it could be argued that (i) a private offering infringes upon shareholders' preemptive rights and is thus in violation of law and the articles of incorporation, (ii) a public offering and contribution in kind can either constitute an issuance in violation of law or a materially unfair issuance and (iii) a shareholder offering is a materially unfair issuance.

On the other hand, there is a question of whether, in addition to the Share Injunctive Right, the right of shareholders to demand a director to desist from engaging in unlawful acts ("Director Injunctive Right") can constitute a right eligible for protection by a Preliminary Injunction.

The difference between the Director Injunctive Right and Share Injunctive Right is that (i) the former is available only for minority shareholders with an equity stake of 1% or more whereas the latter is available for all shareholders, (ii) the former deals only with acts in violation of law or the articles of incorporation whereas the latter can, in addition to such violations, be exercised where there is a material unfairness and (iii) the former is a public-interest right exercised in the face of irreparable damage to the company whereas the latter is exercised where a shareholder faces the threat of

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40) Court Practice Manual, Execution of Civil Affairs IV, at 359.

sustaining injury.

There is a view among legal commentaries that rights protected by Preliminary Injunctions include both of the above Injunctive Rights,[41] and there do not appear to be any opinions that expressly oppose it. However, my personal view is that, to the extent that the issuance of new shares causes an increase of capital in a company, the issue concerned is the infringement of shareholder rights and it cannot be said that a company sustains irreparable damage. Therefore, I have doubts as to whether Director Injunctive Rights should be something that can be protected by a Preliminary Injunction.

2) Timing of filing for the Preliminary Injunction and Duration of Prohibition

Where payment for subscription of the new shares has occurred before a motion is filed for a Preliminary Injunction or before the court renders its decision in response thereto,[42] then a subsequent grant of the Preliminary Injunction has no effect upon the share acquirer.[43] Thus, it is common sense that the filing should be made prior to the issuance of new shares. The problem is that with unlisted companies oftentimes shareholders do not know whether a board meeting is convened. With listed companies, although the general rule for a third-party allocation is that the subscription payment can be made only after a securities notification is filed and the mandatory waiting period lapses, there is an exception where if the new shares are deposited with the Korea Securities Depository ("KSD") for 1 year, then it is possible to make the subscription payment on the date of the board meeting. Thus, it is very difficult to file for the Preliminary Injunction and obtain a judgment before the new shares are issued.

The above problem would be solved if it is possible to obtain the Preliminary Injunction prior to the convocation of the board meeting, and this seems to be related to the issue of whether there is need for protection under a Preliminary Injunction and whether there exists a right that is eligible for

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41) *See e.g.*, Gi Won Choi, *supra* note 25, at 780; Dong Yoon Jeong, *supra* note 8, at 528; Jong Joon Song, *supra* note 7, at 503.

42) In the event a claim for Preliminary Injunction is filed, the FSC restrains the issuance of new shares by not giving effect to the securities report until the court issues its decision. Thus, in contrast to an immediate issuance of shares through deposit, where issuance is sought through the filing of a securities report, actual issuance is difficult while the claim is pending.

43) *See supra* note 40, at 358.

protection by a Preliminary Injunction, i.e. whether there is something against which a Share Injunctive Right can be exercised.

One lower court ruling denied a motion for Preliminary Injunction, holding that in the absence of a board resolution to issue new shares (which is what was being asked to be prohibited), there is nothing against which to exercise a Share Injunctive Right.[44)]

However, if theoretically there is a probability that an unlawful issuance of new shares will occur, then there should not be any reason not to prohibit it. Further, considering the practical need to ensure the actual efficacy of the Share Injunctive Right, the above ruling seems unfair.

In contrast to the above decision, there has been a lower court ruling prohibiting the issuance of new shares before a scheduled board meeting took place (at which a resolution was to be adopted to that effect)[45)] and another court prohibited such issuance for a set period of time even though there was no scheduled board meeting.[46)] This decision held that "Until the date that a decision is issued in case no. 2006 Kahap 685, Daejon District Court, Chunahn Branch, (i) debtor [ ] corporation shall not issue any new shares to a third party and (ii) debtors [ ] shall not engage in any acts in furtherance of the issuance of new shares, including voting at the board meeting of debtor [ ] corporation for the third-party offering of new shares."

Considering that in a battle for corporate control, the target may continuously try to issue new shares without any managerial reason, and once new shares are issued it is difficult to deny their validity,[47)] it appears

44) 2002Ra96 (Busan High Court, Jul. 21, 2003).

45) In a Daejon District Court case (Chunan Branch Court, 2006Kahap671, Oct. 31, 2006), the court ruled that "the issuance of new shares that the respondent is preparing to undertake through a resolution of the meeting of the board scheduled for Nov. 3, 2006 shall be prohibited."

46) 2006Kahap696 (Daejon District Court, Chunan Branch Court, Dec. 4, 2006).

47) In a Seoul Central District Court case (2008Kahap2561, Aug. 11, 2008) involving a claim for Provisional Suspension, the court held that "in cases such as the present one where the provisional disposition affects the validity of shares already issued by the respondent, the plaintiff obtains relief tantamount to a final relief at the conclusion of the main action whereas the respondent, without having the opportunity to fight the main action, has its issuance of new shares invalidated and so may subsequently face difficulty raising capital. Thus, the Provisional Suspension will be allowed only if the reason to nullify the issuance and the need to suspend its validity without delay through a Provisional Suspension is established at a higher degree than in typical provisional disposition cases."

reasonable to argue that the law should permit provisional rulings that prohibit the issuance of shares for a set period of time as above. In particular, considering that (i) both Share Injunctive Rights under Article 424 of the Commercial Code and Director Injunctive Rights under Article 402 of the same are generally recognized to be eligible for protection under a Preliminary Injunction, and (ii) it is typical for a court granting a preliminary injunction to prevent directors from engaging in unlawful acts to set the duration of the prohibition until the date the court ruling is handed down in the main action,[48] it appears reasonable to argue that a similar period of prohibition should be set in a Preliminary Injunction case.[49]

Before its amendment on Dec. 31, 2004, Article 23 Paragraph 4 of the FSCMA contained a provision forbidding a target to issue new shares during a tender offer. In one case, the bidder, in order to prevent the target from issuing new shares, made an offer for an insignificant amount of shares and set the offer period at 60 days, which was the legal maximum. However, this provision has now been removed from the FSCMA, and so it appears to be even more necessary to permit a provisional disposition to set a fixed period during which to prohibit the issuance of new shares.

3. Provisional Suspension

As seen above, once new shares are issued, a Preliminary Injunction is no longer an adequate defense. In such case, one must file for a Provisional Suspension.

Typically, a court decision granting a Provisional Suspension regard reads "The validity of the issuance of [ ] new shares with par value of [ ], which the respondent [ ] corporation issued to respondent [ ] pursuant to a resolution adopted at the board meeting on [ ], shall be suspended." The court sometimes adds language prohibiting the exercise of voting rights.

The problem here is that Provisional Suspensions are hardly granted by the courts. In case no. 2008 Kahap 2561, Seoul Central District Court held as follows: "In cases such as the present one where the provisional disposition

48) *See supra* note 41, at 349.

49) Hyun Tae Kim & Yong Joon Yoon, *supra* note 16, at 134.

affects the validity of shares already issued by the respondent, the plaintiff obtains relief tantamount to a final relief at the conclusion of the main action whereas the respondent, without having the opportunity to fight the main action, has its issuance of new shares invalidated and so may subsequently face difficulty raising capital. Thus, the Provisional Suspension will be allowed only if the reason to nullify the issuance and the need to suspend its validity without delay through a Provisional Suspension is established at a higher degree than in typical provisional disposition cases." Also, this ruling seems to have been influenced by a Supreme Court decision[50] that held that, once shares are issued, even if there is no board resolution or there is a defect therein, board resolutions are merely internal decision-making procedures and so do not affect the validity of the new shares.

This attitude of the courts seems to be taking into consideration the safety of share transactions as shares, once issued, may have passed through several hands. This is all the more so when considering one ruling by a lower court[51] that granted a Provisional Suspension, which held that "shares issued to the respondent are currently deposited with the Korea Securities Depository, thus temporary invalidation thereof will not affect the safety of transactions."

As mentioned above, in order for a listed company to issue new shares, it must either file a securities report with the Financial Services Commission and wait for a prescribed period to lapse or deposit the shares with the KSD for 1 year (which would enable immediate payment of the subscription price and hence the issuance of the shares). In case of subscribing for shares under the former method, an opponent may file for Preliminary Injunction during the waiting period for the securities report to become effective, and once such filing is made the FSC will not give effect to the securities report until the court's ruling is handed down. Therefore, the opponent would be able to obtain a court judgment. In case of subscribing for shares under the latter method, it would be difficult to file for a Preliminary Injunction if the subscription payment is immediately made through the KSD-deposit method, but the likelihood of obtaining a Provisional Suspension in this case seems higher compared to where the same relief is sought with respect to new shares that are not deposited with the KSD.

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50) 2005Da77077 (Supreme Court, Feb. 22, 2007).

51) 2005Kahap744 (Seoul Central District Court, May 13, 2005).

V. Conclusion

Previously, takeover defenses were undertaken in the form of issuing new shares (or convertible bonds) to the controlling shareholder or a white knight. In response, the courts prohibited such issuance almost without exception for the reason that it infringed upon shareholders' preemptive rights.

Attempts have been made to change the way the takeover defense of issuing new shares is used so it is not conspicuous as above but at least from the outside it appears not to infringe upon shareholder rights. The first of such attempts was the public offering of Hyundai Elevator in the takeover dispute between KCC and Hyundai Group. Although the court ultimately forbid this attempt, the reason therefor was not because of infringement upon shareholder rights but rather due to the interpretation of provisions in Hyundai Elevator's articles of incorporation regarding the requirements for a public offering. Considering that most listed companies, unlike the articles of incorporation of Hyundai Elevator, do not restrict public offerings to be conducted only to meet managerial goals, this issue continues to be open to interpretation.

Recently, more drastic attempts have been made in the form of shareholder offerings. In the situation where there is a share price bubble caused by the takeover dispute, the target issues a massive number of shares at a price calculated using the inflated share price as the base, the aim being to induce a large number of forfeited shares. In theory, legal commentators and the courts seem to agree to some extent that this type of issuance is materially unfair. In practice, however, if a motion is filed for a Preliminary Injunction, the courts have almost always denied it, stating that there was insufficient evidence to support a finding that the forfeited shares were induced.

This is currently a problem with the practice of the courts. Considering that there have been cases of abuse where shareholder offerings are used to induce forfeited shares so as to enable their allocation to specified shareholders, the hope is that further study will be conducted on this issue and that the courts' practice will change in this regard.

KEY WORDS: new shares, takeover, takeover defense, Hyundai Elevator, rights offering