Issues and Challenges in Corporate and Capital Market Law: Germany and East Asia

Edited by
HOLGER FLEISCHER, HIDEKI KANDA,
KON SIK KIM, and PETER MÜLBERT

*Max-Planck-Institut
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Mohr Siebeck

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Preface

This volume is based on presentations delivered at a symposium held in March 2016 at the University of Tokyo. The symposium is part of a conference series organized to stimulate the scholarly exchange between company law academics in Germany, China, Japan and South Korea which can be traced back to the late 19th century. The organizers are convinced that this exchange will be very fruitful in solving the challenges for company and capital markets law in the 21st century. A follow-up conference has already taken place in Seoul in March 2017.

We would like to express our gratitude to our Japanese hosts for unforgettable days in Tokyo. Furthermore, we would like to thank all participants for their valuable and much appreciated contributions. Janina Jentz and Jakob Hahn took care of the editing process, their help is gratefully acknowledged. Last but not least, our sincere thanks go to Jocasta Godlieb and Michael Friedman for providing valuable language editing service.

Hamburg, Tokyo, Seoul and Mainz
January 2018

Holger Fleischer
Hideki Kanda
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Peter Mülbert

Contents

Preface V
Abbreviations IX

I. Corporate Divisions (or more generally, Umwandlung)

Rüdiger Veil
The German Law on Transformation 3

Ruoying Chen
Corporate Division: Rules and Practice in China 23

Hyeok-Joon Rho
Statutory Corporate Divisions in Korea 45

Koji Funatsu
Creditor Protections in Company Splits in Japan 69

II. Valuation of Shares and Its Procedure

Lars Klöhn
Exit Rights, Shareholder Compensation and the Valuation of Shares in German Stock Corporation Law 85

Ok-Rial Song
Valuation of Shares in Korean Corporate Law 97

III. Civil Liability of the Company and Its Directors when Financial Statements are False

Klaus Ulrich Schmolke
Civil Liability of the Company and Its Directors for False Financial Statements under German Law 131

Li Guo
General Trends of Misrepresentation Litigation in China 163

Sunseop Jung
Civil Liability of the Company and Its Directors 173

Takahito Kato
A Recent Transformation of the Japanese Civil Liability System against Fraudulent Disclosure in Secondary Market 191

IV. Corporate Law Rules on Squeeze-out of Minority Shareholders

Jens Koch
Corporate Law Rules on Squeeze-out of Minority Shareholders 207

Jiangyu Wang
Squeeze-out (or the Lack Thereof) in the Regulation of Corporate Mergers in China 225

Moon Hee Choi
Corporate Law Rules on Squeeze-outs in Korea 235

Eiji Takahashi
Is the Regime of Japanese Squeeze-out of Minority Shareholders Constitutional? 271

Contributors 283

Abbreviations

ADHGB	Allgemeines Deutsches Handelsgesetzbuch
AEA	Act on External Audit of Joint Stock Corporations
AG	Aktiengesellschaft
AktG	Aktiengesetz
BAG	Bundesarbeitsgericht
BB	Betriebs-Berater
BGB	Bürgerliches Gesetzbuch
BGH	Bundesgerichtshof
BGHZ	Entscheidungen des Bundesgerichtshofs in Zivilsachen
CEO	Chief Executive Officer
CMA	Financial Investment Services and Capital Markets Act
CMFIBA	Capital Market and Financial Investment Business Act
CPA	Certified Public Accountant
CRD	company-recipient-division
CSR	Corporate Social Responsibility
CSRC	China Securities Regulatory Commission
DB	Der Betrieb
DStR	Deutsches Steuerrecht
ECFR	European Company and Financial Law Review
ed.	edition
EGTC	Estate and Gift Tax Code
EU	European Union
FIEA	Financial Instruments and Exchange Act
FSC	Financial Services Commission
FSS	Financial Supervisory Service
FTC	Fair Trade Commission
GmbH	Gesellschaft mit beschränkter Haftung
GmbHG	Gesetz betreffend die Gesellschaften mit beschränkter Haftung
GMS	General Meeting of Shareholders
GPCL	General Principles of Civil Law
HGB	Handelsgesetzbuch
IFRS	International Financial Reporting Standards
IPO	initial public offering

JCA	Japanese Company Act
JFSA	Japanese Financial Service Agency
KCC	Korean Commercial Code
KCML	Korean Capital Market Law
KEGTL	Korean Estate and Gift Tax Law
KG	Kommanditgesellschaft
KGaA	Kommanditgesellschaft auf Aktien
KRX	Korean Stock Exchange
LG	Landgericht
LLC	Limited Liability Company
LLP	Limited Liability Partnership
M&A	Mergers & Acquisitions
MOJ	Ministry of Justice
MRFTA	Monopoly Regulation and Fair Trade Act
NJW	Neue juristische Wochenschrift
NZG	Neue Zeitschrift für Gesellschaftsrecht
OHG	Offene Handelsgesellschaft
OLG	Oberlandesgericht
PRC	People's Republic of China
SFC	Securities and Futures Commission
SOEs	State-owned enterprises
SpruchG	Gesetz über gesellschaftsrechtliche Spruchverfahren
SR	Shareholder resolution
SRD	shareholder-recipient-division
StGB	Strafgesetzbuch
UK	United Kingdom
UmwG	Umwandlungsgesetz
US	United States of America
WpHG	Wertpapierhandelsgesetz
WpÜG	Wertpapiererwerbs- und Übernahmegesetz
ZGR	Zeitschrift für Unternehmens- und Gesellschaftsrecht
ZHR	Zeitschrift für das gesamte Handels- und Wirtschaftsrecht
ZIP	Zeitschrift für Wirtschaftsrecht

I. Corporate Divisions
(or more generally, Umwandlung)

The German Law on Transformation

Principles and Experiences after 20 Years of the Codification of German Transformation Law

Rüdiger Veil

I. Introduction ... 3
II. Types of Transformation ... 5
1. Merger ... 5
2. Division into Several Enterprises ... 6
3. Conclusion ... 7
III. Universal Succession ... 7
1. Agreement ... 7
2. Entry in Commercial Register ... 8
3. Conclusion ... 9
IV. Protection of Creditors ... 9
1. Foundations ... 9
2. Claim for Payment of Security ... 10
3. Liability Arising from a Division ... 11
4. Conclusion ... 12
V. Shareholder Protection ... 13
1. Foundations ... 13
2. Protection *ex-ante* ... 14
3. Protection *ex-post* ... 16
4. Evaluation ... 18
VI. Outlook ... 22

I. Introduction

In Germany company transformations have long played a major role. The first merger took place in 1831, when several coal mines merged to form the *Vereinigungsgesellschaft für Steinkohlebergbau.*[1] In 1861, the legislator in-

[1] R. GOLDSCHMIDT, Die sofortige Verschmelzung (Fusion) von Aktiengesellschaften (Berlin 1930) 5. At that time, a legal basis for a merger did not consist. It had to be approved by the Prussian state.

troduced the first legal basis for a merger.[2] Since then, numerous reforms have been implemented in order to facilitate company transformation.[3] Thus far, this development has culminated in the codification of transformation law via the Transformation Act of 28 October 1994.[4] The purpose of this Act is to provide suitable procedures for the various forms of transformation and adequately protect minority shareholders as well as creditors.

As a codification of fundamental principles and laws, the German Transformation Act aims to regulate all kinds of mergers, divisions and changes of legal form.[5] Its systematic structure is similar to the German Civil Code (BGB), first providing a general section for all types of transformation followed by general and specific sections for mergers, divisions and the change of the legal form of a company.

This article provides an overview of the different types of transformation, explains which principles apply and analyses the main instruments of shareholder and creditor protection. It concludes with a discussion of whether the German Transformation Act has proven its value in practice as a tool for regulating transformations, by considering the merger between *Deutsche Börse* and *London Stock Exchange* concluded by the management of both companies in 2016, but failed one year later. The focus is on mergers and divisions (split-up, spin-off and hive-down), which are characterised by a transfer of assets and liabilities through so-called universal succession. Hence, the instruments of creditor and shareholder protection are essentially the same. This article does not deal with change of a legal form.[6]

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[2] Art. 247 ADHGB of 1861 (Allgemeines Deutsches Handelsgesetzbuch – German Trade Code).

[3] Between 1961 and 1991, 12 reforms took place in Germany. Cf. R. VEIL, Umwandlungen in: Bayer/Habersack (eds.), Aktienrecht im Wandel der Zeit, Volume 2 (Tübingen 2007) 1066–1087.

[4] German Transformation Act (Umwandlungsgesetz – UmwG) of 28 October 1994, BGBl. I 1994, p. 3210. The German Federal Ministry of Justice and Consumer Protection in cooperation with juris GmbH provides an English translation of the Act. It is available at: <http://www.gesetze-im-internet.de/englisch_umwg/>.

[5] The UmwG exclusively regulates types of transformation (so-called *numerus clausus* of transformations, cf. § 1 para. 2 UmwG). However, some types of a transformation are not covered by the UmwG. This is particularly true for specific changes of a legal form of a partnership. In addition, transformations by way of singular succession are not precluded by the Transformation Act. See T. DRYGALA, in Lutter (ed.), Umwandlungsgesetz, 5th ed. 2014, § 1 marg. no. 52.

[6] The legal structure of a company may be modified by way of a change of legal form (§ 190 UmwG). This type of transformation preserves the legal identity of the company (so-called "identitätswahrende Umwandlung"). For more detail see T. RAISER/R. VEIL, Recht der Kapitalgesellschaften, (6th ed., Munich 2015) § 67 marg. no. 21–23.

II. Types of Transformation

1. Merger

The prototype of a transformation is the merger. When merging by way of absorption[7] the assets of one legal entity are transferred to another legal entity,[8] and the entity being acquired is dissolved.[9] Shares in the acquiring legal entity are allotted to the owners of shares in the legal entity being acquired. In contrast, when merging by way of a newly formed legal entity,[10] a new legal entity is formed through allotment of the total assets of two or more legal entities to a separate, newly formed legal entity. As soon as the assets have been allotted to the new entity, the acquired entities are dissolved.

Mergers mostly take place within a group of companies. In practice, the merger of a subsidiary into the parent company *(upstream merger)* is more common, but the merger of a parent company into the subsidiary *(downstream merger)* and the merger of two sister companies *(sidestream merger)* also occur frequently. The merger of two independent companies remains an exception in Germany, although it does occur now and then. The most prominent example is the merger between the *Thyssen AG* and the *Friedrich Krupp AG Hoesch-Krupp* forming the *ThyssenKrupp AG*[11] (so-called merger of equals).

The Transformation Act also provides the possibility of a cross-border merger of companies limited by shares.[12] The key distinguishing feature of such a merger is that at least one of the companies involved must be subject to the laws of another Member State of the EU.[13] However, nowadays owing to a change in preferred practice, large cross-border transactions generally do not take place in accordance with the provisions laid down in the Transformation Act. For example, in case of the current merger between *Deutsche Börse* and the *London Stock Exchange* the management boards have agreed to

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[7] § 2 no. 1 and §§ 4 et seq. UmwG.

[8] Legal entities eligible for mergers are commercial partnerships, companies limited by shares, registered cooperative societies, registered associations, confederations responsible for auditing cooperative societies and mutual insurance companies. See § 3 para. UmwG.

[9] A merger becomes effective with the entry in the register kept at the registered seat of the acquiring legal entity. See § 20 para. 1 UmwG.

[10] See § 2 no. 2 and §§ 36 et seq. UmwG.

[11] The corporations merged in order to meet the challenges of the globalization of plant engineering and steel industry. See OLG Düsseldorf, ZIP 1999 793 und OLG Hamm, ZIP 1999 798.

[12] §§ 122a–122l UmwG.

[13] A challenge for cross-border mergers is that different valuation principles apply. See T. KOHL, A Comparison of Valuation Principles in Germany and Internationally, in: Rödder/Bahns/Schönfeld (eds.), Cross-Border Investments with Germany – Tax, Legal and Accounting, In Honour of Deltev J. Piltz (Cologne 2014), 601–612.

combine the businesses under a UK holding company with the shares of Deutsche Börse AG acquired pursuant to a public takeover, and thus outside the purview of the German Transformation Act.[14] The merger between *Linde AG* and the US-American *Praxair Inc.* will be structured in the same way.[15]

2. Division into Several Enterprises

The division into several enterprises can take place as a split-up, spin-off or hive-down.[16] In case of a split-up, the legal entity[17] transfers its assets to two or more legal entities. Afterwards it is dissolved. In return, its shareholders are allotted shares of the new legal entities,[18] which either already exist or have been newly formed for this purpose. By contrast, in a spin-off, only a part of the legal entity's assets is transferred to a legal entity either already in existence or newly formed[19] and the legal entity transferring the assets also continues to exist. In return, the shareholders are allotted shares of the acquiring legal entity. A hive-down[20] also only involves part of the assets, but the shares of the acquiring legal entity are allotted to the legal entity transferring its assets (and not its shareholders), creating a clear distinction between spin-offs and hive-downs.

Hive-downs occur, for instance, when an enterprise incorporates a subsidiary and transfers parts of its assets to that subsidiary. Split-ups or spin-offs may be considered when two or more families hold shares of one legal entity and wish to part. Moreover, split-ups and spin-offs take place when an enterprise wants to confine itself to its core business, allowing those parts of the business no longer needed to be sold or taken public. A prominent example is the spin-off of the former Osram division of the *Siemens AG.* As consideration for the spin-off, Siemens shareholders were allocated shares in *Osram Licht AG.*[21]

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[14] See in more detail below V.4.b).

[15] R. KÖHN, Linde betreibt die Fusion an seinen Aktionären vorbei, Frankfurter Allgemeine Zeitung (FAZ), 20 January 2017, 19.

[16] § 1 para. 1 no. 2 and § 123 UmwG.

[17] The legal entities eligible for a merger may generally also be involved in a split-up, spin-off or hive-down as legal entities transferring assets, as acquiring legal entities, or as newly formed legal entities. See § 124 para. 1UmwG.

[18] § 123 para. 1 UmwG.

[19] § 123 para. 2 UmwG.

[20] § 123 para. 3 UmwG.

[21] For more detail see the joint spin-off report of the management boards of Siemens AG and Osram Licht AG, submitted pursuant to section 127 Transformation Act. The English version of the report is available at: <https://www.siemens.com/investor/pool/en/investor_relations/events/annual_shareholders_meeting/2013/auslage-top-8-spaltungsbericht_final_en.pdf>.

3. *Conclusion*

The German Transformation Act provides the greatest possible degree of freedom when it comes to corporate restructuring and allows almost all conceivable types of company transformation. Companies have made extensive use of the possibilities provided in the Act.[22] For example, in 2004 and 2005, stock corporations were involved in more than 1,000 mergers and about 200 split-ups.[23]

III. Universal Succession

1. *Agreement*

The legal basis for a merger or a division is an agreement, which stipulates the details of the transformation process.[24] The merger or division agreement is entered into by the management board of the legal entities participating in the transformation. As German law understands mergers and division as structural changes that are decided by the shareholders, the agreement is not effective until a resolution has been passed at a general meeting. Thereby it has not yet become effective.[25] Thus, when a stock corporation is participating in a merger or a division, a resolution via a general meeting is required.

The most important point of the agreement is that the transfer of assets occurs by universal succession. In the event of a merger, all assets and liabilities of the legal entity being acquired are transferred as a whole to the acquiring legal entity. In case of a division, the legal entity may split-off a part of its assets and liabilities and transfer it to the acquiring legal entity.[26] This entails the transfer of liabilities and contracts, including any transferrable rental or lease agreements.

In case of a merger, approval is not required from creditors or contractual partners. This is meanwhile also true for a division. However, in 1994, the German legislature sought to achieve a high level of creditor protection by

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[22] Official statistics do not exist. However, it can be concluded from publicly available data that mergers and divisions often take place and are an important way of a transformation. Cf. W. BAYER/T. HOFFMANN, Restrukturierung von Aktiengesellschaften durch umwandlungsrechtliche Maßnahmen, AG 2006 R468.

[23] W. BAYER/T. HOFFMANN, Restrukturierung von Aktiengesellschaften durch umwandlungsrechtliche Maßnahmen, AG 2006 R469–R470.

[24] § 5 UmwG (merger) and § 125 UmwG (division) specify the minimum substance of the respective agreement.

[25] The agreement shall enter into force only if the owners of shares in the legal entities involved consent to the agreement by a resolution (See § 13 para. 1 and § 125 UmwG).

[26] § 20 para. 1 no. 1 regarding a merger and § 131 para. 1 no. 1 UmwG regarding a division.

applying the "general rules precluding the transferability of a specific asset and the general rules making the transferability of an object subject to conditions or requirements",[27] with the goal of preventing abuse of a division to the detriment of creditors.

This rule gave rise to a number of difficult questions of interpretation.[28] In particular, whether the transfer of liabilities would require the consent of a creditor was the subject of some controversy.[29] In 2007, the legislature decided to repeal section 132 of the Transformation Act, thus clarifying that a transfer of contracts and liabilities in the course of a division does not require the consent of the contractual partner and creditors, arguing these would be sufficiently protected.[30] In fact, creditors may rely upon different instruments of civil law and corporate law, exercising general rights under civil law, such as the right of termination and the right of withdrawal for frustration. Furthermore, creditors are protected under a specific liability rule under the Transformation Act.[31]

2. Entry in Commercial Register

Following the shareholders' resolution, the transformation does not become effective until it has been entered into the Commercial Register. Only then are the assets transferred to the acquiring legal entity. It is also at this point that the shareholders of the acquired legal entity become shareholders of the acquiring legal entity.[32]

Under the Transformation Act, the legal effect of a transformation is irreversible.[33] Hence, a merger or a division cannot be reversed, even if a severe defect of the transformation becomes evident after entry in the commercial register. Though this has been criticised by a number of academics,[34] arguing

[27] § 132 UmwG (since repealed).

[28] See in more detail T. RAISER/R. VEIL, Recht der Kapitalgesellschaften, (4th ed., Munich 2006) § 49 marg. nos. 28-30.

[29] According to the former predominant opinion, a number of rights, such as not freely transferable shares (vinkulierte Geschäftsanteile) of a limited liability company (GmbH) and pre-emptive purchase rights could not be transferred. Cf. H. SCHRÖER, in: Semler/Stengel, Umwandlungsgesetz, 1st ed. 2003, § 132 marg. nos. 31-49.

[30] Explanatory remarks governmant draft, Zweites Umwandlungsrechtsänderungsgesetz, BT-Drucks. 16/2919, 19.

[31] See below IV.3.

[32] See § 20 para. 1 no. 3 UmwG regarding a merger and § 131 para. 1 no. 3 UmwG regarding a division.

[33] See § 20 para. 2 and § 132 para. 2 UmwG: Defects of the merger/division will not have repercussions on the effects of its entry in the register.

[34] Cf. K. SCHMIDT, Haftungsrisiken bei "steckengebliebenen" Verschmelzungen?, DB (1996) 1860; R. VEIL, Umwandlung einer Aktiengesellschaft in eine GmbH (Berlin 1996) 163; C. SCHMID, Das umwandlungsrechtliche Unbedenklichkeitsverfahren und die

the rule affects the fundamental rights of a shareholder, the legislature has justified the rule with the argument that it would be scarcely possible to reverse merger or division transactions, particularly after several years.[35] Instead of an *ex post* cancellation of a merger or division, the Transformation Act provides a broad range of *ex ante* protections for shareholders.

3. Conclusion

The transfer of assets and liabilities by way of universal succession is an important element of German transformation law and allows a flexible and cost-efficient transformation of companies. However, in cross-border matters (e.g. when real estate is located abroad) the question arises whether foreign law recognises the principle of universal succession. If not, assets have to be transferred individually.[36]

IV. Protection of Creditors

1. Foundations

Under German law, creditors do not have any influence on a transformation. However, both mergers and divisions can be disadvantageous for creditors. With a merger, creditors are confronted with a new debtor. In the case of a division an additional problem arises: the recoverable assets are reduced, as the acquiring legal entity and the legal entity being acquired are generally not limited in how they divide their assets and liabilities.

Hence, a key object of transformation law is to provide necessary protection for creditors. Interestingly, the system of creditor protections in Germany has changed fundamentally from 1897 to 1994. Initially, transformation law required the separation of the property for a certain period of time (six months).[37] This approach was abandoned due to numerous practical difficul-

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Reversibilität registrierter Verschmelzungsbeschlüsse, ZGR 1997, 510; C. SCHÄFER, Die „Bestandskraft“ fehlerhafter Strukturänderungen im Aktien- und Umwandlungsrecht – zu neuen, rechtlich nicht vertretbaren Ausdehnungstendenzen und zu ihrer prinzipiellen Ungeeignetheit, missbräuchliche Anfechtungsklagen einzudämmen, in: Bitter et al. (eds.), Festschrift für Karsten Schmidt (Cologne 2009) 1389 et seq.; C. SCHÄFER, Die Lehre vom fehlerhaften Verband (Tübingen 2002) 181 et seq.

[35] Explanatory remarks government draft, § 20 UmwG, published by J. GANSKE, Umwandlungsrecht (Düsseldorf 1994) 75.

[36] B. GRUNEWALD, in: Lutter, Umwandlungsgesetz, 5th ed. 2014, § 20 marg. no. 11.

[37] R. VEIL in: Bayer/Habersack (eds.), Aktienrecht im Wandel, Vol. 2 (Tübingen 2007) 1059, 1063, 1065, 1070.

ties and unresolved legal issues.[38] Instead, a more flexible system evolved from 1937–1980 and was adopted by the legislature in 1994 for all types of transformations.

First, the Transformation Act requires that a merger or division for the purpose of forming a new entity can be done only if the provisions governing the formation of the acquiring legal entity are respected.[39] Additionally, the Transformation Act provides several protective rules. These are: the obligation to provide security (section 22), special provisions for the protection of holders of non-voting preference shares (section 23) and claims for damages against wrongful acts of board members (section 25). For divisions, the Transformation Act also stipulates that the entities involved in the division are liable for the debts, obligations and responsibilities of the legal entity being acquired (section 133). In the following, I will focus on the most important elements: the claim for provision of security as well as the liability of legal entities involved in a division.

2. *Claim for Payment of Security*

If the creditors of legal entities involved in a merger or division cannot demand satisfaction for their claims, security is to be provided to them, provided they file their claim in writing within six months of the merger being registered.[40] This also applies when their claim is not yet due.[41] Furthermore, creditors must provide credible evidence that the fulfilment of their claim could be jeopardised by the transformation. In the event of either a merger or a division, this requirement might be fulfilled if the acquiring legal entity to which the liability has been transferred is endangered, which may be assumed if the equity capital base is diminished.[42] However, this condition is not satisfied if the acquiring company is simply conducting high-risk business.[43]

The duty to provide security is not an unfair burden on companies as only those creditors who are not sufficiently secured are entitled to it. This protective measure has proven its value in practice. It becomes especially relevant

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[38] C. BÖTTCHER/H. MEILICKE, Umwandlung, Verschmelzung und Auflösung (Berlin 1937) § 241 marg. no. 1.

[39] This becomes relevant if an insolvent company is involved in a transformation. Cf. E. WÄLZHOLZ, Aktuelle Probleme der Unterbilanz- und Differenzhaftung bei Umwandlungsvorgängen, AG 2006, 469.

[40] § 22 para. 1 and § 125 UmwG.

[41] B. GRUNEWALD in: Lutter, Umwandlungsgesetz, 5th ed. 2014, § 22 marg. no. 9.

[42] B. GRUNEWALD in: Lutter, Umwandlungsgesetz, 5th ed. 2014, § 22 marg. no. 12; O. VOSSIUS, in: Widmann/Mayer, Umwandlungsrecht, May 2016, § 22 marg. no. 29.

[43] B. GRUNEWALD in: Lutter, Umwandlungsgesetz, 5th ed. 2014, § 22 marg. no. 12.

for continuing obligations arising from rental and lease agreements[44] and pension liabilities.[45]

3. Liability Arising from a Division

The legislature did not regard a claim for a security payment as sufficient protection in the case of a division and therefore introduced an additional safeguard, namely joint and several liability of all entities involved in the division for liabilities existent prior to the division.[46] The reason for this is that creditors not only have to accept the replacement of a debtor, as is also the case in a merger, but also the fact that the legal entity being acquired can, in fact, subsequently freely decide how to divide its assets and liabilities. In particular, it can assign liabilities unilaterally to one of the involved entities while also not providing equal recoverable assets.

Nevertheless, the regime does not establish an unlimited liability for the entities involved. Entities that were not assigned the relevant liabilities are only liable for those liabilities that were due and acknowledged in writing or sued for within five years after the division. As a result, liability is generally limited to five years.[47]

This may be illustrated by two examples. Let's assume that company 1) separates a part of its assets onto companies 2) und 3) and it has a loan liability to a creditor. If the liability to pay back the loan remains with company 1), company 1) is the principal debtor, and must reimburse the loan when it becomes due. Additionally, companies 2) and 3) are liable under the Transformation Act if the claim to repay the loan is due and sued for within five years after the division.

In the second example the division agreement stipulates that liability is transferred to company 2). Under the Transformation Act this transfer of a liability is possible without the creditor's consent.[48] Therefore, after the division, company 2) is a debtor of the creditor. The Transformation Act, however, establishes liability for companies 1) and 3), provided that the loan is due and sued for within five years.

Both examples demonstrate that the Transformation Act makes all the entities involved in a division jointly liable for a period of five years. This liability is of particular practical importance for continuing obligations such as rental agreements or lease agreements, as the conclusion of such contracts constitutes the legal basis for the resulting liabilities.[49]

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[44] See LG Augsburg, 29 March 2011, 2 HK O 363/08, regarding a rental contract.

[45] See BAG, 11 March 2008, 3 AZR 358/06; BAG, 22 February 2005, 3 AZR 499/03 (A).

[46] § 133 paras. 1 and 2 UmwG.

[47] § 133 para. 3 UmwG.

[48] See above III.1.

Let's[49] assume for instance that company 1) leased a property for twenty years and splits this lease agreement off onto company 2), then company 1) is liable for all payment claims regarding the lease which are due within five years after the division. This example demonstrates that liability arising from division is a compromise between the interests of the companies in a flexible restructuring, on the one hand, and the interest of the creditors, on the other.

Compensation between the debtors themselves when one of them has satisfied a creditor is not explicitly laid down by the Transformation Act.[50] In general it can be assumed that the principal debtor is fully liable in relation to the other entities involved in the division.[51] So if in the aforementioned example, a creditor demands payment from company 2) the latter can take full recourse against company 1).

4. Conclusion

When assessing the level of creditor protection, it must be noted that the general provisions of corporate law about forming a corporation and the regime of capital maintenance apply in a transformation of companies. Accordingly, a stock corporation or limited company cannot arbitrarily transfer liabilities in the event of a split-up or spin-off. Thus it makes sense that the protection of the Transformation Act is limited to those creditors whose claims had not yet become due prior to a transformation. The instruments provided by the Transformation Act, particularly the security payment, have proven to be effective, ensuring an appropriate level of creditor protection.

In a split-up and spin-off, the legal entity transferring assets and liabilities to other legal entities is generally free to allocate the items making up the assets and liabilities to each of the acquiring entities as it sees fit. This is justified, as company transformation is grounds for creditors to exercise their termination rights. Furthermore, creditors are protected by a joint liability of the companies involved in such a division. This liability arising from division has stood the test of time.

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[49] See M. SICKINGER, in: Kallmeyer, Kommentar zum UmwG, 6th ed. 2017, § 133 marg. no. 8.

[50] The companies are jointly liable. Thus the recourse has to be assessed according to § 426 para. 1 German Civil Code (Bürgerliches Gesetzbuch – BGB). M. SCHWAB, in: Lutter, Umwandlungsgesetz, 5th ed. 2014, § 133 marg, nos. 146, 148 (however arguing that the liability between principal debtor and all other companies involved in a division would be of an accessory nature).

[51] M. HEIDENHAIN, Spaltungsvertrag und Spaltungsplan, NJW 1995, 2879; K. SCHMIDT, Gläubigerschutz bei Umstrukturierungen, ZGR 1993, 389.

V. Shareholder Protection

1. Foundations

Shareholder interests are affected by all types of transformations. In the event of a merger, the shareholders of the legal entity being acquired become members of another enterprise. Thus, the shareholders lose their participation quota in both the acquiring legal entity and the legal entity being acquired, diminishing their influence, and potentially making them unable to assert minority rights. Moreover, all shareholders are exposed to the risk of capital dilution. This risk materializes when the merger is based on an unequal exchange of shares. If, for example, the entity being acquired is undervalued, its shareholders may suffer a financial loss, as the allotted shares of the acquiring legal entity would not constitute equivalent compensation. Inversely, the merger is disadvantageous to shareholders of the acquiring legal entity, if too many shares are allotted to shareholders owing to an overvaluation of the legal entity being acquired.

Similar problems arise in the various types of division. Additionally, a hive-down forms a sub-group (subsidiary) or extends a group (sub-subsidiary), meaning that shareholders of the parent company lose the authority to participate in important business decisions,[52] as it has been outsourced to the subsidiary.[53]

Hence, merger and division severely interfere with the membership of the shareholders, who enjoy protection of property under constitutional law.[54] Therefore, one main objective of the Transformation Act is to ensure adequate protection of shareholders, and safeguard their specific needs while also preventing transformation from being unduly burdensome.

Put briefly, and very simply, the regime consists of two aspects: firstly, there are instruments of *ex ante* protection, such as the obligation to inform shareholders (via a submission of a merger or division report by the board of directors), the obligation for an audit of the transformation conducted by independent expert auditors, as well as the requirements in regard to the resolution of the general meetings of the companies involved in a transformation. Secondly, *ex-post* protection is provided by the right to cash compensation.

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[52] These decisions are described in § 119 para. 1 AktG.

[53] This has been developed by the BGH in the famous *Holzmüller*-decision (BGH, 25 February 1982, II ZR 174/80, BGHZ 83, 136–138) and still serves as an argument for the court's principles about the competence of a general meeting of a stock corporation to decide upon certain structural changes, such as a hive-down by way of a singular succession (Ausgliederung durch Einzelrechtsnachfolge), BGH, 26 April 2004, II ZR 155/02, BGHZ 159, 40–41 *(Gelatine).*

[54] Article 14 of the German Constitution (Grundgesetz – GG).

2. *Protection ex-ante*

a) *Information requirements*

Shareholders can only exercise their voting rights reasonably when they are well-informed. The general rights of information under corporate law do not suffice for this purpose.[55] The Transformation Act therefore stipulates that the representative bodies of each of the legal entities involved in the transformation must submit a detailed written report.[56] When merging, the management boards have to state the purpose of the merger. Furthermore, they must *explain* and *justify* the details of the merger agreement including the ratio applicable to the exchange of shares and the amount of the cash compensation that may be offered. The report must highlight any particular difficulties encountered in valuing the legal entities as well as outline the consequences the merger will have for the ownership interests of shareholders.[57] In practice, these reports can extend to over 100 pages, and are regarded as an indispensable element of prior shareholder information.[58]

b) *Audit of the merger*

In order to protect shareholders, the law also requires an expert audit of the transformation agreement.[59] This requirement is predominantly to ensure that the ratio applicable to the exchange of shares is a fair equivalent.[60]

The auditor must be independent in accordance with the general rules of the German Commercial Act,[61] and is selected and appointed by the court following a petition filed by the representative body[62] in order to ensure that the auditor is not affiliated with one of the companies involved.[63]

Generally, the auditor does not assess the participating enterprises himself, this would be too time-consuming, but relies instead on audits previously

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[55] According to § 131 AktG, shareholders may only request information from the management board in the general meeting regarding the company's affairs to the extent required to allow a proper assessment of the items on the agenda.

[56] See § 8 para. 1 UmwG. The report is not required if all owners of shares in all legal entities involved waive its preparation, or if all shares in the legal entity being acquired are held by the acquiring legal entity. See § 8 para. 3 UmwG.

[57] See § 8 para.1 UmwG regarding the merger report and § 127 UmwG regarding the division report.

[58] T. DRYGALA in: Lutter, Umwandlungsgesetz, 5th ed. 2014, § 8 marg. nos. 4–5; in more detail T. KEIL, Der Verschmelzungsbericht nach § 340a AktG (Cologne 1990) passim.

[59] § 9 and § 125 UmwG.

[60] BGH, 22 May 1989, II ZR 206/88, BGHZ 107, 303.

[61] See § 11 UmwG in connection with §§ 319 paras. 1-4, 319a para. 1, 320 paras. 1–2 German Commercial Code (Handelsgesetzbuch – HGB).

[62] § 10 (1) UmwG.

[63] G. LANFERMANN in: Kallmeyer, Umwandlungsgesetz, 6th ed. 2017, § 10 marg. no. 1.

obtained by the enterprises.[64] His expertise consists of carefully analysing the given data and ascertaining whether the enterprises' values have been determined reasonably.

The audit report must be in writing[65] and concluded by a declaration as to whether or not the proposed ratio applicable to the exchange of shares is a fair equivalent. To that end, the report has to provide information on the methods behind the proposed ratio and the reasons for the appropriateness of the methods applied. Generally speaking, this procedure has proved successful in practice.

c) *Resolution by the General Meeting*

The merger or division agreement only enters into force if the shareholders of the legal entity being acquired consent by a resolution of the general meeting.[66] When merging and dividing into several enterprises by absorption, resolutions by the general meeting of the acquiring legal entity are required as well.[67] All resolutions require a majority of at least three-quarters of the share capital represented at the adoption of the resolution, which is consistent with the respective requirements for other structural changes.[68] The nine-tenths of the represented share capital majority required under the former transformation law had not proven its value in practice.[69]

The transformation resolution justifies the typical changes of membership resulting from transformation.[70] The situation is different if the transformation interferes with specially protected rights of individual shareholders. In some cases, the Transformation Act requires the individual consent of the shareholders concerned, for instance, when individual rights are lost or affected by transformation.[71]

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[64] BGH, 18 September 2006, II ZR 225/04, AG 2006, 888 regarding a parallel audit.

[65] § 12 UmwG.

[66] §§ 13 and 125 UmwG.

[67] Where at least 90% of the share capital of a company that is being acquired is held by an acquiring stock corporation, no merger resolution need to be adopted by the acquiring stock corporation where the absorption of this company being acquired is concerned. See § 62 (1) UmwG about group mergers.

[68] See § 179 AktG regarding amendments of the articles of association, § 293 para. 1 AktG about enterprise agreements, etc.

[69] See Explanatory remarks government draft, §§ 65 and 240 UmwG, published by J. GANSKE, Umwandlungsrecht, 111 and 257.

[70] See OLG Düsseldorf, 16 January 2003, 6 U 60/02, ZIP 2003, 1749, 1752.

[71] T. RAISER/R. VEIL, Recht der Kapitalgesellschaften, (6th ed., Munich 2015) § 67 paras. 50–55.

Mergers and divisions with the participation of corporations usually require a capital increase in the acquiring corporation.[72] The shares to be allotted to the shareholders of the legal entity being acquired are issued by means of capital increase.

3. *Protection ex-post*

Instruments of *ex-post* protection include firstly the right of shareholders of the transferring company to claim an additional cash payment, if the exchange ratio is inappropriate,[73] and in mergers between companies with a different legal form the right to exit in return for appropriate cash compensation.[74] Secondly shareholders may claim damages against members of the administrative bodies (board of directors and supervisory board), if these have breached their duties under the Transformation Act.[75] Hence, the focus of the *ex-post* protection is on compensation.

a) *Claim for additional cash payment*

Claims for additional cash payment are justified by the fact that an action brought by shareholders from the transferring company against the merger resolution cannot be based on the fact that the share exchange ratio was set at too low a value.[76] This exclusion of such actions is intended to prevent disputes over the value assessment from delaying the transformation taking effect.[77] Instead of filing an action against the merger resolution, concerned shareholders may demand compensation by an additional cash payment from the acquiring legal entity.[78]

The claim is to be asserted in a separate legal action called a "valuation proceeding".[79] The costs of this legal action are, in principal, borne by the legal entity.[80] Most importantly, the courts often require a fresh valuation of the companies involved in a transformation or at least a supplementary opin-

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[72] §§ 66 and 69 UmwG. However, § 68 UmwG allows a merger without an increase in capital, provided that certain prerequisites are fulfilled.

[73] § 15 UmwG.

[74] § 29 UmwG. In addition, shareholders are entitled to dispose of their shares irrespective of existing restrictions of transferability. Cf. § 33 UmwG.

[75] § 25 para. 1 UmwG.

[76] § 14 para. 2 and § 125 UmwG.

[77] However, the shareholders of the acquiring company do have the right to file an action against the resolution of the shareholder meeting of their company. The different legal situation is considered critically (cf. R. VEIL, Aktionärsschutz bei der Verschmelzung von Aktiengesellschaften durch vertragliche und gesellschaftsrechtliche Haftung, in: Damm/Heermann/Veil (eds.), Festschrift für Thomas Raiser (Berlin 2005) 453, 459).

[78] § 15 UmwG.

[79] § 1 no. 4 Act on Appraisal Proceedings (Spruchverfahrensgesetz – SpruchG).

[80] § 15 SpruchG.

ion.[81] The disadvantage of this process is that the judicial valuation proceeding often takes numerous years,[82] however, in the past 20 years courts have often concluded that the valuation of the enterprises was not appropriate.[83] Thus, the claim for additional cash payment is an important element of *ex post* shareholder protection in mergers and divisions.

b) Right to exit

The right of the shareholders to exit the company upon transformation continues to be of major importance. The acquiring legal entity must offer each shareholder recorded as objecting to the merger resolution[84] the opportunity to sell his or her shares in return for appropriate cash compensation.[85] This right, however, only exists in specific types of merger or division: where one legal entity merges with another that has a different legal form, or where a stock corporation whose shares are listed on the stock exchange merges into an unlisted stock corporation. The idea behind this approach is that shareholders will be faced with a totally different legal regime and the transferability of their shares might be affected.[86] As a consequence, they may lose minority rights or will have less influence in the company due to the different corporate governance structure.

The compensation is to be offered under the merger or division agreement,[87] and is generally paid in cash, or when applicable, in shares of the acquiring company.[88] In all cases, merger auditors are to review whether the intended cash compensation is a fair equivalent.[89] The Transformation Act remains silent on which method should be used to determine the value, leaving the courts as the only authority on that question.

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[81] See I. KLÖCKER in: K. Schmidt/Lutter, Aktiengesetz/Spruchverfahrensgesetz, 3rd ed. 2015, § 8 SpruchG marg. no. 4.

[82] See A. ENGEL/K. P. PUSZKAJLER, Bewährung des Spruchgesetzes in der Praxis?, BB 2012, 1691; cf. also BVerfG, 26 April 1999, 1 BvR 467/99, AG 1999, 370 regarding a proceeding which took seven years.

[83] See I. DRESCHER, in: Spindler/Stilz, Aktiengesetz, § 1 SpruchG marg. no. 6; W. DÖRFLER/W. GAHLER/S. UNTERSTRAßER/R. WIRICHS, Probleme bei der Wertermittlung von Abfindungsangeboten, BB 1994, 159 et seq.

[84] An objection is not required if an owner was not admitted to the assembly or if the assembly has not been properly convened, section 29 (2) Transformation Act.

[85] § 29 para. 1 UmwG.

[86] See E. WÄLZHOLZ in: Widmann/Mayer, Umwandlungsrecht, December 2015, § 29 marg. no. 12.

[87] The offer may be accepted only within two months following the day on which the entry of the merger/division has been published. See §§ 31 and 125 UmwG. Under §§ 34 and 125 UmwG, the court is to determine an appropriate case compensation where an owner of shares asserts that cash compensation that was offered to him at too low a value.

[88] §§ 29, 125 UmwG.

[89] § 30 para. 2, § 125 in connection with §§ 9 et seq. Transformation Act.

4. Evaluation

a) Focus of the Transformation Act on the protection of property rights

The appropriate calculation of the share exchange ratio is a key problem in mergers and divisions. Ideally, the share exchange ratio should result in shareholders retaining an equal stake before and after the merger or division, and not suffering a loss as a consequence of the transformation.[90] To that end, the Transformation Act provides a number of *ex ante* and *ex post* instruments to efficiently ensure the protection of minority shareholders. This becomes particularly relevant for transactions within a group of companies. However, one may argue that this highly sophisticated regime is not necessary for a merger of equals. In fact, more than 20 years after the enactment of the Transformation Act, this key issue is still a matter of controversy in legal literature and jurisprudence has developed divergent solutions.

The Higher Regional Court Stuttgart considered it decisive whether there were concerns about the management board acting to the detriment of its company and shareholders. In a merger between two independent stock corporations (so-called merger of equals), this ordinarily would not be the case. An appropriate share exchange ratio seems likely, given that the respective company representatives (board members) are in a "real negotiation situation" and require majority approval from their general meetings – particularly as this approval is not defined by the self-interest of a controlling shareholder, but by the common interest of both minority and majority shareholders.

Therefore, the Court reasoned that the exchange should not be subject to a complete judicial review.[91] According to the Higher Regional Court Stuttgart, a judicial review of the exchange ratio should be limited to determining the legal factors for the valuation of the companies and ascertaining whether the actual basis of the valuation was accurate. It should not be in the court's discretion to replace the resolution of the general meeting with another reasonable evaluation, provided the plans, prognoses and the selection of adequate valuation methods were decisions the management made in the context of the conclusion of a contract; and that these were based on accurate and not inherently contradictory information, and as part of an arms-length negotiation.[92]

However, according to the Federal Constitutional Court, the principles developed by the Higher Regional Court Stuttgart do not fulfil constitutional requirements.[93] The Federal Constitutional Court argued the sole audit of the

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[90] See OLG Karlsruhe, 9 August 1991, AG 1992, 32; T. DRYGALA in: Lutter, Kommentar zum UmwG, 5th ed. 2014, § 5 para. 27.

[91] OLG Stuttgart, 8 March 2006, 20 W 5/05, AG 2006, 422; OLG Stuttgart, 14 October 2010, 20 W 16/06, AG 2011 49.

[92] OLG Stuttgart, 8 March 2006, 20 W 5/05, AG 2006 424.

[93] BVerfG, 24 May 2012, 1 BvR 3221/10, AG 2012, 675.

negotiation process cannot sufficiently ensure the "full compensation of the shareholders of the legal entity being acquired". The constitution demands the agreed exchange ratio to provide "full financial compensation".

The Court reasoned that the negotiations of the managing bodies in the merger may be driven by various entrepreneurial concerns. Therefore, it is not sufficient to guarantee constitutionally required shareholder protection.

The decision of the Federal Constitutional Court has been hotly debated. Thus, some authors have opined that the Federal Constitutional Court did not explain which "diverse entrepreneurial considerations" might cause disadvantageous decisions by the board of directors and justify a further valuation of the company.[94] Furthermore, they argue the Court was not able to answer why the business judgment rule does not apply in this situation.[95]

However, there are also reasons for the approach favoured by the Federal Constitution Court. First, there is some doubt whether a "real negotiation situation" can be said to exist in a merger.[96] This is mainly due to the fact that in practice, one company usually exerts a stronger influence on the merger process.[97] In addition, managers tend to engage in empire building, and it is therefore conceivable that they accept an inadequate exchange ratio in return for a perceived payoff in other areas. It is well known that important decisions in merger transactions are driven by managers' personal interests; an oft-cited example is the future position of managers in the combined company.[98] Finally, how should shareholders demonstrate and prove that managers have a conflict of interest or are at least biased due to personal interests? Given these considerations, it would appear that the Federal Constitutional Court's decision deserves support.[99]

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[94] L. KLÖHN/D. VERSE, Ist das „Verhandlungsmodell" zur Bestimmung der Verschmelzungswertrelation verfassungswidrig?, AG 2013, 6; T. DRYGALA, in: Lutter, Umwandlungsgesetz, 5th ed. 2014, § 5 marg. no. 38.

[95] L. KLÖHN/D. VERSE, Ist das „Verhandlungsmodell" zur Bestimmung der Verschmelzungswertrelation verfassungswidrig?, AG 2013, 7 (however conceding that managers tend to conduct side deals in a final term situation).

[96] For an attempt to define situations of a merger of equals, see K. BLOCK, Das angemessene Umtauschverhältnis im Verschmelzungsrecht (Frankfurt a.M. 2011) 99–112.

[97] In case of the merger between Deutsche Börse and London Stock Exchange the negotiated exchange ratio was criticised as it would not adequately reflect the value of the companies, see. C. KNOP, FDP und SPD nehmen die Börsenfusion aufs Korn, Frankfurter Allgemeine Zeitung (FAZ), 2 December 2016, 19; see also the interview with K. NIEDING, Handelsblatt, 12 July 2016, 29, who claimed that Carsten Kengeter had "individual interests".

[98] It has been argued in the press that the management board of Deutsche Börse had been happy with London as the future seat of the combined group as Carsten Kengeter, CEO of Deutsche Börse would become executive director of the combined group, Frankfurter Allgemeine Zeitung (FAZ), 23 December 2016, Poker um den Börsensitz, 15.

b) Alternative transformations in practice using the example of the merger between Deutsche Börse and London Stock Exchange

Interestingly, in practice, new ways of conducting a transformation have evolved and provide a different level of shareholder protection. This shall be explained using the example of the merger between *Deutsche Börse* and *London Stock Exchange,*[100] which should not take place under the German Transformation Act (though according to section 122a et seq. a cross-border merger would have been possible).

Following approval from the supervisory board of *Deutsche Börse,* the management board concluded an agreement on the implementation of a business combination ("merger") with the *London Stock Exchange* under a UK holding company (UK TopCo), which was formed solely for the purpose of effecting the merger.[101] The (finally failed) merger occurred in several steps. First, UK TopCo announced its intention pursuant to Rule 2.7 of the UK City Code on Takeovers and Mergers to acquire all *London Stock Exchange* shares by way of a scheme of arrangement. Second, UK TopCo decided to submit a voluntary public takeover offer pursuant to section 10 (1), section 29 (1) and section 34 of the German Securities Acquisition and Takeover Act (Wertpapiererwerbs- und Übernahmegesetz – WpÜG) to the shareholders of *Deutsche Börse AG* for the acquisition of their shares by way of a securities exchange offer ("takeover offer").[102] Thus, the shareholders of *London Stock Exchange* and *Deutsche Börse AG* would become shareholders of UK TopCo which would own London Stock Exchange and Deutsche Börse (who then would be subsidiaries).

The "advantage" of this transaction is obvious: All instruments provided for minority shareholders under the Transformation Act do not apply. The transaction is only subject to German takeover law. As a consequence, the transaction did not require a resolution of the shareholder meeting with a majority of 3/4 of the represented share capital, with acceptance from at least 60% of the shareholders being sufficient.[103] Furthermore, the board of direc-

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[99] See also H. FLEISCHER/S. BONG, Unternehmensbewertung bei konzernfreien Verschmelzungen zwischen Geschäftsleiterermessen und Gerichtskontrolle, NZG 2013, 881 et seq. agreeing with the Federal Constitution Court.

[100] The following information on the merger is available at <http://deutsche-boerse.com/dbg-en/investor-relations/potential-merger>.

[101] All of the shares in the UK TopCo are held by a foundation formed under the law of the Netherlands for the purposes of holding shares in the UK TopCo until completion.

[102] The *LSE* acquisition and the UK TopCo offer to all shareholders of *Deutsche Börse* were inter-conditional, stipulating completion would only occur if both the LSE acquisition and the Deutsche Börse offer were completed by UK TopCo.

[103] Initially, the minimum acceptance level for the takeover-offer by UK TopCo. was at 75%. When it turned out that it could be difficult to reach this level, UK TopCo reduced it

tors was not obliged to provide a merger report to the shareholders.[104] Instead, UK TopCo needed only to inform the shareholders about its offer pursuant to German takeover law.[105] Similar to a merger report, the offer document is intended to facilitate an informed decision about the transaction. The obligatory offer document is, however, less informative than a merger report.[106] In addition, shareholders neither have the right to bring an action against the resolution of the shareholder meeting[107] nor to claim additional cash payment. German takeover law is based on the idea that the stock exchange price reflects the true enterprise value. Thus, UK TopCo only had to offer a consideration which corresponded, at a minimum, to the weighted domestic stock exchange price of the shares during the three months prior to the publication of the decision to take over the company.[108]

This brief look at the merger between *Deutsche Börse* and *London Stock Exchange* makes clear that practitioners have found ways to avoid the high level of shareholder protection under the Transformation Act and established by the German Federal Constitution Court. There is no risk of shareholders blocking the transaction by legal actions against a shareholder resolution (which still happens in German stock corporations). It remains to be seen whether alternative transaction structures under the Takeover Law undermine the purposes of German transformation law. This article cannot provide definite answers in this regard. It will be important therefore in the future to analyze in depth whether shareholders are sufficiently protected or whether German takeover law requires further amendment.

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to 60%, see M. BRÄCHER/A. REZMER/R. LANDGRAF/K. SLODCZYK, Neue Regeln, neue Chancen, Handelsblatt, 12 July 2016, 28.

[104] In the case of a cross-border merger, the merger agreement must contain further information on the co-determination, the valuation of the assets and liabilities that are to be transferred to the acquiring or newly formed company and the cut-off date of the balance sheets of the companies involved in the cross-border merger, § 122c para. 2 nos. 10-12 UmwG.

[105] § 11 Securities Acquisition and Takeover Act (Wertpapiererwerbs- und Übernahmegesetz – WpÜG). However, the shareholders of Deutsche Börse received detailed information on the background to and the reasons for the transaction and its consequences. The document "Recommended All-Share Merger of Equals of London Stock Exchange Group PLC and Deutsche Börse AG" is 110 pages thick!

[106] For example, the offeror does not have to explain the legal and economic reasons for the offer and alternative ways of a merger. In this respect, the offer document must only contain information concerning the offeror's intentions regarding the future business activity of the target company, § 11 para. 2 no. 6 WpÜG.

[107] This seems to be an argument brought forward by Linde in the case of the Praxair merger, R. KÖHN, Linde betreibt die Fusion an seinen Aktionären vorbei, Frankfurter Allgemeine Zeitung (FAZ), 20 January 2017, 19.

[108] § 5 (1) WpÜG Offer Regulation (WpÜG-Angebotsverordnung – WpÜG-AngebVO).

VI. Outlook

The German legislature has implemented very effective protection for shareholders and creditors in transformation cases. However, as the instruments of shareholder protection may carry substantial costs, protection levels have been lowered in recent years. Waiving the expert audit in transformation cases may save up to 80,000 Euros in the case of mergers and up to 50,000 Euros in divisions.[109] For management reports, average costs of 3,000 Euros have been ascertained for mergers and up to 10,000 Euros for divisions, which explains why the German legislature has continually facilitated mergers. In some special cases of group mergers, a resolution of the general meeting is no longer needed and it is possible to dispense with merger audits. Additionally, the German legislature has simplified the opportunities of a pre-merger squeeze-out.[110] Thus, transformation law has been modernised in recent years, whilst still providing a high level of shareholder protection.

At the same time however, practitioners have developed different transaction structures allowing cross-border mergers under a different regime. The transaction takes place in accordance with takeover law instead of transformation law. As a consequence, a different level of shareholder protection applies. Legal scholars must now analyse these differences and shed light on the different levels of access shareholders have to information and the range of appraisal rights. Only then it is possible to discuss whether further reform is necessary.

[109] Cap Gemini/Ramboll Management, Data Annex to the final report, EU project on baseline measurement and reduction of administrative costs for priority area annual accounts/company law of 28. February 2009, p. 69, 83, available at <http://ec.europa.eu/enterprise/policies/better-regulation/files/abst09_cl_data_annex_en.pdf>.

[110] A squeeze-out according to § 327a et seq. German Stock Corporation Act requires that a shareholder hold at least 95% of the registered share capital. However, § 62 para. 5 WpÜG provides the possibility of a squeeze-out, if a mother company owns at least 90% of the registered share capital, provided that the subsidiary is merged into the mother company.

Corporate Division: Rules and Practice in China

Ruoying Chen[*]

I. Introduction ... 23
II. Legal Rules for Corporate Division in China ... 26
1. Pre-Company Law Era ... 26
2. 1994 Company Law: Veto Rights Of Creditors and the "Lemon Market" ... 27
3. The 2005 Company Law: Joint and Several Liability Without Creditor Veto Rights ... 29
4. Dissenting Minority Shareholders: The Appraisal Right ... 30
III. Asset-specific Joint and Several Liability for Incorporation Restructuring: Formalistic or Substantial Approach? ... 30
IV. Division of Public Corporations: Selective Regulation by CSRC? ... 32
1. Facts: A Comparison of the Success and the Failure ... 34
2. The Puzzle of Selective Approval by the CSRC ... 36
V. Sub-optimal Regulation of IPOs ... 37
1. CSRC Approval Regime for IPOs ... 37
2. CSRC Approval of Major Transactions: Potential IPO Queue Jumpers ... 41
3. Inter-Agency Conflicts: Conflicting Regulation of IPO Price ... 42
VI. Conclusion ... 43

I. Introduction

To split one firm into two or more was legally permitted in China long before China passed its first company law in 1993. The initial law on creditor's protection was sketchy and vague, while the set of rules that binds division of state-owned enterprises (SOEs) seemed to present a set of objectives and rationale that differed from the conventional wisdom of legal rules governing corporate division. The first company law in China passed in 1993 stipulated quite an elaborate regime with the clear purpose of protecting creditors' interests, which however was ill-designed and counter-productive. Simply put, the rather tedious procedural requirements, combined with weak *ex-post* remedy for creditors, led to serious breaches of these requirements and a large

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volume of litigation brought by creditors. It was not until later, especially when the company law in China was substantially amended in 2005 that a more comprehensive regime for corporate division was established. Under this new regime, the legal requirements for dividing a corporation are straightforward in procedure but substantive in protecting the interests of creditors and those of dissenting shareholders.

Existing literature on corporate division in China largely focuses on creditor protection in close corporations,[1] which has been heavily litigated and led the Supreme Court in China to issue guidance. Especially with respect to the restructuring of state-owned enterprises by dividing existing assets and operations and incorporating firms according to the Company Law of China, there has been enormous alleged misconduct by corporate insiders against outside creditors. Based upon the statutory joint and several liability towards creditors under the Company Law, the court has drawn an analogy between these transactions ("Incorporation Restructuring") and the corporation division stipulated under the Company Law and essentially created a modified form of joint and several liability for companies towards their creditors. This liability is joint and several among all entities surviving the division but limited to the value of the assets that were transferred to the corporation being divided and the relevant corporation(s) which survived division. Such a special form of liability leaning towards creditors' interests generated much confusion and hence more litigation. To reduce the error rate and information costs for the parties and the court, this special form of liability is to be replaced with a standard joint and several liability.

Only one public corporation with shares listed in China's A-share market, has managed to successfully conduct a company division, which occurred in 2010, and resulted in its delisting and initial public offerings (IPOs) for the two surviving corporations. It was five years before the next attempt and the corporation declared permanent suspension of the proposed division after trading of its shares was suspended for almost a year. Compared with the stock market in other jurisdictions, there appears to be a gap in China's stock market, which is rather puzzling. Meanwhile, China should be a fertile land for corporate division due to the existence of a huge number of conglomerates, such as the famous Dalian Wanda Group, HNA Group and financial

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[1] There are numerous articles in Chinese on this topic. Two of the representative papers are: B. PENG, 彭冰，“论公司分立行为的界定”，《证券法苑》。[Defining Corporate Division Transactions], Securities Law Journal, 9 (2013) 621, and J. LOU, 楼建波，“化解企业部分改制下债权僵局的制度设计—兼对最高人民法院改制司法解释第6条、第7条理论基础之争的反思”，《清华法学》[Institutional Design for Resolving Deadlock of Debt Repayment in the Circumstances of Restructuring Incorporation – A Reflection on the Theoretical Debate on Section 6 and Section 7 of Supreme Court Judicial Interpretation on Restructuring Incorporation], Tsinghua Law Review, 3 (2009) 26.

conglomerates such as China CITIC Group.[2] The widely recognized "conglomerate discount" is likely to attract more investors who are interested in one part of the assets of a conglomerate but not the rest of the assets. Given that corporate divisions (spin-offs) generally raise stock prices,[3] there should be substantive market demand for such transactions.

Under-supply of law is one potential explanation for the gap in the market. If we believe the causal relationship proposed in the law and finance literature that law matters for the market,[4] remedying this shortfall may present an effective fix for China's market. However, the casual relationship may run in the opposite direction, meaning that the market precedes and law follows.[5] Hence, it is possible that the gap in the market was caused not by undersupply of law but something else. An alternative explanation is proposed in this paper: the goals for China Securities Regulatory Commission (CSRC) in regulating corporate division create tension with its goals of regulation of IPOs, rendering CSRC reluctant to grant approval for division of public corporation. In addition, there is some tension between the policy objectives of the CSRC and the regulatory objective of another agency, the State-owned Assets Supervision and Administration Commission of the State Council (the SASAC), in regulating the transfer of state-owned assets, including the division of a public corporation. Such potential conflicts have created enormous uncertainty which may well have deterred public corporations that are otherwise interested in dividing themselves.

The rest of this Paper is organized as follows. Section II provides the legal framework for corporate division in China, including the evolution of the relevant rules. Section III assesses the special liability rules created by the court in addressing restructuring transactions in the economic transitional periods in China where firms were turned into closely-held corporations. Section IV presents the puzzle of apparently selective approval of public corporation division by the CSRC. In Section V, I propose an explanation to solve the puzzle along the lines of internal conflicts of different regimes run by the same agency and inter-agency conflicts of regulatory goals of different agencies. A very brief conclusion follows in the end.

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[2] For a more general introduction to the regulation of finacnail conglomerates in China, see F. LIAO, Regulation of Financial Conglomerates in China：from De Factor to De Jure, European Business Organization Law Review, 12 (2011) 267–313.

[3] One of the early findings is: J. MILES/J. ROSENFELD, The Effect of Voluntary Spin-off Announcements on Shareholder Wealth, Journal of Finance, 38 (1983) 1597.

[4] R. LA PORTA/F. LOPEZ-DE-SILANES/A. SHLEIFER/R. VISHNY, Legal determinants of external finance, Journal of Finance, 52 (1997) 1131

[5] J.C. COFFEE, The rise of dispersed ownership: the roles of law and the state in the separation of ownership and control, Yale Law Journal, 111 (2001) 16.

II. Legal Rules for Corporate Division in China

Legal rules governing corporate division in China have been evolving, especially as part of the changes to company law.[6] When it was first permitted to split one firm into two or more in China's first company law, it's clearly focused on protecting creditors' interests. A more comprehensive regime was established when the comanpy law was amended in 2005, for both listed and non-listed corporations.

1. Pre-Company Law Era

Under the General Principles of Civil Law (GPCL), legal persons are permitted to split provided that public notification to creditors is made, and the entities surviving the split are liable for the debts of the original entity being split.[7] However, the GPCL was silent as to the nature of such liability. In particular, it is unclear under the GPCL whether a creditor may hold all the surviving entities jointly and severally liable. It also failed to address the binding force of any agreement reached between the relevant entities and the creditors of the entity to be divided.

Under the first comprehensive set of legal rules governing SOEs, the division of SOEs was permitted, although government approval is required.[8] In terms of the company's liability, its property shall be protected and its credits and liabilities dealt with accordingly.[9] The emphasis on protecting the property of the firm being divided looks curious at first glance, given that the focus of protection in the case of corporate division seems to focus overly on outside creditors and dissenting minority shareholders. The background and objective of this set of rules, however, could shed new light in understanding this rather unprecedented focus. One of the important objectives of this set of rules was to ensure that the interests of these firms are protected.[10] Even though the rules did not identify the specific entity or activity being protected, the former includes individuals, such as managers and creditors, as well as privately-owned entities. In light of this, it is reasonable to interpret such a provision as intending to make sure that the assets of the firm being divided were protected against any potential abuse by managers and creditors, which

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[6] For an overview of Chinese law on business organization including company law, see J. WANG, Company Law in China: Regulation of Business Associations in a Socialist Market Economy, Northampton, Masschusetts, USA, 2014.

[7] Art. 44, 民法通则 (The General Principles of Civil Law), effective as of 1 July 1987 and latest amendment effective as of 27 August 2009.

[8] All-citizen-owned Industrial Enterprises Law (《全民所有制工业企业法》, the Enterprise Law), effective as of 1 August 1988 and last amendments effective as of 27 August 2009. See Art. 18.

[9] Art. 20 Enterprise Law, *supra* note 8.

[10] Art. 1 Enterprise Law, *supra* note 8.

diverged dramatically from the conventional wisdom on the purpose of the statutory provisions on corporate division.

2. 1994 Company Law: Veto Rights Of Creditors and the "Lemon Market"

The first Company Law, effective as of 1994 *(the 1994 Company Law),* provided step-by-step instructions to companies to effect a corporate division. What was distinctive about the 1994 Company Law with respect to corporate division is that each individual creditor was able block the potential division at any time before the division transaction was completed: "a company shall not go through division if it fails to repay its debt or fails to provide corresponding collateral".[11] A company was required to publicly notify creditors of the potential division three times within a 90-day period, with the first notification to be made within 10 days of the decision. Each creditor was entitled to require, to his or her satisfaction, early repayment or collateral to secure their payment in the future. Since no time limit was imposed upon this negotiation between creditors and the debtor company, creditors could potentially drag the whole process out and essentially veto the potential transactions.

Meanwhile, the cost to companies for by-passing creditors' veto rights proved rather low. Under the 1994 Company Law, creditors' claims shall be repaid by any entities surviving the division according to the agreement between creditors and the relevant entities.[12] Presumably, if the creditor never received notice of the division in advance or never reached an agreement with respect to the company being divided or any surviving corporations, such creditors' claims would fall by the wayside, because the 1994 made no provision for the corporation division being actually completed as a legal matter without every creditor reaching an agreement with the surviving entities. The prohibition of division without sufficient collateral or repayment stipulated under Art. 185 1994 Company Law failed to provide any meaningful remedies for creditors, because it did not provide any clue as to what would happen if the corporate division was officially completed without affording creditors proper notice or the chance of repayment or settlement.

Under the 1994 Company Law, once the company claims that it has repaid or settled all creditors' claims, it could go ahead submit a final report of division to the company registrar (the State Administration of Industry of Commerce, i.e. SAIC). Once the final report was approved by the SAIC, as well as the relevant regulatory authorities if the corporation being divided was a state-owned enterprise, the transaction would be completed and the relevant companies could publicly announce the completion of the corporate division. During the course of this exercise, no one had the authority or practical

[11] Company Law of China (《公司法》), effective as of 1 July 1994. See Art. 185.
[12] Art. 185 GPCL, *supra* note 7.

means to check whether the list of creditors' claims provided by the company to accountant and the company registrar was exhaustive and in good faith. Not being able to win a fight on substantive grounds, it was hence natural that most of the litigation brought by creditors challenging corporate divisions were based upon alleged procedural defects, such as the lack of proper notice or a proper opportunity to negotiate repayment or collateral. Even if the creditors could patiently wait, and afford the costs of winning their claims, the enforcement of such judgments could well be an independent challenge.[13]

The combination of the high *ex-ante* cost of creditors' veto rights and the low *ex-post* sanction and deterrence apparently created a "lemon market".[14] A "good" firm would have to face enormous amount of uncertainty and litigation risks, no matter how hard it tried to notify creditors and settle with them before the completion, because no one had the authority or practical measures to ensure that all creditors were satisfied and wouldn't raise law suits with respect to alleged defect in the exercise. A "bad" firm meanwhile, has extremely strong incentives to simply deny the exercise of veto rights of creditors and to face potential litigation after the completion of the corporate division. It is hence only natural that courts were flooded by creditors claiming fraudulent and defective corporate divisions.

Following the passage of the 1994 Company Law, existing firms which were not incorporated went through various restructures, where new companies were incorporated according to the Company Law, as amended from time to time, and the assets of the unincorporated firms were moved into these newly incorporated companies (the *Incorporation Restructuring Transactions*[15]). Most of these restructured firms were SOEs, because investment had long been regarded as a privilege scarcely available to individuals and private entities. Accordingly, a set of judicial interpretations was issued by the court, coming into effect as of 2003 to address various legal issues emerging in the Incorporation Restructuring Transactions *(the Restructuring Rules)*.[16] The Restructuring Rules introduced enormous uncertainty for both parties

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[13] For a comprehensive empirical account of the delay in the court and difficulty in enforcement in Chinese court, see Q. JIANG, Court Delay and Enforcment in China (Wiesbaden 2006).

[14] G. AKERLOF, The Market for 'Lemons': Quality Uncertainty and the Market Mechanism, Quarterly Journal of Eocomics 84 (1970) 3.

[15] The designated term is Qi Ye Gai Zhi (企业改制). It is regarded as a process of reforming SOEs by way of "incorporation without privatization", see N. HOWSON, Protecting the State from Itself? Regulatory Intervention in Corporate Governance and the Financing of China's "State Capitalism", in: Liebman/Milhaupt (eds.), Regulating the Visible Hand?: The Instituional Implications of China's State Capitalism (New York 2015).

[16] Secs. 12 et seq. in The Supreme Court Rules on Several Issues with respect to Adjudicating Civil Disputes regarding Incorporation Restructuring (最高人民法院《关于审理与企业改制相关的民事纠纷案件若干问题的规定》(法释[2003]1号).)

and the court by essentially creating a new category of quasi-corporate division transactions. Accordingly, a new type of liability rule, which can be called "assets-specific joint and several liability" was created to govern these quasi-corporate division transactions. These rules and the corresponding judicial decisions have drawn enormous attention from commentators, which will be discussed in more detail under Section III.

3. The 2005 Company Law: Joint and Several Liability Without Creditor Veto Rights

Even though previous commentators never used the concept of the "lemon market" to describe the consequences of the corporate division regime under the 1994 Company Law, legislators and the court apparently responded to the ill-designed incentive structure. However, the initial fix did not come from the amendment to the 1994 Company Law. Instead, a fundamental change was put into effect under China's first Contract Law, which came into effect in 2000. According to Art. 90 2000 Contract Law, all entities surviving a corporate division transaction shall be severally and jointly liable for the debt of the divided corporate entity.

The amended Company Law of China, which took effect as of 2005, finally settled the several-and-joint liability regime, among other major changes to the legal regime of corporate division (Art. 177). The Company Law of China was further amended in 2013, but the legal regime on corporate division remains intact.

Under the amended Company Law effective as of 2005, the veto rights of creditors are replaced by a default joint and several liability for all surviving companies for the debts of the company being divided, unless otherwise agreed with the creditors. Such a liability rule apparently closed the gap for creditor protection that existed under the 1994 Company Law. Even though creditors can no longer block a transaction, in essence, the 2005 Company Law provided stronger protection to creditors. It is also of note that the new rule shows due respect to and provides strong protection of the freedom of contract among parties, creating valuable space for parties to freely negotiate arrangements that best serve their interests. The 2005 Company Law further reduced the administrative burden of corporate division by requiring creditors only be notified once instead of the three times specified under the old regime. Such an approach combines a relatively low procedural threshold for carrying out a corporate division and a high level of ex-post protection of creditors. The rules and procedure provided are very clear and straightforward. It was regarded as conforming to statutes in other major jurisdictions, such as Germany, France and South Korea, which was regarded as having a better balance between the needs of efficient division transactions and the protection of creditor interests.[17]

4. Dissenting Minority Shareholders: The Appraisal Right

For the first time in China, the 2005 Company Law addressed the protection of minority shareholders in corporate division transactions (Art. 75). Corporate division requires a special resolution of shareholders to approve, which is defined as being equal to or more than two thirds of the vote of shareholders present at the relevant shareholders meeting. Shareholders who voted against the potential division had no remedy under the 1994 Company Law. Following the amendments to the Company Law in 2005, these dissenting shareholders are entitled to an appraisal right: entitled to exit the company by requiring the company to buy their shares at a "reasonable price". Seemingly a strong statutory protection for dissenting shareholders, it has proven extremely hard to exercise in practice, due to the difficulty in determining what counts as a "reasonable price", given that neither the company law nor the Supreme Court provide any further guidance. A dissenting shareholder must first try to reach an agreement with the company with respect to the share purchase. However, if he fails to reach an agreement with the company within 60 days of the resolution of the potential corporate division, he may bring a law suit to compel the company to purchase its shares at the claimed reasonable price, provided that such law suit was brought about within 90 days of the resolution approving the potential corporate division. (Art. 74, 2013 Company Law).

The critical question remaining open is how to determine the appraisal value of the shares held by the dissenting minority shareholders. For close corporations, it presents a substantial challenge given that the shares of such companies have no open market. Judicial practice varied in China when courts adjudicated the appraisal rights of minority shareholders under such circumstances. A common practice that has emerged has been to appoint a licensed independent accounting firm to provide an appraisal value, even though the specific accounting methods chosen by the appraisal firms may be different. In addition, neither the controlling shareholder nor other decision-making entities, such as the board of directors, is under any explicit fiduciary duty in proposing and implementing the transactions of corporate division. Therefore, none of these individuals or entities would be held personally liable towards creditors.

III. Asset-specific Joint and Several Liability for Incorporation Restructuring: Formalistic or Substantial Approach?

Corporate division transaction necessarily involves splitting assets of one company and moving some of these assets to other companies. When the

[17] LOU, *supra* note 1, 28.

assets of a company are abundant, such as for public corporations, creditor protection is a minor concern. Various internal controls and external scrutiny that a public corporation is facing in the capital market also make it harder to conceal any hidden agenda against the interests of creditors, such as the move of the stock price and credit-rating. For a close corporation, however, the danger is much higher for corporate insiders to engage in self-interested transactions at the expenses of outside creditors. It is hence natural for the law to focus on protecting creditors' interests in the case of corporate division transactions. This had the logical consequence of much relevant litigation in China being brought by creditors on the grounds of mistreatment resulting from insiders of close corporations engaging in dubious restructuring, including divisions of business entities and shuffling of assets among different corporate entities.

With respect to the Incorporation Restructuring Transaction following the promulgation of the Company Law in judicial practice, the Supreme Court of China created a modified version of the joint and several liability rule for certain restructuring transactions in China under the Restructuring Rules, which can be called "asset-specific joint and several liabilities". Under Article 6 and Art. 7 Restructuring Rules, the transferees of assets (including debts) in certain corporate restructuring transaction may be held jointly and severally liable for debts to the extent of the value of the assets acquired, unless otherwise agreed with the relevant creditors. These transactions were defined as consisting of two components: (1) a transfer of assets from one firm to another ((Zi Chan Zhuan Rang, 资产转让); and (2) acquisition by the transferor of shares in the transferee (zhuan tou zi, 转投资). These two components are commonly seen in corporate division transactions and there has been anecdotal evidence that this asset-specific joint and several liability was based upon exactly this similarity with corporate division transactions.[18] Such an interpretation resulted in an artificial category of quasi-corporate division transaction, where parties did not explicitly refer to corporate division but are still to be held jointly and severally liable to a certain degree: up to the value of the assets they acquired through such transactions.

Such a pro-active search for the "true intention" of the parties by court has been strongly criticized by one commentator as having subjected freedom of contract to too broad a judiciary discretion, hence destroying the expectations of the parties and the security of transactions.[19] This commentator further supported his argument with the fact that developed industrial countries have no such rule or practice.[20] Another commentator shared a similar view by

[18] PENG, *supra* note 1.
[19] PENG, *supra* note 1.
[20] PENG, *supra* note 1.

criticizing such judicial interference for failing to reduce disputes and for creating enormous uncertainty and legal risks for parties in the market.[21]

To be fair, the danger of abuse of external creditors for the benefits of corporate insiders does exist for close corporations. It is hence completely understandable for the court to try to grant more protection to creditors by drawing a close analogy between a given transaction and a corporate division hence extending the liability of a company towards its creditors. Given the lack of any statutory definition of these quasi-corporate divisions and the thin lines that the courts need to draw in reclassifying the transactions, the ultimate task of the court is to weigh the interests of shareholders and creditors on a case-by-case basis. The mistakes made by the court or corporate board members are usually impossible to reverse, and where it is possible, it is extremely costly to unwind the consequences of corporate transactions. The chilling effect on investment caused by judicial and regulatory decisions is also well recognized even in the most developed market and legal system. This being said, the exercise of judicial discretion is inevitable, even for highly complicated and sophisticated corporate transactions. However, certain institutional features of the court in China made such judicial activism particularly vulnerable to criticism. First of all, the Chinese court has not formally recognized the value and importance of judicial deference to the business judgment of the board members and other experts.[22] The court is hence more likely to jump ahead, replacing the interpretation and analysis proposed by parties with its own understanding and justifications. Secondly, judicial decisions and opinions are relatively brief and lacking detailed analysis, which makes it hard for both the parties and outsiders to understand the exact reasoning behind the decisions and to follow the rationale into the future. Such a low level of transparency increases uncertainty for parties in decision-making, substantially increasing the cost and legal risks for parties.

IV. Division of Public Corporations: Selective Regulation by CSRC?

While litigation with repsect to division of non-listed corporation is common, division of listed-corporation is very rare in China.So far, only one company listed in the A-share market has completed a corporate division, which was in February 2010. The second attempt by a public corporation finally announced its failure in June 2016. Given the volume and value of corporate division transactions in other major stock markets in the world, such as Hong Kong,

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[21] LOU, *supra* note 1.

[22] Z. HONG/S. YIFENG, The Court Adjudication Standard for the Duty of Care of Corporate Directors, Oriental Law, 2013, No. 1.

where many listed companies are either incorporated in China or have their core assets and operations in mainland China, it is very puzzling as to why there are so few division of listed corporation in mainland China. Existing explanation to this rather puzzling phenomena focuses on the fact that there are too little rules and guidance for such transactions in law and the lacking of operational details for division of listed-corporation seems to have constitute a barrier for carrying out such transactions.

However, it seems hard to believe that the economic rationale underlying corporate division transactions in other major stock markets is completely irrelevant to players in China's domestic stock market. In addition, completed transactions of public corporations such as corporate divisions are lucrative for financial advisors and service providers in other major stock markets, and it seems hard to believe that these parties in China's stock market simply did nothing but wait for legislators or the court to instruct them on how to design and conduct such transactions. For example, in the spin-off IPO of PCCW in Hong Kong, the issuer raised 9.3 billion HK-Dollars,[23] which is more than 730 million US-Dollars, a percentage of which went to investment banks, lawyers and accountants. If we take into account the fees payable with respect to the assets transfer and financing arrangements associated with division transaction, the amount of fees to be earned by intermediaries and service providers would be even more notable. In fact, we have seen market intermediaries and service providers taking initiatives and active roles in supplying solutions to existing gaps in law, such as the exercise of listing the shares of China's SOEs in overseas stock markets, including that of Hong Kong.[24] Finally, it would neither be too hard or too costly to simply copy and apply the detailed rules currently effective in other stock markets. For example, the Hong Kong Stock Exchange issued a complete set of rules as well as detailed practice notes on divisions of corporations, which are available in both Chinese and English.[25]

We hence need a more nuanced explanation for such a rather puzzling gap in the market. Given that these corporate division transactions are generally regarded as increasing shareholder value, we also need to provide solutions to facilitate these transactions, which also requires us to first understand the real barrier that blocks these transactions from happening. One potential answer

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[23] See the report on South China Morning Post dated 11 November 2011: <http://www.scmp.com/article/985789/pccw-spin-raises-hk93b-global-ipo>.

[24] R. CHEN, Market Solutions to the Information Challenge of China's Legal System: Overseas Listing of State-owned Enterprises, 1 Peking University Law Journal (2013) 134.

[25] Under the relevant law and rules in Hong Kong, the term describing corporate division is spin-off, see Rule 1.06 of the Listing Rule of Hong Kong Stock Exchange and Practice, Note 15, issued by HKSE.

arises in relation to the rather opaque and sometimes even unlawful fashion that the stock market has been regulated.[26]

1. Facts: A Comparison of the Success and the Failure

So far, we have witnessed attempts by two public corporations to carry out a corporate division under the 2005 Company Law and the relevant securities regulation. One has been successful and the other failed, even though both seemed to have represented text-book circumstances where a corporate division might be the best solution.[27]

Dong Bei Highway (东北高速, Dong Bei Gao Su, stock code: 600003)) was listed on the A-share market in China as a state-controlled regional champion. Highway assets from two neighboring provinces in North-eastern China were consolidated into one corporate entity, seemingly to ensure that the size and revenue of the listing vehicle would meet the stringent criteria set by the regulator approving listing of companies in China's A-share market. However, these two parts of similar highway assets remained relatively separate and independent in various aspects, including management teams and development strategies. Meanwhile, the two groups of founding shareholders who obtained equal shares based upon their respective contribution of highway assets to the listing vehicle continued to enjoy equal share of control after the corporation was listed. This dual corporate control and management structure resulted in serious deadlocks at all levels of decision making: management, board of directors and shareholders. For a public company with an ongoing obligation of disclosure, the internal disagreement and chaotic decision-making processes of Dong Bei Highway was never a secret to its public shareholders and the broader public. Many of its shareholders hence voted with their feet, driving down the stock price of Dong Bei Highway and keeping the price depressed. To split the assets as well as the management team proved a perfect, and probably the only, sensible solution to resolve the standstill, which would be beneficial to all parties involved. The corporate division went through according to the Company Law and the rules issued by the CSRC.

In less than a year, in February 2010, CSRC approved the proposal[28] and the corporate division was announced as completed by the Dong Bei Highway: Dong Bei Highway was delisted from the market and two new corpora-

[26] For an excellent example, see N. HOWSON, Enforcement without Foundation: Insider Trading and China's Administrative Law Crisis, American Journal of Comparative Law, 60 (2012) 955.

[27] The information about these two cases was collected from public announcements made by the two companies respectively on the official websites of Shanghai Stock Exchange: <http://www.sse.com.cn/disclosure/listedinfo/listing/>.

[28] See the announcement made by CSRC: <http://www.csrc.gov.cn/pub/zjhpublic/G00306207/201011/t20101104_186350.htm>.

tions (Long Jiang Jiao Tong (龙江交通，stock code: 601188) and Ji Lin Highway (吉林高速，stock code: 601518)). The two surviving corporations subsequently issued IPOs. This corporate division proved the conventional wisdom in better aligning assets with assets-specific human capital. It received a warm reaction from the market: the share prices for both newly listed companies rose by about 50% on the day immediately following the IPOs.[29]

Ironically, Jianfa (建发股份, Stock code: 600153), the corporation which failed in its attempt to carry out a corporate division, represents an even stronger case where corporate division was likely to be an optimal solution. Jianfa had always had two lines of business ever since it was listed: real estate development and logistics. Each of the two distinctive lines of business was managed by a separate management team, involving completely different sets of expertise and development strategies. Over the years following its IPO, the two lines of business became even more divergent and clearly justified the case for a split. To divide the corporation according to the different lines of business was apparently likely to enable each of the management teams to be more focused, creating a potential to create more value for shareholders. The economic justification for dividing the firm seemed quite apparent, hence the independent board of directors, advised by independent financial advisors, approved the transaction unanimously. The state-owned assets regulator also approved the transaction in October 2015. Jianfa then confidentially announced the proposal and the relevant approvals and suspended the trading of its shares in 29 June 2015, apparently determined wait for the completion of the proposed corporate division. But the completion never occurred. On 9 June 2016, almost a year after the initial suspension in the trading of its shares, Jianfa announced its decision to stop pursuing the proposed corporate division[30] and the trading of its shares resumed on 14 June 2016.

It is of note that there seems one more economic justification for dividing Jianfa, as compared with Dong Bei Highway. The division of Dong Bei highway involved altogether four (4) transactions: corporate division of the listing vehicle, the delisting of the existing corporation (Dong Bei Highway) and the two IPOs of the newly incorporated entities getting highway assets from the corporation being delisted. In the proposed division of Jianfa, in contrast, no delisting was required. The current listed company will continue to exist as a public corporation, and a new corporation undertaking one of the two lines of business would complete an IPO. The division of Jianfa, if successful, would have saved the trouble of delisting and gone through only two

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[29] <http://www.mof.gov.cn/pub/czzz/zhongguocaizhengzazhishe_daohanglanmu/zhongguocaizhengzazhishe_kanwudaodu/zhongguocaizhengzazhishe_caiwuyukuaiji/4765/6456/464/201108/t20110804_584667.html>.

[30] See the announcement made by Jianfa dated 9 June 2016: <http://www.sse.com.cn/disclosure/listedinfo/announcement/c/2016-06-09/600153_20160609_2.pdf>.

instead of four transactions: a transaction of corporation division and an IPO. In total, Dongbei Highway doubled the number of transactions and had to go through the transaction of delisting, which is costly and complicated for everyone including the regulator.

2. The Puzzle of Selective Approval by the CSRC

The regulatory decision in approving the first-ever corporate division by the CSRC was warmly praised by various commentators in the market and CSRC also announced its intention to draft rules on the division of public corporations, giving high hope in the market that more transactions of corporate division would soon occur and be approved by CSRC. However, Jianfa's attempt to obtain approval from the CSRC apparently failed. So far, CSRC has not issued any rules as a follow up to its decision in approving the Dong Bei Highway.

Jianfa attributed its decision to halt the process to the fact that "the proposed transaction is unprecedented (无先例), hence necessarily complicated; even though professional institutions and experts attempted to prove the feasibility of such a transaction, it proved premature to proceed."[31] Communication with the CSRC was not mentioned in any of Jianfa's public documents, even though verification by the CSRC was listed as one of the conditions of completion for the proposed corporate division. The uncertainty of obtaining sign-off by CSRC was not unexpected. In the statement made by CSRC about Dongbei Highway, CSRC explicitly stated that the corporate division of Dongbei Highway shall not be followed as a precedent.[32] It is hence rather clear that the reason Jianfa gave up the attempt is due to its failure in obtaining approval from the CSRC.

It is therefore worth asking why the CSRC approved one rather quickly but apparently refused to grant approval to the other case, which seemed more economically compelling. The lack of corporate division either successful and attempted may well be attributed to the expectation that CSRC would not grant approval. According to current commentators, one possible reason might be that CSRC was afraid to make a decision in the absence of guidance or detail on when to allow a public corporation to divide from legislators or the court. This does not seem realistic, as corporate law and securities regulations regarding corporate division in China did not change substantially between the year of 2010, when the CSRC approved the division of Dongbei Highway and in the year of 2016, when Jianfa gave up its attempt to divide

[31] Sec. 3 *supra* note 31

[32] See the statement made by the speaker for CSRC in an interview by the Securities Time (证券时报) dated 19 March 2010, available at: <http://finance.people.com.cn/GB/11174141.html>.

itself. During this period of time, the law did not undergo any substantial change, yet CSRC seemed to have reacted as if the opposite were true.

In Section V of this Paper, we will explore the possible reasons that may explain why CSRC is so reluctant to grant approval for corporate division by public corporations in the A-share market.

V. Sub-optimal Regulation of IPOs

One set of reasons why CSRC approved the Dong Bei Highway division but not the Jianfa proposal lies in the sub-optimal regulation of IPOs in China. Under this regime, CSRC faces conflicting objectivesin the IPO regulation and the regulation of corporate division. Meanwhile, the regulatory objectives of CSRC and SASAC were going in opposite directions with respect to their respective regulation of the price attached to the assets moved from one entity to another in a setting of corporate division. While CSRC and SASAC need to take time to elaborate, communicate and made decisions in reconciling these conflicts, it is too time-consuming and costly for public companies and potential investors to wait. Such an exercise necessarily creates enormous uncertainty, which is likely to be too costly for market players to bear.

The argument proposed here consists of two components: (1) two critical aspects of a corporate division transaction of a public company need to be approved by the CSRC, which are self-defeating; and (2) where the proposing public company is an SOE, the corporate division transaction is also subject to discretionary approval by the state-owned assets administration authority, whose regulatory objective runs precisely contrary to CSRC's approval regime. Before the internal conflicts of various policy goals of CSRC and the conflicts between regulatory approval of CSRC and SASAC are resolved, the corporate division of public companies is likely to remain rare and exceptional in China's domestic stock market.

1. CSRC Approval Regime for IPOs

At the very beginning of the establishment of the national stock market and the regulatory regime, the central objective of the market and regulation was to help channel funds from the general public to SOEs. Traditionally, SOEs in China had two major sources of funding: direct funding from the government in the forms of subsidies, stimulus funds and tax exemptions and loans from banks, which were all owned and controlled by the state. Regional SOEs relied upon loans from regional branches of banks and central SOEs received loans from the headquarters of the banks located in Beijing. This practice was regarded as extremely unhealthy for banks, the financial market and public finance. Starting from early 1990's, Premier Zhu Rongji started a profound

reform to make banks more independent from provincial and municipal government and to turn banks into profit-making commercial entities. As a result, local government and regional SOEs could no longer use regional branches of banks as their bursary to obtain funding.

To maintain the livelihood of regional SOEs, as well as their hundreds and thousands of employees, SOEs needed alternative funding channels. One solution which emerged then was to allow SOEs to raise funds from a stock market that could attract investment by the massive individual investors and other entities in China. To serve this rather peculiar objective, among others, two domestic stock exchanges were officially opened in the year of 1990: the Shanghai Stock Exchange and the Shenzhen Stock Exchange, following a crack down and closing of quite a number of regional trading markets. In October 1992, CSRC was officially established as an independent regulator of China's domestic stock market. By April 1994, CSRC consolidated all the regulatory power of the securities market and started reporting directly to the State Council of China.

Because of this rather unique regulatory goal attached to the stock market in helping SOEs raising funds, an IPO in this market has long been regarded as an exclusive privilege of the SOEs. It is hence natural that a large majority of public corporations were SOEs and many remain being controlled by the state. Both of the cases discussed in this paper, Dongbei Highway and Jianfa, are SOEs. Furthermore, since not all SOEs were to be allowed to have IPOs in the market, a selection mechanism was put into place for the privilege. With the domestic market gradually opening to non-state investors, privately-owned enterprises were also allowed to launch IPOs in the A-share market. The IPO regime controlled by CSRC hence evolved over time in response to this change, a response which can be divided into roughly two stages: the stage of approval and the stage of verification.

a) Regulation of IPO: The long line of IPO applicants

In the initial years of the stock market, ranging roughly between 1993 through to 1995, the CSRC had no power in setting the selection criterial or conducting the selection.[33] Every year, a central government committee, the predecessor of CSRC, formulated an annual cap on the number of potential IPOs and a few general principles in allocating the capped quotas across the whole country. The quota was then distributed, through the ministry in charge of planning and investment, to local governments and a few central ministries depending on various considerations, such as the number of SOEs, the number of SOE employees and the general population, the weight of certain in-

[33] See the Tentative Rules on Stock Issue and Stock Trading (《股票发行与交易管理暂行条例》), effective as of 22 April 1993.

dustries in the overall regional economy, etc. The power and responsibility of selecting the "winning candidates" then fell to the local government and a number of ministries. The list of winning candidates was finally decided by the central planning and investment authority and handed over to the CSRC. CSRC had no power or responsibility in assessing the merit or suitability of each IPO candidate proposed by local government or other ministries in the central government. CSRC's review of the application materials was more or less formalistic.

Since 1996, CSRC gained more power not only in setting the cap and the overall number of IPO opportunities, but came to be directly involved in allocating those slots to specific provincial governments and central ministries. To prevent "losing companies" from appearing in the stock market and preventing misbehavior of public companies in the future, CSRC has been extremely cautious in assessing the merits and suitability of the candidates proposed by the provincial government and the central ministries, so as to avoid exposing itself to criticism. Given the constraints on staff and budgets, both the number of IPOs and the overall size of funds raised in IPOs were very limited. As a functional matter, such a strict ex-ante screening mechanism from time to time failed in its originally designed objective – screening cannot ensure sound performance of public companies following the IPOs. CSRC hence was under constant pressure to reform the IPO approval regime.

b) Stage of IPO regulation: Verification Regime

Following the passing of China's first Securities Act in 1999, the regulatory regime for IPOs underwent a major change towards a regime of verification instead of approval. The power in selecting candidates was shifted from CSRC to pre-licensed and designated investment banks. This new regime was often described as a "channeling system" (通道制) where each designated investment received a given number of channels for selecting candidates for IPO. But no caps were set over the total number of IPOs and the overall size of the fund to be raised in the IPOs. However, there is an apparent imbalance between the power and the liability of the investment banks and abuses of such an imbalance appeared in the market and drew serious critics.

To address this imbalance, a new regime was put into place in early 2004.[34] Under this new regime of "sponsorship" (保荐制), the investment banks in charge of selecting IPO candidates face much more responsibility and liability, together with the auditors and lawyers serving the IPO candidate and the sponsor. A new wave of liberalizing IPOs followed, especially following the liberalization of the rules for incorporating new companies. On

[34] Tentative Rules on Sponsorship for Securities Issues (《证券发行上市保荐制度暂行办法》), effective as of 1 February 2004.

numerous occasions, senior officials of CSRC and CSRC's supervising authorities, including the Chinese Communist Party leaders, had stressed the importance of making IPOs a more market-based exercise. In 2009, a final step was taken to further reform the IPO regulation regime to further reduce government interference in the selection of IPO candidates and details of the IPOs. In particular, once an IPO application is verified, the issuer is free to launch the IPO any time within 6 months of the date of verification. In 2013, a major policy initiative issued by the Communist Party of China specifically stipulated that the IPO regulation regime in China would migrate from the verification regime towards a registration regime.[35] So far, the details of this new regulatory regime remain to be clarified, but the IPO regulation regime is clearly moving towards a more market-oriented model.

In addition to the standards set out in China's Company Law and the Securities Law, CSRC, together with the stock exchanges, issued elaborated rules about the qualifications and requirement that an IPO candidate must meet. Thus, each applicant for IPOs needed to file detailed information in a designated format for detailed review by CSRC. Such a discretionary approval regime has been criticized on multiple grounds. Given the substantial work load and size of the staff of CSRC, the review process is necessarily far from ideal in terms of speed, resulting in a long line of applicants. This problem has been exacerbated by the fact that in China's stock market, within the 20-year period between July 1994 through to November 2015, IPOs were suspended nine times for various lengths of time with an accumulated suspension period of about 36 months.[36] The registration system remains up in the air and a long line of applicants of IPOs are still waiting outside CSRC's door: as of February 2016, more than 800 companies had filed applications for approval of an IPO by CSRC but were still waiting for response. Given that the number of listed companies in the A-share market is about 3,000, the waiting line of applicants for IPO is extremely striking.[37]

The limited supply of IPOs and essentially unlimited supply of funds for equity investment kept pushing up the IPO price to historically high levels, with an extremely high P/E ratio. The unhealthy IPO price induced many rather risky and strategic activities in the market, such as illegal trading of the pre-IPO shares and undue allocation of IPO subscription rights to insiders of the issuers. One measure that the CSRC took as a response was to implicitly

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[35] See the "Decisions of the Central Committee of the Communist Party of China Regarding a Few Critical Issues in Advancing the Comprehensive Economic Reform (《中共中央关于全面深化经济改革若干重大问题的决定》), issued by the Central Committee of the Communist Party of China on 15 November 2013.

[36] Compiled by the author based upon date collective from the official website of CSRC and other sources.

[37] Data collected and compiled by the research assistants to the author.

impose a cap on the IPO price, in the form of verbal guidance given to market players in training sessions.[38]

In all, the regulation of IPOs by CSRC resulted in two things that are relevant to this Paper. One is the extremely long line of applicants for IPOs and the other is an implicit cap on the IPO price. Both aspects of the IPO regulation have enormous implications for CSRC granting approval for a corporate division, as one of the many types of major transaction of a public corporation that are subject to CSRC's scrutiny.[39]

2. *CSRC Approval of Major Transactions: Potential IPO Queue Jumpers*

To allow any public company to carry out a corporate division, CSRC would also need to approve the IPOs of some of the surviving entities, which essentially allows these companies to jump ahead of the long line of IPO applicants. CSRC is not prohibited by any law from granting such an approval allowing companies to cut in line. However, such a decision would necessarily affect the integrity of the current IPO regulatory regime and CSRC is likely to feel pressured to provide sound justification, if any. If such decision is made, it would expose CSRC to public scrutiny and the risks of failing to provide sufficient justification. Given the central position of the IPO regulation in the overall responsibility of CSRC, especially compared with the regulation of major transactions including corporate divisions, it is completely rational for CSRC to be extremely reluctant to allow companies to jump up the line of IPO applications.

Under this explanation, if there's enough pressure and justification for CSRC to allow candidates to jump ahead of the line, CSRC would approve corporate division transactions. Dongbei Highway seems to be just such a case. The standoff among controlling shareholders and management of Dongbei Highway made it a scar in the stock market, attracting constant protest from public shareholders. To allow a corporate division would put an end to this messy situation for CSRC and turn one losing company into two shining new companies with rising stock prices. In this case, the probability of having a "successful split" is overwhelming. The assets were packaged into the IPO vehicle last minute and have always been managed separately. Moreover, the various provincial governments had been lobbying for a long time to separate the assets and management. Even if the decision to approve the corporate division turned out to be wrong, the provincial governments, instead of CSRC, were to be the ones to take the blame. In contrast, the prospect for Jianfa was much less certain. The two

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[38] R. CHEN: Legal Informality and the Human Capital Development in China, Ch. 8 in Liebman/Milhaupt (eds.), Regulating the Visible Hand?: The Instituional Implications of China's State Capitalism (New York 2015).

[39] Art. 62 (9) Securities Act of China, passed in December 1999 and last amended in August 2008.

lines of business were developed later, making it difficult for CSRC to be sure of their prospective success. Except for the fact that the local state-owned assets administration approved it, there has been no evidence showing any other government agencies taking the lead in lobbying for the case. Therefore, CSRC was completely exposed in this case and would necessarily take full responsibility for the future performance of two public companies.

3. Inter-Agency Conflicts: Conflicting Regulation of IPO Price

CSRC has long been reported to engage in various activities in maintaining the stock price of public companies. To prevent a sudden jump in stock price immediately following IPOs, CSRC has been reported to have imposed an implicit cap on the P/E ratio of IPOs.[40] The same rationale would also apply in the approval of the price of an IPO in the context of a corporate division and the approval of the major transaction of assets from the existing public company to a newly incorporated company. To ensure that public shareholders in the corporations have a new IPO, CSRC would resist any attempt to inflate the value of the assets being transferred. In total, CSRC would want to put a downward pressure on the price of the IPO and the assets transfer in a corporate division transaction. Such an effort, however, would go directly against an upward pressure on the same price from another regulatory authority: the SASAC.

The policy goal of SASAC has been to maintain and increase the value of state-owned assets. In case of selling major assets by an SOE to a none-SOE or another SOE with less share of the state, SASAC imposed a floor: the price for the sale shall not be less than the “net-asset value” of the assets to be sold, and the higher the better. SASAC therefore won’t approve any proposed corporate division with a price lower than the floor price of net assets value, and tries to push up the price as far as it can. When facing pressure from CSRC to push down the same price, we would expect SASAC to engage in a subtle but persistent negotiation with CSRC, likely indirectly through the public company and professional advisors.

The process of inter-agency negotiation is necessarily opaque, non-transparent and time-consuming. We can’t speculate more on this exercise due to a lack of publicly available information. But what’s certain is that the result of such negotiations would be extremely costly and hard for parties to predict. Even if the parties are willing to try, theyare likely to incur substantial costs in lobbying both regulators and the opportunity costs could be enormous. If we take into account the potential costs of rent-seeking, the whole process becomes even more costly. It is hence reasonable to expect that market players will be deterred by such high degree of uncertain and high potential costs.

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[40] CHEN, *supra* note 38.

VI. Conclusion

We shouldn't forget the distinction between close corporations and public corporations, the shares of the latter are traded in public market. Such a distinction would help inform the different issues in the area of corporate divisions.

In the war between corporate insiders and outside creditors, as presented in corporate division transactions conducted by close corporations, the court needs a simple and low-cost rule to achieve the goal of creditor protection. Too many choices in the form of liabilities for companies would simply lead to an endless game of cat and mouse, and prove extremely costly for everyone. The joint and several liability regime should be sufficient in ensuring that the interests of creditors are fully covered and won't block efficient corporate division.

Corporate division of listed companies happens everywhere, but is barely seen in China's stock market. We should resist the temptation to simply attribute the issue to the lack of legal rules that provide operational details and stipulate the legal liabilities of the parties involved. Instead, we must make the effort to understand how the legal and regulatory institutions in different markets diverge and how this difference (if any) may have substantive impact on the volume and structure of these transactions. In this Paper, we have demonstrated that the distinctive features of the IPO regulatory regime and the regime of state-owned assets in China have contributed to the absence of corporate division transactions in the stock market in China.

Another lesson that we should learn from the above analysis relates to the relationship between the law and the development of market. On one hand, law matters to the market. But the way it affects the market can be indirect and complicated, sometimes through links hidden among seemingly irrelevant areas of law and through the practice of courts and regulatory agencies. On the other hand, in terms of the causal relationship between law and the market, the law is not necessarily able to lead to the creation and expansion of a market. When the market demands a new law, the hurdle may not lie in the law-making process, but lies in the resistance of regulatory authorities, which have multiple goals and agendas within their sphere of regulation.

Statutory Corporate Divisions in Korea

Hyeok-Joon Rho[*]

I. Introduction 45
II. Types of Corporate Division Under the KCC and the Current Situation 47
 1. Types of Corporate Division Under the KCC 47
 2. Current Situation and Practices 49
 3. Interim Conclusion 52
III. Issues Regarding Shareholders in Dividing Companies 52
 1. Overview 52
 2. Appraisal Remedy in Statutory Corporate Division 54
 3. Disproportional SRD 55
 4. CRD v. Setting Up a New Company by In-kind Contributions 57
 5. SRDs That Create Pyramidal Structure Using Treasury Shares 58
 6. Sub Conclusion 60
IV. Issues Regarding Creditors in Dividing Companies 61
 1. Joint and Several Liability 61
 2. Contingent Liability and Its Reimbursement 64
V. Concluding Remarks 66

I. Introduction

The statutory corporate division regime under the Korean Commercial Code (KCC) was adopted in 1998. Corporate division, the reverse concept of M&A, serves to downsize corporate business. While M&As pursue the synergy effect, corporate divisions are executed to seek a so-called *senergy* (i.e., separate + energy) effect: by eliminating inessential parts of the business, a company may concentrate its resources on core business, achieving specialization and strengthening its expertise. Other than the statutory regime, there have been various non-statutory devices for corporate division: a company may separate and transfer its assets and debts to a newly-established subsidiary; the sale of blocks of shares in a subsidiary may be classified as corporate division in a broad sense; and the revision of the KCC in 2011 allowed the in-

[*] The author is grateful to Jungyeon Choi for her assistance in putting together and checking the original data from currents reports posted at the Financial Supervisory Services (FSS).

kind dividend, enabling a U.S.-style spin-off. However, the statutory regime has been widely used since its adoption in Korea for various reasons.

First, compared to a business transfer, statutory corporate division is a much easier way to transfer assets and debts to other entities. Thanks to the universal succession doctrine, as in a statutory merger, designated assets and debts in a statutory corporate division plan shall be automatically transferred to the recipient company on the registration date of a corporate division. Thus, statutory corporate division is an efficient way to save the costs involved in individual transfers.

Second, unlike the sale of block shares or the distribution of an in-kind dividend, which presupposes the existence of a subsidiary, a statutory division enables a company to set up a company and distribute the shares of a new company at the same time. The KCC provides a convenient roadmap for a single company without a subsidiary to be divided into several entities.

Further, provided that the business is transferred in its entirety, a statutory corporate division is subject to special tax treatment. The major requirements are (a) the transferred business should be able to operate independently, (b) the assets and debts for the business should be transferred comprehensively, (c) the consideration of the transfer should be proportionally distributed to the shareholders of the dividing company, and (d) 100% (80% in the case of a merger-division) of the consideration should be the transferee company's shares (instead of cash).[1]

While a corporate division is a useful tool for boosting corporate reorganization, it might be misused to the detriment of minority shareholders or creditors. In the process of transferring valuable assets and issuing new shares, a company may manipulate the relative financial status of the stakeholders. Especially in Korea, some corporate divisions were designed at a corporate group level rather than a single company level. This paper aims to explore the major legal issues surrounding statutory corporate division devices from the viewpoint of the shareholders and creditors.

The remainder of this paper proceeds as follows. Section II lists the types of division stipulated in the KCC and the current practices and their features in Korea. Section III discusses the shareholders' viewpoints on issues such as appraisal remedy, disproportional division, and division using treasury shares. Section IV explores the issues concerning creditors in dividing companies by reviewing joint and several liability doctrines under the KCC. As a recent complicated issue, the section analyses reimbursement jurisprudence surrounding penalty surcharges imposed by the governmental agency. Section V then brings these together into concluding remarks.

[1] Art. 46 para. 2 of the Corporate Tax Act; Art. 82-2 of the Corporate Tax Act Decree.

II. Types of Corporate Division Under the KCC and the Current Situation

1. Types of Corporate Division Under the KCC

Under the KCC, the two major types of corporate division are simple-division and merger-division. Under a simple-division regime, a company divides its business undertakings into several companies. The original company may either be dissolved or remain. In a division-merger regime, a company splits a part (or parts) of its business and invests that part (or those parts) into another company (or other companies). Here, the original company may either dissolve or survive, and the invested part (or parts) may be either merged with another company (or companies) into a new company (or companies) or be acquired by another company (or companies). The main difference is that a dividing company in a simple-division regime may decide its division plan on its own; whereas, a dividing company in a merger-division regime must negotiate the conditions of the division contract with its counterparty. From the perspective of the corporate division's counterparty company, a merger-division resembles a (ordinary) merger. In both cases, the business of the target company shall be automatically transferred to the acquiring company on the registration date. The only difference is whether it acquires all of the target's business (ordinary merger) or only some of it (merger-division). Noting the similarity, the KCC mostly applies those provisions regulating a merger to a merger-division.[2] Figure 1 shows typical examples of a simple-division and a merger-division. In Korea, most dividing companies survive a simple-division or merger-division.

One may further classify statutory corporate divisions in Korea into two groups: shareholder-recipient-division (SRD) and company-recipient-division (CRD). The criterion depends on who receives the consideration (i.e., the newly issued shares from the transferee company). In an SRD, shareholders in the dividing company should receive the new shares; whereas, in a CRD, the dividing company is entitled to the new shares. Unlike spin-offs in the U.S., the process of allocating new shares to the dividing company and distributing them to the existing shareholders is not required in an SRD. The new company issues its shares directly to the shareholders in the dividing company. A CRD always ensures the dividing company receives 100% shares of separated undertaking. The result is the same as the set-up of a wholly owned new company through an in-kind contribution.

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[2] For example, the appraisal remedy (Arts. 374 para. 2, 522-3), short form merger (Arts. 527-2, 527-3), and procedures for protecting creditors (Art. 527-5) in a statutory merger shall also apply to a statutory merger-division (Art. 530-11 para. 2).

Figure 1: Types of Corporate Division (I): simple-division and merger-division

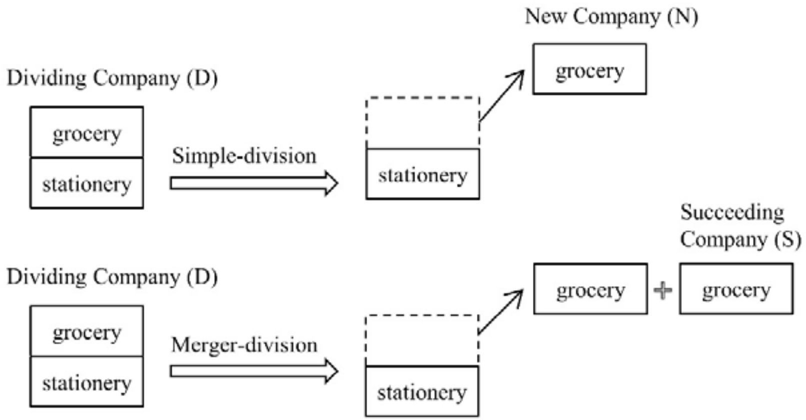

Figure 2: Types of Corporate Division (II): SRD and CRD

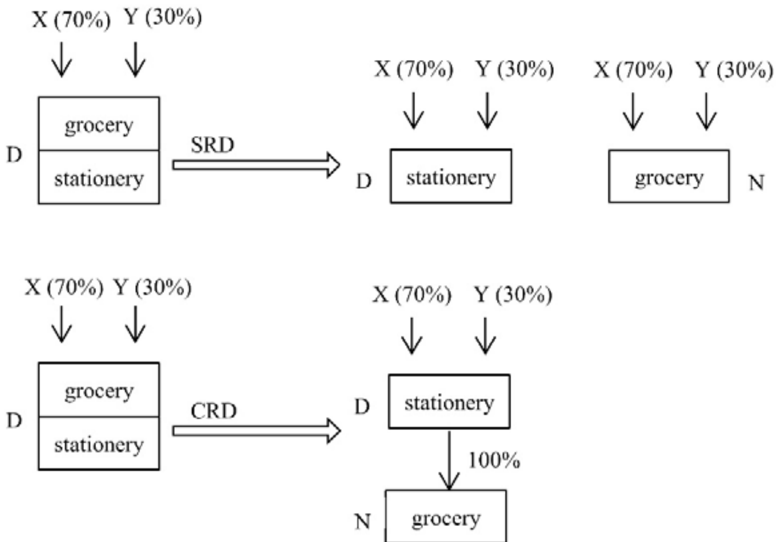

Figure 2 shows SRD and CRD executed by a single company (i.e., a simple-division regime). However, they may also be exercised in a merger-division regime, another company being the transferee. All combined, four types of statutory corporate division are available under the KCC.

2. *Current Situation and Practices*

In Korea, simple-division schemes have been far more frequently used than merger-divisions. Table 1 is based upon disclosure documents (i.e. current report) submitted to the Financial Supervisory Service (FSS) between January 2010 and February 2016. While limited to bigger companies,[3] the statistics show the trend in Korean corporate divisions. Out of 258 reports on corporate division to the Korea Exchange, only 19 cases (7.36%) dealt with merger-divisions. All the merger-divisions are in the form of SRDs; a combination of merger-division and CRD, in which all the shares of the transferee company go to the dividing company, was not found.

As Table 1 shows, simple-division CRDs and SRDs account for 65.11% and 24.81% of all corporate divisions, respectively. Those numbers include corporate divisions that simultaneously established multiple new corporations.[4] Conversely, mixed structures using CRD and SRD schemes simultaneously occupy only 2.71%.

Table 1: Types of Corporate Divisions in Korea (2010–2016)

	Simple-Division			Merger-Division	Sum
	CRD	SRD	Mixed (CRD+SRD)		
2010	33	16	1	7	57
2011	28	6	1	1	36
2012	21	7	1	3	32
2013	25	9	1	1	36
2014	28	12	2	4	46
2015	25	10	1	3	39
2016 (1.1.–2.29)	8	4	0	0	12
Total	168 (65.11%)	64 (24.81%)	7 (2.71%)	19 (7.36%)	258

[3] Companies obliged to submit annual reports to the FSS are also required to post current reports {Art. 161 para. 1 of the Capital Market and Financial Investment Business Act (CMFIBA)}. Under Art. 159 para. 1 of the CMFIBA and Art. 167 of the Decree of the CMFIBA, the obligation is borne by (i) listed companies and (ii) companies whose account should be reviewed by an auditor under the Act on the External Audit of stock corporation (e.g., having a total asset of 12 billion KRW or more) and whose security-holders' number is not less than 500.

[4] More specifically, (a) 9 cases (out of 168 cases) established two or more new corporations through CRDs; (b) 5 cases (out of 64 cases) established two or more new corporations through SRDs.

A similar study was conducted in 2009 examining the period from July 2006 to June 2009 (Table 2). The three-year analysis showed a similar preference for corporate division types: CRDs were the most popular, followed by SRDs. Compared to an earlier period dominated by CRDs, Table 1 shows a move toward diversification: merger-divisions and SRDs became frequent, with the occupation increasing from 1.85% to 7.36%, and from 19.75% to 24.81%, respectively.

Table 2: Types of Corporate Divisions in Korea (2006–2009)[5]

	Simple-Division			Merger-Division	Sum
	CRD	SRD	Mixed (CRD+SRD)		
July 2006–June 2009	123 (75.92%)	32 (19.75%)	4 (2.46%)	3 (1.85%)	162

Table 3 shows the scale of the divisions. The statistics used available datasets of 243 cases[6] to ascertain what percentage of the dividing company's assets was separated. In 50 cases (20.5%), half or more assets of the dividing company were transferred. It was further reported that 90% or more assets were separated via corporate divisions in nine cases. Those large-scale corporate divisions may replace the traditional "business transfer" scheme to create a fully owned subsidiary. The ways to address regulatory arbitrage will be discussed in more depth in Section III.4.

Table 3: Size of Asset Separation in Corporate Divisions

Ratio of Transferred Assets in Dividing Company	Simple-Division			Merger-Division	Sum
	CRD	SRD	Mixed (CRD+SRD)		
0–10%	74 (45.96%)	8 (13.79%)	0 (0.00%)	5 (29.41%)	87 (35.80%)
10–30%	51 (31.68%)	14 (24.14%)	1 (14.29%)	5 (29.41%)	71 (29.22%)
30–50%	18 (11.18%)	14 (24.14%)	0 (0.00%)	3 (17.65%)	35 (14.40%)
50–70%	8 (4.97%)	4 (6.90%)	1 (14.29%)	0 (0.00%)	13 (5.35%)
70–90%	4 (2.48%)	16 (27.59%)	4 (57.14%)	4 (23.53%)	28 (11.52%)
90–100%	6 (3.73%)	2 (3.45%)	1 (14.29%)	0 (0.00%)	9 (3.70%)
Total	161	58	7	17	243 (100%)

[5] T. PARK, Legal Issues on the Types of Statutory Corporate Division, Business, Finance and Law, 15 (2009), 38 *(in Korean)*.

[6] Out of 258 cases in Table 1, 15 cases, where the financial information on asset transfer ratio were not disclosed, were dropped.

A review of disclosure documents in SRDs revealed the following features. (1) Almost every SRD was accompanied by reverse stock splits. For example, a dividing company (D) separates its grocery undertaking, which occupies 30% of its whole business, to establish a new company (N). Under the division ratio of 1:0.3, Shareholder X, who has 10 shares in D, shall receive three shares in N. Most SRD division plans further proceeded with reverse stock splits, in which, for example, each share in D is reduced to 0.7; thus, X ends up with seven shares in D and three shares in N. Out of 63 SRD cases, 60 adopted this structure. (2) If the dividing company was listed, most SRD plans promised to have the new undertaking listed as early as possible. A new company that has been separated from a listed company via an SRD is more likely to satisfy the requirements under the Listing Rule of the Korean Exchange than a start-up,[7] meaning that the approach detailed in the SRD plans was followed in most cases. For the few cases where the prospect of listing new shares was uncertain, the SRD plans were withdrawn,[8] indicating that the listed dividing company and its shareholders regard the possibility of listing new shares as an import element of the corporate division decision-making process.

The two features mentioned above show that Korean SRDs were made to maintain the status quo of the shareholders in the dividing company. Assuming there are 10 shares in D corporation, which operates stationery and grocery undertakings, and the relative importance is 70% and 30%, respectively. If the stationery undertaking is separated into new company N, under typical Korean SRDs, each shareholding ends up with seven shares in the stationery business (D) and three shares in grocery business (N) by distributing new shares from the SRD and a reverse stock split. Reverse stock splits are not mandatory in an SRD under the KCC;[9] however, schemes which reflect the economic substance of the dividing company are generally preferred by shareholders. Further, the listing of new shares may also be viewed in terms of keeping the shareholder's status quo: a shareholder who had 10 listed shares in D may be in a similar position if he or she has three 'listed' shares in N and seven listed shares in D.

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[7] In order to regulate a backdoor listing, the Korea Exchange applies similar requirements of listing to separated new entities. Please refer to Art. 42 para. 2 of the Listing Rules of the Korean Exchange (available at <http://law.krx.co.kr/las/TopFrame.jsp>).

[8] For example, the board of the Ostem Implant Inc. cancelled its decision to an SRD when the Korean Exchange rejected the preliminary application for listing a separated undertaking. Please see the current report of Ostem Implant Inc. dated 11 May 2015 (available at <http://dart.fss.or.kr>).

[9] A handful of cases did not follow typical reverse splits paths.

3. Sub Conclusion

The legislature may regulate corporate divisions by two broad means. One approach adopts a special set of provisions applicable to each statutory corporate division (statutory division approach). Under such a scheme, the requirements for corporate division are easily understood, thanks to clear statutory provisions. The other approach does not provide specialized statutes but rather encourages the companies to use general corporate law devices (general division approach). Corporate divisions may be accomplished as part of the distribution of a dividend and/or a business transfer, which are common tools for corporate operations or transactions.

The U.S. is the representative for the general division approach, while the KCC is based upon the statutory division approach. There are pros and cons to the latter approach. Its major merit is its easy accessibility and user-friendly statutes. From the viewpoint of corporations, the detailed structure provided for each division scheme would be helpful for restructuring their business. Nevertheless, adopting a new set of rules might break the balance held in the previous legal infrastructure.

Statistics in Korea show that various types of statutory corporate division have been actively practiced in Korea of which CRDs, SRDs, and merger-division account for 65.11%, 24.81% and 7.36%, respectively. The ratio of SRDs to merger-divisions is worthy of note. SRDs and merger-divisions constitute over 30%, and their popularity seems to be increasing compared to the earlier period in Table 2. In fact, they may be described as an extended or combined version of a general merger and/or division devices: An SRD may result from a CRD followed by the distribution of shares in a subsidiary (i.e., a U.S. style spin-off); whereas, a merger-division may be broken down into an SRD and a statutory merger. From the general division approach, SRD or merger-division structures, which can be achieved by combining general transaction devices, might seem redundant.[10] However, it might be wise to provide a statutory path that clearly leads more than 30% cases to their final destination. The imbalance caused by the special legislation over corporate divisions may be addressed by fine-tuning the prior legal system, as partly suggested in this paper.

III. Issues Regarding Shareholders in Dividing Companies

1. Overview

A corporate division has been considered to have less potential to impair shareholders than a merger or an acquisition: as opposed to empire-building,

[10] The Japanese Corporate Law abolished the concept of SRD in its 2005 reform.

where directors may seek private benefits, a corporate division, which instead dismantles the empire, is not likely to be misused by directors.[11] Further, it has been said that (1) the shareholders can easily monitor the fairness of the consideration, which is generally made on a proportional basis and (2) the so-called final period problem is less severe in a division.[12] However, the risk of a corporate division being misused as a device for tunnelling deserves a closer look, as is discussed in III. 5.

In the process of corporate restructuring, various legal devices are equipped to protect minority shareholders. In the case of a statutory merger, the merger plan should be approved by qualified resolution, which requires at least two-thirds of the votes present at the General Meeting of Shareholders (GMS), which must at the same time account for at least one-third of the total number of voting shares (Art. 434(1)). Major reference documents should be kept in the main office of the merging or merged company so that the investors and other stakeholders may review whether the merger makes business sense. A registered merger may be declared null and void if it fails to satisfy procedural and/or substantial requirements (Art. 529).

Similar protective measures apply to corporate divisions. In particular, the rules protecting minority shareholders in a merger-division resemble those in a normal statutory merger. The major mechanism is the requirement of a qualified resolution. Where a company pursues a simple-division, the company has to prepare a "division plan" and obtain qualified approval of the plan at the GMS. Companies pursuing a merger-division should prepare a "merger-division agreement" and submit it to the GMS for approval (Art. 530-3(1), (2)). GMS approval is required for each company that is a party to the merger-division. Where a class of shareholders is prejudiced by the simple-division or merger-division, a separate meeting of that shareholder class is also required (Art. 530-3 (5)).[13]

The disclosure also plays an important role for minority shareholders. The representative director of a divided company must retain certain materials at the main office two weeks before the GMS and until six months after the registration of formation (simple-division) or registration of the merger (merger-division). These materials include (i) the division plan or merger-division agreement; (ii) the balance sheet for the divided part; (iii) in the case of merger-divisions, the balance sheet of the acquiring company; and (iv) a state-

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[11] R. KRAAKMAN et al., The Anatomy of Corporate Law: A Comparative and Functional Approach, (2nd ed., Oxford 2009), 213.

[12] See *id.*

[13] Under the KCC, all simple-divisions must be approved by GMS's special resolution. However, a recent temporary legislation (A Special Act for Boosting Enterprises' Reorganization. No. 14030 dated 12 February 2016) allowed short-form division whereby a dividing company may separate 10% or less of its assets without special resolution by the GMS. The Act applies to enterprises belonging to oversupplied industries.

ment of the allotment of shares to the shareholders of the divided company (Art. 530-7(1)). In the case of merger-divisions, the representative director of the acquiring company should keep similar materials at its main office (Art. 530-7(2)).

Those devices, however, might not provide optimal protection for shareholders. This section explores four topics regarding shareholders protection, which, unlike M&As, are somewhat controversial in corporate divisions: (1) an appraisal remedy for dissenting shareholders is readily available in a Korean statutory merger, but not in the case of statutory division; (2) the so-called division ratio has different implications from that of a merger; (3) CRDs may threaten the interests of minority shareholders by transferring a corporation's major assets beyond the reach of its supervision, a phenomenon unwitnessed in a statutory merger; and (4) a unique practice in Korean SRDs has an inherent risk of weakening minority shareholders' relative shareholding ratio to controlling shareholders.

2. Appraisal Remedy in Statutory Corporate Division

As in a merger,[14] dissenting shareholders in a merger-division may resort to an appraisal remedy. Feeling the suggested merger-division plan is absurd, minority shareholders of the dividing company as well as the acquiring company may claim for the purchase of their shares by the company.

For simple divisions, however, the KCC does not provide an appraisal remedy. This is noteworthy because, under the KCC, most transactions that require special resolution are also be subject to an appraisal remedy.[15] The rationale is that simple divisions, whether in the form of an SRD or a CRD, are not substantially detrimental to minority shareholders. In an SRD, the shareholders are supposed to receive shares of the new company on a proportional basis. A CRD is not likely to benefit majority shareholders at the cost of minority shareholders because the new shares are wholly owned by the dividing company. However, a counter-argument points to the so-called "indirectization" of shareholders' rights as the result of a CRD. Even though the transferor company obtains 100% shares in the new corporation, the shareholders may feel uncomfortable, especially if the shareholders have an interest in the separated business. Once a business moves into the hands of a subsidiary it becomes difficult, if not impossible, for the holding company's shareholders to monitor the business. By turning down such an argument and

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[14] Any shareholder who does not agree to a proposal for a division or a division-merger may demand that the company purchase his shares if he gives the company written notice of his dissent against the resolution before the GMS convenes (Arts. 530-11, 522-3).

[15] There is an exception under the KCC: The change of the AOI (articles of incorporation) shall not invoke an appraisal remedy in Korea (please see Arts. 433, 434 and 374 of the KCC).

depriving dissenting shareholders of an appraisal remedy, the KCC contributes to the proliferation of simple divisions, as shown in Table 1. The lack of an appraisal remedy in a simple-division leaves the special resolution requirement as the primary strategy for protecting minority shareholders in simple-divisions.

In 2013, the Korean government revised the Capital Market and Financial Investment Business Act (CMFIBA) to adopt one exception to the No-Appraisal-Rule for simple-divisions. If the newly established corporation through SRD is not supposed to be listed, shareholders of the dividing company, which is listed, are entitled to an appraisal remedy.[16] For shareholders, the SRD means that their shares are divided into two (or more) types of shares. Given the difference in liquidity or price between listed and unlisted stocks, a division plan which gives shareholders unlisted new shares in return for some parts of their listed shares may threaten their propriety rights. The revised CMFIBA tried to give an exit right to minority shareholders in this situation. As mentioned in Section II, most SRDs concerning listed corporations have been designed so that newly established corporations must be listed as soon as possible.

3. *Disproportional SRD*

Korean SRDs generally treat shareholders proportionally. Therefore, shares of the new company tend to be distributed to each shareholder according to their shareholding. Under the proportional scheme, minority shareholders are unlikely to be expropriated by controlling shareholders. For management, a proportional distribution is a useful tool to persuade shareholders to vote for the SRD plan. In addition, the KCC and the Korean Corporate Tax Code provide preferential treatment if new shares are distributed proportionally.[17] But what about a disproportional SRD?

Some shareholders may push for complete separation. For example, X and Y, two major shareholders of corporation D, which operates stationery and grocery businesses, have decided to split. X wants to have the stationery business, while Y wants the grocery business. Under the proportional SRD

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[16] Art. 165-5 para.1 of the CMFIBA, Art. 176-7 of the CMFIBA's Decree.

[17] Generally, those provisions under the KCC regulating incorporation of a company also apply to setting up a new company via SRD (Art. 530-4 para.1). However, the requirement is less strict for a proportional SRD: if a company is set up only with the contribution of the divided company and distributes the new company's shares to the shareholders of the divided company proportionally, an examination by a court-appointed inspector, required for all asset-contributions, will be excused (Art. 530-4 para. 2). From the tax law perspective, special tax treatment is made only if the consideration of the transfer is proportionally distributed to shareholders of the dividing company (Art. 46 para.2 of the Corporate Tax Act; Art. 82-2 of the Corporate Tax Act Decree).

(Figure 3), neither shareholder can obtain what they want. Thus, the possibility of the disproportional SRD (Figure 4) needs to be explored.

Figure 3: Proportional SRD

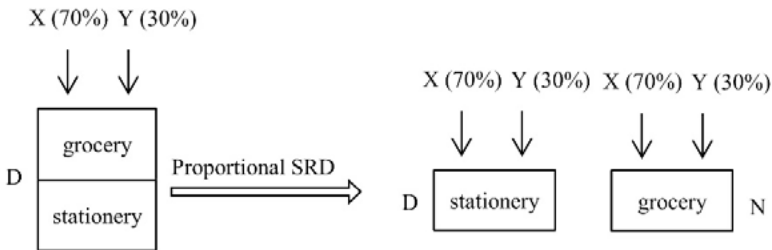
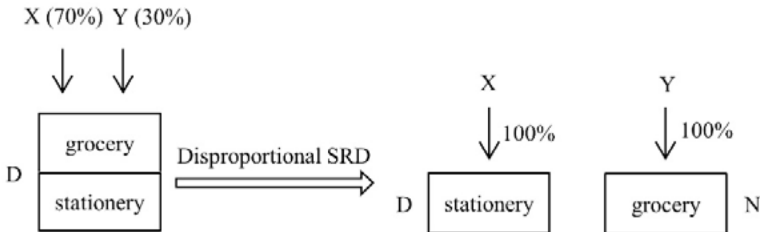


Figure 4: Disproportional SRD



The KCC does not explicitly allow or prohibit a disproportional SRD. The inherent risk here is that of wealth transfer between shareholders. Provided that minority shareholders are fully protected from exploitation, a disproportional scheme that satisfies the business needs of investors should be allowed. From that perspective, a special resolution, which is a general requirement for (proportional) SRD, is insufficient. Under a disproportional regime, minority shareholders may be squeezed by a special resolution by the more prosperous businesses only to be left with shares in dismal undertakings. A good method of protecting minority shareholders facing a disproportional SRD should be to give them an exit right (i.e., an appraisal remedy). However, the KCC limits the availability of appraisal remedies, and general jurisprudence in Korea is that a company may not stipulate a triggering event for an appraisal remedy other than those provided in the KCC.[18] The remaining solution is to give minority shareholders a veto right; without the approval of all shareholders, a disproportionate SRD is not allowed. The imposition of a unani-

[18] The rationale is that the appraisal remedy, which may impair the creditor's interest by buying back shares, should not be freely expanded by the change of AOI (articles of incorporation).

mous consent requirement, however, may imply a ban on disproportional SRDs in companies with dispersed shareholders. Given that a disproportional SRD makes perfect business sense in some cases, the KCC should be revised to allow a disproportional SRD in conjunction with devices for protecting dissenters, including appraisal remedies.

4. CRD v. Setting Up a New Company by In-kind Contributions

Under the KCC, there are two ways for a company to establish a fully owned subsidiary. The traditional way is to use the concept of "business transfer." A business transfer under the KCC is the assignment of organized business facilities and infrastructure in terms of both human resources and physical equipment.[19] The consideration of the transfer may be either cash or shares in the transferee company. To establish a 100% shareholding relationship, a company may make business transfers to the new company, whereby it receives shares in the transferee company (in-kind contribution setup). The general procedure of a business transfer applies here; therefore, (a) assets and debts which comprise organized businesses should be transferred individually, rather than comprehensively; (b) GSM approval by special resolution is required if a company is to transfer its main business (Art. 347 para. 1); (c) dissenting shareholders in the special resolution process may resort to an appraisal remedy (Art. 374-2); and (d) no joint and several liability is imposed on the transferor and transferee companies.

A second way makes use of the CRD scheme. As mentioned in Section II.1, CRD is a device that creates a 100% subsidiary. As a special set of rules dedicated to a corporate division, CRD provisions deviate from traditional business transfers: Under the universal succession doctrine, assets and debts of the transferor company are comprehensively, not individually, transferred to the new company, as stipulated in the division plan; approval by the GMS's special resolution is always required notwithstanding the size of transfer; an appraisal remedy is not provided; and the dividing company and new company shall be jointly and severally liable.[20]

Is it fair to ignore the regulatory arbitrage between an in-kind contribution setup using a traditional business transfer scheme and CRD based upon relative new corporate division devices? The statistics in Table 3 show that CRD might be replacing the in-kind contribution setup: In 50 cases (20.5%), half or more of the dividing company's assets were transferred. Those deals which transferred major parts of the dividing companies' business must have fol-

[19] 2004Da137717, 8 July 2004 (Korean Supreme Court). Accordingly, a business transfer is different from mere asset transfers.

[20] Another difference between a CRD and an In-kind Contribution Setup is that the inspection process by the courts to verify the valuing of transferred assets and debts, which is absent in a CRD, is required in an In-kind Contribution Setup.

lowed an in-kind contribution setup path if the CRD was not adopted. Under the KCC, the directors appear to have a strong incentive to use the CRD structure rather than the in-kind contribution setup; using the CRD structure obviates the need for both the annoying appraisal remedy and the individual transfer and registration procedure inevitable in an in-kind contribution setup. This paper advocates the adoption of a set of rules applicable to specific division types, provided the adoption is harmonized with traditional legal devices with further legislative refinement to address the arbitrage between the in-kind contribution setup and CRD. The major arbitrage arises from the availability of an appraisal remedy. Accordingly, it may be suggested that, as in a CRD, an in-kind contribution setup resulting in 100% ownership should be exempt from an appraisal remedy because the adverse influence against minority shareholders is not severe. Shareholders will still be protected through the special resolution requirement.

5. SRDs That Create Pyramidal Structure Using Treasury Shares

a) General Practice

A CRD is a tool for creating a parent-subsidiary relationship. Once a CRD process is completed, the dividing company becomes the sole shareholder of the new corporation. Conversely, an SRD is not supposed to build a parent-subsidiary relationship, as the shareholders of the dividing company receive the new shares rather than the company itself. However, SRDs are often used to establish a pyramidal structure.

A typical process for a dividing company to create a pyramid is as follows: (1) Company H repurchases its shares with distributable earnings and (2) Company H separates some of its business into a new company (Company S). For tax purposes, the shares of Company S should be proportionally distributed to Company H's shareholders. Company S distributes its shares also to Company H, under the rationale that all shares of Company S, including treasury shares, will enjoy the fruits of the corporate division.

What is the problem with this practice? Figure 5 shows the general concept of a proportional SRD. If H, which operates a construction and chemical business, decides to separate its chemical undertaking through a proportional scheme, shareholders X, Y, and Z should keep their relative shareholding ratio (42:28:30) in new company S.

What if shareholder Z (and the 30% shareholding) is replaced by H with 30% treasury shares? Figure 6 shows the pyramidal establishment using such treasury shares. Unlike a typical proportional SRD, such pyramiding weakens the minority shareholder in the separated business. Before the SRD, the relative shareholding ratio between X and Y was 42% : 28%. At the end of the SRD, however, the balance in the separated business (i.e., chemical) is disrupted; owing to the distribution of S's shares to H's treasury shares, X may

actually enjoy 30% more ownership on top of its original 42%. As far as the chemical business is concerned, the shareholding ratio between X and Y has been changed to 72% (42%+30%):28%.

Figure 5: Typical Proportional SRD

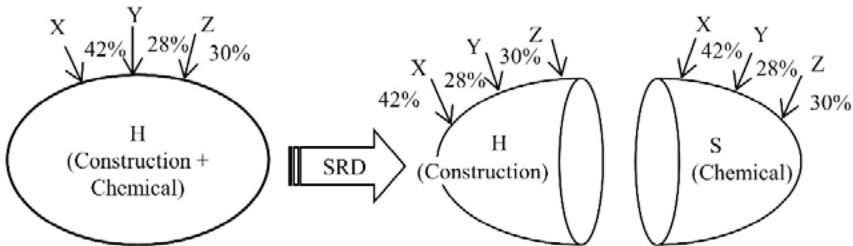
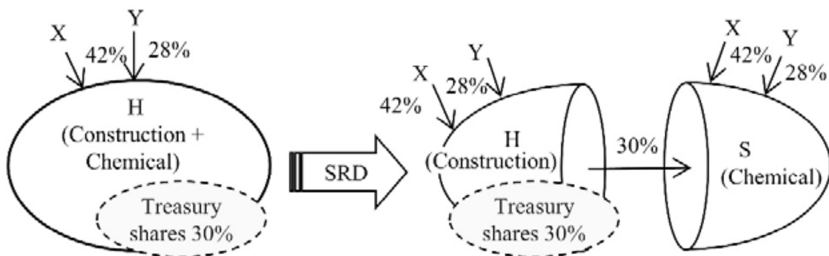


Figure 6: Pyramiding Through Proportional SRD (I)



SRDs using treasury shares to create pyramidal structures are reportedly quite common in Korea. From a minority shareholders' perspective, those SRDs dilute their voting rights in the separated business, strengthening the controlling shareholders' grip over the separate undertaking. A new bill prohibiting the assignment of new shares for treasury shares in the case of a demerger has recently been proposed,[21] which is the right move to correct unjustifiable business practices.

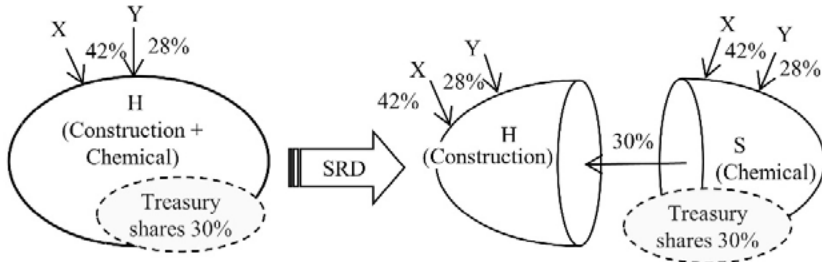
b) Recent Attempt to Circumvent Criticism

In response to severe criticism against pyramiding by distributing new shares to treasury shares in SRDs, a new style SRD is often used. Under the new scheme, (1) treasury shares are made a part of the separated undertaking; thus, S receives H's treasury shares and becomes a 30% shareholder of H. (2) Now qualified as a shareholder in H, S is entitled to the new S shares propor-

[21] Draft Art. 530-8 of the KCC Bill No. 2000837 (12 July 2016).

tionally distributed to all the shareholders in H. Thus, S may receive its own shares (as treasury shares). Figure 7 shows the result of the new scheme.

Figure 7: Pyramiding Through Proportional SRD (II)



This however raises the following questions: May a company transfer its treasury shares as part of a business undertaking? (phase 1); and may a new company (S) be established with its own shares as treasury shares? (phase 2). More importantly, the new structure seems to be a mere change of form from the earlier pyramiding practice. The result of Figure 7 is the same as that in Figure 6, except that the controlling company has changed from H to S. This new attempt to circumvent pyramidal SRD should be banned in terms of shareholder protection along with the former pyramidal SRD approach.

6. *Sub Conclusion*

Under the common belief that a corporate division, as long as it is made on a proportional basis,[22] has less potential to impact negatively on shareholders than a statutory merger, the KCC provides minority shareholders less protection. The lack of an appraisal remedy in SRD or CRD is based upon this belief. However, a unique practice in SRDs seems to exploit the loophole. By distributing new shares, including for treasury shares and creating a pyramidal structure, major shareholders often increase their grip over the separated undertaking, and over entire corporate groups. Treasury shares, which have been bought with the corporate budget, not by the majority shareholder's fund, should not serve to benefit the controlling shareholders. This paper suggests a solution to ban the distribution of new shares to treasury shares in dividing companies.

The issue of imbalance is also noteworthy. As mentioned, a special set of statutory laws is easily accessible and understood by dividing companies, but

[22] This points to a CRD as well as a proportional SRD. A CRD may be economically proportional to shareholders in a dividing company, because the shares in the new corporation shall be fully owned by the dividing company, without benefiting a specific shareholder.

may disrupt corporate law as a whole. This section pointed to the balance between a CRD structure and an in-kind contribution setup. Statistics show that CRDs are the most popular division type, accounting for 65.11% (Table 1) of all divisions. Among the 161 CRD cases from the last six years, 18 cases (around 11%) separated their assets in such a way as to be equivalent to half or more the total assets (Table 3). Those 18 CRDs, if structured as an in-kind contribution setup, must have gone through complicated procedures including an appraisal remedy. A level playing field is necessary. This paper suggests a reform to lessen the burden in establishing a fully owned subsidiary through in-kind contributions: an in-kind contribution setup resulting in 100% ownership should be exempt from an appraisal remedy as the negative impact on shareholders is not severe.

IV. Issues Regarding Creditors in Dividing Companies

1. Joint and Several Liability

a) Principle

A corporate division, in which some assets and debts are transferred to another company, may place creditors' claims in a dividing company at risk. Two typical scenarios are as follows: (a) Company D, against whom P has a claim, transfers most of its valuable real property to the new company N via corporate division. After the division, P's enforcement against D's assets may be unsuccessful; (b) Company L separates Q's claim as well as some valueless assets to establish new company M via corporate division. As opposed to the general jurisprudence that a transfer of debt should be approved by the creditor, the universal succession theorem under statutory corporate division makes this approval unnecessary. Because the new debtor, company M, only owns valueless assets, the prospect of Q's claim's being satisfied becomes dismal.

The solution provided by the KCC is the principle of joint and several liability. In either a simple-division or a merger-division, the dividing company and the transferee company are jointly and severally liable for the dividing company's debt from the date the corporation division is registered (Art. 530-9 (1)). In general cases including (a) and (b) above, a joint and several liability scheme provides appropriate tools for protecting the creditors of the dividing company from a decrease of assets caused by the corporate division. However, it may over-protect or under-protect creditors.

The joint and several liability scheme presumes that valuable assets are owned by either the dividing company or the transferee company. It enables the creditors to enforce their claim either through the dividing company or the transferee company. But what if the valuable assets are lost in the process of the corporate division? Art. 530-5 (1) of the KCC allows so-called cash-out corpo-

rate division; thus, instead of new shares in the new corporation, the dividing company may distribute cash or other assets to the shareholders in an (simple-division) SRD. This leakage of the dividing company's assets in the midst of corporate division may threaten the enforceability of creditors' claim *(under-protection)*. However, the KCC fails to provide further procedures for protecting the creditors in an SRD other than joint and several liability.

Another aspect also deserves attention. The KCC does not set any limits on the scope of the joint and several liability. For example, a transferee company (S) with a net asset worth more than $100 billion receives a small part worth $3 million from the dividing company (D) whose net assets amount to less than $1 million. Because a corporate division, provides limitless joint and several liability, the creditors of D now have all of S's assets under their enforcement *(over-protection)*. The scope of the joint and several liability should be set at the net worth of the transferred assets.

b) Exception: Severance of Joint and Several Liability

A joint and several liability, though desirable to creditors, may impair the operation of several undertakings with financial independence. A single undertaking may be separated out by splitting its financial linkages and dividing the legal entity, thus providing a process for severing joint and several liability.

Under Art. 530-9 (2), (3), (4) of the KCC, a joint and several liability is denied if two requirements are satisfied: (1) the GMS approved the severance in a special resolution; and (2) a special procedure for protecting creditors (Creditors' Objection Process) was completed. Before 2015, however, the result of the severance was incomplete in some aspects. For example, a dividing company that separates its grocery undertaking and keeps its *stationery* undertaking should be jointly and severally liable for those debts transferred to the new company, providing they were owed by the *stationery* part of the business. The rationale is that the creditors in the dividing company's stationery business should be able to rely on their ability to enforce their rights against the dividing company, even after the corporate division, because the dividing company has maintained the stationery business. However, the protection of such creditors may be addressed by the Creditor's Objection Process, which is essential for splitting a joint and several liability. As the KCC of 2015 repealed the limit on the severance, a dividing company may freely choose which of its various obligations it should continue to owe after the division, provided that the two above requirements have been satisfied.

There have been frequent attempts to sever liability. According to current reports submitted to the FSS, around 40% of the corporate divisions declared a split of liabilities between dividing companies and their transferee companies. Table 4 shows different severance practices according to corporate division types and reveals that severances were most frequent in a merger-

division while less common in SRDs. This is likely due to the difficulty of the Creditor's Objection Process. The special resolution by the GMS, the other requirement for severance, is not a serious burden for the dividing companies. To execute a corporate division, a dividing company should proceed with a shareholders' special resolution. The severance clauses in the division plan do not influence the GMS negatively because they are mainly associated with creditor's rights. However, completing the Creditor's Objection Process is quite difficult. This difficulty, combined with the purpose of corporate division, seems to result in different severance practices: (1) In merger-divisions, the Creditor's Objection Process does not impose an additional burden on dividing companies or their counterparts because all merger-divisions in Korea, just like ordinary mergers, must go through the Creditor's Objection Process; (2) many CRDs were made to sell one of the dividing company's undertakings to a buyer. Having turned an undertaking into a fully-owned subsidiary via CRD, the dividing company sells 100% of the shares to the buyer. Because the buyer does not want to be jointly and severally liable for the debts of the dividing company, the subsidiary should be financially severed from its parent. In those cases, dividing companies have a strong motivation to navigate the Creditor's Objection Process despite the difficulty. (3) SRDs in Korea have typically been designed to keep the status quo of stakeholders. Thus, the severance of liability, which might change the creditor's position drastically, tends to be limited to a handful of cases.

Table 4: Severance of Liabilities

Joint and several Liability	Simple-Division			Merger-Division	Sum
	CRD	SRD	Mixed (CRD+SRD)		
Continued	99 (59%)	44 (69%)	6 (86%)	7 (37%)	156 (60%)
Severed	68 (40%)	19 (30%)	1 (14%)	12 (63%)	100 (39%)
Unknown	1 (1%)	1 (1%)	0 (0%)	0 (0%)	2 (1%)
Total	168 (100%)	64 (100%)	7 (100%)	19 (100%)	258

The Creditor's Objection Process deserves further analysis. On the whole, the corporate division scheme in the KCC may be seen as creditor-friendly. As shown by practices in other countries, such as Japan, a corporate division may be misused to threaten a creditor's enforceability by fraudulently transferring valuable assets of a dividing company. In Korea, however, fraudulent corporate divisions have not been frequent, partly because of strong protective devices for creditors. Generally, the Creditor's Objection Process is as follows: (a) A dividing company who wishes to end joint and several liability must issue a public notice of such intent, and an individual notice should be

provided to the creditors known to the dividing company; (b) if a creditor objects to the severance, the dividing company should soothe the disgruntled creditor by paying off or providing sufficient securities – with both these options potentially stalling the completion of a corporate division. With regard to individual notice, the Korean courts tend to interpret the scope of "known creditors" broadly.[23] A creditor known to the dividing company but who does not receive an individual notice may deny the severance of liability.[24] The mechanisms necessary to deal with the creditor's objections are even more problematic, requiring the company pay security even for unsecured claims (or pay off the claim) if it wants to finish the Creditor's Objection Process. The same rule applies even if a debt against the dividing company (with limited assets) becomes a debt against a new company with a better financial positon, thus improving the chances of successful enforcement. In such circumstances, turning an unsecured claim into a secured claim due to a corporate division looks irrational. In that respect, the KCC, which basically stands by the creditors, may need fine-tuning to balance the creditor's interests and efficiency concerns of the dividing company.

2. Contingent Liability and Its Reimbursement

In a statutory merger, a detailed list of assets and debts in the merging or merged corporations is not necessary because all the assets and debts come together. However, statutory corporate division, which is supposed to dissociate some part of the dividing company, requires a list specifying which assets and debts should be transferred, and to whom. In addition, a division plan generally includes clauses deciding who will bear contingent liabilities: If corporation D separates its grocery undertaking through an SRD, the division plan tends to provide that any liability, including a contingent one, which has arisen from the grocery business, should be imposed on the new (grocery) company (N). In addition, the general drafting practice stipulates an obligation to reimburse; therefore, if corporation D happens to pay off the debt of grocery company N after the corporate division, N should reimburse it.

The validity of such a reimbursement clause concerning contingent liability in a corporate division has been discussed in Korea. The general consensus is that the reimbursement clause is valid in the case of a merger-division. Merger-divisions have two parties, i.e., the merging corporation and the dividing company, which can negotiate the terms and conditions of division plan, with the reimbursement clause as one part of that agreement. As in other contracts, one should not deny the validity of the negotiated agreement with-

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[23] 2011Da38516, 29 September 2011 Korean Supreme Court stated that, even though the CEO of the dividing company realized the existence of a creditor on her personal capacity, the company should send the individual notice to that creditor.

[24] 2003Da25973, 30 August 2004 (Korean Supreme Court).

out reasonable cause. When it comes to a simple-division, which may be designed by a dividing company on its own however, the answer is more complicated. Two typical SRD examples help to clarify the matter.

The first situation is that corporation D has separated its grocery business into N. After the corporate division, D was ordered by the court, under the joint and several liability jurisprudence, to pay off the claim of C, who is an unknown creditor of the grocery business. In this case, N should reimburse D, as long as the division plan provides that any liability that has arisen from the grocery business should be imposed upon N. C's claim should have been exercised against N, but D discharged it due to joint and several liability. Under the civil law doctrine, D's reimbursement claim should be allowed.

The second situation is more complex. After the corporate division, the Fair Trade Commission (FTC) imposed a penalty of $1 million on D based upon anti-competition practices in the grocery business before the corporate division. Under the anti-trust law in Korea, the FTC may punish the dividing company (D) or the new company (N) at its discretion if a corporate division has been executed after the anti-competitive conduct was carried out.[25] Having paid the penalty of $1 million, may D argue reimbursement based upon the reimbursement clause in the division plan? There are some reasons to answer in the negative: (a) The reimbursement clause presumes that the claim was made before the corporate division. However, the claim by the FTC was made after the corporation division, and therefore beyond the scope of the reimbursement clause. (b) Unlike a merger-division, a simple-division does not have a counterparty to negotiate the division plan. The extended reimbursement by the dividing company, which may draft the plan on its own, should be narrowly interpreted to protect the stakeholders of the new corporation. However, the Supreme Court of Korea stood by D stating that D is entitled to the reimbursement.[26] In light to the circumstances, the Supreme Court seems to have made the right decision: (1) The gist of the division plan is that any liability from the grocery business, as far as it has arisen before the division, should be borne by the new corporation. The FTC accused the company unfair practice predating the division. (2) In an SRD, the shareholders of the dividing company tend to maintain the same shareholding ratio in the new corporation. Thus, the reimbursement to the new company is unlikely to impair the interests of the shareholders. (3) Major terms and conditions of the division plan including the reimbursement clause must be publicly disclosed. The imposition of a penalty, like other contingent liabilities, is not beyond the scope of reasonable expectation by the creditors and shareholders of the new corporation.

25 Art. 55-3 para. 3 of the Monopoly Regulation and Fair Trade Act (MRFTA).

26 2014Da210098, 29 August 2016 (the Supreme Court of Korea).

V. Concluding Remarks

Corporate division in Korea is essentially regulated by the relevant provisions of the KCC. This paper, by analyzing some statistics on division practices and comparing the legislative framework of corporate division with that of other reorganization devices, explores the features of Korean corporate division and suggests legislative refinement.

First, Korea has a statutory set of rules on corporate division (statutory division approach). Before the adoption of the statutory corporate division device in 1998, a business undertaking was separated into two or more parts using a business transfer device and other general schemes (general division approach). While we can still find pieces of legislation under the general division approach which do not have conspicuous statutes on corporate division, the statistics in Korea show that companies looking to restructure appear to have found explicit provisions on each type of corporate division to be quite useful. There has been active uptake of the major corporate division devices under the KCC, including SRD, CRD, and merger-division since its codification. However, the development of these new devices has brought another problem: harmonization of the legal system as a whole. Of these, this paper points to the possible regulatory arbitrage between setting-up a new company by an in-kind contribution versus CRD. The latter, with the same economic result as the former, tends to be less regulated under the KCC. To redress this imbalance, the Korean legislator may consider dropping the appraisal remedy from the former device.

Second, this paper proceeds with the protection of shareholders under Korean corporate divisions. It is generally accepted that a corporate division, which is designed to break an empire into smaller pieces, is less likely to impair minority shareholders than M&As which motivate directors to build an empire. The KCC regulation on corporate division also reduces the level of shareholder protection, the lack of appraisal remedy in an SRD or CRD being the typical example. An analysis of Korea SRDs has shed some interesting light on this. Most SRDs have been executed in such a way as to maintain the vested rights of each shareholder. However, some SRDs have created a pyramid structure by distributing new shares for treasury shares, thus betraying the common faith in SRD's fairness. The paper showed that the weakening of minority shareholders' actual shareholding ratio can be easily avoided by banning the distribution of new shares for treasury shares.

Finally, issues relating to the creditors of a dividing company also deserve detailed review. The KCC seems to adopt creditor-friendly provisions; that is, the dividing the company and its transferee company should be jointly and severally liable for the dividing company's debts that were made before the execution of the corporate division. In order to sever the liability, the burden-

some Creditor's Objection Process should be followed. Owing to strict creditor protection mechanisms, fraudulent corporate divisions intended to evade creditor's rights have not yet been reported in Korea to any great extent. This strict protection, however, has its drawbacks, including the deterrence of efficient reorganization and creating a windfall for creditors (e.g., the change of the creditor's status from unsecured to secured). This paper suggests readjusting the Creditor's Objection Process within the scope of securing the creditor's vested position.

Creditor Protections in Company Splits in Japan

Problems with the "Single Balance-Sheet Test"

Koji Funatsu

I. Preface 69
II. Standard Procedure of Incorporation-type Company Split 70
1. Preparation of a Company Split Plan (JCA Art. 763) 70
2. Pre-split Disclosure (JCA Art. 803) 71
3. Approval of the Company Split Plan at the Shareholders' Meeting (JCA Art. 804) 71
4. Dissenting Shareholders' Appraisal Procedure (JCA Art. 806) 72
5. Creditor Objection Procedure (JCA Art. 810) 72
6. Worker Objection Procedure (Pursuant to the Act on the Succession to Labor Contracts upon Company Split) 73
7. Effectuation (JCA Art. 764) 73
8. Post-split Disclosure (JCA Art. 811) 73
III. The Rationale of the Creditor Objection Procedure and Its Problem 73
1. Our Focus: Remaining Creditors 73
2. The Rationale of the Japanese Legislative Framework 75
3. The Problem with the "Single Balance-sheet Test" 76
4. Is Another Interpretation Possible? 77
IV. *Ex Post* Creditor Protection Devices in Company Splits 77
1. Actions Seeking Invalidation of a Company Split 77
2. Directors' Liability 78
3. Rescinding a Fraudulent Assignment 78
4. Liabilities of an Assignee Company Using the Assignor Company's Trade Name 79
5. Lifting the Veil 79
6. Remaining Creditors' Direct Claims Against the Incorporated Company 80
V. Legislative Discussion 80
VI. Conclusion 81

I. Preface

This paper will address the "corporate division," and demonstrate some of the problems of creditor protection in corporate divisions under Japanese law. However, it will not use the term "corporate division", using instead the term

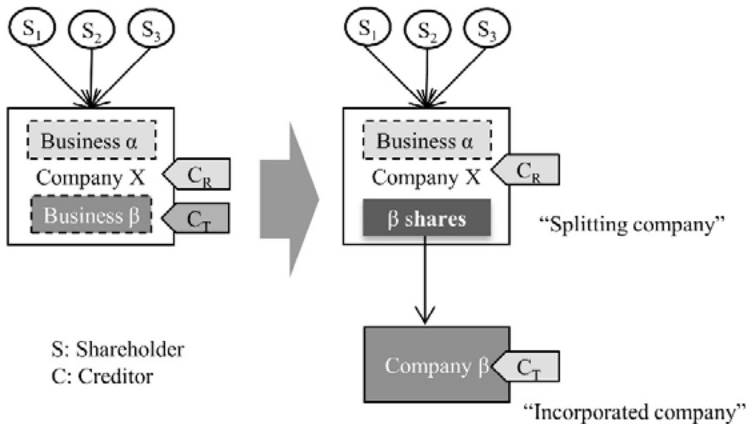
"company split," as is found in the semi-official Japanese translations available on the Internet.[1]

Roughly two types of company splits exist under Kaishahō, or the Japanese Companies Act (JCA).

First, the absorption type typically involves one existing company dividing into two parts: one to become the splitting company, while the other is absorbed by another existing company. The other type of company split is the incorporation type, in which an existing company (the splitting company) typically divides itself, carving off what becomes a newly incorporated company (see, Figure 1).

Our focus is on the incorporation-type, which faces comparatively greater difficulties.[2]

Figure 1: Incorporation-type company split



II. Standard Procedure of Incorporation-type Company Split

A standard procedure of the incorporation-type company split is as follows:

1. Preparation of a Company Split Plan (JCA Art. 763)

A company that splits under the incorporation-type procedure must first prepare a company split plan. The plan includes those matters prescribed for

[1] The English translations of Japanese laws can be found at <http://www.japaneselaw translation.go.jp/?re=02>.

[2] See also M. SAITO, Case No. 23, in: Ito et al., *Jirei de kangaeru Kaishahō* [Case Studies on Corporate Law], (2nd ed., Tokyo 2015) 466.

[normal] company formation (purpose, company name, location of the head office, directors and member of the supervisory board, etc.; JCA Art. 763, para. 1, nos. 1–4), as well as matters concerning the assets, obligations, employment agreements and any other rights and obligations that the incorporated company inherits from the splitting company (no. 5). It must also detail the number of the incorporated company's shares to be delivered to the splitting company, and matters concerning the amount of stated capital and capital reserves in the incorporated company (no. 6).

Incidentally, under the Japanese Companies Act, so-called "spin-offs" can be created, although not through a single procedure. Spin-offs must instead follow a two-step procedure: In the first step, a company is split with receipt of the incorporated company's shares serving as consideration; subsequently, in the second step, dividends from the incorporated company's shares are given to the splitting company's shareholders. This approach correlates with findings of this paper in that it is important for the splitting company to receive the incorporated company's shares as consideration for the net assets assigned to the incorporated company in the company split at the moment of its effectuation (see this Section, 7).

2. Pre-split Disclosure (JCA Art. 803)

Two weeks prior to the day of the shareholders' meeting, the splitting company must disclose the following documents[3] by making them available for inspection at the head office:

- Content of the company split plan (JCA Art. 803, para. 1, no. 2).
- Matters related to the adequacy of the consideration for the assigned object (Kaishahō Shikō Kisoku [Ordinance for Enforcement of the Companies Act, or "JOECA", Art. 205, no. 1]).
- Non-consolidated financial statements from the splitting company (JOECA, Art. 205, nos. 4–6).
- Matters related to the performance of obligations for the splitting and incorporated companies after the effectuation of the planned company split (JOECA, Art. 205, no. 7).
- Material subsequent events (JOECA, Art. 205, no. 8).

3. Approval of the Company Split Plan at the Shareholders' Meeting (JCA Art. 804)

The splitting company must obtain approval for the company split plan, with a majority of two-thirds or more of the votes of shareholders present at the

[3] Trivial matters omitted.

meeting. This meeting must be attended by a majority of those shareholders entitled to exercise their votes (Art. 804; Art. 309, para. 2, no. 12).

4. Dissenting Shareholders' Appraisal Procedure (JCA Art. 806)

Dissenting shareholders may demand that the splitting company purchase the shares that they hold at a fair price (para. 1). "Dissenting shareholders" are defined as shareholders who gave notice to the splitting company of their dissent to such an incorporation-type company split prior to the aforementioned shareholders' meeting (see this Section, 3), and who dissented from such a company split at that shareholders' meeting (limited to those who can exercise voting rights at such a meeting); or those who cannot exercise voting rights at such a meeting (para. 2).

The splitting company must notify its shareholders that it will affect the planned company split, and the trade names and addresses of the splitting and incorporated companies, within two weeks from the day of resolution of the shareholders' meeting (para. 3). A public notice may be substituted for such notice (para. 4).

A dissenting shareholder can exercise his or her appraisal rights by indicating the number of shares regarding which the shareholder exercises appraisal rights, within twenty days from the day of the notice from the splitting company (para. 5).

5. Creditor Objection Procedure (JCA Art. 810)

The creditor objection procedure, pursuant to JCA Art. 810, operates almost solely as an *ex ante* protection device for the creditors[4] of companies involved in a corporate reorganization (mergers, company splits, and share exchanges, etc.).

Companies involved in this procedure must notify the *target creditors* of the planned corporate reorganization through two media: typically, a paper-based official bulletin and an electronic one (JCA, Art. 810, para. 1). The use of the term "target creditors" ("Taishō-saikensha"), which is a translation, and not an official term from the Companies Act, is relatively common in practice. This term involves all creditors of all companies concerned in the case of a merger. However, in the case of an incorporation-type company split, this term is limited to creditors "who are unable to request the splitting company to perform their obligations" (JCA Art. 810, para. 1, no. 2). Should

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[4] A provision for injunction exists in the Japanese Companies Act (Art. 805-2), but this provision only applies to shareholders. A creditor could possibly use a temporary injunction pursuant to the Civil Provisional Remedies Act, but may experience difficulty in establishing the rights or relationship of rights that must be preserved (Civil Provisional Remedies Act Art. 13 para. 1).

a target creditor object within the prescribed period, the relevant company must make payments or provide reasonable security to him or her (JCA Art. 810, para. 5). Target creditors who do not object are deemed to have approved the planned corporate reorganization (JCA Art. 810, para. 4).

This paper's primary subject is a problem involving the limitations of the target of creditor protection procedures.

6. Worker Objection Procedure (Pursuant to the Act on the Succession to Labor Contracts upon Company Split)

The Act on the Succession to Labor Contracts upon Company Split was legislated simultaneous to the introduction of the company split procedure in 2000, to prevent harmful company splits that intend to avoid the strong worker protections offered under Japanese labor laws. All steps toward implementing a company split must be made pursuant to this Act.

7. Effectuation (JCA Art. 764)

When the planned company split is effectuated, the incorporated company receives the assets, obligations, etc., from the splitting company, in accordance with the provisions of the company split plan (JCA Art. 764).

8. Post-split Disclosure (JCA Art. 811)

After the day of formation, the incorporated company must make the following documents[5] available for inspection at the head office without delay:

- The date of effectuation (OECA Art. 209, no. 1; Art. 212, no. 1).
- Progress in the dissenting shareholders' appraisal rights and creditors' objection (no. 2).
- Matters concerning important rights and obligations that the incorporated company succeeded by its transfer from the splitting company (no. 3).
- Other important matters (no. 4).

III. The Rationale of the Creditor Objection Procedure and Its Problem

1. Our Focus: Remaining Creditors

The target creditors in the creditor objection procedure can be protected through this procedure, as mentioned above (see Section II, 5). A target credi-

[5] Trivial matters omitted.

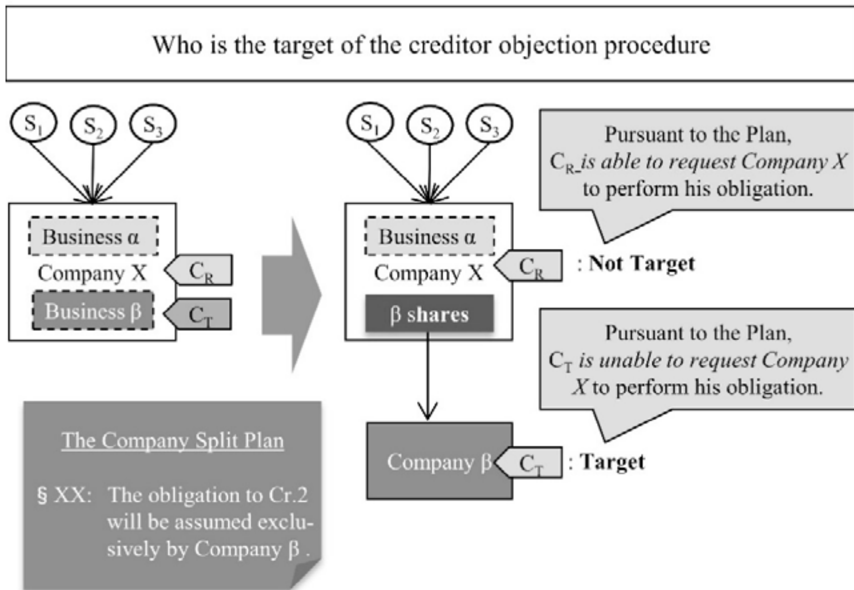
tor who believes the situation will worsen through a planned company split may object within the prescribed period and receive payment or reasonable security from the splitting company (JCA Art. 810, para. 5).

However, creditors other than the target creditors, namely, those who are *not* "unable to request the splitting company to perform their obligations" (JCA Art. 810, para. 1, no. 2) can neither raise objections nor receive payment or security from the company during the creditor objection procedure. This means that those *remaining creditors* have no *ex ante* protection devices in a company split.

To illustrate:

A splitting company has two creditors: First, Creditor T ("C_T") has a claim referenced in the company split plan as an object of assumption by the incorporated company. Thus should his or her claim be exclusively assumed by the incorporated company, C_T will fall under the creditor objection procedure. Therefore, if C_T uses the creditor objection procedure to protest the incorporated company's assumption of his or her claim, C_T can receive payment or reasonable security (JCA Art. 810, para. 5). It follows therefore that if C_T does not object, his or her claim is exclusively assumed by the incorporated company at the time of effectuation of the planned company split.

Figure 2: The target of the creditor objection procedure



The other creditor is Creditor R ("C_R"), whose claim is not referenced in the company's split plan. His or her claim remains in the splitting company even after the effectuation of the planned company split. As C_R is not a creditor of the incorporated company, but only of the splitting company, he or she may not request that the incorporated company perform his or her claim. Thus, C_R does not fall under the creditor objection procedure because C_R is *not* "unable to request the splitting company to perform their obligations." Thus, C_R would receive no payment or reasonable security from the splitting company through the creditor objection procedure, i.e., before the effectuation of the planned company split.

2. The Rationale of the Japanese Legislative Framework

The legislative framework therefore limits the target creditors in the creditor objection procedure to those who are "unable to request the splitting company to perform their obligations." This seems to be derived from what I have named the "single balance-sheet test."

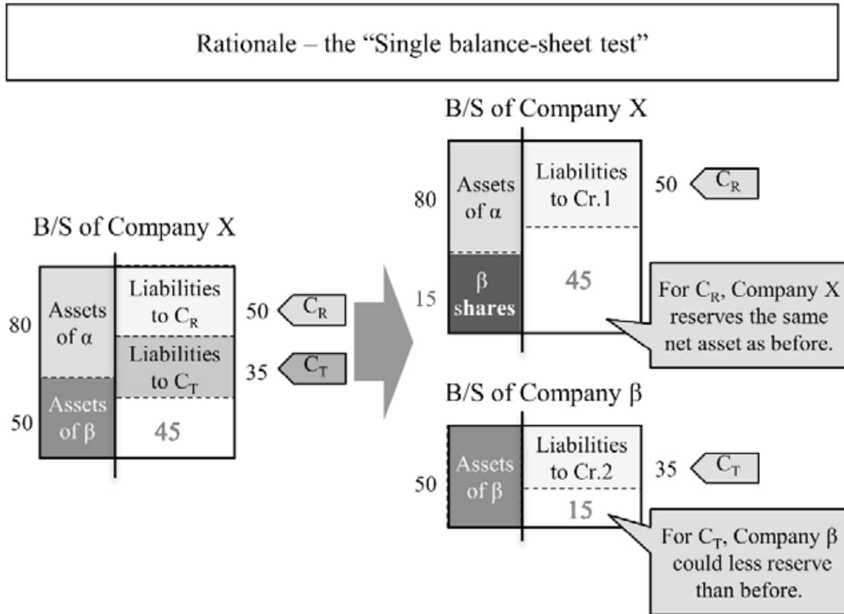
As stated above, the splitting company always receives the incorporated company's shares as consideration for the object of the company split, which is assigned to the incorporated company. Given that the incorporated company possesses all assets and debts assigned by the splitting company, which remain untouched at the effectuation of the company split, it could be theoretically assumed that the shares allotted to the splitting company fully reflect the net value of the entire incorporated company at that moment. In other words, the value of the consideration, or the shares of the incorporated company received by the splitting company, equals the net value of all assets and debts assigned from the splitting company to the incorporated company.[6]

Japanese lawmakers assumed that the company split would not harm remaining creditors because equal economic value flows to the splitting company; therefore, the splitting company can still reserve the same net asset value for remaining creditors as before.

This demonstrates that the necessity to protect remaining creditors can only be assessed based on the difference in book value of the splitting company's net assets, both before and after the planned company split. Therefore, we can call the Japanese legislative framework for creditor protection in a company split the "single balance-sheet test."

[6] K. HARADA, Shōji-Hōmu 1565 (2002) 14.

Figure 3: Numerical explanation of the single balance-sheet test



3. *The Problem with the "Single Balance-sheet Test"*

The "single balance-sheet test" enables a company to split prejudicially. As an extreme example, assume that the splitting company has sufficient funds to satisfy all its creditors' claims ("C_R" and "C_T"). A company split assigns the splitting company's total liquidity and the claims from C_T to the new company, which is concurrently incorporated. The splitting company's remaining creditor (C_R) does not fall under the creditor objection procedure and is unable to object; therefore, he or she cannot receive payment for claims or security corresponding to the splitting company's original claims, as provided by the creditor objection procedure (i.e., before claim maturity). When the claim matures after the effectuation of the planned company split, C_R cannot be satisfied (at least promptly) because of the debtor's (the splitting company) lack of liquidity. Even if C_R files a compulsory procedure against the splitting company, he or she could not be satisfied as its only assets are the incorporated company's shares allotted through the company's split, which have almost no market value.

4. *Is Another Interpretation Possible?*

An additional test to the "balance-sheet test" existed prior to 2005; the splitting company was forced into a pre-split disclosure, stating that both companies (splitting and incorporated) could be expected to be able to perform their own obligations (Commercial Code, former Art. 374-2, para. 1, no. 3). This provision was interpreted as requiring both companies (splitting and incorporated) be able to meet their obligations after the effectuation of the planned company split. As a necessary condition of the company split, a lack of such ability could lead to split's invalidation.[7] Both companies needed to have sufficient liquidity and more assets than obligations under this framework, or at least at the time of the company split's effectuation. This interpretation could be termed an "additional cash-flow test."

However, the aforementioned provision was revised during the corporate law reform of 2005, from the Commercial Code to the Companies Act. Now companies planning to split must only disclose "matters related to performance of the obligations of the splitting company and the incorporated company after the company split" (JOECA Art. 205, no. 7; see also Section II, 2). This revision has made it irrelevant whether both companies (splitting and incorporated) would be able to satisfy their obligations once the company split comes into legal effect. Therefore, the "additional cash-flow test" has been abandoned.

This change in ruling has facilitated prejudicial company splits.

IV. *Ex Post* Creditor Protection Devices in Company Splits

Some *ex post* protection devices do remain, although these are insufficient to fully safeguard creditors' interests:

1. *Actions Seeking Invalidation of a Company Split*

Some creditors may file an action seeking the invalidation of a company split (JCA Art. 828). However, only "a creditor who did not give approval to the incorporation-type company split" has the right to file an action (JCA Art. 828, para. 2, no. 10). As approval is determined based on what target creditors stated in the creditor objection procedure, those creditors who are unable to participate in the creditor objection procedure do not have approval rights,[8] and can therefore not file an action seeking invalidation.[9]

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[7] Specifically, this would constitute grounds to uphold actions seeking the invalidation of a company split.

[8] Tokyo High Court, 26 January 2011, Kin'yū Shōji Hanrei, 1363 [2011] 30.

2. Directors' Liability

Pursuant to the general principles of Japanese corporate law, any directors who are knowingly or grossly negligent in performing their duties are liable to a third party for damages arising as a result thereof (JCA Art. 429, para. 1). According to the prevailing theory, as this aforementioned duty is toward their own company,[10] and not to a third party (including creditors), a creditor seeking compensation must prove that the directors' conduct consisted of a breach of duty towards the company. According to the "single balance-sheet test," no breach of duty towards the company can occur at the time of an incorporation-type company split as the splitting company received the same net value as the assigned object.

3. Rescinding a Fraudulent Assignment

An assignor's creditor under the Japanese Civil Code (JCC) may request that the court rescind any asset assignment carried out by the assignor and assignee with knowledge that this will negatively affect the creditor (JCC Art. 424, para. 1). This rescission of a fraudulent assignment is said to be derived from *actio Pauliana*;[11] however, it cannot be used by the assignor's creditors as part of a bankruptcy procedure.

One possible interpretation posited that a rescission of a fraudulent assignment should not apply to "acts concerning the organization of a company," including company splits, as "the action seeking invalidation of acts concerning the organization of a company"[12] has exclusive priority (JCA Book 7, Chapter 2). However, a decision of the Supreme Court held that the rescission is applicable to fraudulent company splits.[13]

According to the dominant theories from civil and bankruptcy law scholars, fraudulent assignments are classified as follows: (i) fraudulent assignment in a narrow sense, or an assignment that diminishes the assignor's funds; (ii) equivalent exchange, such as selling a debtor's real estate in exchange for reasonable monetary consideration; and (iii) preference, which causes inequity between creditors. The "single balance-sheet test" has led many scholars to regard a fraudulent company split as an equivalent ex-

[9] A. TOKUTSU, in: Egashira/Nakamura (eds.), *Ronten Taikei Kaishahō* [Commentary on the Points of Companies Act], Vol. 6 (Tokyo 2012), Art. 828, Point 15.

[10] K. EGASHIRA, *Kabushikigaisha-hō* [Laws of Stock Corporations], (6th ed., Tokyo 2015) 505.

[11] A. OMURA, *Shin Kihon Minpō* [New Fundamental Civil Law], Vol. 4 (Tokyo 2016) 158.

[12] See A. TOKUTSU, *Kaishabunkatsu tou ni okeru Saikensha no Hogo* [Creditor Protection in Company Splits], in: Kanda (ed.), *Ronten-shōkai Heisei 26nen Kaisei-Kaishahō* [Research on the Point of the Revised Companies Act 2014] (Tokyo 2015) 246.

[13] Supreme Court, 12 October 2012, Minshū Vol. 66, No. 10, 3311.

change. However, an equivalent exchange in the general context of a fraudulent assignment's rescission under the JCC means that the assignor would obtain *more* liquidity, and the rationale of rescinding such conduct is to prevent the risk of dispersing the assignor's solvency. Thus, it is difficult to understand the company split in question, which would lead to the assignor's *decreased* liquidity (the splitting company), as an equivalent exchange in the context of a fraudulent assignment's rescission.[14] In any event, the rationale of the aforementioned decision of the Supreme Court is not clear.

4. Liabilities of an Assignee Company Using the Assignor Company's Trade Name

Art. 22 para. 1 of the JCA provides that where a company is assigned business and continues to use the assignor company's trade name, the assignee company shall also be liable for the performance of any obligations arising from the assignor company's business. The Japanese Supreme Court has found that this provision can be also be applied to company splits by analogy[15]

However, this is less useful for creditor protection in company splits because the creditors of the assignor (splitting company) cannot be protected by this provision, unless the assignee (incorporated company) continues to use the assignor's trade name.

5. Lifting the Veil

One would think that the "lifting the veil" doctrine would be well suited to protecting those creditors remaining with the splitting company, as it would require the satisfaction of obligations directly by the incorporated company.[16]

However, "lifting the veil" in Japan can be invoked only when the legal entity either becomes a mere façade or is abused,[17] and is difficult to invoke in a fraudulent incorporation-type company split.[18]

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[14] According to an influential but not yet dominant theory, a fraudulent company split as detailed above should be assessed as preferential. This is economically true, as this is a matter regarding an inequity of certainty to be liquidated between C_R and C_T. However, while preference in a general bankruptcy law context means only pledging and paying the obligation inequitably, fraudulent company splits contain neither pledging nor paying of the obligation. From a functional perspective, however, a fraudulent company split should amount to pledging due to the separation of legal entities' functioning as affirmative asset partitioning (TOKUTSU, *supra* note 12, 266. See H. HANSMANN/R. KRAAKMAN, The Essential Role of Organizational Law, 110 Yale. L. J. 2000, 387, 422,).

[15] Supreme Court, 10 June 2008, Hanrei Jihō 2014, 130.

[16] Fukuoka District Court, 14 January 2010, Kinyū Hōmu Jijō 1910, 88.

[17] Supreme Court, 17 February 1969, Minshū Vol. 23, No. 2, 511; EGASHIRA, *supra* note 10, 44.

[18] "Lifting the veil" based on mere façade seems to usually apply to denying defensive asset partitioning (HANSMANN/KRAAKMAN, *supra* note 14, 390) in Japan (EGASHIRA,

6. Remaining Creditors' Direct Claims Against the Incorporated Company

The 2014 Companies Act Reform provides an additional device[19] to protect creditors remaining under the splitting company. Pursuant to Article 764, Paragraph 4 of the revised JCA, when a splitting company implements an incorporation-type company split with the knowledge that this would harm remaining creditors, the latter may request that the incorporated company perform their obligations, to the extent of the value of property it received from the split.

One of the most significant problems with the interpretation of this provision is the interpretation of "the knowledge that it would harm remaining creditors." Some insist that "harm" should be interpreted independent of the JCC's provision regarding fraudulent assignments, while others insist that it must be interpreted in the same manner.[20] Regardless, it seems difficult to explain the rationale behind protecting the rights of the creditors who remain with the splitting company as long as the "single balance-sheet test" persists.

V. Legislative Discussion

Referring to European legislation, and especially German law, some scholars insist on adopting creditor protections, such joint liability for the incorporated

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supra note 10, 46). However, the legal personality of the incorporated company in a fraudulent company split cannot be seen as a mere façade, as the splitting company's former primary business is usually actively conducted in and by an incorporated company. In contrast, "lifting the veil" based on abuses of legal personality could be applicable to fraudulent assignments of corporate assets (Supreme Court, 26 October 1973, Minshū Vol. 27, No. 9, 1240). In any case, Japan regards the "lifting the veil" doctrine as the interested person's last resort for remedy (EGASHIRA, *Id.,* 43).

[19] See *infra* note 20.

[20] Strictly, the legal effect of rescinding a fraudulent assignment principally involves returning the assigned asset itself to the creditor of the assignor who filed the rescission [and then to the assignor] (Supreme Court, 25 January 1979, Minshū Vol. 33, No. 1, 12). However, case law has further ruled that if the assigned object cannot be returned, the assignee must monetarily compensate the creditor who brought the suit so the latter can be satisfied in the rescission procedure by setting off his claim to the assignor, and his obligation to return the assignee's monetary compensation to the assignor (Supreme Court, 3 February 1933, Minshū Vol. 12, 175).

In such a case, fewer differences exist between the legal effect of direct claims and the rescission of a fraudulent assignment. Further, if the requirement of "harm" should be interpreted in the same manner, the requirement and effect of both devices are almost the same. However, according to the explanation of those in charge of corporate law reform in 2014, the rescission of a fraudulent assignment is also applicable to a fraudulent company split, even after 2014 (S. SAKAMOTO (ed.), *Ichimon-Ittō Heisei 26nen Kaisei Kaishahō* [FAQ of the Revised Companies Act 2014 (revised version)] (Tokyo 2015) 356.

and splitting companies for the obligations of remaining creditors.[21] However, this model is uncommon in Japan.

VI. Conclusion

This paper primarily concludes that a lack of *ex ante* devices is the most critical problem for creditor protection in company splits. One solution to this problem involves providing for the treatment of creditors remaining with the splitting company as targets in creditor objection procedures.[22] However, we must surrender the "single balance-sheet test" to do so.[*]

[21] K. UKEGAWA, *Kaishabunkatsu ni okeru Saikensha Hogo* [Creditor Protection in Company Splits], in: Festschrift in Honor of Prof. Shōsaku Masai, *Kigyōhō ni okeru Gendaiteki Kadai* [Today's Issue on Commercial Law] (Tokyo 2015) 55. See also M. MAKI, *Doitsu Soshikisaihenhō ni okeru Saikenshahogo Kitei* [Provision for Creditor Protection in German Umwandlungsgesetz], in: Festschrift in Honor of Prof. Katsutoshi Fujita, *Gurōbaru-ka no nakano Kaishahō* [Corporate Law in Globalization] (Osaka 2014) 348.

[22] See C. IKENO, *Kaishabunkatsu ni okeru Zanzonsaikensha no Shūen wo mezashite* [To Solve the Problem of Protecting Remaining Creditors], in: Festschrift in Honor of Prof. Kazuyuki Nagai, *Kigyōhōgaku no Ronri to Taikei* [System of the Enterprise Law Theory] (Tokyo 2016) 18.

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II. Valuation of Shares and Its Procedure

Exit Rights, Shareholder Compensation and the Valuation of Shares in German Stock Corporation Law

Lars Klöhn

I. Transactions 85
1. Transactions Requiring a Court-Administered Valuation of Shares 86
2. Transactions without Mandatory Valuation of Shares 88
II. Valuation 89
III. Price 90
IV. Procedure 91
1. Pre-Trial Appraisal Procedure 92
2. Exit Instead of Voice and Loyalty 92
3. Judicial Appraisal Procedure 93
V. Negotiations 94

In German Stock Corporation Law, there are numerous situations in which shareholders are forced to leave the company. In other cases, shareholders are given the option to exit the company. In many of these cases, the law demands a court-administered appraisal of the true value of the shares. Sometimes, shareholders are not entitled to what the court deems their shares to be worth, but rather to what is determined by the market. In yet other cases, courts have experimented with the idea that no valuation is needed if the parties to the transaction have negotiated the terms of the deal at arm's length. This chapter provides an overview of these transactions and outlines the law governing the valuation of shares, including the most important rules of civil procedure.

I. Transactions

There are numerous transactions which trigger shareholders' exit and compensation rights and require a judicial valuation of shares [1]. In other situations, the law provides shareholders with exit and compensation rights but denies them access to a court-administered valuation of shares [2].

1. Transactions Requiring a Court-Administered Valuation of Shares

a) Formation of a Corporate Group

German corporate law distinguishes between two basic types of corporate groups: "de facto corporate groups" and "contractual corporate groups". The latter are corporate groups based on an intergroup agreement as provided by §§ 291, 292 Stock Corporation Act *(Aktiengesetz),* while the former are purely factual, i.e. not based on such an agreement. Two types of intergroup agreements are particularly common, mostly – but not exclusively – for tax reasons: domination agreements *(Beherrschungsverträge)* and profit- and loss-pooling agreements *(Gewinnabführungsverträge).* These contracts establish a close legal relation between the parent company and the subsidiary, in which the subsidiary gives the parent company access to its assets and activities, thus losing its economic and legal independence.[1] The law does not expect minority shareholders of the subsidiary to condone such a dramatic change of corporate structure. According to § 305 Stock Corporation Act, they may leave the corporation and claim full compensation.

b) Squeeze-out and Mehrheitseingliederung

Under German stock corporation law, majority shareholders may exclude minority shareholders from the company by passing a squeeze-out resolution in the general meeting (§ 327a Stock Corporation Act). Such a resolution requires that the requesting shareholder ("main shareholder") hold a majority interest of 95 per cent in the company. As soon as the resolution takes effect, the minority shareholders' interest in the company is automatically transferred to the main shareholder by law. In return, minority shareholders can demand to be fully compensated for their loss in cash.

§ 320b Stock Corporation Act provides minority shareholders with a similar remedy in the case of *Mehrheitseingliederung,* a special intergroup freeze-out measure particular to German law. Like a squeeze-out, this transaction requires that the parent company hold a majority interest of 95 per cent in the subsidiary. However, unlike the case in a squeeze-out, minority shareholders forced to leave the subsidiary are not compensated in cash but, as a general matter, in stocks of the parent company.

c) Merger

German corporate law provides companies with a relatively easy and convenient way to effectuate a merger by utilizing the concept of universal succession *(Gesamtrechtsnachfolge).* Under § 20 Transformation Act *(Umwand-*

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[1] BVerfG, 7 August 1962, 1 BvL 16/60, BVerfGE 14, 263, 281 *(Feldmühle);* BVerfG, 27 January 1999, 1 BvR 1805/94, NJW 1999, 1699, 1700 *(SEN/KHS).*

lungsgesetz), once a merger is registered with the commercial register, all assets and liabilities of the transferring entity *(übertragender Rechtsträger)* are transferred to the absorbing entity *(übernehmender Rechtsträger)* by law. The transferring entity ceases to exist. Its shareholders become shareholders of the absorbing entity. § 15 Transformation Act provides shareholders of the transferring entity (not of the absorbing entity!) with the right to claim cash compensation if the merger ratio is too low and thus unfavourable to them. This requires a valuation of shares administered by the competent court.

In certain merger situations, obtaining an interest in the absorbing entity may not fully compensate the transferring entity's shareholders for their loss of economic interest, even if the merger ratio is appropriate. As an example, imagine the transferring entity is listed on a stock exchange and the absorbing entity is a non-listed private company *(Gesellschaft mit beschränkter Haftung, GmbH).* In this case, without further remedies, the transferring entity's shareholders would be stuck with shares in a private company, which they cannot sell on a liquid market. § 29 Transformation Act therefore provides the transferring entity's shareholders with exit and appraisal rights. These rights apply in those cases where

- the absorbing entity has a different legal form from the transferring entity (e.g. the above-mentioned example);
- the absorbing entity is a non-listed stock company and the transferring entity was a stock-listed company (i.e. no change in legal form but shareholders' lose the ability to sell their shares on an exchange);[2]
- the absorbing entity's share transferability is restricted as a matter of law (i.e. neither a change in legal form nor a loss in "factual" transferability of shares, but a legal restriction on the ability to sell the shares).

d) Change of Corporate Form

Under § 190 para. 1 Transformation Act, corporations can change their legal form by passing a resolution in the general meeting. Thus, a private company *(GmbH)* may choose to become a stock corporation and vice versa. If they do so, § 207 Transformation Act provides shareholders with the right to leave the company and claim fair compensation.

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[2] There is some dispute among legal scholars regarding what exactly qualifies as a stock listing within the meaning of § 29 Transformation Act, see e.g. C. MÜLLER, in: Henssler/Strohn, Gesellschaftsrecht, 3rd ed. 2016, § 29 UmwG marg. no. 6; L. KLÖHN, Das System der aktien- und umwandlungsrechtlichen Abfindungsansprüche (Tübingen 2009), 318.

e) Increase of Capital

Under § 182 Stock Corporation Act, increasing the legal capital of a German stock corporation requires a shareholder resolution passed in the general meeting with a majority of 75 per cent. To protect shareholders against the risk of dilution, § 186 Stock Corporation Act grants all shareholders a subscription right to purchase newly issued shares in proportion to their interest in the company. However, the general meeting may opt to exclude shareholders' subscription rights – for example, to allow the allocation of newly issued shares to a strategic investor or to issue new shares to finance an important acquisition. In this case, § 255 para. 2 Stock Corporation Act allows shareholders to challenge the resolution on the grounds that the price of the newly issued shares is too low.

2. Transactions without Mandatory Valuation of Shares

In the following situations, German law provides shareholders with compensation rights without requiring a valuation of shares.

a) Public Takeover

In a public takeover the bidder is obliged to make an offer to all shareholders of the target company at a price determined by law (§§ 29, 31 Securities Acquisition and Takeover Act). The takeover price may not be lower than

- the target's stock price average of the last three months prior to the announcement of the bid (§ 31 para. 1 Securities Acquisition and Takeover Act; § 5 para. 1 Securities Acquisition and Takeover Act Offer Regulation),
- any price paid to any other shareholder six months prior to the announcement of the bid (§ 4 Securities Acquisition and Takeover Act Offer Regulation),
- any price paid to any other shareholder one year after the announcement of the bid (§ 31 para. 5) Securities Acquisition and Takeover Act).

In general, there is no mandatory valuation of the target's shares, i.e. shareholders are barred from claiming that the average stock price of the last three months does not represent the true value of their shares.[3] There is an exception, however, if market liquidity was exceptionally low during the last three months prior to the offer (for details see § 5 para. 4 Securities Acquisition and Takeo-

[3] U. NOACK, in: Schwark/Zimmer, Kapitalmarktrechts-Kommentar, 4th ed. 2010, § 31 WpÜG marg. no. 35; R. SÜSSMANN, in: Angerer/Geibel/Süßmann, WpÜG, 3rd ed. 2017, § 31 marg. no. 94; H. KRAUSE, in: Assmann/Pötzsch/Schneider, WpÜG, 2nd ed. 2013, § 5 WpÜG-AngVO marg. no. 20 et seq.

ver Act Offer Regulation). In this case the takeover price must reflect the fair value of the target's shares as determined by a valuation of shares.

The same rules apply if a shareholder acquires at least 30 per cent of a listed stock corporation's shares. In this case, the law assumes that the acquiring shareholder has gained control over the company and therefore forces him or her to submit a mandatory bid to all other shareholders under the rules outlined above (§ 35 Securities Acquisition and Takeover Act).

b) Squeeze-out after Public Takeover

If a bidder in a public takeover acquires a 95 per cent interest in the target, it may execute a back-end squeeze-out, i.e. the bidder may force the remaining shareholders out of the company (§ 39a Securities Acquisition and Takeover Act). In this context, the takeover price is deemed to fully compensate the excluded shareholders if the takeover offer was accepted by 90 per cent of the shareholders to whom the offer was made.

c) Delisting

If a listed stock corporation seeks to withdraw its listing, § 39 Stock Exchange Act provides that stock exchanges grant permission on the condition that the company's shareholders receive a takeover bid under the rules of the Securities Acquisition and Takeover Act. The takeover price may not be lower than the stock price average of the last six months prior to the announcement of the takeover offer. Just as in a takeover, there generally is no valuation of shares. However, there are two exceptions: first, if liquidity is very low and, second, if there are signs of market manipulation (for details see § 39 para. 3 Stock Exchange Act).

II. Valuation

The standard valuation method in German corporate law is the capitalized earnings method. It is routinely used by courts in the above-mentioned contexts,[4] and it is the standard method recommended by the German Institute of Chartered Accountants.[5] As is well known, the idea is that the share value equals the (pro rata) present value of the corporation's future earnings plus

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[4] BVerfG, 27 April 1999, 1 BvR 1613/94, BVerfGE 100, 289, 307 *(DAT/Altana);* BVerfG, 24 May 2012, 1 BvR 3221/10, NJW 2012, 3020, 3022 *(Daimler/Chrysler);* BGH, 21 July 2003, II ZB 17/01, BGHZ 156, 57, 63 *(Ytong).*

[5] *Grundsätze zur Durchführung von Unternehmensbewertungen* [Principles for the Performance of Business Valuations], IDW S 1 (Version 2008).

the value of all non-operational assets.[6] The valuation generally occurs in four steps:

- First Step: determination of past earnings (usually from the last three years, adjusting for exceptional events).
- Second Step: prediction of future earnings (taking into account industry- and economy-wide developments as well as the corporation's strategic plans).
- Third Step: determination of the appropriate discount rate, usually on the basis of the Capital Asset Pricing Model (CAPM).
- Fourth Step: determination of the corporate and share value.

This valuation is governed by three basic legal principles: First, the valuation must take into account all information available at the time of valuation, typically the date of the shareholder resolution in the general meeting (valuation date principle, *Stichtagsprinzip*).[7] Second, the valuation must take into account all future developments whose "seed was planted" at the time of valuation ("seed theory", *Wurzeltheorie*).[8] Third, valuation must occur on a stand-alone basis, i.e. irrespective of effects caused by the transaction, especially expected synergies.[9]

III. Price

It is commonly accepted that assessing the true value of shares is a highly difficult and inevitably inaccurate task. On the other hand, the Efficient Capital Market Hypothesis (ECMH) suggests that stock prices in liquid securities markets at any time fully reflect all publicly available information on the

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[6] V. EMMERICH, in: Emmerich/Habersack, Aktien- und GmbH-Konzernrecht, 8th ed. 2016, § 305 AktG marg. no. 54 et seq.; A. PAULSEN, in: Münchener Kommentar zum Aktiengesetz, Vol. 5, 4th ed. 2015, § 305 marg. no. 96 et seq.; J. KOCH, in: Hüffer/Koch, 12th ed. 2016, § 305 AktG marg. no. 24 et seq.

[7] BGH, 4 March 1998, II ZB 5/97, BGHZ 138, 136, 139 et seq. *(Asea/BBC II);* BGH, 21 July 2003, II ZB 17/01, BGHZ 156, 57, 63 *(Ytong);* PAULSEN, in: Münchener Kommentar zum Aktiengesetz, *supra* note 6, § 305 marg. no. 84.

[8] OLG Stuttgart, 1 October 2003, 4 W 34/93, AG 2004, 43, 44 *(Vereinigte Filzfabriken);* OLG Frankfurt, 7 February 2012, 5 U 92/11 AG 2012, 293, 294 *(Eurohypo);* EMMERICH, in: Emmerich/Habersack, *supra* note 6, § 305 marg. no. 56a et seq.

[9] BGH, 4 March 1998, II ZB 5/97, BGHZ 138, 136, 140 *(Asea/BBC II).* This principle has been questioned by many scholars, see, e.g., H. FLEISCHER, Die Barabfindung außenstehender Aktionäre nach den §§ 305 und 320b AktG: Stand-alone-Prinzip oder Verbundberücksichtigungsprinzip?, ZGR 1997, 368, 376 et seq.; R. HÜTTEMANN, Unternehmensbewertung als Rechtsproblem, ZHR 162 (1998) 563, 571 et seq.; EMMERICH, in: Emmerich/Habersack, *supra* note 6, § 305 marg. no. 71.

traded shares.[10] Thus, just as in many other countries, German courts have had to address the question of the extent to which shareholders' compensation must reflect the pre-transaction share price, i.e. the price shareholders could have received if they had sold their shares prior to the announcement of the transaction.

In 1999 – at the height of the dotcom stock market frenzy – the German Constitutional Court decided that the constitutional right to freedom of property (Art. 14 German Constitution) mandates that courts "take into consideration" the share's stock price when deciding upon shareholders' compensation.[11]

Roughly two years later, the Federal Court of Justice specified the details of this mandate. It ruled that, as a general matter, shareholders' compensation may not be lower (but can be higher) than the stock price average of the last three months before the shareholder assembly's approval of the transaction.[12] Two exceptions apply: first, in cases of exceptionally low liquidity and, second, if there are sufficient grounds to believe that the stock price was influenced by market manipulation.[13]

In 2010, the Federal Court of Justice partly amended this adjudication and decided that shareholders' compensation may not be lower than the stock price average of the last three months before the announcement of the transaction (not the shareholders' approval of the transactions, which under German law may not be passed earlier than 30 days after the announcement).[14]

IV. Procedure

German law uses two procedural approaches to make sure that shareholders exiting the company receive full compensation: a pre-trial appraisal procedure undertaken by an auditor and a court-administered appraisal procedure if shareholders are not happy with the outcome of the pre-trial appraisal. Both mechanisms apply cumulatively, not alternatively.

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[10] E. FAMA, Efficient Capital Markets: A Review of Theory and Empirical Work, Journal of Finance, 25 (1970) 383; for earlier groundbreaking work on this topic see P. SAMUELSON, Proof that Properly Anticipated Prices Fluctuate Randomly, Industrial Management Review, 6 (1965) 41; B. MANDELBROT, Forecasts of Future Prices, Unbiased Markets, and "Martingale" Models, Journal of Business, 39 (1966) 242 and L. BACHELIER, Théorie de la Spéculation, Annales scientifiques de l'École Normale Supérieure, 17 (1900) 21.

[11] BVerfG, 27 April 1999, 1 BvR 1613/94, BVerfGE 100, 289, 305 et seq. *(DAT/Altana).*

[12] BGH, 12 March 2001, II ZB 15/00, BGHZ 147, 108, 118 *(DAT/Altana).*

[13] BGH, 12 March 2001, II ZB 15/00, BGHZ 147, 108, 116 *(DAT/Altana).*

[14] BGH, 19 July 2010, II ZB 18/09, BGHZ 186, 229, 234 et seq. *(Stollwerck).*

1. Pre-Trial Appraisal Procedure

All of the above-mentioned transactions, which necessitate a valuation of shares, also require shareholder approval, i.e. a resolution passed in the general meeting approving the transaction. This resolution serves as the basis of a pre-trial appraisal procedure. In preparation for the shareholder resolution, the corporation and/or the majority shareholder appoint a contract auditor *(sachverständiger Prüfer)* to assess the intrinsic value of the shares (§§ 293c Stock Corporation Act, 10 Transformation Act). The contract auditor determines the share value and submits a detailed valuation report *(Prüfungsbericht)* to the shareholders prior to the general meeting (§§ 293e, 293f Stock Corporation Act, 60, 12, 63 Transformation Act). In the general meeting shareholders may ask questions and question the valuation (§§ 293g Stock Corporation Act, 64 Transformation Act).

2. Exit Instead of Voice and Loyalty

If shareholders are not content with the valuation, they may not challenge the validity of the resolution approving the transaction on the grounds that the valuation of shares is wrong (§§ 305 para. 5, 327f Stock Corporation Act, § 14 para. 2 Transformation Act). Likewise, they may not challenge the resolution on the grounds that they received false or insufficient information about the valuation (§ 243 para. 4 Stock Corporation Act).[15] Thus, there is basically no way for dissenting shareholders who believe the valuation of shares is inaccurate to impede the transaction.

There are two notable exceptions, however: Shareholders of the *acquiring* entity (not of the transferring entity) in a merger may challenge the validity of the approval of the acquiring entity on the grounds that the merger ratio is unfavourable to them.[16] Likewise, shareholders of a corporation increasing its capital in exchange for assets may challenge the approving shareholder resolution on the grounds that the exchange ratio dilutes their interest in the company, if their subscription rights are excluded (§ 255 para. 2 Stock Corporation Act).[17]

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[15] The Federal Court of Justice had accepted this rule before it was expressly adopted by the legislature in § 243 para. 4 Stock Corporation Act, cf. BGH, 18 December 2000, II ZR 1/99, BGHZ 146, 179 *(MEZ);* BGH, 29 January 2001, II ZR 368/98, NJW 2001, 1428 *(Aqua Butzke).*

[16] BGH, 21. May 2007, II ZR 266/0, NZG 2007, 714; R. STRATZ, in: Schmitt/Hörtnagl/Stratz, (7th ed., Munich 2016), § 14 UmwG marg. no. 30; C. JUNKER, in: Henssler/Strohn, *supra* note 2, § 14 UmwG marg. no. 21.

[17] BGH, 13 March 1978, II ZR 142/76, NJW 1978, 1316, 1318 *(Kali + Salz);* KOCH, in: Hüffer/Koch, *supra* note 6, § 255 AktG marg. no. 16; E. STILZ, in: Spindler/Stilz, 3rd ed. 2015, § 255 AktG marg. no. 12.

3. *Judicial Appraisal Procedure*

Instead of challenging the validity of the shareholder resolution, shareholders may question the valuation of shares in a relatively risk-free special judicial appraisal procedure called *Spruchverfahren*. The costs of this procedure are – at least as far as the first instance is concerned – usually borne by the corporation or the majority shareholder (§ 15 para. 1 Appraisal Procedure Act, *Spruchverfahrensgesetz.*[18] Moreover, there is a ban on *reformatio in peius,* i.e. the outcome of the valuation procedure must equal or exceed the original valuation.[19]

The appraisal procedure can be initiated by any shareholder. The suit must put forward reasons why the pre-trial valuation by the contract auditor is wrong. The substantiation requirements are rather low, however. Judicial activism, i.e. the willingness to enter into a new valuation of shares, varies greatly among courts. Courts may review single aspects of the valuation or demand a completely new valuation.

The judgment passed in the appraisal procedure has an *inter omnes* effect. If the court raises the valuation, all shareholders profit from this raise, not only those who sued (§ 13 Appraisal Procedure Act). As a matter of fact, courts have raised pre-trial share valuations many times, although lately it seems that these cases have occurred more rarely.

Both practitioners and academics have criticized certain aspects of the judicial appraisal procedure. The most common critique is that procedures last too long[20] – in some cases, the appraisal procedure has lasted longer than ten years.[21] Second, many commentators complain that the appraisal procedure creates too much legal uncertainty because of the arbitrary nature of the valuation.[22] This complicates calculating the corporation's exposure, a task which is especially onerous if the appraisal procedure is lengthy. Third, the fact that

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[18] EMMERICH, in: Emmerich/Habersack, *supra* note 6, § 15 SpruchG marg. no. 1; I. DRESCHER, in: Spindler/Stilz, *supra* note 17, § 15 SpruchG marg. no. 1.

[19] D. KUBIS, in: Münchener Kommentar zum Aktiengesetz, *supra* note 6, § 11 SpruchG marg. no. 6; EMMERICH, in: Emmerich/Habersack, *supra* note 6, § 15 SpruchG marg. no. 3; BGH, 18 October 2010, II ZR 270/08, NZG 2010, 1344, 1345.

[20] P. HEMELING, Beschlussmängelrecht – Quo Vadis?, ZHR 172 (2008) 379, 381; E. STILZ, Die Anwendung der Business Judgement Rule auf die Feststellung des Unternehmenswerts bei Verschmelzungen, in: v. Geiss et al. (ed.), Festschrift für Karl Peter Mailänder (Berlin 2006) 423, 424; E. STILZ, Unternehmensbewertung und angemessene Abfindung – Zur vorrangigen Maßgeblichkeit des Börsenkurses, in: Habersack et al. (ed.), Festschrift für Wulf Goette (Munich 2011) 529, 530; for empirical data on the length of appraisal procedures see P. LOOSEN, Reformbedarf im Spruchverfahren (Frankfurt am Main et al. 2013) 60 et seq.

[21] LOOSEN, *supra* note 20, 60 et seq.

[22] STILZ, in: Habersack et al., *supra* note 20, 529; 534 et seq.; STILZ, in: v. Geiss et al., *supra* note 20, 423, 427; U. HÜFFER, Unternehmenszusammenschlüsse: Bewertungsfragen, Anfechtungsprobleme und Integrationsschranken, ZHR 172 (2008) 572, 582.

pre-trial valuations have been raised in many cases raises doubts about the reliability of the pre-trial appraisal procedure administered by a contract auditor.[23] Finally, it has been noted that the appraisal procedure is unique to Germany (and Austria) and is therefore not compatible internationally[24] and might fall prey to the ongoing harmonization of EU company law.[25]

V. Negotiations

As initiating a court-administered appraisal is almost riskless for shareholders and onerous for corporations and majority shareholders, legal practitioners advising the latter parties have been looking for ways to avoid such valuation. One option is to claim that a court-administered valuation of shares is obsolete because the parties to the transaction have negotiated at arm's length about the terms of the transaction and thus about the valuation of shares.[26]

Some courts have been sympathetic to this view. In two judgments, the Higher Regional Court of Stuttgart declined to enter into a full-blown judicial second-guessing of the exchange ratio of a merger among equals.[27] The Regional Court of Frankfurt went one step further and declined full-fledged judicial appraisal in the case of a parent-subsidiary merger because it determined that the parties had negotiated in the same fashion as unrelated parties.[28]

By contrast, the German Constitutional Court in an obiter dictum expressed the view that it would violate the constitutional protection of property if courts relied on the parties' bargaining, because such reasoning would not guarantee that shareholders are fully compensated.[29] Although this obiter

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[23] K. BIDMON, Die Reform des Spruchverfahrens durch das SpruchG (Berlin 2007) 265 et seq.

[24] Cf. the cross-border overview by LOOSEN, *supra* note 20, 135 et seq.

[25] L. KLÖHN, Das Verhandlungsmodell bei konzerninternen Verschmelzungen – Rechtsvergleichende Erfahrungen aus Delaware und ihre Implikationen für das deutsche Recht, in: Habersack et al. (ed.), Festschrift für Eberhard Stilz (Munich 2014) 365, 379.

[26] On the US case law see, e.g., *Getty Oil Co. v. Skelly Oil Co*. 267 A.2d 883, 886 (Del. 1970): "Theoretically, the best definition of 'fairness' in parent-subsidiary business dealings would be to require that the transaction between the two be reached as though each had in fact exerted its bargaining power against the other at arm's length"; along the same lines *Weinberger v. UOP, Inc.,* 457 A.2d 701, 709 (Del. 1983); *Kahn v. Lynch Communications Systems, Inc.,* 638 A.2d 1120 et seq. (Del. 1994); *Strassburger v. Earley,* 752 A.2d 557, 571 (Del. Ch. 2000); *Gesoff v. IIC Industries, Inc.,* 902 A.2d 1130, 1148 (Del. Ch. 2006).

[27] OLG Stuttgart, 8 March 2006, 20 W 5/05, AG 2006, 420 *(Wüstenrot/Württembergische);* OLG Stuttgart, 14 October 2010, 20 W 16/06, AG 2011, 49 *(Daimler/Chrysler).*

[28] LG Frankfurt, 13 March 2009, 3-5 O 57/06, NZG 2009, 553 *(T-Online/Deutsche Telekom).*

[29] BVerfG, 24 May 2012, 1 BvR 3221/10, NJW 2012, 3020, 3022 *(Daimler/Chrysler).*

dictum has been criticized as not being convincing from a constitutional law perspective as well as for being inconsistent with earlier adjudication by the Constitutional Court,[30] it seems that it has never been subsequently challenged by lower courts.

[30] L. KLÖHN/D. VERSE, Ist das "Verhandlungsmodell" zur Bestimmung der Verschmelzungswertrelation verfassungswidrig?, AG 2013, 2, 5 et seq. for a much more favourable view of the decision see H. FLEISCHER/S. BONG, Unternehmensbewertung bei konzernfreien Verschmelzungen zwischen Geschäftsleiterermessen und Gerichtskontrolle, NZG 2013, 881.

Valuation of Shares in Korean Corporate Law

Ok-Rial Song

I. Introduction 97
II. Valuation of Listed Shares 100
1. Market Price as the Fair Value of Shares 100
2. Recent Samsung Group Merger 104
3. Discussion 107
III. Valuation of Non-Listed Shares 113
1. Rules and Court Decisions 113
2. Categorizing the Issues 118
3. Seeking a Fair Price Range: A Procedural Approach 120
4. Seeking a Specific Point of Fair Price: Persuasiveness Competition 123
IV. Concluding Remarks 127

I. Introduction

Although it does not seem to be clear whether it is a genuine legal issue, the valuation of a firm or its shares has often been seriously disputed in courts. Most of these lawsuits are important in Korean corporate law. To name a few such instances, (i) when shareholders exercise their appraisal remedy, (ii) when the validity of a merger agreement is challenged for an alleged unfairness in the merger ratio, (iii) when a company is accused of issuing new shares or convertible bonds to a third party at a presumably deeply discounted price, or (iv) when a controlling shareholder ousts minorities by a squeeze-out merger or by a forced purchase of minority shares, the valuation of shares is in fact the key issue in determining the validity of the transaction and the liability of each party. Similar to the advanced jurisdictions around the world, the Korean Commercial Code (hereinafter "KCC") assigns the *courts* the difficult task of determining what the *fair* price of the shares is,[1] although most judges have never been trained on financial asset pricing theories or empirical methods.[2]

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[1] See, e.g., KCC §§ 374-2 (4), (5) (appraisal remedy), 360-24 (8), (9) (squeeze-out).

[2] In fact, the lack of knowledge about financial economics may not be a big problem. In many cases where a valuation of life, antiques, or clean environments is at issue, courts

The difficulty of such a valuation stems from two aspects inherent to this problem. One aspect concerns the uncertainty. A unique fair price, which should be objective at the same time, might not exist at all, or it is almost impossible to find it even if such a fair price ever exists. We have a set of developed financial theories on asset pricing, but most variables used in this process are just estimates, which are inevitably subject to statistical errors. The other aspect is the distorted incentive of each party to report incorrect valuation numbers. In the corporate reorganization process, for instance, creditors are likely to underestimate the firm's value, while shareholders have an incentive to report the value higher than it actually is.[3] Similarly, in most appraisal remedy cases it is often observed that the contending shareholders argue for a price two or three times higher than the company proposes. Such an incentive is created not only from the uncertainty. Although each party may have fairly close estimates of a firm's value, such an incentive problem tends to prevent accurate reporting.

The response of the Korean legislators and courts to this problem appears to be a pursuit for an objective number, regardless of whether it reflects a true or fair value. The Korean Capital Market Law (hereinafter "KCML"), for instance, provides a specific valuation method for determining the merger ratio when a listed company is involved in a merger transaction, either as a merging or merged party.[4] The valuation of non-listed companies involved in that transaction is subject to this rule as well. The Korean Estate and Gift Tax

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have rendered a decision without professional expertise regarding such a valuation. The same approach can be applied for the valuation of shares.

[3] In the reorganization process, shareholders and creditors have incentives to report different estimates on firm value. To illustrate, suppose that a firm's true value is $100. The firm issued 100 shares and raised a debt of $50. The reorganization plan contains a debt-equity swap for all the debt, and thus the firm will be a non-leveraged company after reorganization. In such a case, the final wealth of shareholders and debtholders depends on the valuation of the firm. (1) Suppose that the firm value is reported and approved by the court as $80. In order to distribute $50 to debtholders, 62.5% of the firm should then be assigned to debtholders, since $80 X 62.5% = $50. Debtholders obtain 62.5 shares by debt-equity swap for their $50, and current shareholders should cancel 62.5 shares. As a result, debtholders can get $12.5 more than their true wealth of $50, the amount which debtholders would have if the firm were correctly valued. (2) Suppose, on the other hand, that the firm value is reported as $120. In such case, assigning 41.7 shares is enough to compensate the debtholders $50, since $120 X 41.7% = $50. Current shareholders will cancel 41.7 shares, and finally end up with owning 58.3% of the firm. Debtholders' wealth is just $41.7, which is lower than $50. This simple numerical example clearly shows that creditors – generally investors with high priority – have incentives for under-estimating the company's value, while shareholders – generally investors with low priority – have incentives for over-estimating. Such disagreement on a firm's value may often impede the negotiation between shareholders and creditors.

[4] KCML Enforcement Decree §176-5 (1). For details, see *infra* notes 9 and 32 and the accompanying text.

Law (hereinafter "KEGTL") also stipulates an objective valuation formula, though only for non-listed shares;[5] developed for taxation purpose, it has also been heavily relied on in business negotiations. Judges also seem to prefer numbers that are more objective. To be sure, it has long been held that many circumstantial facts should be taken into account in determining whether the valuation is legally fair. In practice, however, courts tend to obtain a valuation number simply by averaging several objective numbers, such as book value, previous earnings, and market price, if any.[6] Financial economists have criticized that such a tendency was the same as giving up on finding a true value of the firm.

Moreover, such rules and court decisions may create several inefficiencies on the parties' incentive structure as well as the overall distributive outcome. First, the immediate concern is that the valuation number obtained from this process is highly likely to deviate from the true or fair value of the firm. Since the price determines the distribution of total value, this system will end up with an unfair wealth transfer. Second, business deals or negotiations often would fail to continue if the negotiated price were not sufficiently close to the objective number obtained from the above process. Worse yet, negotiations would still fail even if the parties agree on the valuation, which is far from such an objective number, since it is uncertain whether the deal will be approved by the financial regulators or courts.[7] Finally, controlling shareholders in Korean corporate groups may attempt to engage in related-party transactions if they find that such an objective number can be used to their benefit. Such an attempt causes an inefficient tunneling problem, but these shareholders are likely to be exempted from legal liabilities since they will be held to have transacted in accordance with the valuation rules.

This paper aims to address these problems and suggest several alternative approaches to mitigate them. For analytical purposes, these issues will be categorized along the following two dimensions. One is the dichotomy of *listed v. non-listed* shares. In fact, most valuation issues are raised in relation to non-listed shares. Listed shares are traded at the daily market price, which is determined by dispersed investors in the stock market and thus can hardly be distorted by a certain individual. To be sure, market price is not always an exact measurement of a firm's value. There are many financial studies arguing that statistical noise is inevitably associated with the stock price. Admitting that, however, it is still true that the parties involved in the dispute are

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[5] KEGTL § 63 (1); KEGTL Enforcement Decree § 54. For details, see *infra* note 30 and the accompanying text.

[6] See *infra* note 38 and the accompanying text.

[7] Financial regulators tend to reject the registration statement unless the merger ratio is determined by the KCML rule. For details, see *infra* Part II.1.a). Similarly, courts also seem to hesitate to approve a price negotiated on the basis of the discounted cash flow approach. For details, see *infra* note 43 and the accompanying text.

unable to suggest more convincing alternatives than market price. In fact, the market price is accepted in most cases as *the* fair value of listed shares. The Korean court, for instance, has repeatedly held that, unless evidence strongly indicates that the market price diverges from the fundamental value of the firm, the market price should be deemed as the fair value of the shares.[8] Sometimes, however, its fairness has been challenged in civil lawsuits. In a recent merger case between two listed companies within the Samsung Group, for instance, the contending minority shareholder claimed that the merger ratio, which was based on the market price of each company, was unfair. This case has had huge implications for corporate law theory, and thus we will examine it in detail in Part II.

The other dimension is the type of questions that the court is required to handle. Courts are frequently required to *find a specific point* as to the accurate value of shares. Examples here are disputes in relation to an appraisal remedy or the squeeze-out of minorities, in both of which courts have to pick a specific valuation number. In such cases, a dollar change results in a corresponding wealth transfer between the parties. On the other hand, when the fairness of the merger ratio is challenged or directors are held liable for issuing new shares to a third party at a discounted price, the court does not have to determine what the exact number is. Instead, the issue is whether the merger ratio or issue price deviates significantly from a certain range of fair value. In such cases, a small estimation error has little impact on the final court decision, and thus courts are likely to examine more closely the information process used by the company in getting the valuation number. Part III will discuss these two situations separately in relation to non-listed shares.

II. Valuation of Listed Shares

1. Market Price as the Fair Value of Shares

a) Unique Legislation on Valuation of Listed Shares

The story begins with a seemingly *unique* piece of legislation governing the valuation of listed shares. In a statutory merger, it would be common in most advanced jurisdictions that the merger ratio be derived from the relative value of the shares of each contracting company. The valuation of shares, whether they are listed or non-listed, is in fact merely a matter of business negotiation. Even market price does not prevail over contractual freedom. This is not the case in Korea, however, as long as either a merging or merged company is

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[8] Korean Supreme Court 2007 Da 64136, rendered on 10 January 2008. For details, see *infra* note 15 and the accompanying text.

listed on the Korean Stock Exchange. There is no equivalent or similar rule in Japan, China, or Germany.

When a listed company is involved in a merger either as a merging or merged party, the KCML requires that the merger ratio should be based on the value of shares determined by a specific valuation formula. As far as a listed company is concerned, for instance, the value of shares should be their *market price,* which is defined under the KCML as a simple average of three prices, such as monthly average price, weekly average price, and the price at the time of the base date.[9] These three periods start backwards from the base day, which is defined as the day preceding the earlier date of the merger contract and the board of directors' resolution for the merger.[10] It is worthwhile to note that the KCML uses an average of several market prices instead of a single market price at the base date. It intends to prevent market manipulation and mitigate the effect of price fluctuation. The KCML allows for a 30% – or 10%, if both parties belong to the same corporate group – margin above and below the above market price, in order to allow room for negotiations.[11] This provision also regulates the valuation of non-listed shares, which will be revisited later in this paper.[12]

The most astonishing feature of this rule is that it applies *mandatorily* regardless of the intention of the contracting parties. There is no explicit provision mentioning that this is a mandatory rule, but the Financial Supervision Services (hereinafter "FSS"), the Korean government agency for regulating the financial market, has regarded it as such. As a result, when a merging company issues new shares for merger and thus has to file a registration statement with the FSS, the application for such registration is very likely to be rejected unless the merger ratio has been determined by the above valuation rule. Even if the parties lengthily negotiated and finally agreed on a different valuation – falling outside of the 30% or 10% margin mentioned above – such a registration statement will not be accepted by the FSS because they did not comply with the above KCML rule. Thus, this rule has an effect of discouraging negotiations in merger transactions. Roughly put, negotiation on merger ratio is neither possible nor in fact needed in Korea.

b) Economic Rationale

This practice seems to be very odd for legal scholars in most jurisdictions around the world, including Japan, China, and Germany. They will fail to understand out why legislation has left no room for merger negotiations. Korean

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[9] KCML Enforcement Decree § 176-5 (1). For details, see also Regulation on Issuance & Disclosure of Securities § 5-13. Guidance Rule §§ 4 to 6.

[10] *Id.*

[11] *Id.*

[12] See *infra* note 32 and the accompanying text.

corporate law scholars were not able to find any evidence of legislative intent, either. It has been argued, however, that the rule can find economic justification if the ownership structure of Korean companies is taken into account.

Most big companies in Korea are affiliated in corporate groups, which are controlled by controlling families. Although the KCC provides for statutory merger as a typical way of business combination, statutory merger only very rarely occurs in arm's length deals between companies outside corporate groups or between companies of different corporate groups. In those cases, stock acquisitions or asset transfers are instead used for acquiring a target.[13] On the other hand, statutory merger is frequently used in restructuring a business *within a single corporate group,* in which both the merging and merged companies are controlled by the same controlling shareholder. Since such a controlling shareholder is able to determine the deal structure or, more specifically, the merger ratio and timing schedule, serious concerns regarding an abuse of this power seem to be legitimate. The merger ratio inevitably influences the ownership structure of the combined company, and thus controlling shareholders have incentives to, and at the same time are able to, make use of such power so as to end up having more control over the corporate group or extracting pecuniary private gains from the merger.

The agency problem associated with controlling shareholders in Korean corporate groups seems difficult to manage. Most internal and external corporate governance systems in Korea have ultimately failed to prevent controlling shareholders from pursuing excessive private benefits. Against this backdrop, the valuation rule stipulated by the KCML may be fairly said to directly regulate such perverse incentives. It basically prescribes that the merger ratio should not be decided by controlling shareholders. A mere 10% margin is allowed. Instead, market price should prevail in most cases. Simply put, the very nature of a mandatory rule, depriving controlling shareholders of any discretion on firm valuation, is in fact the key element for achieving the legislative goal, given the fact that statutory mergers are only found in business combinations within a corporate group.

c) Court Decisions

To be sure, market price is the best estimate available in most cases. The discounted cash flow method (hereinafter "DCF method"), which involves more uncertainty in terms of applying the variables, cannot guarantee finding more convincing alternatives than market price. This does not mean, however, that market price is always a fair value for listed shares. Sometimes, for instance, market manipulation may be secretly attempted. A sudden exoge-

[13] Stock acquisition is treated merely as a sale of stocks under Korean law and thus is excluded from most of the regulations imposed on a merger. Asset transfer is also free from the creditor protection regime under the KCC.

nous economic crisis may temporarily hammer the stock price down. There are many scenarios in which market price deviates from the fundamental value, if any, of the firm. It is not theoretically impossible, therefore, that a merger ratio based on the market price of each company's shares may fail to provide a fair exchange rate.

In such cases, the contending shareholders of either party will challenge the fairness of the merger ratio. In Korea, if the merger ratio is *significantly unfair,* the legal effect is not limited to triggering ex-post liability of directors. Rather, the merger transaction should be held void under the KCC,[14] since the merger ratio is regarded as a key element to protect minority shareholders. In practice, however, the courts have never as yet held that a merger ratio was significantly unfair and thus that the merger contract should be nullified. But further comment is warranted since, as mentioned above, many merger deals have been made within a corporate group, in which a controlling shareholder has an incentive to pursue private benefits by manipulating the merger ratio, and as a result it might not be rare that the merger ratio was unfair to some extent. Nevertheless, no court decision has repudiated the validity of a deal. One of the reasons, to be sure, is that in order for the merger transaction to be held void, such unfairness should be significant, which could hardly be recognized by judges.

In terms of the valuation problem, however, what bears further emphasis is that most transactions could not avoid adopting the valuation method stipulated by the KCML. The valuation based on market price could deviate from the fair value, but at the same time it was necessarily the case that the valuation was in compliance with the KCML rules. In fact, the court always endorsed the validity of such a merger ratio, arguing that it is the *law itself* that requires contracting companies to value the shares in such a way. Market price calculated by the KCML should be deemed as the fair value of shares, unless evidence strongly indicates that the market price is highly likely to diverge from the fundamental value of the company.[15] The examples of such situations may include the case where most relevant materials and data in relation to conducting a valuation were created without proper authentification, or where important estimates were intentionally manipulated. Such situations have not been recognized by the courts as yet, however.

More interestingly, the court applied this approach even for distressed or bankrupt companies as long as they were still listed on the market, as illustrated by a 2011 Korean Supreme Court ruling.[16] In fact, in this case the district court initially held that market price would not be an adequate estimate for such distressed firms because such price might have been influenced by

[14] This is the dominant view in corporate law academia in Korea.

[15] Korean Supreme Court 2007 Da 64136, rendered on 10 January 2008.

[16] Korean Supreme Court 2008 Ma 264, rendered on 13 October 2011.

the fact that the company was in the vicinity of bankruptcy. The Korean Supreme Court, however, held that there was no convincing reason or evidence for rejecting the prevalence of market price, as long as the market price still exists. The courts remain stuck to the primacy of market price.

2. Recent Samsung Group Merger

Market price prevails in most merger cases, and the KCML mandatorily requires that. In most cases, in fact, it would be widely accepted even among financial economists that there is no better estimate for valuation of listed shares than market price, unless such market price is manipulated. The question raised in this context, therefore, is whether the market price can *necessarily* be said as a fair price in terms of a distribution of wealth between the shareholders of merging and merged companies. The recent merger within the Samsung Group, between Cheil Textile (hereinafter "Cheil") and Samsung C&T (hereinafter "C&T"), cast some doubt on such a conventional belief and raised several theoretical questions in relation to the valuation of listed shares.

a) Merger

It has been well documented in corporate governance literature that family control over the Samsung Group, as well as other Korean Chaebol groups, has been maintained through complicated circular shareholdings or stock pyramids.[17] In the Samsung Group's ownership structure, Cheil was deemed as a holding company. The share ownership controlled by the controlling family reached 52%, including 42% directly owned by the controlling family. On the other hand, C&T was important to the Samsung Group in a different sense, since it owned 3.5% of Samsung Electronics, which was one of the world's leading companies in the smart-phone and electronics industries. Such an ownership of 3.5% should by no means be ignored, since the controlling family directly owned merely around 4% of Samsung Electronics. Thus, successfully maintaining control over C&T was crucial for the controlling family's interests. That might be one of the important reasons that the Samsung Group attempted a merger between Cheil and C&T. The most notable feature in this merger was that the inside control – the control block owned by the controlling shareholders and related parties, no matter whether they were persons or companies – over C&T was quite small. The Samsung-affiliated entities owned merely 13.6% of C&T shares, among which only 1.7% was directly owned by the controlling family.

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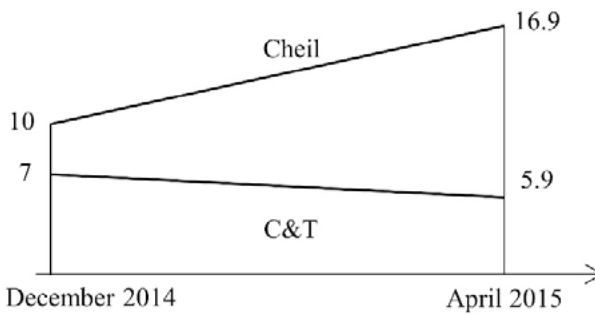
[17] R. La Porta/F. Lopez-de-Silanes/A. Shleifer, Corporate Ownership Around the World, 54 Journal of Finance 471 (1999), 485.

Simply put, Cheil and C&T of Samsung Group were controlled by the same family, but there was a huge gap in the size of direct ownership by the family: 42% for Cheil and 1.7% for C&T. Both companies were listed on the Korean Stock Exchange. It was well known that control over C&T was tremendously valuable to the controlling family. Arguably, therefore, public investors might rationally expect that, when a transaction such as a merger was initiated between Cheil and C&T, the controlling family was likely to do something in order to transfer wealth from C&T to Cheil. Such a scenario would look more plausible if the level of investor protection in the Korean stock market recognized by public investors were low. Thus, investors would start to sell C&T and buy Cheil. As a matter of fact, the following figure illustrates the stock price movement before the merger agreement was disclosed, and it clearly shows that such an expectation indeed existed.

Figure 1: Stock Price Movement



Cheil went public in December 2014, and the merger agreement was disclosed in May 2015. In the meanwhile, the stock price of Cheil gradually increased, while that of C&T decreased. In December 2014, for instance, a C&T share was equivalent to 70% of a Cheil share, but four months later it was worth just 35% of a Cheil share. The market price of C&T compared with Cheil tumbled down by half during this period, but there was no significant shock in Samsung's business nor in the Korean economy. The merger between Cheil and C&T was approved by the C&T board of directors on 26 May 2015, with the merger ratio being based on the corresponding market prices, according to the KCML rule mentioned above. The average market price was KRW 55,767 for C&T and KRW 159,294 for Cheil, and thus surviving Cheil would issue at 55,767/159,294, or 0.35 shares for merger to each share disappearing from C&T shareholders.

b) Disputes and Court Decisions

A U.S. hedge fund, Elliott Associates, L.P. (hereinafter "Elliott"), bought 7.12% of C&T voting common shares and claimed that such a merger ratio was significantly unfair compared with its asset value and annual earnings, and thus it announced its opposition to the proposed merger. Elliott's view was that the market price of Cheil and C&T did not reflect the fundamental value of each company. The book value of C&T, for instance, was three times larger than that of Cheil, but its market capitalization was just less than a half of Cheil. As a result, the price-book-ratio, or PBR, was only 0.65 for C&T, while it was 4.8 for Cheil. Even if it was admitted that there might be differences in the business opportunities and future earnings between the companies, it seemed evident that such a huge gap could not be easily explained. Elliott therefore strongly argued that the merger would end up by transferring wealth from C&T shareholders to Cheil shareholders, 42% of which were in the hands of the controlling family of the Samsung Group.

As a qualified minority shareholder,[18] Elliot filed several motions seeking an injunction to prohibit C&T management from calling a shareholders' meeting to approve the planned merger. In these lawsuits, Elliott argued that the above-described valuation rule of KCML is not a mandatory provision, and thus simply complying with the rule could not necessarily exempt the merger ratio from being judged as significantly unfair. In such a case where the market price seemingly deviated from the fundamental value of C&T, the contracting parties and their directors should have considered several other valuation measures such as asset value, earning value, and a parallel company's value. Unfortunately, however, courts did not agree with this argument. Again, they repeated the established legal doctrine that market price obtained by the KCML rule should be deemed as a fair value of shares, unless the price estimate involved significant fraud or false disclosure.[19] Elliott failed to prove manipulative activities by Cheil management or the controlling family, and the district court finally dismissed the claim on 1 July 2015.[20] The appellate court rejected Elliott's appeal on 16 July 2015.[21] The merger was finally approved by a C&T shareholders' meeting on the next day,[22] 17 July 2015. The Seoul High Court held as follows.

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[18] In order to file a motion for an injunction against a listed company, a shareholder is required to own 0.05% – in the case of large listed companies with total assets of KRW 2 trillion or more, this figure is 0.025% – or more of issued shares for at least six months before filing a motion. KCC § 542-6 (5).

[19] Korean Supreme Court 2007 Da 64136, rendered on 10 January 2008. For details, see *supra* note 15 and the accompanying text.

[20] Seoul Central District Court 2015 Kahap 80582, rendered on 1 July 2015.

[21] Seoul High Court 2015 Ra 20485, rendered on 16 July 2015.

"It is unreasonable to argue that market price does not reflect the objective fundamental value of the firm simply by comparing the asset value, which is just one of the financial indicators, to its market price, which combines every piece of information available, such as the firm's financial condition, profitability, and future business opportunities. […] It is admitted in this case that the market price was lower than the asset value of the firm, while several financial indicators such as total sales and annual earnings per share of C&T were better than those of Cheil. Those facts, however, do not provide evidence enough to prove that the market price was manipulated by the controlling shareholders or was influenced by other manipulative measures which prevented the stock market from properly working. […] Also, it was similarly unproved that the valuation in this case was based on false information or an unreasonable estimation of the variables. Thus, the merger ratio should not be regarded as significantly unfair when the shares of each company were valued by the market price according to the KCML rule."[23]

The merits of these lawsuits were closely linked to the stock price movement of Cheil and C&T. The sharp increase of Cheil and the corresponding decline of C&T might have resulted from unlawful intervention by the controlling shareholder, i.e. the Samsung Group. There were reported rumors, for instance, that C&T suddenly stopped construction or that C&T managers did not disclose valid information. Elliott also argued that C&T management and the controlling shareholder (the Samsung Group) engaged in several unlawful manipulative activities.[24] None of these suspicious rumors, however, were proved at the court.

3. *Discussion*

This paper does not address the issue of whether there were manipulative activities by the management of Cheil and C&T and the controlling shareholder (the Samsung Group). Rather, it will be assumed that there was no such manipulation. Yet even under the contrary assumption, the striking stock price movement described above – a sharp increase for Cheil and a corre-

[22] The merger requires a vote of more than two-thirds of attending shares. KCC §§ 522 (1), (3). As of the end of 2014, the ownership structure of C&T was as follows; Samsung-affiliated persons or companies 16.9%, ESOP 0.1%, financial institutions 28.5% (including 13.1% held by the National Pension Fund), foreign investors 27.6%, public individual investors 21.1%, treasury shares 5.8%. The treasury shares were sold to a friendly shareholder in 2015. In the shareholders' meeting for approval, 58.91% of the total existing shares cast a vote in favor of the merger, whereby 83.57% of all shares were in attendance. It was just slightly over the two-thirds threshold. Most financial institutions, including the National Pension Fund, voted for the merger, and they thus played a pivotal role in this process.

[23] *Id.*

[24] In fact, such manipulative activities were recognized in a court decision. Seoul High Court 2016 Ra 20189, 20190, 20192, rendered on 30 May 2016. This is an appellate court decision on appraisal remedies sought by the minority shareholders of C&T, but the issue is still in dispute. It is now pending at the Korean Supreme Court.

sponding decline for C&T for a relatively short five-month window, without any significant shocks – could still be rationally explained. The stock market knew that succession of control to the next generation was imminent, and the IPO of Cheil in December 2014 was a part of that plan. A merger between Cheil and C&T was anticipated to take place in the near future, although nobody knew the exact timing. The investors knew it long before the official disclosure, and they also knew that, since there was a huge gap in the controlling family's direct ownership of each company, a merger would be structured to favor the shareholders of Cheil. Simply put, they would have rationally believed that the investment strategy of "getting on board with the controlling shareholders" would prevail. Thus, they sold C&T and bought Cheil, and the stock price moved accordingly.

a) Significantly Unfair?

Elliott lost its injunctive relief lawsuits and abandoned court proceedings immediately, but the fairness of the merger ratio was challenged again by another minority shareholder of C&T, who filed a claim for nullification of the merger.[25] Once again, the claim alleged that the merger ratio between Cheil and C&T was significantly unfair and that compliance with the KCML rule *did not necessarily make it fair.* This case is now pending, but the court decision is not that hard to predict. Although it has been established that a significantly unfair merger ratio may result in the invalidation of the whole merger contract,[26] the Korean courts have not yet held in any lawsuit that a certain merger ratio was significantly unfair and thus that the merger contract should be nullified. The court decisions on Samsung's merger are not likely to deviate from such an expectation.

Three aspects can account for why the courts hesitate to discuss the unfairness of the valuation. First, the actual impact of recognizing a significant unfairness is generally huge under Korean corporate law – nullification of a merger agreement that is already in force and where many legal interests have been intertwined accordingly. The contracting companies themselves, for

[25] This suit is now pending at the Seoul District Court, and the final decision is supposed to be rendered in fall 2017, after a court decision is rendered on a criminal charge of bribery pending against Samsung's controlling shareholder and management.

[26] Viewed from the perspective of a merging company, which issues new shares for merger to the shareholders of a merged company, the unfairness of a merger ratio is equivalent to an over- or under-valuation of the assets contributed to the company in exchange for new shares. Under Korean corporate law, like in other major jurisdictions, the issuance of shares is not nullified just for the reason of over- or under-valuation of contributed assets. Rather, it only triggers directors' liability to the company. Thus, it can be argued that invalidation of a merger agreement due to an unfairness in the merger ratio is in fact inconsistent with legal doctrine already established in relation to the issuance of new shares.

instance, will have already incurred numerous search and negotiation costs and will have changed their business strategy reflecting the merger. There will be many third parties who have entered into transactions with the post-merger entity. Thus, the judges may have no choice but to consider the huge costs accompanying a nullification of the merger.

Second, the merger was approved by more than two-thirds of the C&T shareholders,[27] who would then be victims if the merger ratio was in fact determined contrary to their own interests. As mentioned above, the Samsung-affiliated shareholders owned only 13.6% of C&T, and the other 50% or more shareholders who voted for the merger included financial institutions, pension funds, and foreign investors. If they believed that they would be harmed, there was a chance to vote against the merger. Thus, it would be understandable for the courts to be extremely reluctant to undo a process which was approved by the majority of minority shareholders, unless the process violated the law.

The last aspect, which should be the one most emphasized in this paper, is that the merger ratio was in fact determined *not by the controlling shareholders but by the stock market.* The KCML explicitly mandated it, and there was a legitimate objective, which is also to minimize controlling shareholders' discretion. It is unreasonable and hardly convincing to say that an obedience to the law eventually resulted in a significantly unfair treatment of shareholders. Arguably, market investors might anticipate that the controlling shareholder was likely to engage in improper intervention to some extent. It is worthwhile to note that it did not matter whether the controlling shareholder actually committed illegal activities or not. In fact, the stock price reaction between December 2014 and May 2015 was caused not because the controlling shareholder actually engaged in manipulation, but because investors believed so. Thus, the price immediately prior to announcement of the planned merger could still be regarded as a valid market price, in the sense that it reflected all the publicly available information.

b) *Fairness as Enhancing Distributive Justice and Economic Efficiency*

However, the court decision does not imply that there is no problem at all from legal policy perspectives. Fairness in valuation is required mainly to improve distributive justice by protecting minorities, and it also has the efficiency-enhancing effect of preventing value-destroying activities. In this regard, the court ruling combined with the KCML rule may cause several problems.

First, some public investors of C&T were *actually harmed.* Purely theoretically, the controlling shareholders' pursuit of private benefits, whether pursued at a single company level or at a corporate group level, causes social

[27] See *supra* note 23.

inefficiencies, but it does not actually harm individual public shareholders if such possibilities are anticipated and fully reflected in the stock price. They had probably bought the shares at discounted price, and this could be the case for the minority investors who bought the C&T shares several months before the merger was launched. In practice, however, some investors put their money on C&T long before the event, when the market price could not fully capture the controlling shareholders' incentives. To be sure, it was publicly known that family ownership in C&T was quite small, and thus investors should have been aware of the possibility of the controlling shareholder's attempt to extract private benefits. Unfortunately, however, it was too remote to predict when and how a specific event might take place. Thus, such investors would have suffered from unexpected losses. They could not avoid it by selling their shares since the market price was already discounted when the merger was imminent.

Second, *information asymmetry* may harm public investors. There may be significant information asymmetry between the controlling shareholders and public investors in terms of the current performance and the future business opportunities of Cheil and C&T. Thus, the controlling shareholder, who owns 42% of Cheil but only 1.7% of C&T, is willing to engage in a merger between the two companies only when he or she finds out that Cheil is over-valued or C&T is under-valued, since the deals should be made according to market price. In other words, the very fact that the controlling shareholder decided to aim for the merger can be regarded as evidence that C&T's value as an independent entity was higher than its current stock price. Thus, the announcement of a merger plan delivers a corresponding signal to investors. In such a case, investors with that information have two options, depending on how they calculate the likely success of the planned merger. One option is to buy C&T shares at a current low price and vote against the merger, so as to get a share value as an independent company. Such an option, however, was not viable since C&T was also controlled by the same controlling family. The merger would have been highly feasible. Thus, investors will be likely to pursue the other option, which is to sell C&T to minimize their losses. In turn, however, such a rushed sale will end up in a lowering of the price of C&T and as a result amplify their losses.

Finally, particularly from ex-ante perspectives, the court's approval of the merger *cannot bar* the controlling families' pursuit of private benefits, since the court is eventually approving the price which was based on the belief about the controlling shareholder's abuse of his or her control. The KCC, like corporation law in Japan, China, and Germany, restricts controlling shareholders from freely engaging in self-dealing or stealing corporate funds. Securities regulations also ban manipulative activities or disclosure of misleading information. Many attempts by controlling shareholders to pursue private benefits, therefore, would be illegal, but actual shareholder protection is in

itself far from being perfect. Often, for instance, illegal activities are not detected. Several perfectly legal strategies are still available to extract private benefits. Even investors think so, and the market price of Cheil and C&T moved accordingly. Thus, the court's approving the investors' belief carries the implication that the court approved the whole system, one in which controlling shareholders are able to pursue private benefits *without being punished* at all.

c) Hidden Problems in the KCML Rule

An understanding of the Samsung Group merger sheds light on the relationship between ex-ante regulation and ex-post liability to protect minority shareholders. Simply put, considerable emphasis on a bright-line ex-ante rule can potentially weaken a standard-based ex-post liability regime. A good example can be found in the preemptive rights regulation in Korea. The KCC grants each shareholder a preemptive right, by which he or she is able to subscribe to the new share on pro-rata basis.[28] This is a typical ex-ante regulation to protect minority shareholders from the dilution problem. The negative impact, however, of too much emphasis on a preemptive right regulation is that directors or management are misguided. They are likely to have an incorrect perception that they will not be held liable unless they infringe such preemptive rights. Such belief is of course legally wrong, but they tend to believe that they are fulfilling each and every obligation that is required when it comes to issuing new shares, and thus that they are immune from ex-post liability to the company. Until recently,[29] therefore, companies have issued new shares freely to a friendly third party, after shareholders waive their preemptive rights.

Such a problem could be addressed in relation to the KCML rule. In the merger involving Cheil and C&T, the valuation was provided or in fact ordered by the specific legislation. The KCML provides a bright-line rule for valuation of listed shares, and the traditional "rule v. standard" debate teaches us that such a bright-line rule approach tends to have disadvantages of over- and under-regulation. The Samsung Group merger case was a typical example of *under-regulation.* As long as the parties comply with a certain bright-line rule, no substantial scrutiny could be triggered to evaluate its true effect, and such a limitation can be extended even to a directors' liability regime. It can be questioned, for instance, whether it is possible for the court to reach a different conclusion about a corporate decision which has followed the bright-line rule. Arguably, the answer would be negative. Courts could not reject internal con-

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[28] KCC § 418 (1).

[29] In 2013, the KCML was revised to impose more restrictions on the issuance of new shares after shareholders waive their preemptive rights. KCML § 165-6 (2). In principle, such shares should be cancelled, and it is required to put them on a new issuance schedule.

sistency in a legal system, and thus it is very hard to blame the controlling shareholders for obeying the rule. Theoretically, to be sure, the controlling shareholder and management of C&T could be held liable for a violation of their fiduciary duties even if they obeyed the KCML valuation rule. They should have been more cautious about the timing of the merger transaction. In practice, however, it is improbable for the court to say so. Even worse, the KCML valuation rule has been regarded by the FSS as a mandatory rule, and thus courts cannot require the controlling shareholder to decide differently. As a result, the *liability regime* in corporate law could hardly be triggered.

Several efficiency-minded commentators in Korea argue that the KCML rule should be reconsidered or repealed because the rule impedes negotiations between contracting parties. A third party – legislative organization – cannot know about the true value of the firm. More skeptically, it is questionable whether such true value ever exists. Thus, it has been argued that the proper valuation can be achieved only by the negotiation process between parties, which the KCML actually prohibits. This argument is absolutely convincing, but it is not the KCML rule that blocked bilateral negotiations in the Samsung merger case. Even if such a rule did not exist, Cheil and C&T would not be expected to truly negotiate the merger ratio. They are affiliated companies of the Samsung Group, over which the controlling shareholder exercises control. The lack of a negotiation process is absolutely a problem, but it is not a significant issue caused by the KCML rule. Rather, the real problem with this valuation rule is that it is a serious impediment to the directors' liability regime. With the KCML rule in place, the whole legal system, including directors' liability, is – in the name of consistency – obliged to approve the validity of the merger contract. Arguably, this effect was never intended by the legislators, nor would it be theoretically correct. It is inevitable, however, that the court could hardly avoid this conclusion.

d) Note on Repeal of the KCML Rule

It should be briefly noted that repeal of the KCML rule is not a solution for restoring the liability regime. If this rule were abolished, the managerial decision on the merger ratio would be subject to the traditional ex-post liability regime, and thus minority shareholders of C&T could better rely on ex-post remedy. In such a case, however, controlling shareholders could make use of the lack of any ex-ante regulation. The current Korean ex-post liability regime is not effective in deterring controlling shareholders from pursuing private benefits. In the end, all legal rules are complementary to each other, and the KCML valuation rule is regarded as a second-best solution in a country with lower investor protection, such as Korea.

III. Valuation of Non-Listed Shares

1. Rules and Court Decisions

In Korea, like other jurisdictions, valuation has been disputed more often in respect of non-listed shares than in respect of listed shares. Most court decisions concern non-listed shares, and several legal doctrines have been developed. The most frequently filed actions have been appraisal remedy suits, but court challenges have also sometimes been filed in instances of controlling shareholders' allegedly maintaining or expanding their control using non-listed companies.

Since a market price is not available for non-listed shares, such valuation has been based on two different alternatives. One is the "asset-value" (hereinafter "AV") approach, under which the value of a share is defined as a per-share value of a net asset on the firm's balance sheet. The AV method is based on an asset's book value, which can be its historic cost or current market value depending on the principle, and thus it is superior in terms of objectivity, but it does not fit the theoretical definition of firm value. The AV is equivalent to the liquidation value in a bankruptcy proceeding. The other is the "earning-value" (hereinafter "EV") approach, under which the value of a share is defined as a sum of future earnings or cash flows discounted by an opportunity cost of capital. The EV approach is theoretically correct, since the earnings or cash flows are exactly what investors intend to gain by buying shares, but it has a critical disadvantage in terms of objectivity. The whole validity of the valuation process depends too much on a correct estimation of future earnings and the discount rate, which is still very hard to achieve. The EV is equivalent to the going concern value in bankruptcy proceeding. The AV and EV approaches have been combined in several valuation rules and court decisions in Korea.

a) Valuation Rules for Non-Listed Shares

Several rules in Korean tax law and capital market law provide an objective bright-line rule for the valuation of non-listed shares. The KEGTL, for instance, stipulates an objective valuation formula, by which the value of non-listed shares is defined as a weighted average of 3 times the EV and 2 times the AV.[30] In order to make it *objective,* however, the EV approach is modified in the KEGTL. That is to say, the EV does not estimate the future cash flows but instead adopts a weighted average of the net profit for the last three years. The discount rate in this formula is also objectively determined relying on the interest rate of a three-year maturity guaranteed bond.[31] All the num-

[30] KEGTL § 63 (1); Enforcement Decree § 54.

[31] *Id.*

bers adopted in the EV approach in the KEGTL were already fixed in the past balance sheet. The AV is also slightly modified, but the purpose is to prevent tax avoidance.

Another valuation rule for non-listed shares is the KCML. The KCML rule discussed above in Part II also stipulates a specific valuation method for determining the merger ratio in respect of non-listed companies.[32] The precondition is the same. At least one party in a merger transaction should be a listed company. Thus, this rule will apply when it comes to a merger between a listed and a non-listed company. In such cases, the value of non-listed shares should be obtained by a weighted average of 1.5 times the EV and 1 times the AV.[33] Until recently, such formula had also put emphasis on the objectivity of the valuation, and the EV approach was modified to employ numbers that are more objective. Instead of estimating future cash flows, for instance, only earnings forecast for the next two years' balance sheet were used as a proxy for future cash flows. It assumed that such earnings would persist forever. The discount rate was also based on the current market interest rate for bank deposits. In 2012, this approach was amended so as to allow firms to choose any valuation model based on the EV of the company, as long as it could be regarded as fair and generally accepted.[34] Such models include the DCF method, which has been the most controversial in relation to the valuation of non-listed shares. The DCF method will be fully discussed later in this Part. Currently, the KCML rule does not exclude the DCF method.

b) Court Decisions

Judges also seem to prefer numbers that are more objective, but they have not been bound by the statutory valuation rule discussed above. The KFGTL rule and the KCML rule specifically aim at regulating perverse incentives for taxpayers or controlling shareholders, and thus there is no legal ground for courts to follow these rules. In fact, there were several cases in which the court did not approve a business decision that relied on the KFCTL rule. For instance, in a case where a director's liability for a sale of non-listed stock to a related party was claimed, the district court held that valuation according to the KFGTL would in that case violate the director's fiduciary duty.[35] In terms of valuing shares, the court held, the director should have taken the following

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[32] KCML Enforcement Decree § 176-5 (1); Regulation on Issuance & Disclosure of Securities § 5-13; Guidance Rule §§ 4 to 6.

[33] Regulation on Issuance & Disclosure of Securities § 5-13; Guidance Rule § 4.

[34] Regulation on Issuance & Disclosure of Securities § 5-13; Guidance Rule § 6 ("The earning value referred to in Regulation § 5-13 should be calculated reasonably by applying the valuation models that are generally regarded as fair and acceptable, such as the discounted cash flow model, the discounted dividend model, and so on.").

[35] Seoul Southern District Court 2003 Gahap 1176, rendered on 17August 2006.

into account: (1) The business prospects at the time of sale were positive and thus the share value would be likely to increase. (2) The share value should have been determined after a due diligence inquiry on the target firm's assets. (3) A comparison of the determined share price with markets in the same industry reflects a significant price gap that would be unacceptable to the market.[36] In such a case, KGFTL valuation is not an option for directors to take. The court also reached similar conclusion in another valuation case, saying that the directors should have asked a professional institution such as an accounting or consulting firm for a reference price of target shares. Thus, simply valuing the shares according to the KGFTL method without such a process would be a violation of director's fiduciary duty.[37]

Particularly in appraisal remedy suits, which, as stated above, the courts faced most frequently, the KGFTL and the KCML rules did not provide any guidance. The courts had to find their own way through, and now they have actually developed a set of rules in case law. The principle is as follows.

> "When dissenting shareholders claim their appraisal remedy for non-listed shares, the valuation of such shares should be based on the market price, if there were several ordinary transactions on which the objective exchange value of the shares was reflected. The price of these transactions should be deemed as the market price of such shares. In the absence of such transactions, however, *courts should rely on the several generally accepted valuation methods, such as the market value approach, the AV approach, and the EV approach.* […] In doing so, courts should consider several facts, including the business circumstances of the firm and its industry. […] When courts combine several valuation approaches, weightings should be individualized according to the business circumstances of the firm and its industry, the adequacy of each approach to find an objective value in specific situations, and the possibility of errors, if any, in the valuation process."[38]

In short, courts have a wide range of discretion. They can combine several valuation methods and take into account many circumstantial facts of the firm and its industry. A weighting can be assigned differently between the valuation methods, and in extreme cases it is permissible to exclude certain methods. All can be decided by judges. Thus, the above passage seems to announce that the valuation of shares is a *legal* issue, not a financial one. The problem with such discretion, however, is that judges have not been trained on how non-listed shares can be valued. Few can handle the numbers left scattered in front of them. In practice, therefore, courts tend to simply average the market value, the AV, and the EV with equal weightings, unless one of these figures is unavailable or is too remote from the others. At the same time, courts prefer objective information. The EV approach in court rulings, for instance, does not mean the DCF method. Courts instead often ascertain

[36] *Id.*
[37] Seoul District Court 2003 Gohap 237, 311, rendered on 13 June 2003.
[38] Korean Supreme Court 2004 Ma 1022, rendered on 24 November 2006.

the numbers from current balance sheet earnings. Taken as a whole, current practice in Korean courts resembles the Delaware block method, which had been widely used until 1983 in the United Sates,[39] although established legal doctrines look different.

From a comparative law perspective, it is worthwhile to briefly note that several issues particularly relevant to non-listed shares have not yet been examined in Korean court decisions. (1) The synergy effect of a planned merger is not incorporated in determining the price of shares of dissenting shareholders. To illustrate, for instance, suppose that Company X announced a merger with Company Y, and the stock price of Company X was $100 right before such announcement. Immediately after the announcement, however, suppose that the stock price of Company X increases to $130, anticipating the business synergy gain from acquiring Company Y. In such a case, the dissenting shareholders of Company X are entitled to merely $100, the price that does not reflect any information about a planned merger. Currently, therefore, the expected synergy gain from a planned merger is not distributed to shareholders exiting from the company. (2) Even if the deal involves a significant payment in the form of a control premium given to controlling shareholders, such control premium cannot be counted, either, since sharing control premium with minority shareholders has not been recognized under the KCC or the KCML. (3) Non-listed shares are often traded in the OTC market, and in such cases the price tends to be lower than the ordinary market price or the shares' fundamental value, due to the lack of liquidity in non-listed shares. Such a lack of liquidity, however, is not considered in the determination of a fair price. If there were several OTC market transactions, therefore, such a price itself – without any update considering illiquidity – is regarded as a market value.

c) Why Has the DCF Method Been Rejected by the Court?

The most interesting feature in Korean case law is that the DCF method has been more often than not *unaccepted* by judges. The DCF method is the most sophisticated version of the EV approach and obtains a firm value by adding discounted cash flows that the firm will generate in the future. In other words, the DCF simply means the present value of the future cash flows of the firm. The most popular model used in the United States is one in which the discount rate is derived from the "capital asset pricing model (hereinafter "CAPM")", with a five-year window for estimating the future cash flows.[40]

The DCF method can be supported in practice as well as theoretically. This method has been widely adopted in Delaware case law since 1983. In *Weinberger,*[41] the Delaware court discarded the "exclusive" use of the Delaware

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[39] *Weinberger v. UOP, Inc.,* 457 A2d 701 (Del. 1983).

[40] *In re United States Cellular Operating Co.,* 2005 WL 43994 (Del. Ch. 2005).

[41] *Weinberger v. UOP, Inc.,* 457 A2d 701 (Del. 1983).

block method and allowed "any techniques or methods which are generally considered acceptable in the financial community", in which the DCF method is evidently included. Although the DCF method is not the only approach that the Delaware courts have approved, the use of this method has been steadily increasing after *Weinberger*.[42] Most notably, it has been firmly established in financial academia and industry that the DCF method provides the best estimates of a company's value, and thus it has long been argued in the business community that valuation done in courts should also be grounded on the DCF method. Moreover, this approach is theoretically more convincing than any other method in that the valuation reasoning under the DCF method actually corresponds to the investment reasoning on the investors' side. In other words, it is the firm's future cash flows – not accounting earnings or profits on the firm's balance sheet – that investors ultimately wish to have when they decide to invest. It has been reported, for instance, that changes in accounting profits do not necessarily result in a corresponding change in the market price of the firm, unless changes in the future cash flows are involved. From the investors' perspective, therefore, the firm is hardly different from a *bundle of future cash flows.* The DCF approach measures the value of this bundle.

Then what accounts for judges' antipathy toward the DCF method in Korean case law? In a high-profile case where convertible bonds were newly issued to the controlling shareholder at a significantly discounted conversion price, the Seoul District Court had an opportunity to review the validity of the DCF method. Here is the courts view:

"Defendants assessed the fair value of the Company by applying the DCF method, and reached the estimates of a minimum KRW 5,446 and a maximum KRW 10,412. They argued therefore that the conversion price of KRW 7,700 would fall in an acceptable range of fair price. […] However, the DCF method is often flawed, *not only because it is very difficult to determine the expected future cash flows and a reasonable discount rate,* both of which are key elements in this model, *but also because the evaluator – an accounting firm in this case – may have an incentive to distort the valuation in favor of its client.* In this case, (1) the accounting firm failed to pick a similar company. The two companies were completely different in business purpose, financial structure, asset composition, and profit structure. (2) The value of beta – sensitivity of a firm's stock price to the value of its market portfolio – was almost randomly estimated, and the cost of capital of debt, 12.88%, was also wrongly estimated. According to the corporate income tax report, the average interest rate of the Compa-

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[42] *Neal v. Alabama By-Products Corp.,* 1990 WL 109243 (Del. Ch. 1990), at 7 ("It is considered by experts to be the preeminent valuation methodology."); *Grimes v. Vitalink Commc'ns Corp.,* 1997 LEXIS 124 (Del. Ch. 1997), at 3 (The DCF approach is "increasingly the model of choice for valuations in this Court."); *Ryan v. Tad's Enters., Inc.,* 709 F.3d 682 (Del. Ch. 1996), at 702 ("The discounted cash flow valuation model is well established and accepted in the financial community."); *ONTI, Inc. v. Integra Bank,* 751 A.2d 904 (Del. Ch. 1999), at 916 ("While no method of valuation is preferable per se in Delaware, since the abolishment of the Delaware Block method for appraisals in 1983, this Court frequently has employed the discounted cash flow as at least one method of valuation.").

ny was calculated at being no more than 11.85%. […] Therefore, the estimated price that the accounting firm reported to the court could not be acceptable."[43]

Ultimately, the problem lies in the *incentive structure* of the expert witness. To be sure, the estimation of future cash flows and a discount rate inevitably faces an uncertainty problem, but it is not a critical issue. Financial economics has developed sophisticated statistical tools over the last several decades, and now it seems relatively easy to handle the uncertainty. The problem associated with such uncertainty is not the uncertainty itself, but the possibility of manipulating the estimates. The more uncertain the estimates are, the easier they can be manipulated. Against this backdrop, the professional witnesses – mostly accounting firms, consulting firms, and finance professors – are "handsomely paid by one side or the other,"[44] and thus they are likely to have strong incentives to report the estimates in favor of their clients. In appraisal remedy cases, for instance, the expert witness for the dissenting shareholders usually tends to report the corporate value very high, while the expert witness for the company goes in the opposite direction. The experts in Korea are no exception. In most cases where the parties submit their estimations by the DCF method, there is often a tremendous difference between their reports, and it leads the court to distrust such opinions. Thus, in order to approve the DCF method, which is more convincing in theory, the incentive problem should first be resolved.

2. *Categorizing the Issues*

Currently, the Korean courts do not individualize or categorize valuation lawsuits for non-listed shares. In all cases, they examine the valuation method and determine whether the price was fair. The issues surrounding the valuation of non-listed shares, however, can be categorized into two groups, and problems associated with these two categories should be treated differently.

The first category comprises the cases where the courts are required to decide whether the price falls into a *certain range* of fair value. In other words, only a *significant* deviation from a fair value matters. When the plaintiff claims, for instance, that a merger should be invalidated because the merger ratio is unfair, courts do not have to determine an exact fair price or an exact fair price range. They are instead required to decide whether the price overly deviated from a certain range of reasonableness. It is the same when directors are held liable for issuing new shares to a third party at a significantly dis-

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[43] Seoul District Court 2003 Gohap 1300, rendered on 4 October 2005 (emphasis added by author).

[44] *In re Appraisal of Shell Oil Co.,* 1990 WL 201390 (Del. Ch. 1990), at 6. See also *Salomon Bros., Inc. v. Interstate Bakeries Corp.,* 1992 LEXIS 100 (Del Ch. 1992), at 20 ("It appeared to me, both from the experts' reports and their testimony, that their assumptions and choices of multiples were colored by their respective clients' interests.").

counted price. If the price did not deviate too much from a fair price, such issuance is unlikely to be regarded as a violation of the directors' fiduciary duty. In such cases, a small estimation error has little impact on the final court decisions, and thus judges may feel relatively at ease in examining the valuation. They do not have to spend much time to reach a true value of the firm. Considering that the valuation itself is not an appropriate job for judges, it would therefore be a better strategy for judges to examine other elements that can influence the final valuation result rather than to struggle to confirm the true value itself. If the valuation was conducted or monitored by an independent third party, for instance, a court's approval of the valuation is unlikely to be erroneous, even if some minor errors or distortions in the valuation process are involved.

On the other hand, the second category comprises the cases where the problem is to find a *specific point* of true value for the shares. The typical example is appraisal remedy cases, which have been the most frequently raised type of case in Korea. Similarly, in a squeeze-out of minority shareholders, which the KCC implanted in 2011 from both the EU and the United States,[45] courts are required to determine a true value of shares. Since a dollar change results in a corresponding wealth transfer between the parties, courts should do their best to judge the fairness of the price itself. Contrary to the first category of cases, they should closely examine the valuation model and pay attention even to slight statistical errors. The problem, however, is that courts are not capable of conducting such examinations. To make matters worse, an expert's opinion is often far from trustworthy, as mentioned above. In fact, the tendency of the Korean courts to prefer objective information in valuing shares could be the result of not preventing such distorted incentives in expert witnesses.

Since the problems are different, the solutions should be individualized. This paper will discuss several alternative solutions, but before moving on, it should be noted that the key insight in both categories is that courts *should not*

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[45] The KCC, with its 2011 revision, provides for two different ways for a squeeze-out of minority shareholders. (1) The squeeze-out by a dominant shareholder was imported from the European law. A dominant shareholder who has 95% or more of the shares in a company may require the minority shareholders to transfer their shares if 100% ownership is necessary to accomplish the business purpose of the company. The dominant shareholder should present his plan at the shareholders' meeting, and his or her plan should be approved by the shareholders. KCC § 360-24. (2) The 2011 amendments to the KCC also lifted a ban on cash-out mergers. A merging company may provide cash or other assets as consideration for shares in a merged company. KCC § 523. Thus, a company may squeeze out minority shareholders through a U.S. style cash-out merger. For details, see H. RHO, New Squeeze-Out Devices as a Part of Corporate Law Reform in Korea: What Type of Device Is Required for a Developing Economy? 29 Boston University International Law Journal 41 (2011), 55–62.

be required to determine the validity of the estimated price itself, simply because they are not capable of doing this. They are currently required to do this, and they have no choice but to average several objective numbers. They should instead find another way to guarantee the fairness of the determined price.

3. Seeking a Fair Price Range: A Procedural Approach

In the first category of cases, courts have to determine whether the agreed price between the parties falls significantly out of the fair value range of the firm. Most cases involve controlling shareholders' attempt to secure private benefits, and thus it may be argued that, if parties are allowed to arbitrarily set a price, it may be easier for them to extract private benefits by setting the price too high or too low. Consequently the conclusion might be that a certain type of regulation should be imposed to restrict them. It is not necessarily the case, however. Ex-ante regulation on the valuation of shares often gives controlling shareholders or management a better opportunity to engage in inefficient wealth-transferring transactions, since such regulation does not necessarily reach the fair price. Often, it can be significantly far from the fair price. The ex-ante regulation in such cases simply paralyzes the ex-post liability regime.[46] Ultimately, a uniform ex-ante rule does not seem to be the best solution.

This paper instead suggests a procedural approach under which courts are required to examine not the fairness of price itself but the negotiation process used to reach the price. In particular, the *independence of directors or evaluators* from controlling shareholders is the key element to which courts have to pay attention. It can be formulated, for instance, that if the price was approved by a majority of independent directors, the price will not be regarded as significantly unfair.

a) A Procedural Approach

The procedural approach acknowledges that it is virtually impossible for courts to objectively determine the "significance" of "unfairness" to a degree that would allow them to invalidate transactions. At the same time, however, this approach puts emphasis on the fact that courts do not need to do that. Courts do not need to find out a true value of the firm – in fact, no such thing may exist. If the price was negotiated by the parties at an arm's length basis, there is no theoretical ground for courts to reject its fairness. To be sure, however, the problem is the trustworthiness of the negotiation process, or, in particular, the approval of independent outsiders. The price is likely to be influenced by the controlling shareholders' attempt to pursue private benefits, and thus the key question in the procedural approach is how to make it mimic an arm's length deal.

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[46] See *supra* Part II.3.c).

When there are concerns about the perverse incentives or conflicts of interests of controlling shareholders and management, corporate law usually employs a third party as a monitor or an advisor to mitigate the problem. One of the most popular candidates is a "disinterested" or "independent" director, and these individuals can contribute in several ways toward mitigating the conflict of interest problem in valuing the shares. Often, for instance, the approval of a majority of such disinterested directors is required to proceed. They can provide multiple pieces of advice about the valuation or, as a member of an audit committee, take part in examining the accuracy and fairness of a negotiated price. The fundamental insight of the procedural approach is that such disinterested directors, not the judges, should be mainly responsible for price fairness. Courts should refrain from second-guessing the price if such disinterested directors are involved in the decision. Thus, this approach looks like the business judgment rule, conditioned upon approval by independent outsiders.

b) Disinterested Directors?

The problem in Korea with such a procedural approach is that the concept of a "disinterested director" has not been firmly established in the KCC. In fact, it has been almost twenty years since the KCC introduced U.S. style outside directors. The implantation of the U.S. style board-of-director system with an audit committee was a precondition of the IMF bailout program in 1998, after the Asian financial crisis, and it was widely believed that such reform would change the corporate governance practice of big Korean conglomerates. Thus, the regulation regarding outside directors has been strengthened since then; currently, outside directors in listed companies should account for 25% or more of the total number of directors, and the ratio increases to 50% or more in large listed companies.[47]

Despite such regulation, the conventional view on the Korean outside director system is that it has not been successful in substantially changing corporate governance. The system has at least two serious flaws and thus fails to mitigate the agency problem associated with controlling shareholders. First of all, contrary to major advanced jurisdictions, "independence" is not legally defined. No provision in the KCC provides rules or standards by which courts can determine whether a director is independent. Instead, the KCC contains only a laundry list of disqualification for outside directors,[48] most of which concern their formal relationship with companies or controlling shareholders. Not being disqualified, however, does not necessarily mean that a person is "independent" or "disinterested." Qualified candidates, for instance, might have a legally permissible but very close personal relationship with controlling shareholders.

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[47] KCC § 542-8 (1). For a definition of large listed companies, see *supra* note 18.

[48] KCC §§ 382 (3) (for non-listed companies), 542-8 (2) (for listed companies).

Moreover, there are many layers of independence, and thus one definition might not fit for all the problems concerned. Courts have not developed any standards by which the independence of directors can be examined.

The other problem in the Korean outside director system is that the outside directors often lack any expertise on the business of the firm. In practice, professors, lawyers, and former government officers account for more than 60% of the outside directors in big Korean conglomerates. Among 384 outside directors newly appointed in 2013, for instance, there were 131 professors (28.5%), 82 lawyers (17.9%), and 73 former government officials (15.9%).[49] Most of them do not seriously take into account the fact that they could potentially be held liable. Several reasons might account for it, but it is at least undeniable that they are likely to lack the professional knowledge or experience required to perform successfully as independent directors.

Overall, the system of independent directors has not yet been fully developed in Korea. If the court adopted the procedural approach and thus regarded the price as fair if it was approved by outside directors, it would nevertheless fail to monitor or prevent controlling shareholders from extracting private benefits.

c) *Independence as a Proxy for Fairness*

The procedural approach is not a perfect solution, either. From a longer-term perspective, however, it should be emphasized that this approach has several advantages compared with current valuation practices in courts. First of all, it is easier and even more persuasive for the court to scrutinize the fairness of a corporate decision process rather than to examine the validity of the financial asset pricing model. Judges are not familiar with valuation problems, and thus they cannot tell whether the expert opinion might be feasible. Moreover, they have to examine related circumstantial facts that have something to do with fairness, and then determine whether the deviation is significant. Facing all of these hard questions, judges are likely merely to guess at everything. By contrast, identifying conflicts of interest, evaluating circumstantial evidence relating to the independence of directors, and examining the decision process are tasks that are very familiar to judges. They do not have to struggle with numbers and statistics. It makes court decisions more convincing.

Commentators may argue that the procedural approach does not work properly. Currently, outside directors are likely to rubber-stamp the proposal in favor of controlling shareholders, and the court decision based on the procedural approach would not find it illegal. In this regard, it is very important that the court should *develop several standards to scrutinize the independ-*

[49] K. CHUN, Korea's Mandatory Independent Directors: Expected and Unexpected Roles, Working Paper (2016), 23

ence of directors. Such standards may have nothing to do with the current disqualification provision in the KCC. If the court applies its own standards and then begins to approve or deny the fairness of the price depending on the directors' substantial independence, it will change the behavior of companies and controlling shareholders. If controlling shareholders want to engage in value-transferring transactions, they will have to comply with the court's standards on the independence of outside directors, and, in turn, there will be a reduction in the agency costs associated with controlling shareholders' pursuit of private benefits. It will not work perfectly, but it can mitigate the dilemma with regard to the valuation of a firm and improve current corporate governance in big Korean conglomerates. In that sense, rather than aiming to let the current outside directors decide, the procedural approach seeks to substantially examine their independence and enforce firms' compliance with the relevant standards.

4. Seeking a Specific Point of Fair Price: Persuasiveness Competition

The procedural approach cannot apply to the second category of cases because a slight change in valuation results in a corresponding transfer of wealth between the parties. The court is assigned the task of finding a fair value as exactly as possible. The negotiations, which the above procedural approach intends to encourage, have nothing to do with the appraisal remedy and the squeeze-out of minorities. The parties did not negotiate the price. Thus, we have to solve a totally different problem in the second category.

As stated above, the problem does not lie in the methodology. For the past several decades, financial economics has developed sophisticated analytical tools for estimating a firm's value. Rather, the problem is that the court has no means to eliminate the *incentives* of parties and their experts to report an incorrect number. In fact, courts are always facing several conflicting legal argument asserted by prestigious law firms – and evidently, at least one of these cannot be acceptable – but it does not impair judicial justice. Nobody is concerned about it because judges are able to evaluate the reasoning of each argument. This is not the case, however, with regard to the valuation of non-listed shares. Trying to overcome this problem, Korean courts have developed a valuation principle under which a firm's value should be measured by a weighted average of market price, asset value, and earning value, but emphasis has been placed more on the objectivity and predictability of these figures.[50] Considering that the task assigned to the court is to find a fair value as exactly as possible, such a principle is likely to fail to serve its accomplishment.

Theoretically, it is almost impossible to deny that the DCF method provides the most accurate information on a firm's value. In most cases, howev-

[50] See *supra* Part III.1.b).

er, there is a big gap in the figures reported by the minority shareholders and the company (or by dominant shareholders in squeeze-out cases). There are several approaches to deal with this problem. Again, the key is to allow the court to refrain from directly examining the valuation numbers.

a) Estimation by an Independent Third Party

When a court distrusts the expert opinion submitted by each party, a court lacking substantive expertise can ask an independent appraiser to find again a best estimate for a firm value. This method is routinely used to estimate the value of real estate or antiques, and the bright side is that the court is also very familiar with it.

Arguably, however, estimation by an independent appraiser has many dark sides, especially in relation to the valuation of shares. (1) The valuation of a firm is too costly. In order to estimate the future cash flows and discount rate, not only the information about the firm but also the information about the industry and the whole economy is required. It also takes too much time to review the firm's financial reports and documents. (2) It is not easy to find an appraiser with sufficient knowledge and capacity. Valuation requires much time and effort, and thus a good candidate may be so busy as to reject the offer or demand high compensation to do this job. (3) The appraiser may not be independent. Financial experts usually establish personal relationships with the business community through a variety of routes, and the court often unknowingly hires an expert already tainted by either party. Considering such dark sides, therefore, estimation by an independent appraiser is available only in limited cases. Even in such cases, the role may be limited to reviewing the valuation reports that the parties already submitted to the court.

b) Splitting the Baby

The DCF method potentially incorporates the wisdom of the weighted average method currently employed by the courts. As statistical noise can be averaged out, we can approach the true value. Similarly, if the experts of both parties have falsely reported, the truth will be somewhere in between. Thus, the court's settling on the middle of both estimates may reduce the possible errors associated with false reporting. Such a weighted average approach – what may cynically be called a "splitting the baby" approach – was convincing to some extent (as practice in Korean courts shows) with regard to objective and previously established past variables since they cannot be manipulated after the disputes are filed. By contrast, the potential for manipulation that is inherent in the DCF method creates several problems with such a weighted average approach.

Where courts generally approve the DCF valuation submitted by the parties, this weighted average approach has an advantage in that they do not

need to find an independent third party. They do not incur several of the costs discussed above. Moreover, if the parties and their expert witnesses have a similar inclination to manipulate the estimates, averaging the reported figures with similar weighting will be highly likely to approach the truth.

Despite all of such advantages, however, this weighted average approach will significantly distort the incentives of the parties as follows, and thus should not be employed in association with the DCF method. (1) From a normative perspective, this approach actually punishes a party who is so conscientious as to submit figures close to the truth. The more manipulated, the more profitable. Thus, such approach can hardly be acceptable as a normative standard. (2) This approach assumes that each party is able to hire an expert and submit its own estimates on the firm value. Consequently, the overall litigation costs are increased. Moreover, it favors the rich and punishes the poor. A party who cannot afford to report its own valuation is actually punished. (3) This approach has a negative ex-ante effect. The parties will be more inclined to report the figures that are more favorable to them – as long as it looks reasonable to the court – and the gap between the valuations submitted by the parties will become larger. Although the truth still lies somewhere in between, it is more likely that averaging the two figures will result in a significant deviation from the true value. (4) Since the gap between the reported figures is already large, the gap between the judgment and each figure will inevitably be significant. As a result, the judgment will be received less acceptingly by the parties. The weighted average approach in effect has a negative effect in terms of settling disputes with less discontent.

c) Persuasiveness Competition

An interesting approach for solving the problem of expert witnesses is picking the party's valuation which is found to be more convincing than the other.[51] This does not mean assigning more weight to this valuation but rather accepting it in its entirety. Thus, it may be regarded as a competition of persuasiveness between each valuation model. To be sure, sufficient knowledge and experience with financial economics and empirical methods will be required in order to verify which party's model is more convincing, and the court should obtain help from financial economists. Although the final decision will not be entirely made by the economists, it is inevitable that the discretion of the court will be minimized in the end. This approach is similar to that of hiring an independent third party, but there are significant differences in that the role of the independent third party in this model is limited to exam-

[51] This approach was originally proposed by R. GIBBONS, Learning in Equilibrium Models of Arbitration, 78 American Economic Review 896 (1988), and was applied to appraisal remedy suits by C. H. HEINRICH, Game Theory and Gonsalves: A Recommendation for Reforming Stockholder Appraisal Actions, 56 Business Lawyer 697 (2001), 703.

ining the persuasiveness of each valuation model, and in that the court is virtually bound to such examination. This approach is also different from that of splitting the baby in that no weighting is put on the less convincing model. This is a "winner takes all" game. In fact, the logic behind this approach – which looks intuitively convincing – was suggested in *Technicolor* in the early 1990s as follows.

> "Simply to accept one experts' view or the other would have a significant institutional or precedential advantage. […] On the contrary, particularly if the court will ultimately reject both parties DCF analysis and do its own, the incentive of the contending parties is to arrive at estimates of value that are at the outer margins of plausibility – that essentially define a bargaining range. If it is understood that the court will or is likely to accept the whole of one witnesses testimony or the other, […] at least *the parties will have incentives to make their estimate of value appear most reasonable.* This would tend to *narrow the range of estimates,* which would unquestionably be a benefit to the process.[52]

This method has several advantages over the above two methods in terms of the normative aspect and the incentive effect on the parties. (1) From the normative perspective, this approach can be justified easily in that it rewards the conscientious party who reports the figures close to the truth. (2) Most importantly, this approach expects that, where the court will wholly embrace the more convincing model, the parties will eventually compete in an effort to increase the persuasiveness of their models, and thus they will hesitate to engage in intentional manipulation. As a result, the effects from the distorted incentives discussed above are reduced, and the figures submitted by each party will approach each other. (3) The court's full, 100%, acceptance of the winning party's valuation is in fact unlikely to increase the possibility of judicial error, since the gap between each party's estimates is already being minimized. (4) This approach is not that costly. The court will hire, for instance, a financial economist, but the task is only a "comparison" of the two positions with each other. The amount of information that he or she would have to acquire is dramatically reduced. This kind of job is, so to speak, like reviewing a Ph.D. paper, which can never be compared with writing one. Thus, the court can easily find an expert with sufficient knowledge and capacity.

Courts may resist this approach emotionally. The idea of "winner takes all" seems too extreme. If, however, the court decides to utilize the DCF method, there is an inevitable need to reduce the court's discretion and rely more heavily on economists' judgment. The Korean courts are still struggling to deal with the DCF method. It is not likely that the Korean courts will adopt this approach in the near future, but this approach does have important implications for the incentives of parties in relation to the valuation of non-listed shares.

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[52] *Cede & Co. v. Technicolor, Inc.,* 1990 WL 161084 (Del. Ch. 1990), at 26, footnote 17.

IV. Concluding Remarks

Valuation is a problem concerning not only uncertainty but also the incentives of stakeholders and experts. This paper examines several problems associated with such incentives against a backdrop of Korean rules and court decisions. Even the valuation of listed shares involves such incentive problems. The recent merger between Cheil and C&T in the Samsung Group shows that controlling shareholders are still able to extract private benefits even though the KCML mandates the use of market price. The court may not have held that valuation based on the market price was unfair, but most of theoretical questions on the fairness of such valuation remain answered.

The valuation of non-listed shares is even more problematic, and the Korean courts have not yet generally approved the DCF method. The preference for a more objective figure is understandable, but it should be more seriously discussed whether it is a good policy for the court to examine directly the validity of a valuation. This paper has categorized the cases into two groups, and as to both cases this paper has suggested that the court should not look at the economic models or the valuation figures themselves. Instead, the court should place greater reliance on third parties, such as independent directors in the first group of cases and an independent reviewer in the second. By doing so, the court's discretion will be diminished. Arguably, such a change may have positive impacts on the incentives of controlling shareholders and expert witnesses.

III. Civil Liability of the Company and its Directors When Financial Statements are False

Civil Liability of the Company and Its Directors for False Financial Statements under German Law

Klaus Ulrich Schmolke

I. Introduction ... 131
II. A Primer on the Civil Liability of the Stock Corporation and Its Directors under German Law ... 133
1. Who is Liable? ... 133
2. To Whom are the Directors Liable? ... 134
III. Financial Reporting and Disclosure Obligations – A Brief Outline ... 137
1. General Financial Reporting Requirements ... 137
2. Disclosure Requirements under Capital Markets Law ... 142
IV. Addendum: Voluntary Financial Statements ... 146
V. Civil Liability of the Company and Its Directors with Regard to False Financial Statements ... 146
1. General Liability ... 146
2. Liability of Listed Companies and their Directors under Capital Markets Law ... 150
VI. Concluding Remarks ... 155
Appendix ... 157

I. Introduction

Imagine that the CEO of a German bank which is organised in the form of a stock corporation issues a press release which states, "the recent uncertainties with regard to the US subprime mortgage market have practically no impact on our international investment portfolio." The press release is intended to calm the markets and to fight rumours that have assumed significant exposure for the bank and, thus, led to a decline in the price of its shares and bonds. As a matter of fact, however, the bank is heavily invested in the subprime mortgage market and is therefore exposed to considerable default risks. Soon after the press release the truth comes to light and the bank's share price plunges.[1] An investor who bought shares in the bank right after the press release wants to recover his losses. Does he have a claim against the bank and/or the CEO?

[1] This – simplified – scenario is based on the facts of the notorious "IKB case", which was decided by the German Supreme Court (BGH) in the aftermath of the financial crisis, cf. BGH, 13 December 2011, XI ZR 51/10, NJW 2012, 1800 (*IKB*).

The text at hand addresses these questions and more. It provides an overview – albeit an inevitably rough one – of the civil liability of the company and its directors for false financial statements under German law. However, before going into medias res, some preliminary remarks on the scope of this contribution are in order: At least for a German corporate lawyer, the meaning of the term "financial statements" is not totally clear. Understood narrowly, financial statements capture solely the annual or otherwise periodical financial statements which give an overview of the overall financial situation of the respective enterprise. German law provides for the disclosure of such statements in its law on accounting and financial reporting. These provisions are complemented by disclosure requirements under German capital markets law where listed companies (issuers) are concerned. In a wider sense, financial statements are not limited to such periodical reports but comprise each and every statement on financial or financially relevant ("material") information. Understanding financial statements in this wider sense, this overview also focusses on the liability of issuers and their directors for the infringement of continuous disclosure duties under German capital markets law,[2] as well as their liability for voluntary statements that contain false or misleading information. Beyond the scope of this article, however, is the liability for false or deficient disclosure of corporate social responsibility (CSR) information,[3] since such information relates to non-financial (!) issues.

The term "company", on the other hand, is typically understood by German corporate lawyers as comprising the limited liability company (*Gesellschaft mit beschränkter Haftung,* GmbH) as well as the stock corporation (*Aktiengesellschaft,* AG).[4] This contribution, however, focusses on the liability of the German stock corporation and its directors. The legal situation of the GmbH is quite similar, though not identical to that of the AG. One major difference, though, is that the GmbH cannot be listed on a stock exchange and, therefore, the laws and regulations confined to listed companies do not apply.

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[2] To be more precise: EU capital markets law that is directly applicable in Germany.

[3] Rather recently disclosure duties relating to such information have been imposed at the EU level by Directive 2014/34/EU amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, OJ L 330, 15.11.2014, p. 1. The directive has been transposed into German law by the *Gesetz zur Stärkung der nichtfinanziellen Berichterstattung der Unternehmen in ihren Lage- und Konzernlageberichten* (*CSR-Richtlinie-Umsetzungsgesetz*), 18 April 2017, BGBl. I p. 802; for the government's proposal of this statute see, e.g., J. HENNRICHS/M. PÖSCHKE, Die Pflicht des Aufsichtsrats zur Prüfung des „CSR-Berichts", NZG 2017, 121 et seqq.; C. SEIBT, CSR-Richtinie-Umsetzungsgesetz: Berichterstattung über nichtfinanzielle Aspekte der Geschäftstätigkeit, DB 2016, 2707 et seqq.

[4] For the purposes of this paper the partnership limited by shares (*Kommanditgesellschaft auf Aktien,* KGaA) can justifiably be neglected.

The following analysis of the liability of the stock corporation and its directors for false financial statements under German law will proceed as follows: Part II presents a short primer on how the civil liability of the German stock corporation and its directors works in general. Part III introduces the legal framework that requires the company to draw up and publish information about its financial situation, as well as the directors' duties to the company which relate to these requirements. Part IV adds some short remarks on voluntary financial statements. With the groundwork thus laid, Part V returns to the topic at hand by taking a closer look at the civil liability of the stock corporation and its directors for false financial statements under German law. Part VI concludes.

II. A Primer on the Civil Liability of the Stock Corporation and Its Directors under German Law

A primer on the civil liability of the German stock corporation and its directors has to address two fundamental questions: (1) Who is liable if directors breach the law while acting on behalf of their corporation? And with regard to the directors' personal liability, (2) to whom are the directors liable?

1. *Who is Liable?*

As to the first question, i.e. who is liable if directors violate the law when acting on behalf of the company, two natural candidates come to mind: (1) the company and (2) the directors.

a) *The Company*

(1) The Company's Breaching of Its Own Duties as a Prerequisite for Liability

For a successful liability claim against the company, the claimant has to show that the company is legally responsible for the loss for which compensation is being sought. The law typically assigns such responsibility by imposing duties and obligations on the person intended to be liable to another person. Thus, for a German stock corporation (AG) to be liable to a claimant, the crucial question is whether it breached a legal or contractual duty owed to this person or infringed a statutory provision intended to protect the claimant.[5]

[5] The latter refers to a so-called *Schutzgesetz* which gives rise to liability in accordance with § 823 para. 2 BGB. For an overview of this provision, see H. SPRAU, in: Palandt BGB, 76th ed. 2017, § 823 marg. nos. 56 et seqq.

(2) The Attribution of Behaviour and Knowledge to the Company

The act or behaviour leading to the breach of duty or infringement of the law is generally not committed by the corporation itself, since it is a mere legal construct, but by natural persons acting on its behalf. For a claim against the corporation to be established, the behaviour of those natural persons has to be attributed to the company. With regard to acts of directors, § 31 German Civil Code (*Bürgerliches Gesetzbuch,* BGB) provides for this attribution. The provision, which is applied to directors of a stock corporation by analogy, stipulates:[6]

> "The association is liable for the damage to a third party that the board, a member of the board or another constitutionally appointed representative causes through an act committed by it or him in carrying out the business with which it or he is entrusted, where the act gives rise to a liability in damages."[7]

b) The Directors

As already explained with regard to the liability of the company, a successful liability claim against a director requires the claimant to show that the person alleged to be liable breached a duty owed to the claimant or infringed a statutory provision intended to protect the interests of the claimant.

Thus, when carrying out the business of the corporation the directors are, as a general rule, only liable to their corporation for any misconduct, since they only owe duties to the company, and not to individual shareholders, employees, creditors or other third parties. Only under certain exceptional circumstances are the directors also liable to third parties.[8] This leads directly to our second question: To whom are the directors liable?

2. To Whom are the Directors Liable?

a) The Company (Internal Liability)

When carrying out the business of the corporation the directors have to employ the care of a diligent and conscientious manager as laid down in § 93 para. 1 German Stock Corporation Act (*Aktiengesetzbuch,* AktG). When the

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[6] Cf. also the list of statutory provisions presented in the appendix. The translation of § 31 BGB is taken from the German Ministry of Justice and Consumer Protection. It is available online at <https://www.gesetze-im-internet.de/englisch_bgb/index.html>.

[7] For a recent in-depth analysis of the provision, see J.-E. SCHIRMER, Das Körperschaftsdelikt (Tübingen 2015), who challenges the traditional understanding of § 31 BGB.

[8] E.g., H. FLEISCHER, in: Spindler/Stilz AktG, 3rd ed. 2015, § 93, marg. nos. 307 et seq.; K. HOPT/M. ROTH, in: Großkommentar AktG, 5th ed. 2015, § 93 marg. nos. 623 et seq., 648 et seq.

directors breach this duty of care they are jointly and severally liable to the corporation for any resulting damage (§ 93 para. 2 AktG).[9]

This duty of care also applies to specific obligations of the managing directors explicitly provided for in the statutory law, such as the duty to keep the books of account (§ 91 para. 1 AktG) or to sign the financial statements according to § 245 German Commercial Code (*Handelsgesetzbuch,* HGB). Furthermore, the duties owed by the board members to their company include the obligation to abide by the law. Thus, any infringement of the law in the course of doing business for the company is a breach of the managerial duty of care (so-called "duty of legality"[10]).

§ 93 AktG imposes liability only on the managing directors of a German stock corporation *(Vorstandsmitglieder).* However, the provision is also applicable to the members of the supervisory board *(Aufsichtsratsmitglieder)* by way of reference in § 116 AktG.[11]

b) Third Parties (External Liability)

As already mentioned, the directors of a stock corporation, in general, owe duties only to their company when acting on its behalf. As a consequence, their liability for any misconduct occurring within the course of doing business on behalf of the company is limited to the company (internal liability).[12] However, as an exception to this general rule, the directors are liable to third parties (= external liability) if and only if (1) they breach duties owed to the latter personally or (2) they infringe statutory provisions which are intended to protect the person claiming damages.[13]

With regard to category (1), one has to keep in mind that obligations imposed by tort law are by definition owed to everyone, since the whole of tort law is derived from the principle of not harming anybody ("neminem laedere").[14] Take, for example, § 826 BGB, which stipulates:

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[9] For a general overview of the liability of directors under German law, see H. GRIGOLEIT, in: German and Asian Perspectives on Company Law (Tübingen 2016) 105.

[10] In German: *Legalitätspflicht*. For further details, see FLEISCHER, *supra* note 8, § 93, marg. nos. 14 et seqq.; GRIGOLEIT, *supra* note 9, 105, 120 et seqq.; HOPT/ROTH, *supra* note 8, § 93 marg. nos. 74 et seqq., 132 et seqq.

[11] A provision very similar to § 93 AktG is § 43 *Gesetz betreffend die Gesellschaften mit beschränkter Haftung* (GmbHG), which provides the legal basis for the liability of the directors *(Geschäftsführer)* of a German GmbH.

[12] So-called *Haftungskonzentration*. Cf. the references in note 8.

[13] E.g., FLEISCHER, *supra* note 8, § 93, marg. nos. 307 et seqq.; HOPT/ROTH, *supra* note 8, § 93 marg. nos. 623 et seqq., 48 et seqq.

[14] Cf. SPRAU, *supra* note 5, Introduction to § 823, marg. nos. 1; with a view to the liability of directors HOPT/ROTH, *supra* note 8, § 93 marg. nos. 656. However, still contended and subject to debate is the issue of whether and when the breach of an obligation of the company to take precautionary measures *(Verkehrssicherungspflichten)* for the benefit of

"A person who, in a manner contrary to public policy, intentionally inflicts damage on another person is liable to the other person to make compensation for the damage."[15]

Thus, the director who intentionally inflicts damages on another person is personally liable according to § 826 BGB. If he has done so while carrying out the business of the corporation, the company is also liable due to the attribution of the director's behaviour by way of § 31 BGB[16].[17]

Furthermore, directors may personally owe quasi-contractual duties to third persons when entering into contract negotiations on behalf of the company (cf. §§ 241 para. 2, 311 paras. 2 and 3 BGB).[18] However, according to § 311 para. 3 BGB, such personal duties vis-à-vis the intended contract partner of the company only come into existence where the director acting on behalf of the company "substantially influences the pre-contract negotiations or the entering into of the contract by laying claim to being given a particularly high degree of trust".[19] Again, the director's personal external liability is extended to the company by way of § 31 BGB.[20]

The following example may illustrate the above:

The director of a stock corporation negotiating a loan contract with a bank refers to the corporation's financial statements in order to receive favourable credit terms. Even though the director knows the books have been manipulated he assures the sceptical bank clerk that he himself would vouch for the soundness of the statements. In this case, the director is personally liable to the bank according to §§ 280, 311 paras. 2 and 3 BGB. Furthermore, the director's conduct amounts to fraud as a criminal offense in the sense of § 263 German Criminal Code (*Strafgesetzbuch,* StGB). § 263 StGB is a statutory provision that is intended to protect the interests of the deceived. Thus, the bank also has claim for damages with regard to the losses caused by the fraud according to § 823 para. 2 BGB in connection with § 263 StGB.[21] In addition, the corporation

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third parties may give rise to tortious liability of the directors acting (or negligently not acting) on behalf of the company; see, e.g., FLEISCHER, *supra* note 8, § 93, marg. nos. 308, 314–317; HOPT/ROTH, *supra* note 8, § 93 marg. nos. 661–665, both with further references.

[15] Translation from the German Ministry of Justice and Consumer Protection, Gesetze im Internet, online: <https://www.gesetze-im-internet.de/englisch_bgb/index.html>.

[16] Cf. *supra* II.1.a)(2).

[17] In this scenario the director and the stock corporation are jointly and severally liable according to § 840 para. 1 BGB.

[18] For a general overview, see FLEISCHER, *supra* note 8, § 93, marg. nos. 310 et seqq.; HOPT/ROTH, *supra* note 8, § 93 marg. nos. 652 et seqq.

[19] Translation of § 311 para. 3 BGB from the German Ministry of Justice and Consumer Protection, Gesetze im Internet, online: <https://www.gesetze-im-internet.de/englisch_bgb/index.html>.

[20] The claim for damages is granted by §§ 280, 311 paras. 2 and 3 BGB.

[21] For the exact content and wording of § 823 para. 2 BGB see *infra* in the appendix.

itself is liable to the bank pursuant to §§ 280, 311 para. 2 BGB and §§ 823 para. 2 BGB, 263 StGB, both in connection with § 31 BGB.

III. Financial Reporting and Disclosure Obligations – A Brief Outline

Having laid the groundwork for understanding the civil liability of a stock corporation and its directors in general, it is now time to proceed with a brief overview of the financial reporting and disclosure obligations of a German stock corporation and the accompanying duties of its directors. Before we take a closer look at this legal framework, one of its fundamental characteristics has to be pointed out up front: In Germany, two layers of law imposing financial reporting and disclosure obligations have to be distinguished – the law of the European Union on the one hand and domestic German law on the other. With this in mind, we start with an outline of the law on (annual) financial reporting which applies generally – i.e. to listed and non-listed companies (1) – before turning to disclosure obligations imposed exclusively on listed companies (2).

1. General Financial Reporting Requirements

a) EU Law

The law on financial reporting, that is the disclosure of annual financial statements and related reports, is mainly governed by the interplay of two instruments of EU secondary law – namely, the Accounting Directive (AD)[22] and the new Directive (EU) 2017/1132[23]. While the Accounting Directive mandates the public disclosure of certain financial statements, it refers to Title I Chapter III Section 1 of Directive (EU) 2017/1132 regarding how this mandatory disclosure is to be carried out.[24] Both the AD and the relevant provisions of Directive (EU) 2017/1132 apply not only to the German AG, but also to the GmbH and the KGaA.[25]

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[22] Directive 2013/34/EU on annual financial statements, consolidated financial statements and related reports (Accounting Directive), OJ L 182, 29 June 2013, p. 19.

[23] Directive (EU) 2017/1132 relating to certain aspects of company law, OJ L 169, 30 June 2017, p. 46. The relevant section, i.e. Title I Chapter III Section 1, is taken from the repealed Directive 2009/101/EC, OJ L 258, 1 October 2009, p. 11.

[24] For further details, see S. KALSS/C. KLAMPFL, Europäisches Gesellschaftsrecht (München 2015), marg. nos. 207–208, 212 et seqq., 255 et seqq.

[25] As to the scope of Chapter III of Directive (EU) 2017/1132 see its Art. 13. The AD applies, furthermore, to the partnership (*offene Handelsgesellschaft,* OHG) and the limited partnership (*Kommanditgesellschaft,* KG), provided they have no natural person as a member with unlimited liability ("atypical partnership"); cf. Art. 1(1) AD in connection with

Art. 30 para. 1 subpara. 1 AD stipulates that the undertakings covered by the directive shall publish the duly approved annual financial statements (i.e. as a minimum, the balance sheet, the profit and loss account and the accompanying notes, cf. Art. 4 para. 1 AD), as well as the management report (cf. Art. 19 AD) – together with the opinion submitted by the statutory auditor.[26] Furthermore, parent undertakings of corporate groups have to draw up consolidated financial statements (cf. Art. 22 AD) and consolidated management reports, which have to be published (Art. 30 para. 1 subpara. 1 AD).

The above is, however, just a rough outline since the AD provides for a very sophisticated and elaborate system of reporting and disclosure requirements and exemptions thereof which takes account of the size of the undertaking (micro, small, medium-sized, large), whether public interest entities are concerned, the line the undertaking is doing business in, and whether the undertaking's shares are traded on a regulated market.[27] If such publicly traded companies are obliged to draw up consolidated accounts this has to be done according to the IAS Regulation[28]. Pursuant to Art. 5 of this regulation, EU Member States may permit other companies to prepare their accounts according to the international accounting standards (IAS) as well. However, German law grants this option only with regard to consolidated financial statements.[29]

With regard to responsibility and liability for drawing up and publishing the financial statements, Art. 33 para. 1 AD provides that EU Member States shall ensure that the members of the administrative, management and supervisory bodies of an undertaking, acting within the competences assigned to them by national law, have collective responsibility for ensuring that (a) the annual financial statements, the management report and, when provided separately, the corporate governance statement and (b) the consolidated financial statements, consolidated management reports and, when provided separately, the consolidated corporate governance statement are drawn up and published in accordance with the requirements of the AD and, where applicable, with the IAS adopted in accordance with the IAS Regulation. This assignment of responsibility is complemented by Art. 33 para. 2 AD, which stipulates that

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Annex I and II. As to the scope of the AD, see, e.g., KALSS/KLAMPFL, *supra* note 24, marg. nos. 257, 263.

[26] These documents have to be kept in a file in a national register (Art. 16 paras. 1 and 3 Directive (EU) 2017/1132). This can be accessed Europe-wide via the "system of interconnection of registers" (Art. 18 para. 1 Directive (EU) 2017/1132).

[27] For further details, cf. KALSS/KLAMPFL, *supra* note 24, marg. nos. 257, 263 et seqq.

[28] Regulation (EC) No 1606/2002 on the application of international accounting standards, OJ L 243, 11 September 2002, p. 1.

[29] For a list of the accounting options provided by the different Member States, see <http://ec.europa.eu/finance/accounting/docs/legal_framework/20140718-ias-use-of-options_en.pdf>.

the Member States shall ensure that their laws on liability, at least to the undertaking, apply to the members of the administrative, management and supervisory bodies of the undertakings for breach of their duties under Art. 33 para. 1 AD.

In addition, Art. 28 lit. (a) Directive (EU) 2017/1132 demands that Member States provide for appropriate penalties at least in the case of failure to disclose the accounting documents which are required to be published in accordance with the AD.[30]

b) German Law

(1) Reporting Requirements under Accounting Law

The requirements of the aforementioned directives have been transposed into German law. The corresponding provisions are laid down in the German Commercial Code (HGB). According to §§ 242, 245 HGB, each and every merchant[31] has to draw up and sign annual financial statements. §§ 264 et seqq. HGB provide additional requirements for *Kapitalgesellschaften* (AG, GmbH, KGaA), which are "merchants by form of organisation", as to the information and documents to be drawn up. Their directors[32] have to disclose these financial statements on behalf of their company by submitting the relevant documents to the electronic Federal Gazette (*Bundesanzeiger*), where they have to be promulgated (§§ 325 et seqq. HGB). The data is communicated to the central electronic company register (*Unternehmensregister*)[33] and can be retrieved via its website (cf. § 8b para. 2 no. 4 HGB).

(2) Reporting Requirements under Tax Law

Aside from these accounting law requirements, German tax law requires the maintenance of books of account, for taxation purposes, from taxpayers on whom such an obligation is imposed by other laws (cf. §§ 140 et seqq. *Abgabenordnung,* AO).

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[30] As to the interpretation of the predecessor provision of Art. 7 Directive 2009/101/EC see ECJ, Case 97/96 *Verband deutscher Daihatsu-Händler eV v Daihatus Deutschland GmbH,* ECLI:EU:C:1997:581; H. HIRTE, Daihatsu: Durchbruch für die Publizität, NJW 1999, 36 et seqq.; S. LEIBLE, Bilanzpublizität und Effektivität des Gemeinschaftsrechts, ZHR 162 (1998), 594 et seqq.

[31] Who qualifies as a merchant under the HGB is determined by §§ 1 et seqq. HGB.

[32] § 325 HGB refers to the "legal representative" of the company. Cf. A. DRINHAUSEN, in: Münchener Kommentar zum Bilanzrecht, 2013, § 325 HGB marg. no. 15.

[33] The operator of the Federal Gazette has to communicate the data to the register according to § 8b para. 3 no. 1 HGB. Cf. DRINHAUSEN, *supra* note 32, § 325 HGB marg. no. 5.

(3) (Internal) Duties of Board Members with regard to Financial Statements

The accounting and tax regulations on the disclosure of annual financial statements are complemented by company law provisions relating to financial statements, which deal with procedural issues within the company and allocate the responsibility to comply with the corporation's obligations. The company law dealing with the AGs stipulates that the managing board *(Vorstand)* has the duty to maintain the requisite books of account on behalf of the corporation (§ 91 para. 1 AktG). This duty refers to the requirements established by §§ 238 et seqq. HGB, including the obligations to draw up and to sign annual financial statements (§§ 242 and 245 HGB).[34] Thus, the corporation's responsibility to conform with the requirements of accounting law is internally assigned to the managing board[35] – that is, the managing board as a whole. While the maintenance of the books of account can be internally delegated to a member of the board, the other board members remain responsible and, thus, liable insofar as they are obliged to monitor the member who is internally assigned the task of maintaining the books.[36]

In addition to the obligation to maintain the books of account pursuant to § 91 para. 1 AktG the managing board is required, as a general matter, to carry out any other legal or contractual obligation to disclose financial statements with respect to the corporation. Disclosing false statements amounts to a breach of the board members' duty to comply with the law *(Legalitätspflicht)* as part of their general duty of care (§ 93 para. 1 and 2 AktG).[37]

According to § 111 para. 1 AktG, the supervisory board *(Aufsichtsrat)* has the duty to supervise the management of the company. This also refers to the task of keeping the books of account. Apart from this general supervisory duty, the law explicitly assigns the supervisory board the duty to supervise "the accounting process, the efficiency of the internal control system, the risk management system and the internal revision system as well as […] the annual auditing, in particular […] the select ion and independence of the external auditor and the additional services rendered by the external auditor" (§ 107 para. 3 sent. 2 AktG). It also assigns the duty to "examine the annual financial statements, the annual report and the proposal for appropriation of distributable profits, in the case of parent companies (§ 290 paras. 1 and 2 of the Commercial Code [HGB]) also the consolidated financial statement and con-

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[34] Cf. FLEISCHER, *supra* note 8, § 91 marg. no 5; J. KOCH, in: Hüffer/Koch AktG, 12th ed. 2016, § 91 marg. nos. 2 et seqq.

[35] The same is true with regard to the obligation according to §§ 140 et seqq. AO; cf. FLEISCHER, *supra* note 8, § 91 marg. no. 9, referring to § 34 para. 1 AO.

[36] For further details, cf. FLEISCHER, *supra* note 8, § 91 marg. nos. 10–14.

[37] As to these duties in general, see *supra* II.2.a).

solidated annual report" (§ 171 para. 1 AktG).[38] The results of this examination have to be reported to the shareholders' meeting and to the managing board. This task of examining the annual financial statements cannot be delegated to a committee, but has to be performed by the supervisory board as a whole (cf. § 107 para. 3 sent. 3 AktG).[39] If the supervisory board approves of the annual financial statements submitted by the managing board upon their completion (cf. § 170 AktG), the annual financial statements are approved unless the managing board and the supervisory board resolve that the annual financial statements are to be submitted to the shareholders' meeting for approval (§ 172 AktG).[40]
With regard to the liability of the board members, the crucial question is whether the aforementioned duties are only owed to the corporation or also to third parties. We will soon come back to that question.[41]

(4) Criminal Sanctions in the Case of a Breach of Directors' Duties

§ 331 HGB provides for criminal sanctions for the directors of a company obliged to disclose annual financial statements in the case of (1) intentional misrepresentations in the accounting documents to be disclosed or (2) intentional or reckless disclosure of such documents containing false or disguising material information. Potential perpetrators are members of the managing board (*Vorstand*)[42] as well as members of the supervisory board (*Aufsichtsrat*).[43] For less severe infringements of the accounting laws, § 334 HGB provides for civil penalties. The addressees are again the members of the managing board/the body representing the corporation as well as the members of the supervisory board.[44]

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[38] Translation taken from Norton Rose Fulbright LLP, online: <http://www.nortonrosefulbright.com/files/german-stock-corporation-act-147035.pdf>.

[39] Cf. KOCH, *supra* note 34, § 107 marg. no. 27. Cf., for further details about the duties of the supervisory board, H. F. GELHAUSEN, in: Krieger/Schneider (eds.), Handbuch Managerhaftung, 2nd ed. 2010, § 30 marg. nos. 73–98.

[40] As to the recent amendments of the AktG by the *Abschlussprüfungsreformgesetz* – AReG, BGBl. 2016 I 1142 (concerning the selection and supervision of the auditors in listed companies), see, e.g., R. SCHILHA, Neues Anforderungsprofil, ZIP 2016, 1316 et seqq.

[41] *Infra* V.1.b)(1).

[42] But also directors *(Geschäftsführer)* of a GmbH or personally liable partners *(Komplementäre)* of a partnership limited by shares (KG).

[43] Cf. M. P. WASSMER, in: Münchener Kommentar zum Bilanzrecht, 2013, § 331 HGB marg. nos. 6 et seqq., 20.

[44] The new provision in § 333a HGB which stipulates criminal sanctions especially for members of the audit committee who severely infringe their duties relating to the selection and supervision of the auditors does not apply to the AG, cf. K. HOPT/H. MERKT, in: Baumbach/Hopt HGB, 37th ed. 2016, § 324 marg. no. 3.

Apart from the criminal offences laid down in § 331 HGB, a member of the managing board or the supervisory board commits a punishable crime if he or she

> "(1) misrepresents or conceals the condition of the company […] in presentations or summaries on the financial condition of the company, statements or information provided at the shareholders' meeting, unless this act constitutes a criminal offence pursuant to § 331 nos. 1 or 1a of the Commercial Code [HGB], or (2) makes false statements or misrepresents or conceals the condition of the company in disclosures or statements which are required to be submitted to the auditor of the company […], unless this act constitutes a criminal offence pursuant to § 331 no. 4 [HGB]" (§ 400 para. 1 AktG).[45]

As will become more apparent in Part V, the committing of these crimes and offences may trigger liability claims by third parties against the delinquent directors and their company.[46]

2. *Disclosure Requirements under Capital Markets Law*

EU and German capital markets law impose specific duties on listed companies, i.e. "issuers", to disclose financial information. With regard to these duties, a broad distinction can be made according to whether the disclosure shall inform the primary market (2.1) or the secondary market (2.2).[47]

a) *Primary Market Disclosure – The Securities Prospectus*

A stock corporation intending to offer securities to the public or seeking to be admitted to trading on an organised market in Germany is obliged to draw up and to publish a securities prospectus as laid down in the German Securities Prospectus Act (*Wertpapierprospektgesetz,* WpPG), which implements the requirements of the EU Prospectus Directive (PD)[48] and accompanying implementing and delegated acts[49].

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[45] The translation of § 400 para. 1 AktG has again been taken from Norton Rose LLP, *supra* note 38. Cf. also the offences in the state of insolvency laid down in §§ 283 para. 1 no. 5 and 283b StGB which are based on the infringement of the obligation to keep books of account.

[46] Cf. *infra* V.1.b)(1).

[47] Cf. H. FLEISCHER, in: Assmann/Schütze (eds.), Handbuch des Kapitalanlagerechts, 4th ed. 2015, § 6 marg. no. 4; with regard to the EU regime, e.g., M. BENGTZEN, EU and UK investment disclosure liability: at cross purposes, CMLJ 11(2016), 429, 432 et seqq. ("Prospectuses" and "Continuing disclosure requirements").

[48] Directive 2003/71/EC, OJ L 345, 31.12.2003, p. 64, as amended by Directive 2014/51/EU, OJ L 153, 22 May 2014, p.1.

[49] A full list of these so-called level-2 measures can be retrieved under <https://ec.europa.eu/info/law/prospectus-directive-2003-71-ec/amending-and-supplementary-acts/implementing-and-delegated-acts_en>.

Such a prospectus "shall contain information concerning the issuer and the securities to be offered to the public or to be admitted to trading on a regulated market" (Art. 5 para. 2 PD). According to § 7 WpPG, which refers to Commission Regulation (EC) No. 809/2004,[50] the minimum information to be provided by the prospectus has to include selected financial information regarding the issuer, presented by financial year (Art. 3 para. 2 Commission Regulation (EC) No. 809/2004 with Annex I to this regulation).[51]

The prospectus rules at the EU level recently underwent an overhaul.[52] This overhaul resulted in the adoption of a new prospectus regulation on 14 June 2017 the rules of which do apply from 21 July 2019 onwards.[53] The new regulation aims to make it easier for EU businesses, especially SMEs, to obtain funding and to improve investor protection by (1) reducing the administrative burden of drawing up a prospectus, (2) making the prospectus a more relevant disclosure tool for potential investors, and (3) achieving more convergence between the EU prospectus and other EU disclosure rules.[54]

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[50] OJ L 149, 30 April 2004, p. 3.

[51] In Annex I to Commission Regulation (EC) No. 809/2004 it says in item 3: "3.1. Selected historical financial information regarding the issuer, presented for each financial year for the period covered by the historical financial information, and any subsequent interim financial period, in the same currency as the financial information. The selected historical financial information must provide the key figures that summarise the financial condition of the issuer. 3.2. If selected financial information for interim periods is provided, comparative data from the same period in the prior financial year must also be provided, except that the requirement for comparative balance sheet information is satisfied by presenting the year end balance sheet information."

[52] This overhaul was initiated by the last consultation on the review of the Prospectus Directive, which fundamentally questioned the current regime [cf. Commission Consultation Document – Review of the Prospectus Directive, 18 February 2015, online: <http://ec.europa.eu/finance/consultations/2015/prospectus-directive/docs/consultation-document_en.pdf>. The Commission published its proposal for a prospectus regulation in November 2015 [see Commission, Proposal for a Regulation on the prospectus to published when securities are offered to the public or admitted to trading, 30.11.2015, COM(2015) 583 final, online: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52015PC0583>; for a short summary, see Commission press release, The Commission proposes to overhaul prospectus rules to improve access to finance for companies and simplify information for investors, 30 November 2015, IP/15/6196]; on 16 December 2016 a compromise between Parliament and Council was reached [as to the state of the legislative procedure and the contents of the new regulation, see EPRS Briefing: EU Legislation in Progress, Prospectuses for investors, February 2017, PE 599.289]; for an overview, see also S. SCHULZ, Die Reform des Europäischen Prospektrechts, WM 2016, 1417 et seqq.; especially with a view to disclosure liability and against the background of UK law, see BENGTZEN, *supra* note 47, 432–435.

[53] Regulation (EU) 2017/1129 of 14 June 2017, OJ L 168, 30 June 2017, p. 12.

[54] Recitals 3 to 7 of Regulation (EU) 2017/1129; cf. also Commission, Proposal for a regulation on the prospectus to published when securities are offered to the public or ad-

b) Secondary Market Disclosure

Mandatory secondary market disclosure – that is, continuing disclosure obligations imposed on issuers whose securities are already traded on the capital markets – is commonly divided into two main categories: periodic disclosure and ongoing disclosure.[55]

(1) Periodic Disclosure

The obligations of issuers to periodically disclose financial information are laid down in §§ 114–118 of the Securities Trading Act (*Wertpapierhandelsgesetz,* WpHG), which implement the requirements provided for in Art. 4 et seqq. of the EU Transparency Directive (TD)[56].[57] These requirements apply to domestic issuers *(Inlandsemittenten)* as defined in § 2 para. 14 WpHG.[58] According to § 114 WpHG, the issuer shall draw up and make available to the public an annual financial report four months after the end of each financial year at the latest. This annual financial report shall include the audited financial statements, the management report, and statements made according to §§ 264 para. 2 sent. 3, 289 para. 1 sent. 5 HGB[59] (so-called *Bilanzeid*), whereby the directors of a domestic issuer have to certify that, to the best of their knowledge, the financial statements give a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer.[60] However, § 114 WpHG only

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mitted to trading, 30 November 2015, COM(2015) 583 final, p. 3; as to the liability requirements of the new Prospectus Regulation, see *infra* V.2.a).

[55] As to this common categorisation, cf., e.g., FLEISCHER *supra* note 47, marg. no. 5. This distinction is also reflected in the different legal basis of these disclosure rules. While the Transparency Directive requires annual and half-yearly financial reports, the Market Abuse Regulation requires continuous disclosure of inside information. For further details, see *infra* (1) and (2).

[56] Directive 2004/109/EC, OJ L 390, 31 December 2004, p. 38, as amended by Directive 2013/50/EU, OJ L 294, 6 November 2013, p. 13. Art. 7 TD requires that "Member States shall ensure that responsibility for the information to be drawn up and made public in accordance with Articles 4, 5, 6 and 16 lies at least with the issuer or its administrative, management or supervisory bodies and shall ensure that their laws, regulations and administrative provisions on liability apply to the issuers, the bodies referred to in this Article or the persons responsible within the issuers."

[57] The *Zweites Finanzmarktnovellierungsgesetz* (2. FiMaNoG), BGBl. I 2017, 1693, which was adopted on 23 June 2017, moved the former provisions of §§ 37v-37z WpHG only with very minor changes to §§ 113–118 WpHG. This part of the 2. FiMaNoG entered into force on 3 January 2018.

[58] For further details with regard to the predecessor regime (cf. note 57), see S. MOCK, in: Kölner Kommentar WpHG, 2nd ed. 2014, § 37v marg.nos 51–56a.

[59] Similar affidavits are required by §§ 297 para. 2 sent. 4, 315 para. 1 sent. 6 HGB with regard to the (consolidated) management report and the consolidated financial statements.

[60] See, for further details, H. FLEISCHER, Der deutsche „Bilanzeid" nach § 264 Abs. 2 Satz 3 HGB, ZIP 2007, 97 et seqq. According to § 311 no. 3a HGB the directors have to face

applies to domestic issuers who are not obligated to comply with these requirements as stipulated by the HGB anyway. As a consequence, § 114 WpHG applies only to domestic issuers which are foreign companies.[61]

In addition to this annual financial disclosure requirement, a domestic issuer has to publish a half-yearly financial report covering the first six months of the financial year without undue delay (§ 115 WpHG). This report shall at least contain (1) a condensed set of financial statements, (2) an interim management report, and (3) a statement of the directors according to §§ 264 para. 2 sent. 3, 289 para. 1 sent. 5 HGB.

The WpHG's periodic disclosure regime is rounded off by the obligation to publish interim management statements informing the public about the business developments and financial situation during the interval between the annual and the half-yearly financial statements according to § 114 and § 115 WpHG (§ 116 WpHG). Issuers which publish quarterly financial reports – e.g. to comply with stock exchange rules – are exempt from publishing interim statements as required by § 116 WpHG.

These periodic disclosure requirements are complemented by § 117 WpHG, which provides for a modified application of §§ 114 to 116 WpHG on issuers which are obliged to draw up and disclose consolidated financial statements and management reports. Lastly, § 118 WpHG contains exemptions from the disclosure regime laid down in § 114 to § 119 WpHG.

The managing and supervisory board of a listed company[62] shall also declare annually that the recommendations of the government commission responsible for the German Corporate Governance Code have been or will be complied with, or which recommendations have not been or will not be applied and why (§ 161 AktG). These recommendations also refer to the reporting and audit of financial statements (cf. § 7 German Corporate Governance Code).[63] However, it is more or less undisputed that the infringement of this obligation does not trigger the civil liability of the company or its directors, at least as a general matter.[64]

(2) Continuous Disclosure of Inside Information

The ongoing disclosure regime comprises the disclosure of major shareholdings and the continuous disclosure of inside information. However, only the

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criminal sanctions if they do not certify correctly as required by §§ 264 para. 2 sent. 3, 289 para. 1 sent. 5 HGB (and again also by §§ 297 para. 2 sent. 4, 315 para. 1 sent. 6 HGB).

[61] MOCK, *supra* note 58, marg. no. 58, with further references.

[62] As defined in § 3 para. 2 AktG.

[63] The German Corporate Governance Code has recently been amended (the amendments took effect on 7 February 2017). A translation of the new 2017 version is available at <http://www.dcgk.de//files/dcgk/usercontent/en/download/code/170214_Code.pdf>.

[64] Cf., for further details, FLEISCHER, *supra* note 47, marg. no. 62.

latter is of relevance to the topic at hand – namely, (liability for) false financial statements. The obligation to disclose inside information has been harmonised by EU law: Art. 17 of the Market Abuse Regulation (MAR)[65] provides that an issuer shall inform the public as soon as possible regarding inside information which directly concerns that issuer. Such inside information also covers the issuer's financial information.[66]

IV. Addendum: Voluntary Financial Statements

Apart from all these reporting and disclosure requirements imposed by law, the company and its directors may, of course, give statements concerning the company's financial situation on a voluntary basis. Such statements include press releases, letters to shareholders as a means of investor relations, and the like. It goes without saying that such voluntary statements may also trigger liability where they are false or misleading.[67]

V. Civil Liability of the Company and Its Directors with Regard to False Financial Statements

Following on the above overview of the basic mechanisms of civil liability for a German stock corporation (AG) and its directors (II) and, albeit in a rather general way, the multitude of financial reporting and disclosure obligations of such a company under German and EU law, as well as the accompanying duties of its directors (III), it is time to move on to the core issue of this paper – namely, the civil liability of the stock corporation and its directors with regard to false financial statements under German law. The following analysis deals, firstly, with the liability of the company and its directors for false financial statements in general (1), before turning to liability issues specific to listed companies (issuers) and their board members (2).

1. General Liability

a) Civil Liability of the Company

First of all, there is no general statutory provision in German law which holds the company liable to persons who have relied on the content of false financial statements and thereby incurred losses. Rather, additional acts and cir-

[65] Regulation (EU) No. 596/2014, OJ L 173, 12 June 2014, p. 1.

[66] The publication of such financial inside information is a "financial statement" in the broader sense of this term; cf. *supra* I.

[67] Cf. FLEISCHER, *supra* note 47, marg. nos. 64–65; *infra* V.2.b)(3).

cumstances are necessary for the corporation to be liable.[68] Such additional circumstances arise, for example, where the company enters into negotiations with a third party. Remember the case where the director vouched for the soundness of the books he knew had been manipulated when negotiating a loan on behalf of the company with a bank. In such a case the company is liable for damages pursuant to §§ 31, 280, 311 para. 2 BGB.[69] Another example would be the use of false financial statements to negotiate the sale of a subsidiary.[70]

Aside from such contractual or negotiation settings, any unlawful use of the annual financial statements, whereby the directors of the company are liable according to § 823 para. 2 BGB or § 826 BGB, can trigger the liability of the corporation by means of § 31 BGB, which assigns the responsibility for those acts to the company itself.[71]

b) Civil Liability of the Directors ...

The above discussion raises the question of when the directors are personally liable to third persons for false financial statements (1). The picture is completed by analysing the (internal) liability of the directors to the corporation (2).

(1) ... to Third Parties (External Liability)

With regard to the external liability of the directors for false financial statements, there are essentially three bases for a claim against the members of the board, which have already been mentioned in the more general context of directors' liability[72]: When the director lays claim to being given a high degree of trust by the counterparty of the company in ongoing contract negotiations, this may lead to liability according to §§ 280, 311 paras. 2 and 3 BGB. Where the board member intends to inflict damage on another person, she is liable according to § 826 BGB. If the behaviour of the director amounts to outright fraud, the director is liable according to § 823 para. 2 BGB with § 263 StGB.[73]

§ 823 para. 2 BGB with § 263 StGB is a valid basis for claiming damages because § 263 StGB[74] qualifies as "a statute that is intended to protect another person" in the sense of § 823 para. 2 BGB (so-called *Schutzgesetz*), the infringement of which entitles the persons whose interests are to be protected to

[68] GELHAUSEN, *supra* note 39, marg. no. 24.
[69] *Supra* II.2.b).
[70] These examples are given by GELHAUSEN, *supra* note 39, marg. no. 25.
[71] GELHAUSEN, *supra* note 39, marg. no. 27. See, in general, already *supra* II.2.b).
[72] *Supra* II.2.b).
[73] Cf. also GELHAUSEN, *supra* note 39, marg. nos. 66, 72.
[74] As a reminder: § 263 StGB stipulates that fraud is a criminal offence.

claim damages from the perpetrator.[75] Therefore, the debate on the liability of directors (and their companies) to third persons for false financial statements focusses on the question of which statutory provisions imposing obligations to supervise, assess or disclose financial reports and other financial information qualify as *Schutzgesetze* in the sense of § 823 para. 2 BGB. The results of this discussion can be roughly summarised as follows:

Neither the duty to keep books of account according to § 91 para. 1 AktG[76] nor the provisions of §§ 238 et seqq. HGB[77] are intended to protect third parties[78]. This is at least the view of most of the scholars who participated in the debate.[79] The same is true with regard to the obligation to certify that the financial statements give a true and fair view, which is imposed on the members of the management board by §§ 264 para. 2 sent. 3, 289 para. 1 sent. 5, 297 para. 2 sent. 4, 315 para. 1 sent. 6 HGB *(Bilanzeid)*.[80]

On the other hand, if a director (1) intentionally misrepresents the company's financial situation in the annual financial statements or (2) intentionally or with gross negligence discloses such annual financial statements which are false or misleading or (3) provides an incorrect certification and, thus, commits a crime laid down in § 331 HGB, he or she also infringes a statute that is intended to protect third parties in the sense of § 823 para. 2 BGB.[81] Thus, directors committing such a crime are not only to be punished, but also face civil liability for damages. The same is true with regard to § 334 HGB (inten-

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[75] See, in general, SPRAU, *supra* note 5, § 823, marg. nos. 56 et seqq.; with regard to the liability of directors for false financial statements, GELHAUSEN, *supra* note 39, marg. no. 67.

[76] See *supra* III.1.b)(3).

[77] BGH, 10 July 1964, I b ZR 208/62, WM 1964, 1163, 1164; OLG Düsseldorf, 4 March 2010, I-6 U 94/09, AG 2011, 31 et seqq.; LG Bonn, 15 May 2001, 11 O 181/00, AG 2001, 484, 486; FLEISCHER *supra* note 47, marg. no. 60; GELHAUSEN, *supra* note 39, marg. no. 69; P. MÜLBERT/S. STEUP, in: Habersack/Mülbert/Schlitt (eds.), Unternehmensfinanzierung am Kapitalmarkt, 3rd ed. 2013, § 41 marg. nos. 270 et seqq.; This view is, however, not uncontended; see, e.g., H. MERKT, Unternehmenspublizitität (Tübingen 2001), 249 et seqq., 481 et seq.; R. SCHNORR, Geschäftsleiteraußenhaftung für fehlerhafte Buchführung, ZHR 169 (2006), 9, 26 et seqq.

[78] LG Bonn, 15 May 2001, 11 O 181/00, AG 2001, 484, 486; FLEISCHER, *supra* note 8, § 91, marg. no. 25 et seqq.; GELHAUSEN, *supra* note 39, marg. no. 68; KOCH, *supra* note 34, § 91 marg. no. 3, all with further references; but see also BGH, 13 April 1994, II ZR 16/93, BGHZ 125, 367, 377 et seqq. (with regard to § 41 GmbHG, which is the equivalent of § 91 AktG).

[79] For references supporting the opposing view see note 77.

[80] FLEISCHER, *supra* note 60, 103, 106; FLEISCHER, *supra* note 47, marg. no. 60; GELHAUSEN, *supra* note 39, marg. no. 70; MÜLBERT/STEUP, *supra* note 77, marg. no. 270.

[81] LG Bonn, 15 May 2001, 11 O 181/00, AG 2001, 484, 486 (with regard to § 331 No. 1 HGB); see also FLEISCHER, *supra* note 47, marg. no. 60; GELHAUSEN, *supra* note 39, marg. no. 71; MÜLBERT/STEUP, *supra* note 77, marg. no. 266, all with further references.

tional infringement of certain accounting provisions)[82] and § 400 para. 1 no. 1 AktG[83]. The latter provision makes it a criminal offence for the directors to intentionally misrepresent or disguise the condition and affairs of the company in presentations or summaries of the assets of the company or in statements or presentations in the general meeting, unless such behaviour is already covered by § 331 HGB.

The above discussion clearly shows that the courts as well as the majority of legal scholars are reluctant to qualify statutory provisions as *Schutzgesetze* where such a qualification would result in liability for mere negligence. This reluctance not only stems from concerns that this would expose the directors to an unduly high liability risk, but is also justified for reasons of coherence and consistency (liability pursuant to §§ 97, 98 WpHG and §§ 21, 22 WpPG[84] is only triggered in the event of gross negligence or intent).[85]

(2) ... to the Company (Internal Liability)

With regard to the internal liability of the directors to their company, the situation under German law is as follows: The breaching of a directors' duties according to § 91 para. 1 AktG[86] or §§ 238 et seqq. HGB[87] triggers their liability pursuant to § 93 para. 2 AktG. However, the infringement of these duties generally does not result per se in any direct loss or damage to the company. If the corporation itself is liable to third persons due to a breach of the directors' duties it may of course seek redress via its claim pursuant to § 93 para. 2 AktG.

The same is true with regard to members of the supervisory board who have breached their supervisory duties with regard to the process of keeping the books and drawing up the financial statements pursuant to § 171 AktG[88] (§§ 116, 93 para. 2 AktG).

Finally, since the infringement of § 331 HGB or any other *Schutzgesetz* in the sense of § 823 para. 2 BGB by a director while he or she is acting on

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[82] FLEISCHER, *supra* note 47, marg. no. 60; GELHAUSEN, *supra* note 39, marg. no. 71; MÜLBERT/STEUP, *supra* note 77, marg. no. 268, all with further references.

[83] BGH, 17 September 2001, II ZR 178/99, AG 2002, 43, 44; BGH, 19 July 2004, II ZR 218/03, AG 2004, 543, 544; FLEISCHER, *supra* note 47, marg. no. 60; GELHAUSEN, *supra* note 39, marg. no. 71; MÜLBERT/STEUP, *supra* note 77, marg. no. 268, all with further references.

[84] As to these provisions, see *infra* 2.

[85] See, for an instructive overview of the debate, FLEISCHER, *supra* note 8, § 91, marg. nos. 25–28, with further references; also MÜLBERT/STEUP, *supra* note 77, marg. nos. 271–272.

[86] See *supra* III.1.b)(3).

[87] See *supra* III.1.b)(3).

[88] As to these duties, see *supra* III.1.b)(3).

behalf of the company is attributed to the company via § 31 BGB[89], the company may seek redress from its directors for the damages paid to third parties.

2. Liability of Listed Companies and their Directors under Capital Markets Law

The liability of listed companies (issuers) and their directors under capital markets law for disclosing false or misleading information has been discussed extensively in Germany in recent decades. The following analysis, again, distinguishes between the liability for disclosing false or misleading information in a prospectus (primary market, a)) and after a security has been admitted to trading (secondary market, b)).[90]

a) Primary Market

At the EU level, Art. 6 Prospectus Directive (PD)[91] stipulates that Member States

> "shall ensure that responsibility for the information given in a prospectus attaches at least to the issuer or its administrative, management or supervisory bodies, the offeror, the person asking for the admission to trading on a regulated market or the guarantor, as the case may be."

Art. 6 para. 2 PD explicitly requires the Member States to apply their "laws, regulation and administrative provisions on civil liability […] to those persons responsible for the information given in a prospectus." The requirements of Art. 6 PD are transposed into German law by §§ 21 and 22 *Wertpapierprospektgesetz* (WpPG). According to these provisions the purchaser of securities which have been admitted to trading on an organised market or have been offered to the public is entitled to rescind the purchase or to claim damages for losses incurred if the prospectus upon which the securities were admitted to trading or offered to the public contains materially false or misleading information.[92] Such false or misleading information can of course also be due to false annual financial statements being included in the prospectus or to

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[89] See, in general, *supra* II.1.a)(2); with regard to § 331 HGB, MÜLBERT/STEUP, *supra* note 77, marg. no. 266.

[90] See already *supra* III.2; cf. also BENGTZEN, *supra* note 47, 432–435.

[91] See *supra* III.2.a) with note 48. Art. 11 Prospectus Regulation will replace Art. 6 PD from 21 July 2019 onwards. The Member States have to take the necessary measures to comply with Art. 11 (cf. Art. 49 para. 3 Prospectus Regulation).

[92] Whether a claim against the issuer to redeem the shares and repay the purchase price is admissible against the background of certain safeguards for the protection of creditors and members of the company as laid down in Directive 2012/30/EU (former Directive 77/91/EEC) was the subject of considerable debate. However, the matter was settled by ECJ, Case C-174/12 *Alfred Hirmann v Immofinanz AG,* ECLI:EU:C:2013:856.

information taken from such false financial statements.[93] The prospectus liability pursuant to §§ 21, 22 WpPG requires grossly negligent or intentional conduct[94] and is directed against persons "who have assumed responsibility for the prospectus" *(Prospekterlasser)* as well as persons "who originated the issuance of the prospectus" *(Prospektveranlasser).*

The issuer, i.e. the corporation, is without doubt a person responsible for the prospectus and, thus, liable under §§ 21, 22 WpPG.[95] While the question of whether the auditors who are involved in the preparation of the prospectus are also such persons is disputed,[96] the courts as well as legal scholars largely agree that the directors of the issuer are not liable pursuant to §§ 21, 22 WpPG as long as they are not the "mastermind" behind the offer of the securities.[97]

However, according to § 25 WpPG, other claims based on contractual obligations or on tort law are not precluded by §§ 21, 22 WpPG. Thus, the directors of the issuer may be personally liable for false or misleading information contained in the prospectus if the requirements of § 826 BGB (intentional infliction of damage on claimant)[98] are met or the behaviour of the directors amounts to the infringement of a *Schutzgesetz* in the sense of § 823 para. 2 BGB. The latter may be the case with regard to § 263 StGB (fraud), § 264a StGB (securities fraud) or § 400 para. 1 no. 1 AktG[99].[100] If the director is personally liable under these provisions, the respective claims can also be brought against the corporation due to the fact that the responsibility for the unlawful conduct of the directors is assigned to the company via § 31 BGB.[101]

The new Prospectus Regulation[102] will cause no major changes to the liability regime presented above. This is because Art. 11 of the new prospectus regulation, which deals with the liability of the persons responsible for the information given in a prospectus, is largely based on its predecessor, Art. 6 PD.[103]

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[93] GELHAUSEN, *supra* note 39, marg. no. 26.

[94] Cf. § 23 para. 1 WpPG, which also shifts the burden of proof; see also *supra* 1.b)(1).

[95] E.g., W. GROSS, Kapitalmarktrecht, 6th ed. 2016, § 21 WpPG, marg. no. 31.

[96] Cf., for further details on the debate, K. HOPT, Die Haftung für Kapitalmarktinformation, WM 2013, 101, 103; GROSS, *supra* note 95, marg. nos. 36–37.

[97] Cf., e.g., GROSS, *supra* note 95, marg. no. 35, with further references. Cf., for a comparative overview, HOPT, *supra* note 96, 103, 109: Austrian and English law also do not hold the directors liable, while Swiss law does.

[98] See *supra* II.2.b).

[99] As to § 400 para. 1 no. 1 AktG, see *supra* 1.b)(1).

[100] H.-D. ASSMANN, in: Assmann/Schütze (eds.), Handbuch des Kapitalanlagerechts, 4th ed. 2015, § 5 marg. no. 207; GROSS, *supra* note 95, § 25 WpPG, marg. nos. 9.

[101] See *supra* II.1.a)(2).

[102] See *supra* III.2.a).

[103] However, the new provision extents liability to supplements to the prospectus as well as to a registration document or a universal registration document where such document is in use as a constituent part of an approved prospectus.

b) Secondary Market

The issuer of a security has to meet a multitude of disclosure obligations after the security has been admitted to trading.[104] Beyond such mandatory disclosure requirements the issuer may provide (financial) information to the public on a voluntary basis.[105] Whenever the information disclosed is false or misleading, the question of whether the issuer – i.e. the corporation – or the directors acting on its behalf are liable for losses incurred by market participants due to the false or misleading information. To approach the issue of liability, it seems appropriate to form three subcategories of such liability and address each in turn – namely, civil liability for false information in periodically published financial reports (2.b)(1)), civil liability for the publication of false inside information (2.b)(2)), and civil liability for false information in voluntary statements (2.b)(3)).

(1) Civil Liability for False Information in Periodically Published Financial Reports

There is no specific statutory basis for a liability claim (as in the case of prospectus liability)[106] if the issuer infringes its obligation to periodically publish financial reports and statements according to §§ 114 et seqq. WpHG by disclosing false or misleading information in such reports and statements.[107] It has been suggested that § 98 WpHG be applied, by analogy, to these cases. This section provides a liability claim for infringing Art. 17 MAR[108].[109] However, the courts have rejected this suggestion.[110] Thus, again, the potential claimant has to turn to general claims based on the law of contracts or torts (such as § 826 BGB or § 823 para. 2 BGB).[111] If such a claim can be estab-

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[104] See *supra* III.2.b).

[105] See *supra* IV.

[106] See *supra* 2.a).

[107] This has been criticised as a severe gap in the statutory liability regime. Cf., e.g., P. MÜLBERT/S. STEUP, Emittentenhaftung für fehlerhafte Kapitalmarktinformation am Beispiel der fehlerhaften Regelpublizität, WM 2005, 1633, 1651, 1655; R. VEIL, Der Schutz des verständigen Anlegers durch Publizität und Haftung im europäischen und nationalen Kapitalmarktrecht, ZBB/JBB 2006, 162, 168 f.

[108] See *supra* III.2.b)(2).

[109] MÜLBERT/STEUP, *supra* note 107, 1651; MÜLBERT/STEUP, *supra* note 77, marg. no. 277, both with regard to the predecessor provision of § 98 (i.e. former § 37c WpHG).

[110] Cf. BGH, 13 December 2011, XI ZR 51/10, ZBB/JBB 2012, 222, 223 et seq. *(IKB),* which dealt with the predecessor provisions to §§ 97, 98; the prevailing view in the literature is in line with the courts, see, e.g., FLEISCHER, *supra* note 47, marg. no. 61; K. U. SCHMOLKE, Die Haftung für fehlerhafte Sekundärmarktinformation nach dem „IKB"-Urteil des BGB, ZBB/JBB 2012, 165, 167, both with further references.

[111] FLEISCHER, *supra* note 47, marg. no. 61.

lished against a director, the liability of the corporation ensues due to the assignment of the director's conduct via § 31 BGB.

(2) Civil Liability for the Public Disclosure of False Inside Information

Art. 17 MAR requires the issuer of a financial instrument to publish inside information that directly affects that issuer as soon as possible.[112] According to § 98 WpHG, issuers of financial instruments that are admitted to trading on a domestic, i.e. German, trading venue[113] who breach this statutory disclosure duty by publishing false inside information are liable to investors who (1) bought the financial instruments of the issuer after the publication and still own them at the time when it becomes publicly known that the information was inaccurate or (2) bought the financial instruments before the public disclosure of the false information and sold them before it became clear that the information was inaccurate.[114] The successful claimant is entitled to compensation for his losses. According to a decision of the Federal Court of Justice (*Bundesgerichtshof,* BGH) in 2011 *(IKB),* this compensation is not limited to the payment of the difference between the price actually paid or received and the hypothetical price level that would have been the case if the issuer had not given a false statement. Rather, the successful claimant who has bought the instruments at too high a price is entitled to opt for the repayment of the whole amount paid provided that he or she transfers ownership of the instruments in question to the issuer.[115] With regard to this aspect of its decision the court has, however, met with harsh and widespread criticism.[116] Apart from this dispute, the liability pursuant to § 98 WpHG is limited insofar as it only applies to the issuer (but not to its directors)[117] and requires at least gross negligence.

So what about the personal liability of the directors who publish false inside information on the issuer's behalf? This question arose in the famous

[112] See already *supra* III.2.b)(2).

[113] The same applies to issuers of financial instruments where the admission to a domestic regulated market or multilateral trading facility is pending.

[114] In addition to this statutory liability claim, § 97 WpHG provides the basis for liability for damages due to failure to publish inside information without undue delay. While this is, as such, beyond the scope of this paper (dealing with false information), § 97 WpHG nevertheless may play a role with regard to the publication of false information. As to this role, see *infra* 2.b)(3).

[115] BGH, 13 December 2011, XI ZR 51/10, ZBB/JBB 2012, 222, 228 et seq. (*IKB*), with regard to liability pursuant to the predecessor provision to § 97 WpHG.

[116] E.g., FLEISCHER, *supra* note 47, marg. no. 52; MÜLBERT/STEUP, *supra* note 77, marg. no. 210 et seqq; SCHMOLKE, *supra* note 110, 175 et seq., all with further references.

[117] Cf., e.g., FLEISCHER, *supra* note 47, marg. no. 41; MÜLBERT/STEUP, *supra* note 77, marg. no. 252.

case *EM.TV* decided by the Federal Court of Justice in 2005,[118] the facts of which are basically as follows: The directors of the EM.TV & Merchandising AG published several disclosure statements according to § 15 WpHG, the predecessor to Art. 17 MAR. One of these statements contained a financial report of the EM.TV AG. The business figures presented were intentionally inflated by incorrectly adding past sales and profits of a newly acquired company to the accounts. The judges could draw on newly established case law according to which a person who intentionally publishes disclosure statements that contain grossly incorrect inside information is liable for damages according to § 826 BGB[119], at least if such person aims to personally benefit from such behaviour.[120] The BGH held in *EM.TV* – as later in *IKB* with regard to liability pursuant to (the predecessor to) § 97 WpHG – that the successful claimant can not only demand the difference between the actual purchase price and the "correct price", but also reimbursement of the whole purchase price in exchange for the shares bought.

Furthermore, a claim against the directors can be based upon § 823 para. 2 BGB in connection with § 400 para. 1 no. 1 AktG, if the conditions are met.[121] In contrast, no valid claim can be based on the infringement of the statutory ban on market manipulation, since the relevant provision, i.e. Art. 15 MAR, is not a *Schutzgesetz* in the sense of § 823 para. 2 BGB.[122] This is, however, the subject of debate. The discussion centres on whether EU law demands civil liability for market manipulation under the laws of the Member States.[123]

The liability of the directors based on general tort law (§§ 823 para. 2, 826 BGB), in turn, triggers the liability of the issuer, i.e. the listed corporation, by way of § 31 BGB.

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[118] BGH, 9 May 2005, II ZR 287/02, NZG 2005, 672 (*EM.TV*).

[119] As to this statutory claim in general, see *supra* II.2.b).

[120] See BGH, 19 July 2004, II ZR 402/02, BGHZ 160, 149, 151 et seqq. *(Infomatec II).*

[121] Cf. BGH, 9 May 2005, II ZR 287/02, NZG 2005, 672, 675 (*EM.TV*). The directors of the EM.TV & Merchandising AG were convicted under § 400 para. 1 sent. 1 AktG, see BGH, 16 December 2004 – 1 StR 420/03, NJW 2005, 445. While the provisions of §§ 263, 264a StGB are also *Schutzgesetze* in the sense of § 823 para. 2 BGB [as to § 263 StGB, see *supra* II.2.b)], publishing false inside information does not, at least as a general rule, satisfy the requirements of these criminal offences. See BGH, 19 July 2004, II ZR 218/03, BGHZ 160, 134, 141 et seq. *(Infomatec I);* FLEISCHER, *supra* note 47, marg. no. 18; MÜLBERT/STEUP, *supra* note 77, marg. no. 254.

[122] As to the predecessor of Art. 15 MAR, namely § 20a WpHG, see BGH, 13 December 2011, XI ZR 51/10, ZBB/JBB 2012, 222, 224 et seq. *(IKB);* SCHMOLKE, *supra* note 110, 168 et seqq., all with further references.

[123] For an overview of the debate, see K. U. SCHMOLKE, Private Enforcement und institutionelle Balance, NZG 2016, 721 et seqq.

(3) Civil Liability for the Publication of False Information in Voluntary Statements

Finally, one last issue remains to be addressed: the civil liability of issuers and their directors for the publication of false information in voluntary statements. The BGH had to decide on this issue in the previously mentioned case of *IKB*.[124] The scenario presented at the beginning of this paper essentially describes the facts of that case.[125] Thus, the court had to answer the question of whether the investor who had bought shares in IKB Deutsche Industriebank AG at too high a price had a claim against the bank because its CEO had published false information about the bank's investment in the subprime mortgage market in a press release.

In its judgment the BGH rejected a claim pursuant to § 98 WpHG[126] on the grounds that a press release does not qualify as a proper disclosure statement on inside information as referred to in Art. 17 MAR (formerly § 15 WpHG).[127] However, the bank was held liable under § 97 WpHG, because it failed to publish without undue delay the inside information that it actually was heavily invested in subprime mortgages.[128]

Aside from this, a successful claim against the issuer (corporation) as well as its directors for voluntarily given, but incorrect financial information may be based on general tort law. The corporation assumes responsibility for the tortious act of its directors according to § 31 BGB.

VI. Concluding Remarks

As has been shown in this paper, German law provides a rather fragmented and complex body of rules on the civil liability of a stock corporation and its directors for providing false financial statements. This has been recognised as a problem among legal scholars. Against this background it does not come as a surprise that there is a widespread call for a comprehensive liability regime for false, misleading or omitted information at least with regard to issuers and their directors, i.e. as far as capital markets law is concerned. Thus, it is the legislature's turn to take steps to reform the German liability rules. A first attempt in that direction was taken in 2004. The draft of a *Kapitalmarktin-*

124 BGH, 13 December 2011, XI ZR 51/10, ZBB/JBB 2012, 222 et seqq. *(IKB)* with regard to the predecessor provision.

125 *Supra* I.

126 See *supra* 2.b)(1) and 2.b)(2).

127 Cf. also OLG Braunschweig, 12 January 2016, 7 U 59/14, ZIP 2016, 414 *(Porsche)*.

128 BGH, 13 December 2011, XI ZR 51/10, ZBB/JBB 2012, 222, 226 et seqq. (*IKB*). The courts view met with support from the literature, see, e.g., SCHMOLKE, *supra* note 110, 168, with further references.

formationshaftungsgesetz (KapInHaG)[129] intended to establish liability claims against issuers and their directors for the publication of false information or the omission or concealment of true information contrary to statutory disclosure requirements.[130] However, the rules on the liability of directors to third parties (external liability) which were provided for in the draft met with considerable criticism, even though the liability was limited to gross negligence.[131] The then federal minister of finance responded to this criticism by withdrawing the draft.[132] No further attempt to tackle the issue has been made since. More than a dozen years later it appears to be time to try again.[133]

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[129] The unpublished proposal is available online at <http://www.wpk.de/uploads/tx_news/wpk-stellungnahmen_kapinhag-diskussionsentwurf.pdf>.

[130] The draft did not cover liability for prospectuses containing false or omitting material information since such liability rules already existed at that time. For details on the reform discussion at that time, see K. HOPT/H.-C. VOIGT, in: Hopt/Voigt (eds.), Prospekthaftung und Kapitalmarktinformationshaftung: Recht und Reform in der Europäischen Union, der Schweiz und den USA (Tübingen 2005) 9 et seqq.

[131] For a summary of the critique, see HOPT/VOIGT, *supra* note 130, 120.

[132] Similar attempts to establish external liability of the directors have failed in Austria and the UK; for a comparative overview, see HOPT, *supra* note 96, 109.

[133] For an overview of the issues to be addressed in such a reform of the liability regime under capital markets law, see HOPT/VOIGT, *supra* note 130.

Appendix[134]

German Civil Code (*Bürgerliches Gesetzbuch,* BGB)

§ 31 – Liability of an association for organs

The association is liable for the damage to a third party that the board, a member of the board or another constitutionally appointed representative causes through an act committed by it or him in carrying out the business with which it or he is entrusted, where the act gives rise to a liability in damages.

§ 280 – Damages for breach of duty

(1) If the obligor breaches a duty arising from the obligation, the obligee may demand damages for the damage caused thereby. This does not apply if the obligor is not responsible for the breach of duty.

§ 311 – Obligations created by legal transaction and obligations similar to legal transactions

[…]

(2) An obligation with duties under § 241 para. 2 [i.e. to take account of the rights, legal interests and other interests of the other party] also comes into existence by

1. the commencement of contract negotiations
2. the initiation of a contract where one party, with regard to a potential contractual relationship, gives the other party the possibility of affecting his rights, legal interests and other interests, or entrusts these to him, or
3. similar business contacts.

(3) An obligation with duties under § 241 para. 2 may also come into existence in relation to persons who are not themselves intended to be parties to

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[134] The translation of the statutory provisions is taken from the following sources: German Ministry of Justice and Consumer Protection, Gesetze im Internet, online: <https://www.gesetze-im-internet.de/englisch_bgb/index.html> (German Civil Code); Federal Financial Supervisory Authority (BaFin), online: <https://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/WpHG_en.html> (German Securities Trading Act), modified by author to reflect the latest changes in the law; Norton Rose Fulbright LLP, online: <http://www.nortonrosefulbright.com/files/german-stock-corporation-act-147035.pdf> (German Stock Corporation Act); VAHLDIEK, in: Vahldiek, German Banking Law, March/April 2015, § 8 Securities Prospectus Act, pp. 34–35. (§ 21 German Securities Prospectus Act); a Research Assistant working at my chair together with translator Melissa Nelson (§ 331 German Commercial Code).

the contract. Such an obligation comes into existence in particular if the third party, by laying claim to being given a particularly high degree of trust, substantially influences the pre-contract negotiations or the entering into of the contract.

§ 823 – Liability in damages

(1) A person […] is liable to make compensation to the other party for the damage arising from this.

(2) The same duty is held by a person who commits a breach of a statute that is intended to protect another person. If, according to the contents of the statute, it may also be breached without fault, then liability to compensation only exists in the case of fault.

§ 826 – Intentional damage contrary to public policy

A person who, in a manner contrary to public policy, intentionally inflicts damage on another person is liable to the other person to make compensation for the damage.

German Stock Corporation Act (*Aktiengesetz,* AktG)

§ 91 – Organisation; Accounting

(1) The managing board shall ensure that the requisite books of account are maintained. […]

§ 93 – Duty of Care and Responsibility of Members of the Management Board

(1) In conducting business, the members of the management board shall employ the care of a diligent and conscientious manager. They shall not be deemed to have violated the aforementioned duty if, at the time of taking the entrepreneurial decision, they had good reason to assume that they were acting on the basis of adequate information for the benefit of the company. […]

(2) Members of the management board who violate their duties shall be jointly and severally liable to the company for any resulting damage. They shall bear the burden of proof in the event of a dispute as to whether or not they have employed the care of a diligent and conscientious manager. […]

§ 400 – Misrepresentation

(1) Whoever as a member of the management board or of the supervisory board or as liquidator:

1. misrepresents or conceals the condition of the company, including its relations with affiliated enterprises, in presentations or summaries on the financial condition of the company, statements or information provided at the shareholders' meeting, unless such act constitutes a criminal offence pursuant to § 331 No. 1 or 1a of the Commercial Code, or
2. makes false statements or misrepresents or conceals the condition of the company in disclosures or statements which are required to be made to an auditor of the company or an affiliated enterprise pursuant to the provisions of this Act, unless such act constitutes a criminal offence pursuant to § 331 No. 4 of the Commercial Code

shall be punished by imprisonment of up to three years or by fine. […]

German Commercial Code (*Handelsgesetzbuch,* HGB)

§ 331 – Misrepresentation

A person who

1. as a member of the management or supervisory board of a corporation misrepresents or conceals the state of affairs of a corporation in the opening balance sheet, annual report, management report or in the interim balance sheet according to § 340a para. 3,

1a. as a member of the management or supervisory board of a corporation deliberately or frivolously publishes for the purpose of exemption according to § 325 para. 2a sentence 1, para. 2b a financial statement according to the IFRS mentioned in § 315a para. 1, in which the state of affairs of the corporation has been misrepresented or concealed,

2. as a member of the management or supervisory board of a corporation misrepresents or conceals the state of affairs of the corporate group in the consolidated annual financial statement, consolidated management report or in the consolidated interim financial statement according to § 340i para. 4,

   […]

3a. incorrectly certifies contrary to § 264 para. 2, sentence 3, § 289 para. 1 sentence 5, § 297 para. 2 sentence 4 or § 315 para. 1 sentence 6,

4. as a member of the management of a corporation or as a member of the management or as a representative shareholder of one of its subsidiary undertakings (§ 290 para. 1, 2) provides false information or misrepresents or conceals the state of affairs of the corporation, of a subsidiary undertaking or the corporate group in explanations or records which, according to § 320, have to be given to an auditor of the corporation, of an affiliated undertaking or of the corporate group,

shall be punished by imprisonment of up to three years or by fine.

German Securities Prospectus Act (*Wertpapierprospektgesetz,* WpPG)

§ 21 – Liability for incorrect prospectuses for exchange listing

(1) The purchaser of securities which have been admitted to exchange trading on the grounds of a prospectus in which facts essential for the assessment of the securities are incorrect or incomplete may demand from

1. the persons who have assumed liability for the prospectus, and
2. the persons who initiated the issue of the prospectus,

as joint and several debtors, that they take back the securities against reimbursement of the purchase price, insofar as this price does not exceed the initial issue price of the securities, and the costs usually involved in the purchase, provided that the purchase was concluded after publication of the prospectus and within six months after the first listing of the securities in trading. […]

German Securities Trading Act (*Wertpapierhandelsgesetz,* WpHG)

§ 97 – Liability for damages due to failure to publish inside information without undue delay

(1) If an issuer of financial instruments that are admitted to trading on a domestic trading venue or where the admission to a regulated market or a multilateral trading facility is pending fails to publish in accordance with Art. 17 Regulation (EU) No. 596/2014 and without undue delay, inside information that directly affects that issuer, he shall be liable to compensate a third party for the damage resulting from the omission if the third party

1. has bought the financial instruments after the omission and still owns the financial instruments upon disclosure of the information or
2 has bought the financial instruments before the existence of the relevant insider fact and sells them after the omission.

[…]

§ 98 – Liability for damages based on the publication of false inside information

(1) If an issuer of financial instruments that are admitted to trading on a domestic trading venue or where the admission to a regulated market or a multilateral trading facility is pending publishes false inside information that directly affects that issuer in a notification pursuant to Art. 17 Regulation (EU) No. 596/2014, he shall be liable to compensate a third party for the damage

resulting from the fact that the third party relied on the accuracy of the inside information, if the third party

1. has bought the financial instruments after publication and still owns the financial instruments at the point in time at which it becomes publicly known that the information was inaccurate or
2. has bought the financial instruments before publication and sells them before it becomes clear that the information was inaccurate.

[…]

General Trends of Misrepresentation Litigation in China

Li Guo

I. Inclination to Abolish the Requirement of a Prior Administrative or Criminal Ruling....166
II. The First Supported Litigation in the Securities Market....166
III. Summary of Cases on Misrepresentation by Listed Companies....167

Since the first securities fraud case in China, *Chen Lihua et al v Daqing Lianyi Ltd & Shenyin Securities Ltd* (no. 1 in the chart),[1] civil litigation against listed companies, their controlling shareholders, or any other responsible parties[2] has been proliferating, as is clearly indicated by the chart.

Unlike the first case, where the Securities Law was not even applicable and only some civil principles could be referred to in the judgment,[3] subsequent cases regarding misrepresentations by listed companies have tended to be easier for judges to approach or tackle. The Securities Law established general principles and specific punishment measures[4] that deal with misrepre-

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[1] English translation of the final judgment is available at <http://en.pkulaw.cn/display.aspx?cgid=1970324837041975&lib=case>; for a detailed analysis of this case, see L. GUO/ A. VY ONG, The fledgling securities fraud litigation in China, Hong Kong LJ 39 (2009) 697.

[2] Pursuant to Art.7 of Several Provisions of the Supreme People's Court on the Trial of Civil Compensation Cases Arising from Misrepresentation in the Securities Market (1 February 2003), liable entities or individuals include:

1. Actual controllers such as the sponsors and controlling shareholders;
2. Issuers or listed companies;
3. Securities underwriters;
4. Those recommending the listing of securities;
5. Professional intermediary service agencies, such as accounting firms, law firms and asset appraisal organizations;
6. Responsible senior management of the unit concerned, such as directors, supervisors and managers in the above Item 2, 3 or 4 and directly responsible persons in above Item 5; and
7. Other institutions or natural persons who make the misrepresentations.

[3] In this case, the misrepresentation behavior occurred in 1997, whereas the (original) Securities Law of China was issued on 29 December 1998 and took effect on 1 July 1999.

[4] For general principles, see Arts. 31, 63, 66, 78, and 173, and for specific punishment measures, see Arts. 55, 56, 192, 193, 222 and 223 of the Securities Law of China (31 August 2014).

sentation. Detailed definitions, determining criteria, and other technical issues have largely been solved or provided for in two judicial interpretations regarding the civil litigation of misrepresentations in securities markets.[5]

Consequently, the demarcation of misrepresentation behavior or the fixing of critical dates, such as the "implementation date", the "disclosure date" or the "correction date", and the "base date" have become less difficult and more routine. Formulae have been used by the judges not only when calculating investment loss,[6] but also in writing judgments. While the misrepresentation conduct varies in different cases, as do other facts, most of the issues spotted were quite analogous. Disputes and debates within an ordinary case of misrepresentation center on the following issues:

1. Does the defendant's conduct constitute misrepresentation?
2. Is there causality between the plaintiff's investment loss and the defendant's misrepresentation conduct?
3. How can the implementation date, the disclosure date or the correction date, and the base date be determined?
4. How can the plaintiff's loss be calculated?

However, this does not mean that judges can analyze and then decide a case by simply calculating and applying the formula. Discussions of these cases actually delve much deeper than this.

One vital analysis focuses on the materiality of misrepresentations. Article 17 of the Provisions only mentions articles in the Securities Law regarding material information in disclosure documents such as the listing documents, the semi-annual reports, the annual reports, and the interim reports.[7] However, in real cases this statutory guidance seems insufficient. Thus, in a speech[8] delivered by Linping Yang, a chief judge from Chamber II of Civil Trials of the Supreme People's Court, it was pointed out that when weighing materiality, the impact of such misrepresentation on the price and volume of

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[5] Several Provisions of the Supreme People's Court on the Trial of Civil Compensation Cases Arising from Misrepresentation in the Securities Market (1 February 2003) ("the Provisions"), English translation available at <http://hk.lexiscn.com/law/content.php?eng=0&provider_id=1&origin_id=479846&isEnglish=Y>; Circular of the Supreme People's Court on Relevant Issues concerning the Acceptance of Civil Tort Cases Arising from Misrepresentation in the Securities Market (15 January 2002) ("the Circular"), English translation available at <http://hk.lexiscn.com/law/content.php?provider_id=1&isEnglish=N&origin_id=29679&eng=0&isEnglish=N&keyword=6Jma5YGH6ZmI6L%2BwLOmZiOi%2FsCzomZrlgYc%3D&t_kw=6Jma5YGH6ZmI6L%2BwLOmZiOi%2FsCzomZrlgYc%3D>.

[6] In the case against *CHTC Helon Co., Ltd.* (no. 5 in the chart), the following computational formula was used: Investment Variation Loss = (Average Purchase Price - Base Price) * Number of Sold or Held Shares after the Base Date.

[7] See Arts. 59, 60, 61, 62 and 72 of the Securities Law of China (1 July 1999).

[8] Several Issues in Current Commercial Trials, published by the Supreme People's Court on 24 December 2015.

the transacted securities should be carefully considered. This standard has also been applied in the cases against *Shenzhen Energy Group Co., Ltd.* (no. 2 in the chart) and *Huangshi Dongbei Electrical Appliance Co., Ltd. and Huangshi Dongbei Mech-electrical Group Co., Ltd.* (no. 7 in the chart).

Another intriguing point concerns the explanation of systemic risk. The Provisions state only that causality can be interrupted and liabilities thereby exempted if the defendant is able to prove that the loss actually resulted from systemic risk,[9] but they state nothing about how to define the systemic risk and apply the principle of exemption of liabilities. A few instructions can be found in another speech[10] by Xiaoming Xi, the former vice president of the Supreme People's Court, explaining that systemic risk may, to some extent, be correlated with certain trigger events – financial policies (such as the exchange rate and the interest rate), foreign and domestic emergencies, as well as the transformation of an economic or political regime; but even when these trigger events happen, the judge should still be extremely careful and should note the fluctuation or variation of relevant indices.

Accordingly, in recent cases judges have been observed striving to give their own insights on this issue. In the case against *CHTC Helon Co., Ltd.* (no. 5 in the chart), trigger events were classified into three types – i.e. political, economic and social events – and the fluctuation of the market and sector indices were deemed an appropriate test for determining whether there is systemic risk. Namely, if there is a drastic fluctuation in these indices, systemic risk may be established. This test has also been adopted in other similar cases, including the cases against *Hareon Solar Technology Co., Ltd.* (no. 6 in the chart), *Hubei Sanxia New Building Materials Co., Ltd.* (no. 4 in the chart),[11] *Foshan Electrical and Lighting Co., Ltd.* (no. 3 in the chart),[12] and *Huangshi Dongbei Electrical Appliance Co., Ltd. and Huangshi Dongbei Mech-electrical Group Co., Ltd.* (no. 7 in the chart).[13]

Aside from what is mentioned above, misrepresentation litigation in China has also undergone other changes or challenges.

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9 See item 4 of Art. 19 of the Provisions.

10 Fully Promote the Function of Civil and Commercial Trials and Provide Judicial Protection for Constructing a Socialist Harmonious Society, published by the Supreme People's Court on 30 May 2007.

11 Both the cases chose the Shanghai Stock Exchange Composite Index as an indicator.

12 In this case, in addition to using the Shenzhen B-share Index as an indicator, the judge invented a formula to calculate the loss from systemic risk: Loss from Systemic Risk = Average Purchase Price ∗ Total Loss (1- Shenzhen B-share Index When Selling / Shenzhen B-share Index When Purchasing).

13 In this case, a broader picture was taken into consideration. Examined factors included aspects such as the falling global financial market from 2007 to 2008, indices from the Shanghai, Shenzhen and Hong Kong Stock Exchanges, the subprime crisis, currency inflation, and monetary policies.

I. Inclination to Abolish the Requirement of a Prior Administrative or Criminal Ruling[14]

Regarding securities fraud litigation, the lack of remedy in the absence of a prior administrative or criminal ruling has always been criticized. In respect of the law in force, the Securities Law, the Circular, and the Provisions still emphasize this prerequisite for civil litigation. But against the general background of reforms simplifying the filing of a case,[15] it was confirmed in the speech[16] by Linping Yang that civil litigation arising from misrepresentations, insider trading, and market manipulation should not be rejected at the first stage of litigation in cases where there is no prior administrative or criminal ruling.

This would undeniably be good news for investors who are cheated but left without relief, since the standard of proof needed for a criminal or administrative ruling is quite distinct from that needed for civil law cases. In this way, the rights of the consumers of financial products can be highly protected. Nevertheless, current observations suggest that few cases on misrepresentations have genuinely adopted this practice. Also, without a real ruling from the China Securities Regulatory Commission or a criminal court, it is possible that the plaintiff may bear a great burden of proof and the judge may face the challenge of determining critical and professional issues that are beyond his legal knowledge or capacity.

II. The First Supported Litigation in the Securities Market

The securities market in China, a fledgling one, is made up of a large number of individual investors who are regarded as more vulnerable than institutional investors. But, in terms of litigation, the protection accorded to them is indeed limited. Not to mention the prior requirement analyzed above, a class action is not allowed either,[17] which makes it very hard for those comparatively weak individual investors to seek remedies and realize their rights in instances of infringement.

However, the first supported litigation in the Chinese securities market may bring an end to the aforesaid dilemma. On 23 January 2017, with the

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[14] For a detailed analysis of queries into the legitimacy of the requirement of a prior administrative or criminal ruling, see L. Guo / A. VY Ong, The fledgling securities fraud litigation in China, Hong Kong LJ 39 (2009) 697.

[15] See Opinions on Carrying out Reform concerning the Case Filing Registration System in People's Courts (1 May 2015), English translation available at <http://hk.lexiscn.com/law/content.php?provider_id=1&isEnglish=Y&origin_id=2565910&>.

[16] See *supra* note 8.

[17] See Art. 4 of the Circular and Sec. 3 of the Provisions.

support of China Securities Investor Services Center[18], a misrepresentation lawsuit filed by 14 investors was undertaken at trial.

As a matter of fact, the principle of supported litigation is provided for in Article 15 of the Civil Procedure Law, which allows a state organ, a social group, an enterprise, or a public institution to support an entity or individual who suffers infringement in instituting an action in a people's court. Even though this principle has been practiced in other fields before, like customer protection or environmental protection, this was nevertheless the first time that it was actually implemented in the securities market.

In promoting this practice, greater private participation in securities market is to be anticipated. It would be beneficial to enhance the cost of illegal actions of listed companies and therefore indirectly establish a better supervised and better regulated market.

III. Summary of Cases on Misrepresentation by Listed Companies (As of 6 February 2017)

This chart was prepared in chronological order as of 6 February 2017 and collected most of, but not all, the major and influential misrepresentation cases arising so far in China. Most of the Chinese judgments are available at China Judgements Online, <http://wenshu.court.gov.cn/>, and some of the English translations are available at <http://en.pkulaw.cn/Search/SearchCase.aspx?rdoType=1>. Relevant administrative penalty decisions in Chinese by China Securities Regulatory Commission are available at <http://www.csrc.gov.cn/pub/zjhpublic/>. “SH” and “SZ” respectively refer to the Shanghai Stock Exchange and Shenzhen Stock Exchange, and the numbers before them represent the stock code or bond code of the listed companies.

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[18] A public welfare financial institution under the governance of the China Securities Regulatory Commission.

Company Name	Adjudication Date	Adjudication Court	Misrepresented Facts	→
1. *Daqing Lianyi Petro-Chemical Co., Ltd.* (600065.SH)	21.12.2004	Higher People's Court of Heilongjiang Province	Fraudulent listing; inflated profits	→
2. *Shenzhen Energy Group Co., Ltd.* (000027.SZ)	24.4.2014	Intermediate People's Court of Shenzhen Municipality, Guangdong Province	Misrepresented liabilities, revenues, and profits; tax evasion	→
3. *Foshan Electrical and Lighting Co., Ltd.* (200541.SZ)	2.12.2015	Intermediate People's Court of Guangzhou Municipality, Guangdong Province	Failed to disclose major guarantees; failed to disclose connected parties and connected transactions; failed to truthfully disclose investment and acquisition with connected parties; failed to disclose loans for connected parties in a timely manner.	→
4. *Hubei Sanxia New Building Materials Co., Ltd.* (600293.SH)	13.6.2016	Intermediate People's Court of Wuhan Municipality, Hubei Province	Undercounted costs and inflated profits; misrepresented annual reports	→

Cause of Action	Administrative Penalties	Result and Reasoning of Civil Litigation
The company's misrepresentation caused a fluctuation in its stock price, thereby leading to investment losses which should be compensated. The securities company should bear joint liability.	· The company: warning, retrieving proceeds raised and investing them in the promised projects; · The chairman: banning entry into the securities market; · The directors: warnings and fines.	*Compensation and joint liability of the securities company.*
The defendant failed to disclose information properly, misleading investors who should thus be compensated.	· The company: fines, rectification, adjustment of accounting matters, and payment of relevant tax.	*No compensation.* The company's irregular financial accounting conduct did not constitute misrepresentation; lack of causality between the company's conduct and investors' loss.
The company's misrepresentation caused a fluctuation in its stock price, leading to investment losses which should be compensated.	· The company: correction, warning, and fines; · The chairman, president, vice president, board secretary, vice chairman, and directors: warnings and fines; · The vice president: warning.	*Compensation for investment loss and derivative loss.*
The company's misrepresentation caused investment losses which should be compensated.	· The company: warning and fines; · The chairman, directors, chief financial officer, presidents, vice president, board secretary, and independent directors: warnings and fines; · The chairman of the board of supervisors, and supervisors: warnings.	*Compensation for investment loss.*

Company Name	Adjudication Date	Adjudication Court	Misrepresented Facts	→
5. *CHTC Helon Co., Ltd.* (00067.SZ)	29.6.2016	Intermediate People's Court of Jinan Municipality, Shandong Province	Failed to disclose external guarantees; failed to disclose connected parties and connected transactions	→
6. *Hareon Solar Technology Co., Ltd.* (600401.SH)	18.10.2016	Intermediate People's Court of Nanjing Municipality, Jiangsu Province	Misrepresented statements in disclosed notice and proposal of allocation; failed to fully disclose the over-reduction of shares of concerted parties	→
7. *Huangshi Dongbei Electrical Appliance Co., Ltd.* (900956.SH) *Huangshi Dongbei Mech-electrical Group Co., Ltd.* (the controlling shareholder)	19.12.2016	Intermediate People's Court of Wuhan Municipality, Hubei Province	Failed to truthfully disclose connected relationships and connected transactions in a timely manner	→

Cause of Action	Administrative Penalties	Result and Reasoning of Civil Litigation
The company's misrepresentation caused a fluctuation in its stock price, leading to investment loss which should be compensated.	· The chairman, vice chairman, vice president, chief financial officer, directors, president, board secretary, independent directors, and chairman of the board of supervisors: warnings and fines; · The independent directors and supervisors: warnings.	*Compensation within a certain range.* Loss from systemic risk should be deducted.
The company's misrepresentation caused a fluctuation in its stock price, leading to investment loss which should be compensated.	· The company and three controlling shareholders: warnings and fines; · The board secretary: warning and fine.	*Compensation for investment loss and derivative loss.*
The company's misrepresentation caused investment losses, which should be compensated; The controlling shareholder should bear joint liability.	· The company: correction, warning and fines; · The chairman, directors, vice president, president, board secretary, and general manager: warnings and fines.	*No compensation and no joint liability.* Misrepresentation was not material and did not influence investor behavior; lack of causality between the misrepresentation and the investment loss due to systemic risk.

Civil Liability of the Company and Its Directors

When Financial Statements are False: The Korean Perspective[1]

Sunseop Jung

I. Introduction ... 173
II. The Regulatory Regime for False Financial Statements ... 175
1. Overview ... 175
2. Regulatory System ... 175
3. Disclosure Regulation ... 176
4. External Audit System ... 178
III. The Liability Regime for False Financial Statements ... 180
1. General ... 180
2. Liability of the External Auditor Under the AEA ... 180
3. Civil Liability for False Financial Statements under the CMA ... 181
IV. Conclusion ... 189

I. Introduction

Finance is an information business. Banks can find most of the necessary information for financial services in financial statements. In capital markets, financial statements are the starting point for the function of credit rating agencies, underwriters and other gatekeepers. Investors also rely on the numbers documented in financial statements for their investment decisions.

After the 1997 financial crisis, the Korean government began to enhance the size and role of capital markets in corporate finance and risk management.[2] In 2015, the total capital raised by bank loans was 724 trillion Korean Won, while the capital raised by direct financing, including issuing bonds and shares, amounted to 131.1 trillion Korean Won.[3] There also exists a growing demand for more transparency and stricter compliance with capital market laws and regulations.

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[1] This paper is based on K. KIM/S. JUNG, *Ja-Bon-Shi-Jang-Beob* [Capital Markets Law], (Du-Seong-Sa 2013), 161–293.

[2] One of the major results of this policy change was the *Financial Investment Services and Capital Markets Act* 2007, enacted on 3 August 2007 Law No. 8635 and effective from 4 February 2009.

We have experienced large-scale corporate bond scandals in *chaebol*s as well as several *mutual savings bank* financial frauds involving false financial statements. The most well-known examples include the Daewoo corporate bond scandal in the late 1990s and the LIG CP and *mutual savings banks* mis-selling of subordinated bonds in the late 2000s. All these scandals involved false financial statements. Currently, the financial supervisor and the public prosecutor's office are conducting investigations on alleged accounting fraud cases in the shipbuilding and construction industries.

There exist various tools to control and maintain the quality of financial statements and accounting practices, including disclosure regulation, regulation of accounting firms and civil liability regimes for false financial statements. Major regulatory laws in the context of financial statements and accounting systems include the Commercial Code ("KCC") (enacted on 20 January 1962, Law No. 1000 and effective from 1 January 1963), the Act on External Audit of Joint Stock Corporations (enacted on 31 December 1980 Law No. 3297 and effective from 1 January 1981, "AEA"), and the Financial Investment Services and Capital Markets Act 2007 (enacted on 3 August 2007 Law No. 8635 and effective from 4 February 2009, "CMA"). Most civil liability cases for false financial statements are based on external auditors' liability under the AEA and defective disclosure liability under the CMA. However, investors can also claim general tort liability under Art. 750 Civil Code (enacted on 22 February 1960, Law No. 471 and effective from 1 January 1960) and directors' liability under the KCC.

This paper consists of three parts: The Regulatory Regime for False Financial Statements (II.) provides a general overview of the regulatory system for financial statements in Korea together with capital market regulations. The Liability Regime for False Financial Statements (III.) examines civil liability for false financial statements. The final part, Conclusion (IV.), summarizes the above discussions and suggests several legal issues related to the fostering of more credible financial statements in Korea.

[3] Direct and Indirect financing in Korea (trillion Korean Won)

		2011	2012	2013	2014	2015
Loans		556.2	589	623.8	675.8	724
Securities (Bonds and shares)	Securities	143.4	131.1	121.5	121.9	131.1
	Financial Institutions	27.3	26.2	28.3	31.5	36
	ABS	12.6	18.4	20.5	18.2	19.5

(Statistics Korea)

II. The Regulatory Regime for False Financial Statements

1. Overview

The major statutes regulating financial statements in Korea are the KCC, the AEA and the CMA. The KCC governs the duties of companies and directors for preparing correct financial statements. In Korean law, the term “financial statements" means balance sheet, an income statement or all-inclusive income statement, a statement of changes in stockholders' equity, a statement of cash flow, footnotes the following documents prepared by a joint stock company (Art. 1-2 AEA).

The KCC, as the basic law for companies, prescribes general principles for preparing and maintaining accounting records and financial statements of companies. The KCC also sets the duties of directors and others in the context of accounting and financial statements.

The AEA is, in a sense, the basic law for accounting standards and accounting practices. The legal basis for corporate accounting standards is the AEA. Under Art. 13 AEA, the Financial Services Commission, (FSC) can entrust accounting standards setting to the Korea Accounting Institute and Korea Accounting Standards Board. In legal terms, the final setter of corporate accounting standards under the AEA is the FSC. The AEA makes the external audit of listed companies and other large companies mandatory and stipulates the liability of external auditors for false financial statements.

The CMA is the basic statute for capital market regulation.[4] The CMA organizes the disclosure system in primary and secondary markets with enforcement tools. The CMA also provides a liability regime for defective disclosure mainly resulting from false financial statements. The regulator’s approach for enforcing accounting practice is also growing stricter.

Financial statements are subject to disclosure regulations, the mandatory external audit system and the regulation of accounting firms. The Securities and Future Commission (SFC) may designate external auditors and examine audit reports periodically under the AEA. Although these two systems are unique in nature, they are effective tools for controlling the quality of accounting practice. The liability regime will be explored in part III (The Liability Regime for False Financial Statements).

2. Regulatory System

The financial regulatory system in Korea is composed of three institutions. The FSC is the main financial controller regulating all financial sectors. The

[4] J. PARK, Consolidation and Reform of Financial Market Regulation in Korea: Financial Investment Services and Capital Markets Act, National Taiwan University Law Review, Vol. 6, No. 1, March 2011, 91.

SFC is a special committee under the FSC in charge of capital market regulation, including accounting among other areas. The Financial Supervisory Service (FSS) is the enforcement body of the FSC.

The FSC, SFC and FSS were originally established by the Act on the Establishment of Financial Supervisory Organizations etc (enacted on 31 December 1998, Law No. 5490, effective from 1 April 1998). The title of the Act was later changed to the current name, the Act on the Establishment etc of Financial Services Commission (enacted on 29 February 2008, Law No. 8863, effective from 29 February 2008).

The reform of the financial regulatory system is an issue of hot debate in Korea. Some argue for the introduction of a twin peak system divided into prudential and consumer protection functions. Others seek a financial regulator as a non-governmental organization to enhance the independence of a financial regulator. Currently, while the FSC and the SFC are government agencies, the FSS is a non-governmental body.

3. Disclosure Regulation

As financial statements are attached to (or incorporated in) most primary and secondary market disclosure documents, they are subject to strict disclosure regulations as well.[5]

a) Primary Market Disclosure

For a public offering of securities, the issuer should submit a registration statement and prospectus to the FSC with relevant financial statements and an external auditor's report (Art. 119 CMA).

Before the CMA, the provision of a prospectus to investors was not compulsory for a recommendation of securities under the Securities Transaction Act. Primary market disclosure documents include registration statements, prospectuses, and amendments or attached documents. In the event of shelf registration, primary market disclosure documents include the registration statement itself and the shelf registration supplement submitted in each case of issuance.

There is also a debate on the use of primary market disclosure documents in Korea. However, the contents of the documents could be a starting point for controlling the quality of disclosure and ensuring the liability of issuers and other persons involved in primary market transactions. Primary market

[5] K. CHUN, Investor Protection in Korean Capital Market through Disclosures and Litigation, Journal of Korean Law, Vol. 16, 2016, 199; Korea Financial Investment Association, Capital Markets in Korea, 2015, 276.

disclosure documents are basic tools for current capital market regulations based on a disclosure model.[6]

b) Secondary Market Disclosure[7]

Secondary market disclosure consists of periodic disclosures and ad-hoc disclosures.

Periodic disclosure includes annual, semi-annual, quarterly and current reports. Listed companies should submit an annual report to the FSC and the Korea Exchange (KRX) within ninety days after the conclusion of the business year. The report includes an overview of the company, details of business activities, remuneration for executives, matters concerning finance, such as financial statements, the external auditor's audit opinion, the organizational structure of the company, details on transactions with major shareholders and matters concerning investor protection. Listed companies submit a semi-annual report for the first six months of the business year, and a quarterly report for the first three or nine months of the business year to the FSC and KRX within forty-five days of the closing of the period.

Where certain events having significant impact on the companies' business operations occur, listed companies should submit a current report on details of the event to the FSC by the following day. These events include a bill or check issued by the corporation being returned or the suspension of its checking account transactions, the complete or partial suspension of a corporation's business activities, and the filing of an application for the commencement of proceedings for rehabilitation under the Debtor Rehabilitation and Bankruptcy Act. Before the enactment of the CMA, the companies were to have submitted ad hoc disclosure reports to the FSC and KRX at the same time. Under the CMA, the companies submit ad hoc disclosure reports to the KRA and a current report to the FSC.

These documents are publicly available in the electronic disclosure system operated by the KRX[8] and the FSS.[9] The FSS and KRX have information sharing arrangements for secondary market disclosure documents.

[6] Capital market regulation in Korea is based on a disclosure model. However, the CMA also introduced protective tools for retail investors, such as the suitability/ appropriateness requirement and the duty to explain. PARK, *supra* note 4, 117; KIM/JUNG, supra note 1, 763. J. PARK, Impact of 1997 Economic Crisis and IMF Bailout Financing on Financial Laws in Korea, Seoul Law Journal Vol. 55 No. 1, 2014. 186.

[7] Korea Financial Investment Association, *supra* note 5, 276.

[8] KIND: Korea Investor's Network for Disclosure System.

[9] DART: Data Analysis, Retrieval and Transfer System.

4. External Audit System

a) Mandatory External Audit

The AEA makes the external audit of financial statements for listed companies and certain large joint stock companies.[10] Listed joint stock companies and other large joint stock companies that meet the standards prescribed by Presidential Decree in terms of the total amount of assets, the amount of liabilities and the number of employees are subject to a mandatory external audit of their financial statements (Art. 2 AEA). Currently, companies that fall under one of the following types of joint stock companies are subject to this requirement:

1. listed companies,
2. companies with total assets of 10 billion Korean Won (approx. 9 million US-Dollar) or more,
3. companies with total liabilities of 7 billion (approx. 6.3 million US-Dollars) or more and total assets of 7 billion Korean Won or more, and
4. companies with a total of 300 or more employees and total assets of 7 billion Korean Won (approx. 6.3 million US-Dollars) or more.

There are reportedly some companies that have avoided mandatory external audit requirement by establishing company structures other than a joint stock company.[11] A new bill was thus introduced in the National Assembly to amend the AEA to include large limited liability companies within the scope of the mandatory external audit requirement.[12] It was reported that at present more than 90% of the LLCs registered in South Korea have less than 10 billion Korean Won in assets and that the main target of the bill is likely to include global companies which have established their branches in Korea in the form of LLCs.[13]

b) Internal Accounting Management System

Listed companies and large joint stock companies whose total assets are more than 100 billion Korean won are required to have an internal accounting man-

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[10] "[L]isted companies to publish not only half year financial statements prepared and reviewed by external auditors in accordance with international standards" was included in the IMF Conditionality in 1998. Corporate Governance and Restructuring on the 5th Update Memorandum on Economic Program for the 2nd Quarterly Review, on 4 May 1998, 4). J. W. LEE, IMF Conditionality and Corporate Governance in Korea, 2007, 4.

[11] Yoon & Yang LLC, Scope of application of the Act on External Audit of Joint Stock Companies to be expanded, 13 November 2013.

[12] Bill No. 2002348, 20 September 2016; Bill No. 2005075, 12 January 2017.

[13] Revision of LLC Law: S. Korean Government to Compel LLCs to Undergo External Audit, Business Korea, 10 August 2016.

agement system to manage and operate the preparation and disclosure of reliable accounting information (Art. 2-2(1) AEA). This system is for internal control in the area of accounting practices.

c) Public Designation System

In some cases, the SFC may designate an accounting firm for the external audit of companies. In principle, the company is to appoint an auditor within four months of the date of commencement of each business year. In such cases, audits of financial statements and consolidated financial statements are to be performed by the same auditor (Art. 4 AEA). However, the SFC will nominate an auditor of companies that meet certain conditions, including a violation of accounting standards (Art. 4-3 AEA). In Korea, the audited company is generally dominant in the relationship between the company and the accounting firm in the context of an external audit. To alleviate such unfair relationships, the FSC is planning to expand the cases of a public designation of external auditors by the SFC. For example, candidates for such public designation can be listed companies that have an executive who was previously punished for embezzlement or breach of trust.[14]

d) Public Examination of Audit Report

The SFC/FSS may examine audit reports of external auditors under Art. 15 AEA. In 2015, the SFC/FSS examined audit reports of 78 listed companies and 28 non-listed financial companies, and they found 68 cases violating accounting standards.[15]

In cases of improper external audit, the FSC may, under Art. 16 AEA, revoke the registration or suspend the business of the CPAs and/or the accounting firms involved. The public examination report of the SFC/FSS is one of the major information sources for investor litigation against companies and accounting firms. Investor litigation based on false financial statements is also increasing.

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[14] FSC・FSS, Policy Response to Enhance Accounting Transparency and Credibility, 20 January 2017, 15. Fraudulent Accounting: S. Korean Government Determined to Prevent Repetition of Fraudulent Accounting, BusinessKorea, 23 January 2017.

[15] FSS, Annual Report, 2015, 107.

III. The Liability Regime for False Financial Statements

1. General

The civil liability regime for false financial statements is an efficient tool for enforcing capital market regulations, including accounting rules. Under Korean law, the civil liability regime for false financial statements is composed of liability of the external auditor under the AEA and liability of the issuer and other persons involved under the CMA for defective disclosures.[16] Investors can also rely on basic laws such as the Korean Civil Code or the KCC. Investors can claim general tort liability of persons involved in preparing false financial statements under Art. 750 KCC. Directors, statutory auditors and others involved in false financial statements may be liable under the KCC. In particular, directors in breach of their duty are required to compensate damage to the company or to a third party (Arts. 399 and 401 KCC).

These remedies are not mutually exclusive (Supreme Court, 12 September 1997, 96Da41991).[17] The court of original judgment in this case noted that the civil liability provision in the CMA does not preclude general tort liability under the Korean Civil Code with more stringent requirements which are more difficult to prove" (Seoul District Court, 28 February 1996, 96Na-15298). In terms of form, liability under Art. 125 CMA is special and different from the general tort liability under Art. 750 Korean Civil Code (Supreme Court, 24 April 1998, 97Da32215). However, as its legal nature does not differ from the general tort liability under Art. 750 KCC, the Civil Code principles of tort liability may be applied to the Art. 125 CMA liability (Supreme Court, 28 September 2016, 2014Da221517).

There are several cases where investors relied on the general tort liability under Art. 750 KCC (Supreme Court, 28 September 2016, 2014Da221517 etc). There also several cases in which plaintiffs filed claims based on directors' liability to the company under the KCC in the context of false financial statements (Supreme Court, 30 November 2007, 2006Da19603 etc).

This paper focuses on the liability structure under the AEA and the CMA.[18]

2. Liability of the External Auditor Under the AEA

An external auditor may be liable for damage to the audited company due to negligence in the performance of his/her duties (Art. 17(1) AEA). If the auditor is a member of audit team, CPAs who have participated in the audit of the com-

[16] CHUN, *supra* note 5, 210.
[17] *Ibid.*
[18] For more information on the liability structure of the Korean Civil Code and the KCC, see CHUN, *supra* note 5, 193–213.

pany are jointly liable for damages. If an external auditor (i) failed to record material items or made a false statement in audit report and, (ii) caused damage to a third party who has relied on and used such report, the external auditor is liable for damage to the third party (Art. 17(2) AEA). External auditors may be liable for the damages under Art. 17 AEA even though "false statements about material items" or "omissions of material items in the audit report were made negligently (Supreme Court, 15 December 2016, 2015Da243163).

If an external auditor is liable for damage suffered by a company or a third party, and the company's director or statutory auditor is also liable for the damage, the external auditor is *jointly and severally liable* along with them. Where the person liable for damage has caused the relevant damage unintentionally, he/she is only proportionately liable on the basis of a court-determined sharing ratio (Art. 17(4) AEA).[19]

The amount of damages is ["the price actually paid by the plaintiff to purchase the security"] minus ["the real value of the security or the market price of the security formed if there was no accounting fraud or improper auditing"] (Supreme Court, 26 June 2008, 2007Da90647, Supreme Court, 15 April 2016, 2013Da97694).

3. *Civil Liability for False Financial Statements under the CMA*

a) *Overview*

The CMA provides civil liability of an issuer, directors and others involved in the process of defective disclosures based on false financial statements in Art. 125 (primary markets) and Art. 162 (secondary markets). Liability for the damage incurred by the investors due to *misstatements or omissions of material items* in the disclosure, both in the primary and secondary markets. Claims under the CMA apply to various defendants and alleviate plaintiffs' burden of proof.[20]

b) *CMA and Capital Market Regulatory Reform*

In March 2006, the then Ministry of Finance and Economy of Korea (MOFE), now the FSC, announced its intention to consolidate existing capital market-related laws into a single statute. The reform, according to the MOFE, aims to enhance the quality of capital markets and to promote the development of financial investment services in Korea. Korea was traditionally considered to be a bank-based system rather than a market-based system. One of the main purposes of the reform was said to be making our capital circulation

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[19] As of 14 February 2017, there are no available cases interpreting this provision.

[20] CHUN, *supra* note 5, 216.

system more multiple. The CMA was passed by the National Assembly on 13 June 2007 and came into effect on 4 Feb. 2009.

The CMA was enacted to revamp the capital market regulatory system based on product and institutional distinctions. Such an institution or product-based regulation was a creature of the days when sectoral differences in capital markets were clear enough to justify different regulatory approaches. Capital markets existing today are markedly different from the model presupposed by the traditional regulations. It was noted that the previous laws were deficient primarily in the following three respects: insufficient and inflexible key statutory definitions, regulatory inequality among financial sectors, and unsystematic vertical and horizontal distribution of regulatory measures.

The scope of the CMA is, in principle, dependent on two core concepts, *financial investment products* and *financial investment services.* "Financial investment products" refers to the extent to which the areas of financial regulation should be covered in the CMA. "Financial investment services" relates to the scope of financial activities included in the CMA. The CMA will cover all areas of capital markets and financial investment services, including licensing, prudential regulation and non-prudential regulation of financial investment services providers. It will also cover market infrastructures such as exchanges, clearing facilities and settlement facilities. The CMA incorporated the Securities Transaction Act, the Futures Trading Act, the Trust Business Act, the Indirect Investment Asset Management Business Act, the Merchant Bank Act, and the Korea Securities and Futures Exchange Act.

The scope of regulated activities covered by the CMA will be determined based on three core concepts: financial investment products, financial investment services and a classification of the investors. In principle, the CMA applies to all financial investment services dealing with financial investment products. Financial investment products refer to products carrying out specific financial investment functions, while financial investment services cover dealing, brokerage, advising and other activities involving financial investment products. The CMA distinguishes between wholesale and retail investors. Additionally, several regulations on the conduct of business do not apply to financial investment services with professional investors.

c) Liability Structure

The CMA has two civil liability provisions for defective disclosures, Art. 125 for primary market disclosures and Art. 162 for secondary market disclosures.

(1) Substantive aspects

(a) Defective Disclosure

(i) Conduct

According to Art. 125 CMA, "false statements about material items" or "omissions of material items" in primary market disclosure documents are subject to liability for resulting damage. It is still an issue of debate as to how to treat misleading statements in this context.[21] Art. 162 CMA provides that "false statements or representations for material items" or "omissions of material items" in secondary market disclosure documents" are subject to liability for resulting damage.

(ii) Disclosure Documents

Primary market disclosure documents include registration statements or prospectuses and any amendments or attached documents. Secondary market disclosure documents include annual reports, semi-annual reports, quarterly reports, current reports and any amendments or attached documents. However, Art. 162 CMA does not include audit reports in secondary market disclosure documents. The external auditor may be liable for an audit report under Art. 170 CMA and Art. 17 AEA.

(iii) Materiality

Both false statements and omissions need to relate to "material items". The CMA defines material items as "items that may produce a significant impact on the investor's reasonable judgment or the value of the relevant financial investment product" (Art. 47(3) CMA).

In a case on the application of Art. 162 CMA, the Supreme Court provided three standards for interpreting the materiality of the items concerned. Firstly, there exists a significant probability that reasonable investors may consider the items as important when he/she makes an investment decision or engages in decision-making. Secondly, the materiality test is to be performed at the time of defective disclosure. Thirdly, the above-mentioned significant probability should be assessed in relation to reasonable investors in the markets and not the plaintiff (Supreme Court, 10 December 2015, 2012Da16063).

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[21] KIM/JUNG, *supra* note 1, 231; CHUN, *supra* note 5, 216.

(b) Defendants: "Persons Subject to Liability"

(i) Issuer and Directors

Persons subject to liability under Art. 125 CMA include the issuer of the securities and any director of the issuer at the time of the filing of the registration statement. In cases of public sales, the seller may be liable as well (Art. 125(1) CMA). A director of the issuer at the time of the filing of the registration statement is liable regardless of actually being involved in the process of preparation and filing. If there is no director in the issuer company, the staff in charge of preparing disclosure documents may be liable (Art. 125 (1) CMA).

The meaning of director under Art. 125 CMA does not exclude an outside director of a mutual savings bank (Seoul Central District Court, 25 April 2014, 2012Kahap500945). In a case on Art. 162 CMA liability, the Supreme Court affirmed the liability of an outside director who did not attend the board meeting at all (Supreme Court, 24 December 2014, 2013Da76253). The Supreme Court rejected the outside director's defense that, as he did not attend the board meeting at all, he could not have had any idea about defective disclosures resulting from false financial statements. The Court's ruling emphasized the duty to monitor other directors' business operations in general and to supervise the business operations of the representative directors and other directors by exercising voting rights on the board of directors (Supreme Court, 24 December 2014, 2013Da76253).

Director in this case includes d*e facto* directors under Art. 401-2 KCC who gave instructions on or prepared the registration statement.

(ii) Professionals and Others

Professionals, including certified public accountants, appraisers, credit rating specialists, lawyers, patent attorneys, and tax attorneys, may also be liable if they certified with their signature that descriptions in the registration statement or its attachments are true and correct. An organization to which each of the professionals belongs may be liable as well. CPAs may also be liable under Art. 17 AEA. These two liabilities do not preclude each other.

A person may also be liable when he/she consented to include his/her statement of evaluation, analysis, or verification in the registration statement or its attachments and confirmed such statement. An underwriter of the public offering and a person who prepared and delivered the prospectus may also be liable.

In general, persons subject to liability under Art. 162 CMA are the same as those persons liable under Art. 125 CMA. However, as Art. 162 CMA liability is concerned with secondary market disclosure documents, the persons do not include parties involved in the public offering itself, such as underwriters.

If two or more persons are found to be liable, each person is *jointly and severally liable* with the others (Seoul District Court, 30 June 2000, 98Gahap 114034).

(c) Plaintiff: Claimants

Investors who "acquired the securities" may allege liability under Art. 125(1) CMA. Those who acquired the securities directly from the issuer at the offering are also included. However, those who acquired the securities on the exchange market may not allege Art. 125 CMA liability for defective disclosures in the registration statements (Supreme Court, 14 May 2002, 99da48979; Supreme Court, 24 September 2002, 2001da9311, Supreme Court, 23 December 2015, 2013Da88447).

Investors who "acquired or disposed of the securities" may allege liability under Art. 162 CMA. As this liability is concerned with secondary market disclosure documents, the CMA added investors who disposed over securities to the list of claimants. One commentator contended that a Supreme Court case, Supreme Court, 27 November 2008, 2008da31751, recognized the right of investors who acquired the securities on the exchange market to assert liability under Art. 125 CMA.[22] However, the defective disclosure in that Supreme Court case was made in the annual report, not in the registration statement.

Investors who "acquired the securities" can be claimants for liability under both Art. 125 and Art. 162 CMA. However, the definition of securities is different in these two provisions. Securities in Art. 162(1) CMA include (i) securities, (ii) depositary receipts (DR) related to the securities, (iii) EB related to (ii), and (iv) securitized derivatives whose underlying asset is solely (ii) or (iii).

(d) Defense: Due Diligence of Defendant or Knowledge of Plaintiff

Defendants may rely on a due diligence defense against a claim of defective disclosure liability under Arts. 125 and 162 CMA. The CMA, by incorporating this defense in the liability structure, effectively shifts the burden of proving the defendant's negligence from plaintiffs to defendants. A defendant must prove that "he/she was unable to find such false statements or omissions even if he/she exercised reasonable care" (Arts. 125(1) and 162(1) CMA). For the proof of this defense, defendants should have reasonably believed that there were no false statements or omissions after having exercised investigations reasonably expected in his/her position (Supreme Court, 21 September 2007, 2006Da81981, Supreme Court 24 December 2014, 2013Da76253, Supreme Court 12 December 2015, 2015Da210194).

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[22] See KIM/JUNG, *supra* note 1, 238 note 131.

(e) Calculation of Damages

(i) Presumption regarding the Amount of Damages

As there exist many factors influencing the price of securities, it is not easy for general investors to calculate the amount of damages. Therefore, the CMA stipulates a *presumption provision* for the amount of damages (Arts. 126 and 162(3)(4) CMA). In effect, this provision shifts the burden of proof regarding the amount of damages to defendants from plaintiffs. The amount of damages is presumed to be the price actually paid by the plaintiff to purchase the security minus the market price of the security at the time of the closing the lawsuit proceedings. If the plaintiff sold the security before the closing of the proceedings, "the actual price of sale" will be used instead of "the market price of the security at the time of closing the proceedings of the lawsuit".

Defendants can reduce the amount of damages by proving other factors affecting the price of the securities, i.e. the absence of loss causation, based on the event study (Supreme Court, 25 October 2007, 2006Da16758, 16765, Supreme Court, 29 January 2015, 2014Da207283, Supreme Court, 27 October 2016, 2015Da218099).[23] Plaintiffs can increase the amount in the same way. The *Securities Class Action Act* (enacted on 20 January 2004 Law No. 7074 and effective from 1 January 2005, "SCAA") permits sampling, average, statistical methods or other reasonable methods in consideration of the overall circumstances in cases where it is impracticable to calculate the exact amount of damages or through the investigation of evidence (Art. 34(2) SCAA).

However, courts do not permit the use of event studies in criminal cases.[24] The CMA has provisions linking the level of criminal penalties for insider trading, market manipulation and other market misconduct to the amount of profits gained and losses avoided through the financial crimes (CMA, Article 443(1)(2)). However, it is not easy to calculate the exact amount of profits gained and losses avoided. In many cases, defendants tried to reduce the figure of profits gained and losses avoided by proving the absence of loss causation through means of an event study.

(ii) Alternative Solution

In this regard, there could be a windfall loss or gain in accordance with the changing price of the securities during the proceedings of the lawsuit. It is not easy to expect closing day of the proceedings of the lawsuit. There can be no single answer to this question.

[23] CHUN, *supra* note 5, 221.
[24] KIM/JUNG, *supra* note 1, 484–506.

In my view, an alternative solution to this problem could be that plaintiffs have a put option to sell the securities to the defendants at the actual price of the plaintiffs' original acquisition or purchase. If plaintiffs can sell the securities at their original acquisition or purchase price to defendants, we do not need to determine the best time for measuring the current value of the securities. Instead, this approach can maximize the precautionary effect against potential defendants in defective disclosure lawsuits.

Table 1: Comparing Liability Structure of CMA Art. 125 and CMA Art. 162[25]

		Art. 125 (primary market disclosure)	Art. 162 (secondary market disclosure)
Conduct	Documents	registration statements (including amendments or attached documents) prospectus (including preliminary and short-form)	annual reports, semi-annual reports, quarterly reports, current reports and any amendments or attached documents excluding external auditor's audit report
	Defective disclosure	false statements about material items omissions of material items	false statements about material items omissions of material items
	Materiality	material item	material item
Securities		securities	securities including - <i>DR related to the securities - <ii> EB related to <i> - securitized derivatives whose underlying asset is <i> or <ii>
Claimant		acquirer of securities	acquirer or disposer of securities

[25] KIM/JUNG, *supra* note 1, 240.

Persons subject to liability	Issuer, director of the issuer at the time of the filing of the registration statement. Professionals, including a certified public accountant, an appraiser, a credit rating specialist, a lawyer, a patent attorney, and a tax attorney, may also be liable if they certified with signature that the descriptions of the registration statement or its attachments are true and correct A person who consented to inclusion of his/her statement of evaluation, analysis, or verification in the registration statement or its attachments and confirmed such statement An underwriter of the public offering and a person who prepared and delivered the prospectus may also be liable Seller (in cases of public sale)	. Issuer, director of the issuer at the time of the filing of the registration statement. Professionals, including a certified public accountant, an appraiser, a credit rating specialist, a lawyer, a patent attorney, and a tax attorney, may also be liable if they certified with signature that the descriptions of the registration statement or its attachments are true and correct A person who consented to inclusion of his/her statement of evaluation, analysis, or verification in the registration statement or its attachments and confirmed such statement
Defense	Due diligence of defendant Knowledge of plaintiff	Due diligence of defendant Knowledge of plaintiff

(2) Procedural Aspects

(a) Role of Regulators

In cases on liability for false financial statements, still hotly debated is how to expand the availability of evidence for plaintiffs.[26] In practice, the public examination report of the SFC/FSS is one of the major sources for investor litigation on false financial statements. In some cases, investors cannot file lawsuits against false financial statements until the release of the public examination report by the SFC/FSS.

[26] CHUN, *supra* note 5, 227.

(b) Securities-related Class Action

Since the SCAA became effective in 2005, class action cases are still rare, but they are increasing in particular with regard to cases involving the mis-selling of financial products (Supreme Court, 9 April 2015, 2013Ma1052,1053 etc). Under Art. 3(1) SCAA, securities-related class actions are permitted for damages associated with defective disclosures (Arts. 125 and 162 CMA), insider trading and other market misconduct (Arts. 175, 177 or 179 CMA), and improper audit reports (Art. 170 CMA).

Recently the Supreme Court permitted a class action filed seeking damages resulting from a false statement in a registration statement under Art. 125 CMA (Supreme Court, 4 November 2016, 2015Ma4027). Since 2005, only three cases have been permitted as class actions under the SCAA, these from a total of nine filings.[27]

IV. Conclusion

Financial statements are regulated by a mandatory external audit system and a stringent liability regime in Korea. The civil liability regime for false financial statements consists of liability of the external auditors under the AEA along with the liability of the issuer and other related persons under the CMA. Investors can also rely on general tort liability under Art. 750 KCC and on liability of the issuer's directors under Art. 401 KCC.

This paper summarizes issues for reform in the regulatory and liability regime for false financial statements. Among other issues, procedural aspects of the liability regime need more discussion. In particular, this paper emphasizes the role of financial regulators in expanding the availability of evidence for investor litigation and also the need for courts to adopt more flexible approaches to the SCAA.

There remain rooms for further reform in the relationship between audited companies and their accounting firms. For this, the FSC is planning to expand the cases where there is a public designation of external auditors by the SFC.

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[27] For more discussion, CHUN, *supra* note 5, 221.

A Recent Transformation of the Japanese Civil Liability System against Fraudulent Disclosure in Secondary Market

Takahito Kato

I. Introduction 191
II. Before the 2004 Amendment 192
III. The 2004 Amendment 194
IV. Impacts and Problems of the 2004 Amendment 196
1. How Easy Has It Become to Sue a Listed Company After the 2004 Amendment? 196
2. Is the New Liability an Adequate Tool for the Enforcement of Securities Regulations? 197
3. LIVEDOOR...200
V. The 2014 Amendment 201
1. Why Was the 2014 Amendment Necessary?..201
2. How Should Intention or Negligence Be Judged Under the New Liability? 202
3. A Review of the Relationship Between the Legally Determined Amount of Damages and Materiality 202
VI. Concluding Remarks 203

I. Introduction

In Japan, a listed company is required to disclose a range of information under the Financial Instruments and Exchange Act (FIEA).[1] Investors may use this information when they decide to buy, sell, or hold shares. Even without directly accessing such information, they can be influenced by a share price in which this information is reflected.

If a company does not disclose truthful information, investors will not be able to assess share value and might sometimes withhold investments. The less investors participate in the market, the less accurate the share price will

[1] Before the 2006 amendment, the law was called the *Securities and Exchange Act*. See Financial Service Agency, Financial Instruments and Exchange Act, <http://www.fsa.go.jp/en/policy/fiel/>. The provisions of civil liabilities are substantially the same before and after the amendment. This article, for convenience purposes, will refer to the Securities and Exchange Act and its renamed equivalent, the Financial Instruments and Exchanges Act, collectively as FIEA.

become, and the less effectively resources will be distributed throughout the market. Although a misrepresentation or omission in disclosure interferes with the development of the securities market, some companies disclose information that is false or misleading.

For the prosperity of securities markets, it is necessary to effectively deter misrepresentations or omissions in disclosed statements. Countries with developed securities markets usually also have agencies responsible for the enforcement of securities regulations; these agencies are given authority by the government. However, these agencies often suffer from fiscal problems and do not have enough resources to detect and punish harmful conduct within their securities markets. Thus, to effectively deter misrepresentations or omissions in disclosed statements, a system is required to supplement public enforcement bodies. One such system is civil liability in which listed companies, directors and other relevant parties are liable to claims made by investors who bought shares after misrepresentations or omissions.

FIEA has similar provisions for civil liabilities as the U.S. Securities Exchange Act of 1934. One such feature of Japan's securities regulation is the FIEA provision imposing civil liability on listed companies that have disclosed false information to secondary markets. This provision was established in 2004. Before the 2004 amendment, there were no reported cases in which listed companies were judged liable for misrepresentations or omissions in disclosed statements.

While liability for companies which have disclosed false information to secondary markets has only been a real threat since 2004, in 2014, the provision underwent another important amendment. The purpose of this article is to consider the significance and difficulty of securities regulation enforcement through civil liabilities by examining the circumstances of the Japanese situation in the time period between these two amendments of 2004 and 2014.

II. Before the 2004 Amendment

As previously mentioned, before the 2004 amendment, FIEA had provided for civil liability for directors and other relevant parties except the listed company itself,[2] and such FIEA provisions made it easier for investors to sue directors and other relevant parties for damages than was possible based on the Japanese Civil Code §709 *(tort law liability).*

Under *tort law liability*, investors have to prove the following two items for their claims to be considered valid:

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[2] Art. 24-4 FIEA.

1. The listed company intentionally or negligently disclosed false information *(intention or negligence).*
2. The investors suffered as a result of this misrepresentation or omission in the disclosed information *(causation).*

Of these two requirements, finding proof of *causatio*n is very difficult.[3] When investors sue directors or other relevant parties, they can rely on the special provision of FIEA, which exempts them from proving *intention* or *negligence* of defendants,[4] but even in such cases, they still have to prove *causation*.[5] For this reason, most cases resulted in liability not being found. The difficulty in proving *causation* has also, in all probability, made it rare for investors to claim for damages.

It is uncertain why the courts were not active in imposing civil liabilities, although I suspect that a discussion about the reasonability of imposing liabilities on companies was an influencing factor. Such a discussion would include the points outlined in the subsequent paragraphs.

The first point relates to the problems brought about by differences between primary and secondary markets. In a primary market, FIEA imposes strict liability for investors when a company discloses false information in a disclosure statement required by law.[6] In this case, investors would not have to prove *intention or negligence*. The purpose of such liability is to force the company to return unfairly collected money to investors. In the case of secondary markets, a listed company does not collect money from the market by disclosing false information.

The second point is deals with deterring misrepresentation or omission in secondary markets. If the purpose of civil liability is to deter listed companies from disclosing false information, civil liability does not need to be imposed on the companies because it is not the companies but the directors or officers who benefit from misrepresentations or omissions in the secondary market.

The third point addresses the question of whether company liability distorts absolute priority between creditors and shareholders. Absolute priority means that creditors have preferential rights to a company's assets over its shareholders. As described below, a company's civil liability could prejudice absolute priority. If shareholders claim for damages and succeed, they can get a monetary benefit from a company's assets without the procedure required by compa-

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[3] Eg.Tōkyō District Court, 20 December 2001, Kinnyū Shōji Hannrei 1147 [2002] 34.

[4] Art. 24-4 FIEA.

[5] The defendants could release themselves from liabilities by proving the legally determined facts that indicate the nonexistence of *intention* or *negligence*. In the case of directors, it is "the fact that he/she did not know of, or was not able to know of even with reasonable care, the existence of the fake statement or the lack of the required statement." Art. 21 para. 2 no. 1 FIEA (cited by Arts. 24-4 and 22 FIEA).

[6] Art. 18 FIEA.

ny law to protect creditors' rights. If harsh liabilities are imposed on the company, the company could go into bankruptcy. In such a case, creditors may suffer if investors' claims are treated in the same way as creditors' claims.

III. The 2004 Amendment

While the aforementioned disputes had not been resolved, the 2004 amendment established a civil liability that is imposed on a listed company that discloses false information *(new liability)*.[7] It was said that the purpose of the *new liability* in the 2004 amendment was to increase the level of enforcement because securities regulations had not been enforced in a way that would achieve fair and efficient markets.[8]

The report by the First Subcommittee of the Sectional Committee on the Financial System of the Financial System Council, "Toward Building a Financial System with Market Function as its Core" (Report 2004), published in December 2003, proposed the amendment and gave a similar theoretical justification: "It is indicated that the reason why civil liabilities based on violation of [FIEA] are not pursued is not only that it is difficult to discover illegal acts including a misrepresentation or omission but also that it is almost impossible for plaintiffs to prove an amount of damages and in Japan there is no class action lawsuit. While the difficulty of proof is not limited to securities trading and its stability must be considered, some legislative measures, for example, a provision to estimate the amount of damages, should be established to achieve a balance of the burden of proof between the party disclosing wrong information and the investors."[9]

The new liability made it easier for investors to claim for damages than *tort law liabilit*y for the following reasons.

1. A listed company disclosing false information about a material item in a disclosure statement required by law is strictly liable to investors who purchased its shares after the false disclosure.[10]

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[7] Art. 21-2 FIEA.

[8] H. MITSUI (ed.), Civil Penalty and Civil Liability; Article by Article Commentary of the Securities and Exchange Act (Tokyo 2005) 32 et seq.

[9] "Report by the First Subcommittee of the Sectional Committee on Financial System of the Financial System Council; Toward Building a Financial System with Market Function as its Core", at 17 (24 December 2013) (Japanese) *(on file with author).*

[10] But the amount of damages to be paid under Art. 21-2 para. 1 FIEA shall be not more than the amount calculated by deducting the amount specified by either of the following items from the amount paid for acquisition of the securities by the person who is entitled to claim for damages:

2. Investors can claim for compensation of an amount equal to the difference of the average share price calculated over a period of one-month prior to and after the *day of announcement*, the day when the fact that the company had disclosed false information was revealed *(legally determined amount of damage)*.[11]

Strict liability of the listed companies was not suggested by *Report 2004*. The officer in the Financial Service Agency in charge of drafting the 2004 amendment said that strict liability was established because it was impossible that the company disclosing wrong information would not have either *intention or negligence*; in the primary market it is strictly liable.[12]

Putting aside consideration as to whether this reason for a *new liability* is justifiable, the 2004 amendment obviously made it easier for investors to claim for damages against the listed companies by eliminating the burden of proof of *intention or negligence* and c*ausation*, both of which would have to be proved in cases of *tort law liability*.

If investors claim for compensation of the *legally determined amount of damage,* they only have to prove two things. One is that the listed company disclosed false information about a material item in a legally obligated disclosure statement *(materiality)*. The other is the *day of announcement*. The listed company can lower the amount of damages by proving that the *legally determined amount of damage* includes damages that were not caused by misrepresentation or omission. In other words, *new liability* transfers the burden of proof of *causation* from the investor to the company. If the company can prove that compensation of the *legally determined amount of damage* would result in overcompensation, even without succeeding in proving the exact amount of lower damages, a court can reduce the amount of damages at its discretion.[13]

(i) market value of the securities at the time when claiming damages under Art. 21-2 para. 1 FIEA (or, where no market value exists, their estimated disposal value at such time); or

(ii) disposal value of the securities, if the securities have been disposed of before the time referred to in the preceding item.

[11] The investors who can claim for compensation of the amount of the difference of averages of share prices between one-month prior and after the *day of announcement* are only those who acquired shares during one year before the *day of announcement* and continued to hold them on the *day of announcement*. Art. 21-2 para. 3 FIEA and before the 2014 amendment Art. 21-2 para. 2 FIEA.

[12] H. OKADA et al., Commentary of an Amendment to the Securities and Exchange Act for Strengthening Market Monitoring Function; Establishment of Civil Penalty and Review of Civil Liability, Shōji Hōmu 1705 (2004) 44, 50 et seq–.

[13] Art. 21-2 paras. 5–6 FIEA and before the 2014 amendment Art. 21-2 paras. 4–5.

IV. Impacts and Problems of the 2004 Amendment

1. How Easy Has It Become to Sue a Listed Company After the 2004 Amendment?

The *new liability* strengthened the liability of a listed company that discloses false information. We will review this amendment by comparing it with the U.S. securities regulations.

In the U.S. there are many cases where investors sue companies that disclosed false information for damages based on violations of the Securities Act of 1934 Rule10b-5. In order to win such a claim, investors must prove the following:

1. That, in connection with the purchase or sale of a security, defendants made an untrue statement of a material fact or omitted a material fact necessary in order to make the statements appear truthful (i.e. not misleading), in light of the circumstances under which they were made;
2. The defendants had *scietner* during the conduct described in the first requirement;
3. It was rational for the plaintiffs to rely on the misrepresentation or omission shown in the first requirements *(transaction causation*); and
4. The plaintiffs suffered by the reliance shown in the third requirement *(loss causation).*

The first requirement is composed of two elements—that violations are "in a connection with the purchase or sale of a security" and a material misrepresentation or omission. The latter is substantially the same as *materiality* in *new liability*. *Scienter* is similar to *intention or negligence* in that both of them are related to mental states of the defendants. *Scienter* is a narrower legal concept than *intention or negligence*. While *scienter* is recognized without dispute when the defendants have intention of disclosing wrong information, it is disputable whether *scienter* includes recklessness.

It is widely known that the third requirement, *transaction causation*, is presumed by fraud-on-the-market-theory.[14] While *transaction causation* is presumed, investors still have to satisfy the remaining requirements. It can also be said that most cases end before final judgment due to procedural hurdles or settlements. As a result, it seems to be unclear what investors have to prove for existence of *scienter* or *loss causation*. For example, a series of recently issued judgments by the Supreme Court of the U.S. incited an academic discussion about the relationship between *materiality*, *transaction causation*, and *loss causation*.[15]

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[14] See *Basic Inc. v. Levinson,* 485 U.S. 224 (1988) *(Basic).*

The claims based on Rule 10b-5 might be broader and easier than the *new liability* because Rule 10b-5 allows investors to file class action lawsuits based on misrepresentations or omissions not only in disclosure statements required by law but also in voluntarily disclosed ones.

On the other hand, in terms of the burden of proof, the *new liability* is advantageous for investors. When they sue a company based on the *new liability*, they do not have to prove *scienter*, *transaction causation*, or *loss causation*. In Japan, investors do have to prove *materiality* for items that listed companies are legally obligated to disclose; misrepresentations or omissions in voluntarily disclosed statements are exempt. It seems to be easier in Japan than in the U.S. to claim that the *materiality* requirement was satisfied when the company's share price dropped just after the revelation of a misrepresentation or omission. The fact that companies are legally obligated to disclose that information is one of the grounds for *materiality*.

After the 2004 amendment, some courts have admitted claims based on the *new liability*. It indicates that it might be easier for investors to win under the *new liability* in Japan than by Rule10b-5 in the U.S. The purpose of the amendment in Japan was to strengthen the enforcement of securities regulations against listed companies that disclose false information in secondary markets. If the *new liability* achieves its purpose, liability for companies will be a real threat. If the expected cost of claiming the *new liability* were larger than the expected benefits, no investors would do it. In the U.S., class action lawsuits play an important role in lowering the cost of such claims. In Japan, however, investors are not allowed to file special class action lawsuits. Thus, to lower the cost for investors in Japan, it is important to lighten the burden of proof placed on investors.

2. Is the New Liability an Adequate Tool for the Enforcement of Securities Regulations?

We have to keep in mind that the *new liability* is a tool to strengthen the enforcement of securities regulations. Whether the establishment of the *new liability* is adequate can only be assessed based on how it contributes to that end. While the purpose of the *new liability* is not disputed, its significance in enforcing securities regulations is more obscure than it may appear to be. The dispute is whether the purpose of provisions of civil liabilities in securities regulations is compensation or deterrence. There is a similar dispute about *tort law liability.* While Japanese Civil Code scholars consider compensation as the main purpose, some law and economics scholars claim that tort law should be restructured to make it function as deterrence system.[16]

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[15] See *Erica P. John Fund, Inc. v. Halliburton Co.,* 131 S. Ct. 2179 (2011); *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds,* 133 S. Ct. 1184 (2013); *Halliburton Co. v. Erica P. John Fund, Inc.,* 133 S. Ct. 1184 (2014).

What makes it more difficult to evaluate the adequacy of the *new liability* is the opinion that it might not be a rational way to ensure either compensation or deterrence.[17] This opinion focuses on who ultimately bears the cost for the liabilities of listed companies, i.e., the shareholders, as long as the companies do not go into bankruptcy. More precisely, it focuses on the inequality between the shareholders who can and cannot claim for damages based on the *new liability*.

At the time a company has to bear the liability, the shareholders are composed of two types. *Type 1* investors are those who bought before the company had disclosed the false information. *Type 2 investors* are those who bought shares after such a disclosure. It is only *type 2 investors* who may sue a company based on the *new liability*; therefore, only *type 1 investors* bear the cost for the liabilities of listed companies. This is broadly known as circularity problem.[18] The following paragraph will outline why circularity might be problematic.

First, the compensation of *type 2 investors* by *type 1 investors* could be considered an unfair system. When the share price drops after the revelation of a false disclosure by a company, both types of investors suffer equally. Thus, not only *type 1 investors* but also *type 2 investors* are victims of a false disclosure. The rationality of a compensation system in which one group of victims compensates another might need to be reconsidered.

Second, it is not necessarily clear why putting the economic burden on *type 1 investors* contributes to deterring false disclosure. If *type 1 investors* were controlling shareholders, they would have an incentive to deter false disclosures to prevent the economic loss caused by the *new liability*. However, this might not be applicable to other *type 1 investors*. Even for a company's controlling shareholders, how much of the economic burden should be imposed might be also unclear. The *legally determined amount of damages* in *new liability* might not be adequate because that amount is not related to social harm caused by the false disclosures.[19]

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[16] H. MORITA/S. KOZUKA, The Purpose of Tort Law; Is Compensation its Main Purpose?, NBL 874 (2008) 10.

[17] E.g., S. IWAHARA et al., Seminar on Securities Law–Disclosure, Anti-fraud and Business Regulation (Tokyo 2011) 140 et seqq.; T. KATO, Fraudulent Disclosure in the Secondary Market and the Damage to Investors, Hokkaido Journal of New Global Law and Policy 11 (2010) 303.

[18] See J. COFFEE, Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation, 106 Colum. L. Rev. (2006) 1534, 1546 et seq.; M. FOX, Civil Liability and Mandatory Disclosure, 109 Colum. L. Rev. (2009) 237, 280 et seq.; J. PARK, Shareholder Compensation as Dividend, 108 Mich. L. Rev. (2009) 323, 329.

[19] See W. TANAKA, Liabilities of Issuing Companies due to Fraudulent Disclosures in Secondary Markets, in: Hidefusa Iida et al. (ed.), A New Cornerstone of Commercial Law (Tokyo 2014) 857.

Therefore a few proposals were made to make the *new liability* operate in a way consistent with both compensation and deterrence. One of the proposals was to adjust the amount of damages *type 2 investors* may claim. This proposal tried to provide a rationalization based on legal theory for the transfer of economic benefits from *type 1* to *type 2 investors*, but it still needed to define an adequate amount of damages for deterrence.

One of the challenges that *new liability* faces is that one group of victims suffers from economic loss caused by false disclosure because they are required to compensate another group of victims. If the *new liability* was to be used for deterrence purposes, its unfairness as a compensation system would continue to be disputed and might contribute to a deterioration of the system by legislative actions. These problems, however, could be avoided by limiting the economic loss for which *type 2 investors* can ask the company to compensate to the loss that only *type 2 investors* are considered to have suffered. These limits would be an attempt to rationalize the fact that only *type 2 investors* can claim for damages under the *new liability*.

It could also be attempted by lowering the *legally determined amount of damages*. As mentioned earlier, the decline in share price caused by the revelation of false disclosures inflicts economic loss on both *type 1 investors* and *type 2 investors*. A *legally determined amount of damages* is derived from the amount the share price fell after the revelation. In order to define the loss that only *type 2 investors* are considered to have suffered, it is necessarily to pay attention to a variety of potential causes for the decline in share price.

The decline could be caused by the fact that true information is reflected in the share price *(price correction),* concern about the corporate governance of a company that discloses false information, or the possibility of delisting of the shares. The only difference between *type 1* and *type 2 investors* is the point at which they bought shares. When *type 2 investors* bought shares, the market price had been distorted by a false disclosure, which resulted in a higher purchase price for the shares than would have been the case if the company had disclosed true information. This is the economic loss that only *type 2 investors* suffer, the amount of which can be legally considered as corresponding to the decline caused by *price correction*. Therefore, by decreasing the amount of decline caused by the other reason than *price correction* from the *legally determined amount of damages*, we could remove the unfairness from the concept of the *new liability*.

For such attempts to succeed, it is necessary to measure how much the share price declined due to reasons other than *price correction*. Unfortunately, research in this area has not been well developed, at least among Japanese legal scholars. To make matters worse, this approach might have been made futile by the *LIVEDOOR* ruling of the Supreme Court of Japan.[20]

[20] *Saikō Saibansho,* 13 March 2012, Saikō Saibansho Minji Hanreishu [Minshū] 66, 1957.

3. LIVEDOOR

In *LIVEDOOR*, the amount by which the *legally determined amount of damages* should be lowered was disputed. In this case, where shares of a company that had engaged in accounting fraud sharply declined after the revelation of the fraud, it was obvious that the decline happened not only as a result of *price correction* but also for other reasons, for example, the fact that the accounting fraud had been revealed by criminal investigation, the founder of the company had been arrested, and the possibility of delisting the shares had been widely broadcasted.

However, *LIVEDOOR* decreased the *legally determined amount of damages* by 10%. This decrease was based solely on the fact that false information, other than the information on which the *new liability* was claimed, had been revealed at the same time. The fact that the share price had declined due to reasons other than *price correction* was not regarded as a legal basis for decreasing the *legally determined amount of damages*. The reason given was that a decline caused by reasons other than *price correction* usually occurs when a company discloses false information. While the impact of *LIVEDOOR* on future cases has not been well analyzed, it is obvious that the Supreme Court of Japan admitted causation between the false disclosure and the decline of the share price, even if the decline was caused by reasons other than *price correction*. Thus, Japanese case law will not actively lower the *legally determined amount of damages*.

Other tools to make the *new liability* operate reasonably might include the *materiality* requirement. This requires false information disclosed by a company to be related to material items in the statutory disclosure statements. Generally, that requirement would be fulfilled if investors did not purchase securities at the same price without a misrepresentation or omission. In other words, only a misrepresentation or omission that seems to influence an investment decision will be material.[21]

A listed company that discloses false information will not be liable for damages if the information is not material. The *materiality* requirement is a suitable tool in an all-or-nothing approach, but does not seem to be adequate for adjusting the *new liability*. In reality, in most of the cases where investors claim for damages based on the *new liability*, the misrepresentation or omission was indisputably material.

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[21] The materiality requirement in Japan is substantially the same as the one in the U.S. For example, *Basic* said, "to fulfill the materiality requirement 'there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.'" See *Basic*, 485 U.S. 231 et seq.

V. The 2014 Amendment

1. Why Was the 2014 Amendment Necessary?

The *new liability* makes civil liability a real threat for listed companies that disclose false information. Whether it is intended as compensation or deterrence, if *new liability* is to contribute to the prosperity of the securities market, some adjustments in its operation are needed.

Adjusting the extent of causation to account for false information in investor losses is regarded as the most promising legal means to adjust the *new liability*. Although such adjustments might have been appropriate for the other cases, *LIVEDOOR* made them almost impossible. According to *LIVEDOOR*, a decrease of the *legally determined amount of damages* is unlikely to be admitted even if a decline in share price is largely caused by reasons other than *price correction*.

Although it does not directly refer to LIVEDOOR, a report of The Financial System Council Working Group on the Provision of Risk Money to New/Growth Companies (Report 2013), which was published on December 25, 2013, suggested a review of the *new liability*.[22] According to the analysis in this report, the 2014 amendment changed the *new liability* into a negligence liability in which a listed company has to prove had neither intention or negligence. If the company sued on the basis of the *new liability* proves that it did not disclose inaccurate information intentionally or negligently, it can avoid liability to its investors.[23]

Report 2013 points out that the necessity of imposing strict liability on a listed company that discloses inaccurate information is decreasing because there are other tools for deterrence.[24] The 2004 amendment introduced not only the *new liability* but also a civil penalty (Kachōkin), which Japanese Financial Service Agency (JFSA) imposes on listed companies disclosing false information, and which is a much lighter process than a criminal penalty, to an amount made larger by the 2008 amendment. The 2008 amendment also obligated listed companies to submit Internal Control Reports to the JFSA, which means that they undergo the same regulations as SOX in the U.S.[25]

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[22] Report of the Financial System Council Working Group on the Provision of Risk Money to New/Growth Companies, at 20 (25 December 2013) (on file with author) (Report 2013).

[23] Art. 21-2 para. 2 FIEA. It is also important that the 2014 amendment made it easier for investors who sold their shares after a misrepresentation or omission to sue listed companies.

[24] Report 2013, *supra* note 22, 21.

[25] Art. 24-4-4 FIEA.

2. How Should Intention or Negligence Be Judged Under the New Liability?

As previously mentioned, *LIVEDOOR* made it almost impossible to decrease the *legally determined amount of damages*. Such rigidity could prevent the *new liability* from functioning as an enforcement mechanism in Japanese securities regulations. While the *new liability* might have regained a certain level of flexibility as a result of the 2014 amendment, it is now also faced with a tough, new problem, namely, the question of whether a listed company has intentionally or negligently disclosed false information.

Report 2013 indicates two different approaches to the problem.[26] From one point of view, a company is only judged to have intentionally or negligently disclosed false information when either directors or officers did so intentionally or negligently. From the other point of view, if an employee intentionally or negligently supplies manipulated information to officers or directors which is not discovered and subsequently allowed to be disclosed, this is also judged as intentional or negligent. While the report left case law to resolve those problems, it is interesting that it says either position would lead to the same conclusion, because company liability is only disputed in the case of a material misrepresentation or omission; in that case, directors or officers are often found to be negligent.[27]

The 2014 amendment may be held in high regard for recovering the flexibility lost for the *new liability* after *LIVEDOOR*. However, such esteem is contingent upon whether the courts are able to address the difficult matter of determining when a listed company intentionally or negligently disclosed the false information. It is broadly acknowledged that when court is able to decide whether a defendant took sufficient socially desirable measures to prevent a harmful incident, that negligent liability is preferable to strict liability.[28] If the court cannot make such a determination, strict liability might be a better choice to deter a material misrepresentation or omission.

3. A Review of The Relationship Between the Legally Determined Amount of Damages and Materiality

So far, in Japan the materiality requirement has not been disputed as much as the amount of damages. The 2014 amendment might promote new controversy about a relationship between a materiality requirement and negligence under the *new liability*. Investors will sue for damages based on the *new liability* when revelation of a misrepresentation or omission has lowered the stock price and they can claim a *legally determined amount of damages*. I doubt that a court could reject these claims by reasoning that the misrepresentation or omis-

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[26] Report 2013, *supra* note 22, 21.

[27] *Id*.

[28] M. POLINSKY, An Introduction to Law and Economics, 3rd ed. (Boston 2003).

sion was not material when the price has declined after the revelation of said misrepresentation or omission. The decline, even if small, may even be considered proof of materiality. If the materiality of information disclosed falsely could be a proof of negligence, as *Report 2013* indicates, there would be less room for a company to avoid the *new liability* than expected.

Before the 2014 amendment, the *new liability* was too simple to be an enforcement mechanism. Theoretically, every time a share price declined after revelation of a misrepresentation or omission, it was highly probable that courts would admit claims for damages by investors based on the *new liability*. Since the 2014 amendment, the *new liability* seems to be too complex to be an enforcement mechanism. The reason for this might be the rigidity of the *legally determined amount of damages*. That rigidity might influence courts' judgments about other requirements, especially *materiality*.

Before the 2004 amendment, in Japan, the *causation* requirement was a serious obstacle that might discourage investors from suing a company that had disclosed false information. The 2004 amendment got rid of that obstacle and made it less costly and easier for investors to sue such companies. It became even easier after *LIVEDOOR*, which made adjustment of the *legally determined amount of damages* very difficult. As a result, investors could have easily sued the company even though such a suit would not have been overly desirable before the 2014 amendment. In other words, there was a good chance that an investor would sue and succeed based on the *new liability* whenever a share price declined after a revelation of misrepresentations or omissions, even when they were not material.

If *materiality* is to be maintained as a separate and independent requirement, we need to pay more attention to why the share price declines. If the decline was largely due to causes other than *price correction*, which means that manipulated or hidden information was reflected in the share price, that information should not be judged to be material.

VI. Concluding Remarks

Private enforcement, including civil liability, is indispensable for securities regulations. An agency responsible for public enforcement often suffers from a fiscal problem and does not have enough resources to detect and punish harmful conduct in securities markets. The relationship between public and private enforcement varies between countries, but it can be said that private enforcement lightens the burden on public enforcement and allows public enforcement agencies to concentrate its resources on the most important cases.

In this article, I briefly described how a listed company's civil liability has been developed to enforce Japanese securities regulations. Due to the com-

plexity of securities markets, civil liability would not function well without structural supports.

In Japan, the relaxation of the requirements for liability helps investors claim for damages in substantially the same way as class action suits allow for the same in the U.S. The Japanese experience described in this article shows the effectiveness and difficulties of such choices. Countries with developed securities markets face a similar problem; comparative analysis is a fruitful way to address them.

IV. Corporate Law Rules on Squeeze-out of Minority Shareholders

Corporate Law Rules on Squeeze-out of Minority Shareholders

Jens Koch

I. Introduction 207
1. General Remarks and Constitutional Considerations 207
2. Practical Significance 211
II. Principal Requirements 211
1. Stock Corporation or Partnership Limited by Shares 211
2. Majority Requirements 211
3. Adequate Cash Compensation 212
4. Resolution of the General Meeting 213
5. Missing Requirements 214
III. Procedure 216
1. Request of the Principal Shareholder and Adequate Cash Compensation 216
2. Preparation of the Shareholders' Meeting 217
3. General Meeting 217
4. Registration in the Commercial Register 218
5. Guarantees 218
6. Interaction Between Principal Shareholder and Management Board 218
IV. Legal Consequences 219
1. Shares 219
2. Convertible Bonds 219
V. Judicial Review 220
1. Special Court Procedures for Reviewing the Cash Compensation *(Spruchverfahren)* 220
2. Shareholder Suits 222
VI. Conclusion 224

I. Introduction

1. General Remarks and Constitutional Considerations

The squeeze-out is a scheme used by majority shareholders to strengthen their position within a stock corporation. Under certain circumstances the majority shareholder is granted the right to squeeze the minority out of the company by paying adequate cash compensation for the loss of his shareholder position. This is – in a nutshell – the general idea of a squeeze-out. The German

legislator has formulated this general scheme in § 327a para. 1 of the German Stock Corporation Act (in the following referred to as: AktG [Aktiengesetz]):

> The shareholders' meeting of a stock corporation or of a partnership limited by shares may resolve upon request of a shareholder holding 95 per cent of the share capital (principal shareholder) the transfer of the other shareholders' (minority shareholders') shares to the principal shareholder against the payment of adequate cash compensation.

This provision describes the German corporate squeeze-out regime, laid out in §§ 327a–327f AktG, but there is a special emphasis on the adjective 'corporate' because German law currently does not provide one squeeze-out procedure but three. Apart from the corporate squeeze-out described above, there are two other subtypes: the takeover squeeze-out (§§ 39a–39c WpÜG – German Securities Acquisition and Takeover Act) and the squeeze-out in the aftermath of a merger (§ 62 para. 5 UmwG – German Transformation Act). In their general structure both subtypes are closely related to the basic corporate squeeze-out, but they have some special characteristics. This article, however, focuses on the corporate squeeze-out and confines itself to some oblique references to these two subtypes.[1]

When the corporate squeeze-out was first introduced into German law in 2002[2] it caused a heated academic debate centered on constitutional concerns.[3] The German Basic Law (Grundgesetz – GG) is silent on the particular issue of shareholder protection, but it contains provisions for the protection of private property which covers shareholder ownership rights.[4] When minority shareholders are squeezed out of their company it is obvious that their ownership rights are being compromised in a very serious, unusual and – one might even say – radical way. First of all, the fact that the squeeze-out regime is a scheme aimed at protecting the majority shareholder against minority shareholders is unusual as safeguards normally are geared the other way around. Legislation and the courts usually endeavour to protect the minority against the majority. Furthermore the legal consequences are particularly far-reaching: the minority shareholders are virtually expelled from their own company with nothing but financial compensation in return. And last but not least, the squeeze-out is

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[1] For more details see J. KOCH, in: Hüffer/Koch, AktG, 12th ed. 2016, § 327a marg. no. 2 et seq.

[2] Gesetz zur Regelung von öffentlichen Angeboten zum Erwerb von Wertpapieren und von Unternehmensübernahmen, 20 December 2001, BGBl. I, 2001, 3822. The Act entered into force on 1 January 2002.

[3] For an overview of this discussion see HABERSACK, in: Emmerich/Habersack, Aktien- und GmbH-Konzernrecht, 8th ed. 2016, § 327a marg. no. 7; J. KOCH, *supra* note 1, § 327a marg. no. 6; FUCHS, Der aktienrechtliche Squeeze-out (Cologne 2009), 34 et seq.; SCHOPPE, Aktieneigentum (Cologne 2012), 281 et seq.

[4] BVerfG, 30 May 2007, 1 BvR 390/04, AG 2007, 544, 545; SCHOPPE *supra* note 3, 68 et seq.; for a critical view of this concept see LEUSCHNER, Gibt es das Aktieneigentum wirklich?, NJW 2007, 3248 et seq.

based on a unilateral decision of the principal shareholder. The minority shareholders not only lose their legal status as co-owners of the company, but they are also denied a voice in the process. As will be shown later, a German squeeze-out requires a resolution of the shareholder meeting, allowing the argument to be made that the minority shareholders do, in fact, participate in some way in the decision-making-process. However, given the majority requirement of 95% of shares held by the principal shareholder, minority shareholders have no influence whatsoever on the outcome of this resolution. The decision may be made by the principal shareholder alone, which contradicts our general ideas of private autonomy. Perhaps a more astonishing aspect of the scheme is that the minority does not have any influence on the amount of compensation either. The compensation amount is neither determined in a negotiation process nor is it set by an independent third party, but is uniquely and exclusively determined by the principal shareholder. This is a highly unusual way of fixing the terms of a transaction.

In view of these far-reaching consequences it is not surprising that constitutional concerns were put forward.[5] Today, however, this discussion has lost its practical importance. Both the Bundesverfassungsgericht (Federal Constitutional Court) as well as the Bundesgerichtshof (Federal High Court of Justice) have acknowledged the constitutionality of the squeeze-out-procedure.[6] The reasons why the Courts have ruled in favour of the squeeze-out are based on practical and economic considerations. The squeeze-out is considered necessary to facilitate corporate procedure because minority shareholders (and even the smallest minority) can cause numerous inconveniences not only for the principal shareholder, but also for the company itself.[7] For example, the company has to convene annual general meetings, that can lead to high costs,[8] there are rules of minority protection that have to be respected and finally, the company carries the risk of additional shareholder litigation costs.[9] Especially this last point has to be seen against the background of a particular German problem which has kept German companies and their lawyers busy for over three decades now: the so-called 'räuberische Aktionäre',

[5] See LG Wuppertal, 6. November 2003, 12 O 119/03, AG 2004, 161 et seq.; HANAU, Der Bestandsschutz der Mitgliedschaft anlässlich der Einführung des „Squeeze-Out" im Aktienrecht, NZG 2002, 1040, 1042 et seq.

[6] BVerfG, 30 May 2007, 1 BvR 390/04, AG 2007, 544, 545; BVerfG, 28. August 2007, 1 BvR 861/06, AG 2007, 821; BVerfG, 19. September 2007, 1 BvR 2984/06, AG 2008, 27 et seq.; BGH, 25 October 2005, II ZR 327/03, AG 2005, 921 et seq.; for ample references see SCHOPPE, Aktieneigentum, 2012, S. 281 et seq.

[7] On the following considerations, see BVerfG, 30 May 2007, 1 BvR 390/04, AG 2007, 544, 545; et seq.; FLEISCHER, Großkommentar zum Aktiengesetz, 4th ed. 2007, Vor § 327a marg. no. 8 et seq.

[8] FLEISCHER, Das neue Recht des Squeeze out, ZGR 2002, 757, 761.

[9] See for this consideration BVerfG, 30 May 2007, 1 BvR 390/04, AG 2007, 544, 545.

meaning professional claimants that use their shareholder rights to block company operations in order to achieve higher settlements.[10]

In light of these potential disruptions, it must be acknowledged that the principal shareholder has a legitimate interest in transforming the company into a single-member company. But that alone cannot justify his interests outweighing those of the minority shareholders. Rather, this is justified by the fact that a minority holding less than 5% of the company's stock has no influence whatsoever on the business affairs of the company. Despite having some minority rights that may be (ab)used to cause trouble for the company, the minority shareholder has no say in how the company's business should be conducted. This is where the core idea behind the squeeze-out lies: a minority of less than 5% does not need its entrepreneurial position to be protected because it does not have one. Effectively, these minority shareholders only hold a position similar to that of a financial investor, and this position is sufficiently protected by the financial compensation they receive.[11]

This idea was crucial for introducing the squeeze-out into German law, but its significance goes far beyond the squeeze-out procedure, as it implies an important shift in the perception of shareholder property. In this new perception, shareholders are regarded not so much as members of an association, but as investors whose financial interests have to be protected, but only to the extent that these interests extend. In Germany this is a rather new way of looking at shareholder ownership rights and the application of this approach in other contexts is still very controversial.[12]

At least as far as the squeeze-out is concerned, this new perception is widely considered a reasonable approach, which is why the squeeze-out procedure as such (not in its details but in its general conception) today is more or less generally approved.[13] This assessment is also confirmed by an international comparison that shows that the squeeze-out is by no means a specifically German solution, but a mechanism that is to be found in numerous major jurisdictions.[14]

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[10] For this phenomenon see KOCH, *supra* note 1, § 245 marg. no. 22 et seq. with further citations.

[11] BVerfG, 30 May 2007, 1 BvR 390/04, AG 2007, 544, 545 et seq.

[12] For further details see MÜLBERT, in: Habersack et al. (eds.), Festschrift für Peter Ulmer (Berlin 2003) 433 et seq.

[13] J. KOCH, *supra* note 1, § 327a marg. no. 7; AUSTMANN, in: Hoffmann-Becking (ed.), Münchener Handbuch Gesellschaftsrecht, 5th ed. 2015, § 75 marg. no. 3; DAV-HRA, NZG 2001, 420, 430 et seq.; KIEM, Das neue Übernahmegesetz: „Squeeze-out“, RWS-Forum 20, 2011, 329 et seq.; E. VETTER, Squeeze-out in Deutschland, ZIP 2000, 1817, 1818.

[14] For a comparative overview over various jurisdictions see FLEISCHER, *supra* note 7, Vor § 327a marg. no. 60 et seq.; SIEGER/HASSELBACH, Ausschluss von Minderheitsaktionären (Squeeze-out) im ausländischen Recht, NZG 2001, 926 et seq.; VAN DER

2. *Practical Significance*

Looking at the practical significance of the squeeze-out, it shows that it is not only an internationally widespread mechanism, but also a very popular one. Since its introduction into German law in 2002, more than 400 squeeze-outs have been carried out.[15] This number has begun to decrease, although this has more to do with the limited number of companies meeting the majority requirements rather than the squeeze-out becoming a less attractive option.[16] In the beginning there were several older cases that had been waiting for a long time for such a device to be introduced into German law. In 2002 alone, 130 squeeze-out-procedures were initiated.[17] As most of these companies have already concluded the squeeze-out process, the number is gradually shrinking, but there are still approximately 25 squeeze-out procedures every year, mostly carried out in the aftermath of a take-over.[18]

II. Principal Requirements

1. *Stock Corporation or Partnership Limited by Shares*

The next section of this article takes a closer look at squeeze-out requirements. First of all, the squeeze-out regime only applies to stock corporations and partnerships limited by shares (see § 327 para. 1 sent. 1 AktG). It is not a viable option for private limited companies or partnerships. As has been shown, neglecting the interests of minority shareholders can only be justified by considering them to be financial investors and nothing else (see comments under section I.1.). Members of private limited companies or partnerships however are presumed to have a greater level of interest in how the company's business is conducted, meaning they cannot be squeezed out solely in return for cash compensation.

2. *Majority Requirements*

The next requirement is a majority requirement. A squeeze-out can only be undertaken by a shareholder holding – directly or indirectly – 95% of the shares. It is still open to debate whether the legislature has made the right

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ELST/VAN DEN STEEN, Balancing the Interests of Minority and Majority Shareholders: A Comparative Analysis of Squeeze-out and Sell-out Rights, ECFR 2009, 390 et seq.

[15] SCHOCKENHOFF/LUMPP, Der verschmelzungsrechtliche Squeeze out in der Praxis, ZIP 2013, 749.

[16] For more details see AUSTMANN, Der verschmelzungsrechtliche Squeeze-out nach dem 3. UmwÄndG 2011, NZG 2011, 684.

[17] AUSTMANN, *supra* note 16, 684.

[18] AUSTMANN, *supra* note 16, 684.

decision in setting the threshold at 95%.[19] This question is more political and economic than legal in nature. But even from an economic point of view it is difficult to draw a clearly defined dividing line. Many commentators claim that a threshold of 90% would be more appropriate[20] and in fact Great Britain, Austria and – most recently – Japan have chosen this threshold.[21] Italy and Switzerland, however, have chosen a 98% threshold.[22] Thus, Germany walks the middle path, which makes it at least a plausible solution.

The principal shareholder can be both a company as well as a natural person and – unlike other alternative procedures[23] – does not have to be resident in Germany. This is a huge advantage of the squeeze-out-procedure because a considerable number of shareholders of German companies are domiciled outside Germany.[24] Nevertheless, it obviously creates some additional problems for minority shareholders. When they are squeezed out by a foreign company, they could face practical difficulties in obtaining the compensation that has to be paid. However, such problems are prevented by § 327b para. 3 AktG, which requires the majority shareholder to present a declaration from a German bank guaranteeing the amount of compensation to be paid.

3. *Adequate Cash Compensation*

The next requirement is that an adequate cash compensation has to be offered to the minority shareholders. Setting this amount is by far the most controversial issue in the squeeze-out process[25], and most judicial challenges to a squeeze-out have been on the grounds of inadequate compensation. Currently, the method of calculating the compensation is the most interesting question surrounding squeeze-outs, making it tempting to go into greater detail. This article, however, will resist this temptation because these questions are the subject of another article in this book by *Lars Klöhn*. Put briefly: As in other contexts, the custom-

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[19] For an overview over this debate see FLEISCHER, *supra* note 8, 757, 774 et seq.

[20] See BAYER/J. SCHMIDT, Der Referentenentwurf zum 3. UmwÄndG: Vereinfachungen bei Verschmelzungen und Spaltungen und ein neuer verschmelzungsrechtlicher Squeeze out, ZIP 2010, 953, 960 et seq.; the legislator, however, has discussed and rejected this proposal – see NEYE, Neuigkeiten beim Umwandlungsrecht, NZG 2011, 681, 682.

[21] For a comparative overview see VAN DER ELST/VAN DEN STEEN, *supra* note 14, 390, 404 et seq.

[22] SIEGER/HASSELBACH, *supra* note 14, 926, 928, 930 note 22.

[23] See for example § 319 et seq. AktG.

[24] See DEUTSCHE BUNDESBANK, Monthly report, September 2014, 19 (available at <https://www.bundesbank.de/Redaktion/DE/Downloads/Veroeffentlichungen/Monatsberichtsaufsaetze/2014/2014_09_eigentuemerstruktur_aktienmarkt.pdf;jsessionid=0000VUC7JHdAck9Kp0rSG2kLKLT:-1?__blob=publicationFile>).

[25] For an overview over this discussion see HABERSACK, *supra* note 3, marg. no. 9; J. KOCH, *supra* note 1, § 327b marg. no. 4 et seq.; AUSTMANN, *supra* note 13, § 75 marg. no. 96 et seq.

ary assessment method is to deduce the value of the shares based on the value of the company. This value of the company is determined by means of an enterprise valuation *(Ertragswertverfahren)*.[26] However, given the complexity, expense and time consumed by this procedure, there is an understandable push to find alternative methods of assessment. The most obvious – at least for a listed company – is to use the stock market value as basis of calculation. Even though this solution seems compelling at first glance, it is subject to serious objections. There are major concerns that when trading price volatility strikes, the stock market value might not reflect the true value of the company.[27] This holds true for any assessment on the basis of stock market value, but it is even more significant when it comes to the squeeze-out-regime. The squeeze-out is characterized by one shareholder holding 95% of the shares. The remaining free float, thus, is less than 5%. Under these market conditions, the significance of the share price is very low.[28]

4. Resolution of the General Meeting

The next requirement is the most surprising one and in fact a German peculiarity: The German squeeze-out requires a shareholders' resolution. At first glance one might consider this requirement obsolete,[29] as the majority requirement ensures that the outcome of this resolution will not be much of a surprise. In fact the resolution is not so much about the actual decision to be taken, but serves more as a vehicle to provide a certain legal structure, in which minority rights can be exercised. In deciding, for example, how the squeeze-out has to be made public, how shareholders are to be provided with information, how the squeeze-out can be legally challenged, there need be no separate legal procedure, instead using the general mechanisms applying to shareholder resolutions. So despite the initial surprise and the requirements

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[26] J. KOCH, *supra* note 1, § 305 marg. no. 24 et seq.

[27] BRÖSEL/KARAMI, Der Börsenkurs in der Rechtsprechung, WPg 2011, 418, 419 et seq.; BURGER, Keine angemessene Abfindung durch Börsenkurse bei Squeeze-out, NZG 2012, 281 et seq.; RUTHHARDT/HACHTMEISTER, Ermittlung der angemessenen Barabfindung beim Squeeze Out, NZG 2014, 41 et seq.; in earlier case-law the calculation on the basis of market prices was thus denied – see BGH, 30 March 1967, II ZR 141/64, AG 1967, 264; BayObLG, 31 May 1995, 3 Z BR 67/89, AG 1995, 509, 510; OLG Celle, 31 July 1998, 3 Z BR 67/89, AG 1999, 128, 129; OLG Düsseldorf, 2 August 1994, 19 W 1/93 AktE, AG 1995, 85, 86.

[28] HABERSACK, *supra* note 3, § 327b marg. no. 9; J. KOCH, *supra* note 1, § 327b marg. no. 6

[29] So in fact HABERSACK, Der Finanzplatz Deutschland und die Rechte der Aktionäre, ZIP 2001, 1230, 1236 et seq.; E. VETTER, Squeeze-out nur durch Hauptversammlungsbeschluss?, DB 2001, 743 et seq.

oddity from an international comparative point of view, it might still be considered a reasonable solution.[30]

Another interesting feature of this resolution is that it does not need any justification – it is always considered legitimate, because the squeeze-out in itself is considered to pursue legitimate goals.[31] There is, however, an ongoing discussion as to whether there should be exceptions from this rule when the squeeze-out is used in a way that is clearly abusive, for example if a company changes its legal form to carry out a squeeze-out that would not have been admissible in its original legal form.[32]

5. *Missing Requirements*

These are the principal requirements that have to be met to initiate a squeeze-out. As unexpected as the last requirement is, it is the "missing" requirements that are the greatest surprise. In this context the term "missing" is used from a comparative perspective because other jurisdictions provide corresponding requirements. These missing requirements have already been named by *Holger Fleischer* and *Mathias Habersack* in 2001/2002: The German squeeze-out is not limited to listed companies; it does not depend on a previous takeover-bid; there are no time constraints. Minority shareholders have no sell-out-right, nor are they informed what the future might have in store for them by a corresponding provision in the articles of incorporation.[33]

Of the broad discussion available, one matter stands out for deeper consideration here. Widely regarded as one of the major defects of the German regime, it involves the failure to limit the squeeze-out to listed companies. This criticism must be seen in its broader context as a fundamental question of corporate law – the question of the extent of the need for two different sets of stock corporation law, one for listed and one for closed companies. This is a very complex question that goes far beyond the narrow scope of this article.[34]

The current squeeze-out-regime, however, is committed to the idea of a uniform stock corporation law without these distinctions. Whether this is the right legislative course of action is very debatable. To understand the very

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[30] Positive appraisal by J. KOCH, *supra* note 1, § 327a marg. no. 12; KOPPENSTEINER, Kölner Kommentar zum Aktiengesetz, 3th ed. 2004, § 327a marg. no. 18; DAV-HRA, NZG 1999, 850, 851 et seq.; KIEM, *supra* note 13, 329, 335 et seq.

[31] HABERSACK, *supra* note 3, § 327a marg. no. 26; J. KOCH, *supra* note 1, § 327a marg. no. 14.

[32] For further details see HABERSACK, *supra* note 3, § 327a marg. no. 27 et seq.; J. KOCH, *supra* note 1, § 327a marg. no. 20 et seq.

[33] See FLEISCHER, *supra* note 8, 757, 768 et seq.; HABERSACK, *supra* note 29, 1234 et seq.

[34] Discussing the pros and cons of such a distinction BAYER, Gutachten E zum 67. Deutschen Juristentag (Munich 2008) 81 et seq.; MÜLBERT, Verhandlungen des 67. Deutsche Juristentags, Vol. II/1 (Munich 2009) N 51 et seq.

generous approach in German legislation it has to be seen in light of the particular German problem of abusive shareholder suits,[35] which had practically been at its peak in 2002. In the light of this phenomenon, the German legislator intended this remedy to have a broad scope of application. Under different circumstances a more nuanced path may have been taken.

Furthermore, one must bear in mind that a squeeze-out situation will rarely come into being because a company was originally founded with this particular composition – with 95% of shares held by one shareholder. In most cases it will be the result of a previous takeover-bid or a transaction that has shifted the shareholder composition. Thus, the legislator probably did not have the classic closed company in mind, but rather a company that is 'no longer listed' which might be considered a different case from a company originally founded as a closed company. While it may have been a reasonable alternative to introduce a transitional scheme for old cases,[36] the formulation of a scheme suitable for every possible constellation would have been a difficult task. However, even if one accepts these reasons it becomes more urgent to flank this system with an additional control based on the duty of loyalty. This duty would prevent use of the squeeze-out being overtly abusive, for example changing the legal form of the company to carry out a squeeze-out that would not have been admissible in its original legal form.[37]

Even with this additional safeguard in place, it cannot be denied that this broad approach may put minority shareholders in a difficult position that becomes even more problematic in combination with the other missing requirements. For example, as there are no time constraints, the principal shareholder is granted an unlimited call-option.[38] Minority shareholders thus have to live with the uncertainty of being shut out for an indefinite period of time. This can be a burdensome situation, particularly when the company is not listed as there is no market to sell the shares, nor are the minority shareholders granted a sell-out right. That is the reason why the squeeze-out today is mostly considered to be rather more advantageous for the principal shareholder than for the minority. This weak position of the minority shareholder, however, is counterbalanced when it comes to the judicial review of the squeeze-out. Once the squeeze-out is contested in court (and in most cases it is contested), it is the minority shareholder who finds himself in a superior position (see comments under section V.).

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[35] See for this consideration BVerfG, 30 May 2007, 1 BvR 390/04, AG 2007, 544, 545; for more details see J. KOCH, *supra* note 1, § 245 marg. no. 22 et seq.

[36] FLEISCHER, *supra* note 8, 757, 772.

[37] For further details see HABERSACK, *supra* note 3, § 327a marg. no. 27 et seq.; J. KOCH, *supra* note 1, § 327a marg. no. 20 et seq.

[38] FLEISCHER, *supra* note 8, 757, 769.

III. Procedure

1. Request of the Principal Shareholder and Adequate Cash Compensation

If the basic requirements are met, the squeeze-out can be initiated by a corresponding request addressed to the managing board. The first challenge for this procedure is the difficult task of setting the amount of compensation by the majority shareholder. As was mentioned above, this is a unilateral decision; the minority shareholders do not participate in the assessment (see comments under section I.1.). The principal shareholder, however, has a strong incentive not to take advantage of this prerogative as the judicial review of the assessment is rigorous and – from majority shareholder's point of view – rather unfavourable (see comments under section V.). To establish this compensation, the majority shareholder needs information about the company. To this end, § 327b AktG obliges the managing board to provide him with all necessary information. At this point, however, the majority shareholder may experience some practical difficulties as the prevailing opinion to date has taken the view that the calculation has to be presented at the same time the majority shareholder puts forward the squeeze-out proposal.[39] In practice, however, this interpretation puts him in a tricky position because in order to do the maths the principal shareholder depends on information that can only be provided by the company itself – information which even the majority shareholder is not legally entitled to prior to the initiation of the squeeze-out procedure. It is only after the opening of the squeeze-out procedure that § 327b para. 1 sent. 2 AktG relieves the management board of their general confidentiality obligation. That is why a growing number of commentators rightly consider it sufficient for the calculation to be delivered to the management board before the general meeting is convened.[40]

[39] FLEISCHER, *supra* note 8, § 327a marg. no. 58; HABERSACK, *supra* note 3, § 327b marg. no. 4; KOPPENSTEINER, *supra* note 30, marg. no. 14; RIEDER, in: Grigoleit, Aktiengesetz, 2013, § 327b marg. no. 4.

[40] HASSELBACH, Kölner Kommentar zum WpÜG, 2nd ed. 2010, § 327a marg. no. 66; HEIDEL/LOCHNER, in: Heidel AktG, 4th ed. 2014, § 327a marg. no. 11; HOLZBORN/MÜLLER, in: Bürgers/Körber, Aktiengesetz, 3rd ed. 2014, § 327a marg. no. 13; SCHNORBUS, in: K. Schmidt/Lutter, Aktiengesetz, 3rd ed. 2015, § 327b marg. no. 9; SINGHOF, in: Spindler/Stilz, Aktiengesetz, 3rd ed. 2015, § 327a marg. no. 19; AUSTMANN, *supra* note 13, § 75 marg. no. 34; DRINKUTH in Marsch-Barner/Schäfer, Handbuch der börsennotierten AG, 3rd ed. 2014, § 62 marg. no. 29; GRUNEWALD; in. Münchener Kommentar zum Aktiengesetz, 4th ed. 2014, § 327a marg. no. 11 comes to similar results using the construction of a 'preliminary request'.

2. Preparation of the Shareholders' Meeting

The following steps of the procedure are all focused on the shareholder resolution and its preparation, with the compensation and its adequacy at the centre of all legal provisions. In particular, minority shareholders must be provided with sufficient information to comprehend the principal shareholder's calculation. To this end, the principle shareholder is required to provide a great deal of information. The German Stock Corporation Act contains two provisions to this effect: the first, § 327c AktG, provides instructions on the preparation of the shareholders' meeting, and the second, § 327d AktG, outlines the conduct of the meeting.

As for the preparation of the meeting, a notice of the transfer has to be announced as an item on the agenda. This notice of transfer must contain the following information: (i) business name and domicile of the principle shareholder, in the case of natural persons, the name and address; (ii) the amount of cash compensation set by the principal shareholder (§ 327c para. 1 AktG).

Furthermore the principal shareholder must provide the general meeting with a written report that sets out the preconditions for the transfer and explains and justifies the adequacy of the cash compensation. The adequacy of the cash compensation must be reviewed by one or more expert auditors selected and appointed by the court on application of the principal shareholder (§ 327c para. 2 AktG).

Furthermore, certain documents have to be made available for inspection by the shareholders: (i) the draft of the transfer resolution, (ii) the annual financial statements and management reports for the last three business years, (iii) the report made by the principal shareholder, (iv) the audit report (§ 327c para. 3 AktG). On request, each shareholder shall be given a copy of these documents without undue delay and free of charge (§ 327c para. 4 AktG). The company, however, can avoid the obligations set out in § 327c para. 3 and 4 AktG by making this information accessible on its internet page (§ 327c para. 5 AktG).

3. General Meeting

The provisions on the meeting itself are less detailed because most of the information has to be provided in advance. In addition, § 327d AktG requires the company to make all documents accessible in the general meeting. Furthermore the management board may give the principal shareholder opportunity to present an explanation of the draft transfer resolution and the setting of the amount of cash compensation at the beginning of the meeting. It has rightly been pointed out that it would have been more appropriate to make this statement an obligation rather than an option.[41] In most cases this question will only be a hypo-

[41] KIEM, *supra* note 13, 329, 341 et seq.

thetical one because it is hard to imagine that a principal shareholder would refuse any such offer given by the management board. Even in light of this, the legislator should not trust the normal courses of action, but formulate precise guidelines for the course of the general meeting.[42]

4. *Registration in the Commercial Register*

Once the general meeting has passed the squeeze-out-resolution, the transaction comes into effect as soon as it is registered in the commercial register. To this end the managing board must file the transfer resolution for registration in the commercial register, accompanied by the written transfer resolution and its appendices as the authentic original or a notarized copy (§ 327e para. 1 AktG).

5. *Guarantees*

As has been shown, German law provides many mechanisms to ensure that the cash compensation is adequate. But it is not enough that the offer is adequate, other safeguards are required to make sure that it is actually paid. To this end, § 327b AktG provides two mechanisms. First it requires the principal shareholder to present the declaration of a credit institution authorized to operate within the territorial scope of this law. This credit institution declaration guarantees the performance of the principal shareholder's obligation to pay the minority shareholders the set cash compensation for the transferred shares immediately after registration of the transfer resolution (§ 327b para. 3 AktG). Secondly it provides an obligation to pay interest on the cash compensation of five percentage points over the applicable base rate according to § 247 of the German Civil Code (Bürgerliches Gesetzbuch – BGB) calculated from the date the transfer registration is published in the commercial register (§ 327b para. 2). Looking at the current German level of interest rates, this is about the most lucrative investment that can possibly be made. In this way, the mechanism offers a strong incentive to pay the compensation on time, accompanied by the fact that the assertion of further claims for damage is not excluded (§ 327b para. 2).

6. *Interaction Between Principal Shareholder AND Management Board*

An interesting feature of the German squeeze-out-regime is the distribution of roles between the principal shareholder and the management board.[43] These procedural steps reveal that the principal shareholder is always in charge. Although the management board has to provide some technical support, it is

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[42] KIEM, *supra* note 13, 329, 342.

[43] See for the following considerations KIEM, *supra* note 13, 329, 341 et seq., 347 et seq.

not the key protagonist of this procedure. In practice, this leads to some difficulties in orchestrating the interaction of these two players and in some respects, raises the question of whether some of the tasks assigned to the principal shareholder would not better be taken care of by the management board. For example, it has been asked whether the managing board should be obliged to give its views on the cash compensation offered.[44] This question is however subject to its own debate, although ultimately it seems more appropriate to refrain from introducing such an obligation. In contrast to a takeover-bid, shareholders do not have any opportunity to choose whether or not they want to accept the compensation. The adequacy of the compensation is not guaranteed by shareholder consent, but by the subsequent judicial review in which the compensation is thoroughly scrutinized (see comments under section V).[45] A statement of the management board, thus, would not help minority shareholders in making this decision. However, for the management board, it would open another source of liability and put the board in a very difficult position – either to compromise its principal shareholder by claiming that the cash compensation offered is not adequate or confirm the adequacy and risk being dragged into a legal dispute between the principal shareholder and the minority shareholders.[46]

IV. Legal Consequences

1. Shares

The legal consequence of a squeeze-out is that the minority shareholders lose their shares in return for financial compensation that has to be paid by the majority shareholder. Upon registration of the transfer resolution in the commercial register, all shares of the minority shareholders are transferred to the principal shareholder (§ 327e para. 3 sent. 1 AktG). The corporation becomes a single member company. Any share certificates issued for the minority shareholders' shares only attest to the claim for cash compensation until their delivery to the principal shareholder (§ 327e para. 3 sent. 2 AktG).

2. Convertible Bonds

A very controversial issue is how the squeeze-out affects the owners of convertible bonds. They are not yet shareholders and so according to the wording of the law, they are not directly affected by the legal consequences of the regulation. From the company's point of view, this might lead to practical

[44] See E. VETTER, *supra* note 13, 1817, 1822 et seq.
[45] KIEM, *supra* note 13, 329, 348 et seq.
[46] KIEM, *supra* note 13, 329, 348.

obstacles as convertible bonds could undermine the success of a squeeze-out. While minority shareholders could be forced out of the company, as soon as the convertible bonds are converted to shares there would be new shareholders and the squeeze-out would have to be repeated. Furthermore it seems counterintuitive that the mere option of becoming a shareholder is better protected than the shareholder position itself. However, from the bondholders' point of view it is hard to see what possible interest they could have in becoming single minority shareholders in a company governed by a principal shareholder with an overwhelming majority.[47] This is the reason why prevailing opinion does not differentiate between shareholders and bondholders. Both groups get a claim to the cash compensation that replaces both the shares and the claims based on convertible bonds.[48] Even though these questions are still fiercely disputed in legal scholarship, in practice, however, they have lost their practical significance. Standard provisions in the bond terms now contain special provisions for the event of a squeeze-out.[49]

V. Judicial Review

1. Special Court Procedures for Reviewing the Cash Compensation (Spruchverfahren)

All the critical or controversial features of the squeeze-out-procedure mentioned in this article have to be fought out in court should the squeeze-out-resolution be contested. Unfortunately, there is a very high number of share-

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[47] SÜSSMANN, Die Behandlung von Options- und Wandelrechten in den einzelnen Squeeze-out-Verfahren, AG 2013, 158, 159.

[48] LG Düsseldorf, 4 March 2004, 31 O 144/03, NZG 2004, 1168, 1170; HABERSACK, *supra* note 3, § 327a marg. no. 7; HASSELBACH, *supra* note 40, § 327e Marg. no. 22; AUSTMANN, *supra* note 13, § 75 marg. no. 113; DAV-HRA NZG 2001, 420, 431; ENGELHARDT, Convertible Bonds im Squeeze-Out, 2007, 108 et seq.; ENGELHARDT, Optionen im Squeeze-out: Abfindung der Bezugsrechteinhaber – aber wie?, BKR 2008, 45, 47 et seq.; KRIEGER, Squeeze-Out nach neuem Recht - Überblick und Zweifelsfragen, BB 2002, 53, 61; SÜSSMANN, *supra* note 47, 158 et seq.; WILSING/KRUSE, Zur Behandlung bedingter Aktienbezugsrechte beim Squeeze-out, ZIP 2002, 1465, 1467 et seq.; for a critical view see HÄGER, in: Steinmeyer (ed.), WpÜG, 3rd ed. 2013, § 327e Marg. no. 33; PH. BAUMS, Ausschluss von Minderheitsaktionären, 2001, 156 et seq.; PH. BAUMS, Der Ausschluss von Minderheitsaktionären nach §§ 327a ff. AktG n.F., WM 2001, 1843, 1847 et seq.; SCHÜPPEN, Übernahmegesetz ante portas! – Zum Regierungsentwurf eines „Gesetzes zur Regelung von öffentlichen Angeboten zum Erwerb von Wertpapieren und von Unternehmensübernahmen", WPg 2001, 958, 975 et seq.; ZIEMONS, Options- und Wandlungsrechte bei Squeeze out und Eingliederung, in: Bitter et al. (eds), Festschrift für Karsten Schmidt (Cologne 2009) 1777, 1783 et seq.

[49] KIEM, *supra* note 45, 329, 350.

holder suits in this field. In fact 80 % of all squeeze-out resolutions are judicially challenged.[50] This is obviously an unhealthy development, but from an academic point of view it has some positive side effects – namely our current understanding of how a squeeze-out has to be handled in practice. The courts have had so many opportunities to comment on this procedure that most controversial issues have been clarified over the years.[51]

Before entering into the details of judicial review, an interesting feature of this litigation can be pointed out, namely regarding the acting persons. Up to this point the protagonist of the squeeze-out was the principal shareholder. When it comes to litigation, however, it is the management board that takes charge. The squeeze-out itself is not the company's affair, but surprisingly, defending it in court *is* the company's affair. This too, might be considered a questionable feature of German law.[52]

As to the details of judicial review, a differentiation must be made between two different kinds of proceedings. The first form is laid down in the Award Proceedings Act (in the following referred to as: SpruchG [Spruchverfahrensgesetz]). This is a special procedure to review one single feature of the squeeze-out, namely the most important and most criticised feature: the amount of compensation. The key idea of these proceedings is to provide proper judicial review of the compensation without slowing down the transaction itself. To this end, this particular review is detached from the customary judicial review, being instead subject to a separate award proceedings that do not prevent the resolution from being registered in the commercial register.[53]

Generally speaking, this is a convincing, even a compelling scheme. A detailed analysis, however, shows some remaining flaws.[54] The most obvious of these is the current time frame of seven years.[55] There is an ongoing political discussion dedicated to reducing this time frame.[56] In many fields of valuation proceedings this is achieved by taking the stock market value as basis of assessment.[57] However, as has been discussed previously, this approach is more questionable when it comes to the squeeze-out procedure than in other areas of company law (see comments under section II 3). Also subject to

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[50] GRUNEWALD, *supra* note 40, Vor § 327a marg. no. 16.

[51] AUSTMANN, *supra* note 13, § 75 marg. no. 3.

[52] For this discussion see KIEM, *supra* note 45, 329, 345 et seq.

[53] J. KOCH, *supra* note 1, § 305 appendix § 1 SpruchG marg. no. 2.

[54] For an overview of this discussion see M. NOACK, Das Spruchverfahren nach dem Spruchverfahrensgesetz (Berlin 2014) 34 et seq., 39 et seq.

[55] J. KOCH, *supra* note 1, § 305 appendix § 1 SpruchG marg. no. 3; D. LORENZ, Das Spruchverfahren – dickes Ende oder nur viel Lärm um nichts?, AG 2012, 284, 286.

[56] See J. KOCH, *supra* note 1, § 305 appendix § 1 SpruchG marg. no. 2 et seq.; DAV-HRA, NZG 2002, 119, 120; DAV-HRA, NZG 2013, 694, 698; PUSZKAJLER/ SEKERA-TERPLAN, Reform des Spruchverfahrens?, NZG 2015, 1055, 1059 et seq.

[57] J. KOCH, *supra* note 1, § 305 Anh. § 1 SpruchG marg. no. 3.

criticism is the fact that the Award Proceedings are very favourable for minority shareholders, as seen in the very attractive interest rates the principal shareholder has to pay throughout the course of these proceedings (see comments under section III 5),[58] in the minimal cost risk faced by the minority shareholder as the company usually has to bear the cost of the entire procedure (§§ 6, 15 SpruchG)[59] and in the so-called "concept of no deterioration" (prohibition of reformatio in peius), meaning that the judicial review may increase, but not reduce the compensation offered.[60] All these advantages may be considered justified as they counterbalance the minority shareholders' rather weak position in the actual squeeze-out procedure. On the other hand, it cannot be overlooked that these provisions strongly incentivize minority shareholders to initialize judicial review even if the compensation offered actually did not give any cause for complaint.[61]

2. Shareholder Suits

The second form of judicial review is the common form of shareholder suits under § 243 AktG. This action applies to any other violation of a substantial or formal provision, apart from the cash compensation. In practice, this standard contestation of shareholder resolutions has been widely replaced by a modern device, the so called release proceedings *(Freigabeverfahren).*[62] These are special summary proceedings to accelerate the registration of contested shareholder resolutions. Upon application, the competent court will determine that the pending action against the squeeze-out-resolution will not hinder registration. The core idea of this procedure is to allow the immediate and permanent effectiveness of the resolution if the material disadvantages of the company and its shareholders outweigh the disadvantages on the part of the claimant. This is a relatively new legal concept that transfers the principle of proportionality into the judicial review of shareholder resolutions. For release proceedings to be successful, one of the following preconditions needs to be met: (i) the action is inadmissible or manifestly unfounded, (ii) the claimant has not provided documented proof within one week after serving of the petition that he has been holding shares representing an amount of 1000 € since the publication of the convocation or (iii) the immediate effectiveness of the resolution of the shareholders' meeting should be given priori-

[58] M. NOACK, *supra* note 54, 146 et seq.

[59] See J. KOCH, *supra* note 1, § 305 appendix § 6 SpruchG marg. no. 7; § 15 SpruchG marg. no. 2 et seq.

[60] See J. KOCH, *supra* note 1, § 305 appendix § 11 SpruchG marg. no. 2; M. NOACK *supra* note 54, 146 et seq.

[61] See J. KOCH, *supra* note 1, § 305 appendix § 1 SpruchG marg. no. 2; SIMONS, in: Hölters AktG, 3rd ed. 2014, § 1 SpruchG marg. no. 4.

[62] See J. KOCH, *supra* note 1, § 245 marg. no. 31 et seq., § 246a marg. no. 1 et seq.

ty as, according to the court's opinion, the material disadvantages to the company and its shareholders as set forth by the claimant outweigh the disadvantages for the respondent, unless the infringement is particularly severe.

This new scheme is a reaction to the German phenomenon of abusive shareholder suits and it has, in fact, been of great assistance in reducing the number of such suits.[63] Nevertheless, it is considered to be highly problematic, as it raises some very serious questions about the systematic consistency of judicial review in corporate proceedings.[64] This is currently one of the most controversial issues in corporate law that deserves a much deeper analysis.

Release proceedings are a new device that is not confined to squeeze-out-resolutions, but applies to all kinds of shareholder resolutions. Most of these cases are decided in favour of the company. This is understandable as many shareholder resolutions are passed on items that may be worth billions of Euro while the shareholder interests blocking them are not equally substantial. When it comes to squeeze-out resolutions, however, this assessment is not equally clear. Most squeeze-out resolutions aim at making life easier for the principal shareholder, but – unlike an increase of capital stock – the company does not suffer any substantial losses if the squeeze-out resolution does not enter into effect immediately. So, even though the introduction of the release proceedings has in many ways facilitated the decision-making process, it has not proven equally effective as far as squeeze-out resolutions are concerned.[65]

Nevertheless, release proceedings are not without practical significance in squeeze-out situations. Most cases, however, are not decided on the grounds that the company's interests outweigh the interests of the minority shareholder, but on the grounds that the suit is manifestly unfounded. As has been shown earlier (see comments under section II 3), the squeeze-out resolution does not need any justification. This leaves little room for shareholder suits. In the past, claimants have tried to fill this gap with constitutional objections, but as both the Bundesverfassungsgericht (Federal Constitutional Court) as well as the Bundesgerichtshof (Federal High Court of Justice) have acknowledged the constitutionality of the squeeze-out-procedure (see comments under

[63] See J. KOCH, *supra* note 1, § 246a marg. no. 2.

[64] See OLG Jena AG 2007, 31, 36 et seq.; J. KOCH, *supra* note 1, § 245 marg. no. 31 et seq., § 246a marg. no. 1 et seq.; HABERSACK/STILZ, Zur Reform des Beschlussmängelrechts, ZGR 2010, 710 et seq.; K.-P. MARTENS/S. A. E. MARTENS, Strategien gegen misbräuchliche Anfechtungsklagen in Deutschland und den Vereinigten Staaten, in: Bitter et al. (eds.), Festschrift für Karsten Schmidt (Cologne 2009) 1129, 1141; SCHALL/HABBE/WIEGAND, Anfechtungsmissbrauch – Gibt es einen überzeugenderen Ansatz als das ARUG?, NJW 2010, 1789, 1792; VERSE, Das Beschlussmängelrecht nach dem ARUG, NZG 2009, 1127, 1130 et seq.

[65] For a critical appraisal see AUSTMANN, *supra* note 13, marg. no. 88.

section I.1), these objections are now considered manifestly unfounded, so the release proceedings may succeed on these grounds.[66]

VI. Conclusion

Looking at the whole picture this article concludes on a positive note. Today, the squeeze-out procedure as such is widely accepted both in academic scholarship and in practice. The most critical points are hidden in the details of its requirements, its procedure and most of all its judicial review. But this last point in particular is not so much an issue specific to the squeeze-out but a general problem in current German corporate law. While further research is needed in this area, the squeeze-out-procedure in itself offers few points for criticism.

[66] OLG Düsseldorf, 16 January 2004, 16 W 63/03, AG 2004, 207, 208; OLG Oldenburg, 30 September 2002, 1 W 45/02, AG 2002, 682; LG Osnabrück, 5 July 2002, 13 O 177/02, AG 2002, 527; J. KOCH, *supra* note 1, § 327e marg. no. 3b; WIRTH/ARNOLD, Anfechtungsklagen gegen Squeeze-out-Hauptversammlungsbeschlüsse wegen angeblicher Verfassungswidrigkeit, AG 2002, 503, 506; for a critical view see LG Hamburg, 13 January 2003, 415 O 140 /02, AG 2003, 279.

Squeeze-out (or the Lack Thereof) in the Regulation of Corporate Mergers in China

*Jiangyu Wang**

I. Introduction 225
II. Regulatory Framework of Mergers in China 227
III. The Majority-Minority Shareholder Conflict in Takeovers 228
IV. Alterantive Mechanisms to Squeeze Out Minority Shareholders: Short-Form Merger and Corporate Liquidation 229
V. Reasons Behind the Absence of Squeeze-out in China 230
VI. Prospects for Legislating Squeeze-out in the Future 232
VII. Concluding Remarks 234

I. Introduction

Squeeze-out, also known as freeze-out, is the compulsory sale of a minority shareholders' shares to the controlling shareholder. Many jurisdictions provide squeeze-out techniques in merger transactions so that a controlling shareholder can use the merger structure to get rid of minority shareholders either for cash or stock. In a squeeze-out takeover, the acquiring company, or bidder, is given the right to force the minority shareholders to sell their shares to the acquirer. Thus, under French law, "a shareholder group holding 95 percent or more of voting rights in a listed company may eliminate the minority by making a public offer to acquire their shares, followed by a compulsory acquisition of the shares of the non-accepting shareholders".[1] German law permits a squeeze-out procedure "at the 95 percent level for all public companies".[2] In the United States, a minority freeze-out transaction is typically accomplished by either by a one-step merger or a two-step deal in which a tender offer is followed by a short-form merger. According to Sec. 253 Delaware General Corporation Law, if at least 90 percent of a corporation's shares

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[1] R. KRAAKMAN et al., The Anatomy of Corporate Law, (3rd ed., Oxford 2017) 190.

[2] KRAAKMAN, *supra* note 1, 191.

are owned by another corporation, the two corporations can merge into each other. Under the UK Companies Act 2006, the squeeze-out right may be exercised in a takeover transaction in which the bidder has acquired or has unconditionally contracted to acquire "not less than 90% in value of the shares [of any class] to which the offer relates" or where the shares of that class are voting shares with "not less than 90% of the voting rights carried by those shares".[3]

A conspicuous feature of China's takeover regulation is that it lacks explicit procedures for squeezing out minority shareholders. The absence of such right is curious both legally and practically. From the legal perspective, since 1998 (when the PRC Securities Law was adopted), China has established rather sophisticated legal and regulatory frameworks for the takeover of listed companies, in which most of the major issues concerning takeovers have been addressed. The doctrine of squeeze-out, however, is lacking. From a practical perspective, the market for mergers and acquisitions (M&A) in China, including the takeover of listed companies, is already tremendously large and nevertheless rapidly growing. According to a report of PricewaterhouseCoopers, the number of deals in the China-related M&A market reached 11,400 in 2016, having increased by 21% from the previous year. The total M&A value was 770 billion US-Dollars, an increase of 11% from 2015.[4] It is only natural for one to wonder, in such an immense market, why squeeze-out has not been legislated to increase the efficiency of corporate takeovers. But, on the other hand, not having an explicit squeeze-out rule does not necessarily entail a shortage of means to expel minority shareholders from a Chinese company, with of course fair compensation.

This chapter aims to explain the possible reasons for the lack of squeeze-out under Chinese law in the context of majority-minority shareholder conflict in corporate takeovers. It starts with an overview of the regulatory framework of takeovers in China, followed by a discussion on the majority-minority conflict and minority shareholder protection in the takeover process. Then, in light of the absence of a clear rule for squeeze-out, it considers the alternative mechanisms available in Chinese corporate and securities law to expel minority shareholders in mergers. Afterwards, the chapter discusses the future prospects for legislating squeeze-out in China.

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[3] Sec. 979 para. 2 UK Companies Act.

[4] "2016年中国企业并购市场回顾与2017年展望", 12 January 2017, PricewaterhouseCoopers (China), at <http://www.careers.pwccn.com/webmedia/doc/636202604771950933_ma_press_briefing_jan2017_chi.pdf>.

II. Regulatory Framework of Mergers in China

Fundamental changes in a Chinese company may involve corporate combination (merger) and corporate division. These fundamental changes are loosely called "mergers and acquisitions" (M&A).[5] The Company Law talks of two types of mergers: merger by absorption *(xishou hebing),* which is effected by the absorbing of one existing company into another, and merger by new establishment *(xinshe hebng),* in which two existing companies are consolidated into a new one.[6]

The controlling interest of a public company, known as a joint stock limited company or a company limited by shares, can be purchased by an acquirer through acquisition of the shares of the public company in the stock market. This process is called a takeover, the acquisition of the control of a public company by way of private sale, tender offer, or public trading of shares. It is as a part of this process that this chapter considers squeeze-out and its alternatives in Chinese corporate and securities law.

The foundational framework for regulating the takeover of listed companies was first codified in the PRC Securities Law of 1998, which outlines the guiding principles for corporate takeovers.[7] Authorized by the Securities Law,[8] the China Securities Regulatory Commission (CSRC), China's regulator of its stock market, promulgated the Administrative Measures for the Takeover of Listed Companies in 2002, which was redrafted in 2006 and most recently revised by the CSRC in 2014 (hereinafter the "Takeover Measures").[9] According to the Takeover Measures, the acquirer and persons acting in concert with it must disclose their foothold position when their ownership of the target company reaches 5 percent, and when there is any increase or decrease by 5 percent of the company's total outstanding shares. On this basis, the acquirer may launch a takeover by tender offer, through which the acquirer proposes to publicly and openly purchase shares directly from shareholders of the target company.[10] It also may negotiate a share transfer agreement privately with a shareholder owning controlling blocks of the target company's shares. The mandatory bid rule applies to both tender offers and private sale deals. That is, if the shareholding of the acquirer and persons acting in concert with it reaches 30 percent of the target company's

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[5] J. WANG, Company Law in China: Regulation of Business Organizations in a Socialist Market Economy (Cheltenham 2014) 298.

[6] PRC Company Law (中华人民共和国公司法, promulgated in December 1993 and most recently revised in December 2013), Art. 172; see also WANG, *supra* note 5, 298.

[7] Arts. 85–101 PRC Securities Law (中华人民共和国证券法, promulgated in December 1998 and most recently revised in 2014.

[8] Art. 101 PRC Securities Law.

[9] Takeover Measures (上市公司收购管理办法).

[10] Art. 23 Takeover Measures; see also WANG, *supra* note 5, 319.

total outstanding shares and the acquiring group still wishes to continue to buy shares, it is to issue a tender offer to all the shareholders of the listed company to buy all or part of the shares held by all the shareholders.[11]

In the case of a tender offer, the acquirer must disclose information in the form of a takeover report, in which the acquirer must indicate its follow-up plans for the target company in respect of effecting any changes to the company's assets, business, personnel, organizational structure or articles of association.[12]

III. The Majority-Minority Shareholder Conflict in Takeovers

Naturally, Chinese corporate and securities law assumes the acquirer is in the stronger position relative to the non-controlling shareholders in mergers, and thus it provides several mechanisms for minority shareholders to be involved in the decision-making concerning the merger, or to ultimately leave the company. First of all, the approval of the shareholders' meeting, which is defined as the "power organ" of the company,[13] is required for fundamental corporate changes such as combination, division, dissolution, liquidation, and change of the corporate form.[14] In fact, a two-thirds supermajority of the total voting rights held by all the shareholders is required for approving such fundamental changes.[15] Secondly, the board of directors of the target company is required to engage an independent financial consultant to provide an independent assessment of the merger terms.[16] Third, minority shareholders have statutory appraisal rights. That is, a shareholder who objects to the resolution passed by the shareholders' meeting concerning a merger or division involving the company can request the company to buy back the shares he or she owns.[17]

However, the most salient right the law confers upon minority shareholders is minority buyouts. Pursuant to Art. 97 PRC Securities Law, the target company in a takeover will be delisted by the stock exchange if it no longer meets the listing conditions. In such a situation, all other shareholders would be entitled to sell their shares to the acquirer on the same terms of the takeover.[18] The Securities Law mandates that, among other requirements, a listed company's total share capital must not be less than Renminbi 30 million and

[11] Art. 88 PRC Securities Law; Arts. 30 and 47 Takeover Measures.
[12] Art. 29 para. 11 Takeover Measures.
[13] Art. 36 PRC Company Law.
[14] Arts. 37 and 99 PRC Company Law.
[15] Arts. 43 and 103 PRC Company Law.
[16] Art. 67 Takeover Measures.
[17] Art. 142 PRC Company Law.
[18] Art. 97 PRC Securities Law.

publicly issued shares must account for at least 25% of the company's total outstanding shares (the figure is at least 10% if the company's share capital exceeds Renminbi 400 million).[19] The Listing Rules of the Shanghai Stock Exchange further increased the total share capital requirement from Renminbi 30 million to 50 million.[20] The Shanghai Stock Exchange may also terminate the listing of a company's shares if the company exhibits major defects in respect of revenue-making, information disclosure, low trading volumes or share trading prices below par value.[21]

As can be seen from the listing rules, Chinese securities law facilitates minority buyouts when the controlling shareholder owns more than 75% of the total shares of a company having share capital of less than Renminbi 400 million or when it owns more than 90% of the total shares of a company having share capital of more than Renminbi 500 million.

IV. Alterantive Mechanisms to Squeeze Out Minority Shareholders: Short-Form Merger and Corporate Liquidation

The absence of a squeeze-out right does not mean that an acquirer will have no means to purge a non-accepting minority shareholder from the company. In fact, it is legally permissible to have a "short-form merger" of a parent corporation and its subsidiary under Chinese company law. When a company acquires the controlling interest of another company with the intention to merge, it could initiate a corporate combination in accord with the Company Law. Such a combination would be achieved through the following procedures:

a. The parent company and the subsidiary sign a merger agreement.[22]
b. The boards of directors of both companies produce a plan for the combination[23] and the shareholders' meetings of both companies approve the merger plan and agreement with two-thirds of the total voting rights.[24]
c. The companies formulate balance sheets and checklists of assets, notify their creditors within 10 days, and make a public announcement in newspapers within 30 days after the shareholders' meetings has adopted the resolutions to merge. The company would have to pay the debts or provide guarantees to the creditors who raise objections.[25]

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[19] Art. 50 PRC Securities Law.
[20] Art. 5.1.1 Listing Rules of the Shanghai Stock Exchange (2014 version).
[21] Art. 14.3.1 Listing Rules of the Shanghai Stock Exchange (2014 version).
[22] Art. 173 PRC Company Law.
[23] Arts. 46 and 108 PRC Company Law.
[24] Arts. 43 and 103 PRC Company Law.
[25] Art. 173 PRC Company Law.

d. The merger is completed either by the parent company absorbing the subsidiary, or the parent company and the subsidiary are combined into a new company. In either case, the target company/subsidiary will be dissolved without liquidation.

Absent the squeeze-out rule, the controlling shareholder cannot expel non-accepting minority shareholders from a company in which they are both shareholders. But, clearly, the controlling shareholder, as the acquirer, can absorb the target company/subsidiary into the acquier itself, thus causing the dissolution of the target company. However, the price for the acquirer is that it still cannot totally do away with the non-accepting shareholders, who will end up becoming shareholders in the acquiring company.

As noted, the short-form merger as examined above does not involve corporate liquidation. In order to merge the subsidiary into the acquiring company – or, inversely, merge the parent company into the subsidiary, no company needs to be liquidated. However, at least theoretically, the controlling shareholder can banish the minority shareholders from the whole system by dissolving and liquidating the subsidiary. Under Art. 180 PRC Company Law, a company can be dissolved if the shareholders' meeting passes a resolution deciding to do so. That is, the acquirer, as the controlling shareholder, can easily initiate the company's voluntary dissolution, which is to be followed by liquidating and deregistering the company.[26] Naturally one would question the practicality of such a scorched-earth policy, as by doing so the acquirer would not only lose the target company as a subsidiary but also have to deal with the liquidation formalities and other troubles, including paying the company's debts and dismissing employees.

V. Reasons Behind the Absence of Squeeze-out in China

Why does China still not have the squeeze-out rule? The first reason goes to the power of the conventional wisdom that no person should be coerced into handling his/her properties in ways not desired by him/her, especially by another private person. Art. 71 General Principles of Civil Law, promulgated in 1986 and once China's mini civil code,[27] states that "the owner of a property enjoys the rights to possess, use, benefit from and dispose of the property", subject only to constraints imposed by the law. Property rights are of course not absolute in the Chinese legal system. Indeed, the many exceptions carved

[26] WANG, *supra* note 5, 340–348.

[27] The National People's Congress enacted the General Provisions of Civil Law in March 2017, which is purported to be the General Provisions part of an ambitious PRC Civil Law.

out in the property law system in China make it easy for the state to interfere in citizens' exercise of property rights.[28] However, there is little room in the Chinese legal culture to tolerate the oppression of the weak by the rich through openly stripping the latter of their property. As squeeze-out would deprive the minority shareholders of their civil law rights to freely dispose over their property – absent provisions in the national law to limit the protection of shareholders' rights for the sake of protecting public interests – it does not currently fit in the Chinese legal culture and contradicts the fundamental principles of China's civil and commercial law.

A more important reason, however, might be that squeeze-out is not yet highly demanded in the market for corporate control in China. As noted by Fang Zheng, a senior official of the CSRC:[29]

> "In a stark contrast with the situation of developed economies that where voluntary delisting is a normal, there are very few cases of delisting listed company through going private in China. In 2005, the China National Petroleum Corporation (CNPC) spent Renminbi 6 billion to publicly purchase the shares of JilinChem, Liaohe Oilfields, and JinzhouChem, three of CNPC's own subsidiaries, which was the first instance in China's A Shares market whereby a listed companies was delisted as a result of a general tender offer from the parent company. In 2006, SinoChem spent Renminbi 14.3 billion to buy the shares of YangtzeChem, Zhongyuan Oil & Gas, PetroDaming and Qilu Chem, still four of SinoChem's own subsidiaries, through a general tender offer. After this, the A Shares market experienced a 7-year "vacuum" period without any going-private case until 2013, when Shenhua Guoneng Co., the controlling shareholder of Jinma Group Limited, took the latter private via a general tender offer. Jinma Group Limited became the eighth listed company that was delisted by way of going private. Clearly, going-private transactions by listed companies in our country are very scarce and have mainly involved reorganization of state-owned enterprises and state assets, which makes it questionable whether there is a market need for the squeeze-out mechanism in China."

It has been further noted that the existing regulatory framework for corporate takeover does not pose a material obstacle to the complete acquisition of a target company through a general tender offer.[30] For instance, in the aforementioned Jinma takeover case, "there were indeed non-accepting shares constituting 0.51% of Jinma's total ownership. Without Shenhua Guoneng squeezing those non-accepting shareholders out, the going-priviate transaction was nevertheless smoothly completed, and the non-accepting shareholders did not effect a material (negative) impact on the post-privatization opera-

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[28] As Pitman B. Potter has noted, while the Property Rights Law of the PRC, which came into force in 2007, "provides a basic foundation for property relations in China's changing political economy, it also reflects the policy tensions around the protection of public and private rights." See P. B. POTTER, China's Legal System (Cambridge 2013) 114.

[29] F. ZHONG, Building the Squeeze-Out Mechanism], *China Finance* (2015) 64. [方重：“构建余股强制挤出机制”，《中国金融》，2015年第9期].

[30] ZHONG, *supra* note 29, 64.

tion of the company."[31] That is to say, so far there has been no case of strong resistance from minority shareholders in the limited number of corporate takeover cases, thus rendering no need for the controlling shareholder to squeeze anybody out.

VI. Prospects for Legislating Squeeze-out in the Future

Granting the controlling shareholder a squeeze-out right has its grounds first of all in efficiency. From a comparative law perspective, some of the world's leading corporate law jurisdictions, defined as the "core jurisdictions" by a classic comparative corporate law work,[32] enable the compelled sale of minority shares in subsidiaries for the following efficiency-based reasons. First, such transactions "eliminate the chronic conflicts of interest between parent companies and partly owned subsidiaries that arise from intra-group self-dealing transactions and allocations of business opportunities". Second, they may encourage controlling shareholders to allow minority shareholders to "cash out of otherwise illiquid investments". Third, "controlling shareholders may be less inclined to invest additional capital in positive net present-value projects if they are forced to share their returns with minorities". Finally, squeezing out minority shareholders is indispensable in going-private transactions that eliminate the costs of being a public company, thus adding additional value to the company.[33]

In the Chinese context, both efficiency and legal fairness have been raised as reasons to advocate for a codification of squeeze-out. It has been argued that, economically, squeezing out minority shareholders can prevent the latter from constraining the implementation of the controlling shareholder's business strategy. It can also save the controlling shareholder costs in regard to prolonged negotiations with the minority shareholders, burdensome information disclosure, and involvement in litigation (direct or derivative action) initiated by minority shareholders.[34]

It has also been argued, from a legal perspective, that it is unfair to deny the controlling shareholders the squeeze-out right. As mentioned previously, when the controlling shareholder has acquired an overwhelming majority of the company's shares, that company will be delisted because it no longer meets the listing conditions. In such a situation, the minority shareholders would be entitled to sell their shares to the controlling shareholders per the "sell-out" right provided in Art. 97 Company Law. This could be counterbal-

[31] ZHONG, *supra* note 29, 64.
[32] KRAAKMAN, *supra* note 1, 3.
[33] KRAAKMAN, *supra* note 1, 174.
[34] ZHONG, *supra* note 29, 63.

anced only by giving the controlling shareholder a squeeze-out right, according to scholarly writing in China.[35]

Several signs have suggested that the codification of squeeze-out is indeed being seriously considered by Chinese regulators and lawmakers. First, on 15 October 2014, the CSRC issued the document "Several Opinions on Reform, Improvement and Strict Implementation of the System for Delisting Listed Companies",[36] in which the CSRC proposed to establish the squeeze-out mechanism to facilitate voluntary corporate delisting in the stock market. This happened when the National People's Congress, China's central legislature, was considering a draft which aimed to substantially amend the PRC Securities Law.[37] Art. 122 of the draft provides:

> "After the expiration of the tender offer, if the acquirer has acquired 90 per cent of the total voting shares from the non-affiliated shareholders of a listed company, or 95 per cent of the total voting shares of a listed company, the acquirer shall be entitled to acquire the remaining shares held by other shareholders in the company by the same terms of the tender offer, and the other shareholders shall so sell their shares."

It is also postulated in the aforesaid Art. 122 that the other shareholders have the right to bring legal action against the acquirer if the acquirer violated laws and administrative regulations and harmed the interests of the other shareholders when exercising the squeeze-out right. Presumably, this means to indicate that squeeze-out may be a legal entitlement, but it is not an absolute right. At a minimum, it is to be exercised by the acquirer in good faith.

It is however not clear when the draft of the new Securities Law will be passed by the Chinese legislature. Debate on the amendment has focused on whether China should keep the approval system for initial public offerings (IPO) of shares and switch to the so-called registration-based share issuance system. This ideal was enthusiastically embraced by lawmakers,[38] but it has apparently been dropped from the draft according to a more recent report.[39] It

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[35] ZHONG, *supra* note 29, 63. See also D. LI, Research on Improving the Regulatory System for the Takeover of Listed Companies, Tribute of Political Science and Law, Vol. 33 (2015) 123–124. [李东方："上市公司收购监管制度完善研究"，《政法论坛》第33卷第6期 (2015)].

[36] Chinese text available at <http://www.csrc.gov.cn/pub/zjhpublic/zjh/201410/t20141017_261947.htm>.

[37] The draft has not been officially released by the NPC but was made accessible to the public at a quasi-official website at <http://www.financialservicelaw.com.cn/article/default.asp?id=4777>. Reportedly, the amendment "added more than 100 pieces of content, modified about 100 existing ones and deleted about 20 ones" with respect to the Securities Law; see L. XIANG, Amendment to Securities Law to Get Green Light, China Daily*,* 11 March 2015, at <http://www.chinadaily.com.cn/bizchina/2015-03/11/content_19775585.htm>.

[38] See XIANG, *supra* note 37.

[39] See "Draft Amendment to Securities Law Submitted for Review", Xinhua Finance Agency, 25 April 2017, at <http://en.xfafinance.com/html/Dont_Miss/2017/324431.shtml>

is unclear whether the squeeze-out right will be finally introduced into the bill presented to the NPC.

VII. Concluding Remarks

In examining the "transplant effect" in the process of legal transplantation and reception, Berkowitz, Pistor and Richard (2003) argued that "for law to be effective, a demand for law must exist so that the law on the books will actually be used in practice and legal intermediaries responsible for developing the law are responsive to this demand".[40] Thus, legal reform with a view to borrowing laws from foreign counties should make attempts "to induce an internal process of law development and to generate a self-sustaining demand for legal innovation and change".[41]

The nonexistence of the squeeze-out right in the regulation of corporate takeovers in China is mainly attributed to two interrelated factors. First, the demand from the market for such a legal institution is not high enough. Second, there are alternative mechanisms for the controlling shareholder to drive out minority shareholders in case of need. In the early stage of China's legal development, it often imported foreign laws in whole packages, without caring too much about whether they could work or not in the Chinese environment.[42] However, the hesitation of Chinese regulators and lawmakers in bringing squeeze-out to the market for corporate control in China may suggest that legal transplantation in China is increasingly being generated by internal demands, rather than simply following foreign examples.

(reporting the statement of AN JIAN, a vice-chairman of the NPC Law Committee, that "[p]reparatory works for the registration-based IPO system are still under way", and therefore "NO specific reform measures have been introduced yet").

[40] See D. P. BERKOWITZ/K. PISTOR/J. RICHARD, The Transplant Effect, American Journal of Comparative Law, Vol. 51 (2003) 167 et seq.

[41] BERKOWITZ/PISTOR/RICHARD, *supra* note 40, 167et seq.

[42] For example, the importation of the supervisory board system from Germany into China's Company Law (1993) was proven to be fruitless and almost useless; see J. WANG, The Strange Role of Independent Directors in a Two-Tier Board in China's Listed Companies, in: Nakamura (ed.), Changing corporate governance practices in China and Japan: adaptations of Anglo-American practices (Basingstoke 2008), 189 et seq. (discussing the "ineffectiveness of the supervisory board").

Corporate Law Rules on Squeeze-outs in Korea

A Comparative Study

*Moon Hee Choi**

I. Introduction 235
II. The Rationales for Squeeze-out and the Protection of Minority Shareholders...........237
1. Controlling Shareholders' Rationales and Motives for Squeeze-out.....................237
2. Protection of Minority Shareholders...240
III. The Regulatory Framework on Squeeze-outs and Sell-outs in Korea........................242
1. General 242
2. Scope of Application...243
3. Approval at a Shareholders' Meeting 247
4. The Procedure for Determinants of a Sale Price...247
5. Transfer of Shares...253
IV. Comparative Analysis: the Similarities and Differences..254
1. General 254
2. Similarities...255
3. Differences 263
4. The Feasibility of Squeeze-outs and Other Alternatives in Korea 267
V. Conclusion 269

I. Introduction

A *squeeze-out*[1] is a transaction in which a controlling shareholder forces minority shareholders to sell their shares to the controlling shareholder,[2] thereby

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[1] In the US, the term squeeze-out is known, with some occasional loss of precision, as freeze-out. For more details, see R. C. CLARK, Corporate Law (Boston 1986) 497. In European jurisdictions, the term squeeze-out is often used interchangeably with freeze-out. Directive 2004/25/EC of The European Parliament and of the Council of 21 April 2004 on takeover bids, Official Journal of the European Union L142/12 (April 30, 2004).

[2] G. SUBRAMANIAN, Fixing Freezeouts, 15 Yale L. J. 2 (October 2005), note 1.

compelling minority shareholders to lose their status as shareholders. As described later, controlling shareholders have economic rationales and motives to squeeze-out minority shareholders, and in some situations a squeeze-out might be justified. Accordingly, most jurisdictions allow, in one way or another, the squeeze-out of minority shareholders.[3] The rules on squeeze-out, however, differ among jurisdictions. Even among European jurisdictions the rules are not identical.[4] This is noteworthy, as convergence in corporate and capital market law has been progressing among jurisdictions.

The Korean Commercial Code (KCC)[5] introduced provisions for a supermajority type of corporate squeeze-out (Arts. 360-24–360-26) in 2011, modelled after the German Company Code (GCC; *Aktiengesetz* §§ 327a–327f), which has often inspired the enactment of Korean corporate rules. Although the provisions of the KCC for a squeeze-out are quite similar to those of the GCC, the contents of the relevant provisions differ.[6] It has been only five years since the new Korean provisions for a squeeze-out have come into effect. Only a few suits contesting squeeze-outs have been filed in Korea.[7] The meanings of relevant provisions are quite ambiguous, and Korean courts are wrestling with how to interpret the requirements of squeeze-outs. Some issues regarding a squeeze-out can be crystallized clearly by a comparative analysis of squeeze-outs in Germany, where the relevant issues have been more hotly debated.

The purpose of this paper is to examine the Korean rules on squeeze-out in comparison with German law and to assess the law and reality of squeeze-out in Korea from a broader comparative perspective. As is well known, devices for squeeze-out are classified into two categories: one is a takeover bid-related squeeze-out as in a compulsory acquisition, following a takeover bid,

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[3] P. DAVIES/K. J. HOPT, Control Transactions, in: Kraakman et al. (eds.), The Anatomy of Corporate Law: A Comparative and Functional Approach, (3rd ed., Oxford 2017) 264.

[4] For a comprehensive comparative study among European jurisdictions, see C. ELST/L. STEEN, Balancing the Interests of Minority and Majority Shareholders: A Comparative Analysis of Squeeze-out and Sell-out Rights, 4 ECFR (2009) 391–439.

[5] Unlike most advanced jurisdictions, Korea does not have an independent code of company law. The statutes related to stock companies are contained mostly in the third book of the Commercial Code. As to basic information on the KCC regulation of Korean companies, see K. KIM/M. CHOI, Declining Relevance of Lawsuits on the Validity of Shareholder Resolution in Korea: A Comparative Essay, in: Fleischer/Kanda/Kim/Mülbert (eds.), German and Asian Perspectives on Company Law: Law and Policy Perspectives (Tübingen 2016) 217.

[6] For a brief comparative study of the US, UK, Germany, and the Korean Reform Bill of 2008, see H. RHO, New Squeeze-Out Devices as a Part of Corporate Law Reform in Korea: What Type of Device Is Required For a Developing Economy? 29 Boston Univ. Int'l L. J. (2011) 41 et seqq.

[7] As of 11 December 2017, only one decision has been rendered at the Supreme Court of Korea. Supreme Court, 14 July 2017, 2016Ma230. The suit was filed by minority shareholders contesting the price of shares.

and the other is corporate law squeeze-out as stipulated in the GCC. This paper will focus mainly on the latter, as Korea does not stipulate the former type of squeeze-out.

This paper proceeds as follows. Section II starts first with the rationales and motives behind squeeze-outs from the perspective of the companies and controlling shareholders in Korea. In addition, concerns about squeeze-outs from the perspective of the protection of minority shareholders will be addressed. To balance competing concerns, this paper will mention why a policy analysis weighing the advantages and disadvantages of a squeeze-out is needed – not only for controlling shareholders, but also for minority shareholders.

Section III sets forth the legal framework on Korean squeeze-outs in comparison with German law. In section IV, the similarities and differences between Korea and Germany will be analyzed. Additionally, in analyzing the reality of the supermajority type of squeeze-out, this paper will explain other techniques such as cash-out mergers and comprehensive share exchanges, that may also function as squeeze-outs in comparison with the supermajority type of squeeze-out. Finally, this paper will conclude with a few remarks about the feasibility and usefulness of the supermajority type of squeeze-out.

II. The Rationales for Squeeze-out and the Protection of Minority Shareholders

1. *Controlling Shareholders' Rationales and Motives for Squeeze-out*

a) *Incentive for Delisting*

On the part of controlling shareholders, common economic factors justify and motivate the execution of a squeeze-out. For listed companies, squeeze-out is a convenient way to delist themselves from stock exchanges, in particular, following a takeover. Even though no reliable survey on squeeze-outs has been published in Korea, it can be inferred from tender offer statistics that listed companies need squeeze-outs for delisting. Table 1 shows related tender offer statistics for the purpose of voluntary delisting in Korea from 2012 to 2016.[8] Table 2 shows the number of tender offers for voluntary delisting and squeeze-out plans in tender offer reports. Squeeze-out provisions of the KCC took effect in 2012. Since then, according to Table 1, 23 out of 63 tender offers were for the purpose of delisting accounts (about 36.5%). Tender offers for delisting might be executed not only for eliminating minority

[8] The Korean Financial Supervisory Service provides statistics on going-private tender offers on its website, *available* at <http://dart.fss.or.kr>. The present author reviewed all tender offer reports from 2012 to 2016.

shareholders but also for other reasons. Out of the above-mentioned 23 cases, controlling shareholders in 18 cases (accounting for 78.2%) tried to acquire all shares. In addition, in 10 cases out of the 18 cases (accounting for 55.6%), the offers contained explicit plans for squeeze-outs following tender offer in tender offer reports.

Table 1: All Tender Offers (2012–2016)

Purpose of Tender Offer	Year					Total
	2012	2013	2014	2015	2016	
Holding Company Requirement	6	2	6	8	7	29
Delisting	7	3	6	5	2	23
Other	1	1	1	3	1	7
Securing Management's Position	1	–	1	1	–	3
M&A	–	1	–	–	–	1
Total	15	7	14	17	10	63

Source: <http://dart.fss.or.kr>

Table 2: Tender offers for voluntary Delisting and Squeeze-out Plan (2012–2016)

	Year					Total
	2012	2013	2014	2015	2016	
Voluntary Delisting	7	3	6	5	2	23
Plan for Acquiring All Shares	5	3	5	3	2	18
Explicit Plan for Squeeze-out	2	1	3	2	2	10

Source: <http://dart.fss.or.kr>

These statistics may suggest whether and how much listed companies need voluntary delisting and squeeze-outs. Companies may to choose to delist for several financial, regulatory, and organizational reasons, which are intertwined and mutually interactive. Cost-benefit analyses motivate going-private when the net costs of being a listed company exceed the benefits.[9] This may be because of the costs of complying with the mandatory disclosure system or because of the costs of complying with the mandatory provisions of the listed company regulatory structure. The common motive for delisting is to avoid the cost of compliance with securities laws and regulations. Aside from the

[9] M. VENTORUZZO, Freeze-Outs: Transcontinental Analysis and Reform Proposals, 50 Va. J. of Int'l L. 841, 847 (Summer 2010). For a more detailed overview and reasons for delisting, see VENTORUZZO, *Id.*

costs of mandatory disclosure,[10] listed companies are subject to vexatious lawsuits associated with a publicly-held status.[11] Going private and delisting curbs the risk of disruptive private class litigation. As the European Commission stated,[12] via squeeze-out the bidder can be liberated from costs and risks that the continued existence of minority shareholders could trigger.

b) Reducing the Cost Regarding Minority Shareholders

While the aforementioned statistics and considerations are limited to listed companies, another reason for a squeeze-out is relevant to listed companies as well as non-listed companies in Korea. Management and controlling shareholders want to operate companies efficiently and reduce the cost of retaining small minority shareholders. Retaining small minority shareholders can be fairly costly to companies.[13] It takes substantial resources to hold the general shareholders meeting (GSM), and any minority shareholders with small fractions of shareholdings, even one single share, have the right to participate at GSM. Minority shareholders may bring lawsuits contesting the validity of shareholder resolution (SR lawsuits), when there are 'procedural' defects in the procedures of the GSM.[14] The Supreme Court of Korea, however, despite the defects in convening a GSM,[15] made favorable rulings for the defendant companies, suggesting that a resolution is deemed to be valid when all shareholders or the sole shareholder are present at the GSM. Hence, companies with a sole shareholder can avoid the costs related to convening and holding a GSM. Moreover, although derivative suits are far more infrequent than SR

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[10] In Korea, under the Financial Investment Services and Capital Markets Act (CMA) companies listed in the Korean Stock Exchange (KRX) are supposed to submit to the Financial Services Commission (FSC), Korea's financial regulator, the Financial Supervisory Service (FSS) and the KRX (i) annual business reports *(sa-eop-bo-go-seo)* within 90 days after the end of each business year, (ii) semi-annual reports *(ban-gi-bo-go-seo),* and (iii) quarterly reports *(bun-gi-bo-go-seo)* within 45 days after the end of the respective period (Art. 160 CMA). In addition, listed companies are also required to notify the FSC or the FSS of material events no later than one day after the event (Art. 161 para. 1 CMA).

[11] In Korea, although securities class actions are rare, securities litigation based on several substantive grounds under the CMA are generally increasing.

[12] European Commission, Report on the Implementation of the Directive on Takeover Bids, February 2007, at 9, stating the aim of squeeze-out rules is to force minorities out of the company, liberating the bidder from costs and risks that the continued existence of minority shareholders could trigger.

[13] M. HABERSACK, in: Emmerich/Habersack, Aktien- und GmbH-Konzernrecht, 8th ed. 2016 § 327a marg. no. 4.

[14] Regarding procedural defects, the KCC provides for lawsuits to rescind a resolution ("a rescission lawsuit") `and lawsuits to confirm the non-existence of a resolution ("a non-existence lawsuit"). For a more detailed discussion, see KIM/CHOI, *supra* note 5, Table 4.

[15] Supreme Court, 10 December 2004, 2004Da25123.

lawsuits, derivative suits have recently been brought more often in Korea.[16] During the period from 1995 to 2004 only 9 derivative suit decisions were produced by the Seoul Central District Court, the largest district court in Korea, while 29 decisions were produced from 2005 to 2013. These shareholder suits were brought without merit. In Korea, nuisance suits are less serious than in Germany, where pending SR lawsuits can block the implementation of important shareholder resolutions regarding restructuring,[17] and a plaintiff may file an SR lawsuit merely to hinder its progress. Still, in Korea, shareholder suits have great potential for abuse as well.

In addition, minority shareholders have rights of information and rights of access to the books of companies. Although the shareholdings of minority shareholders are quite low, the costs related to these rights are almost the same. These costs can be avoided by eliminating minority shareholders from companies.

Taken all together, squeeze-out is a means to reduce the costs regarding remaining minority shareholders and to manage a company more efficiently.[18]

c) Benefits of Holding Companies

Being a holding company may be another reason why companies execute squeeze-outs. In Korea, holding companies receive favorable tax treatment, in the form of a consolidated tax return system under the Korean Corporate Tax Act (Art. 76-8 para. 1).[19] According to this system, a holding company and its wholly owned subsidiary may report their tax using a consolidated system rather than a separate tax return system. Hence, holding companies can reduce the tax burden on the subsidiary. Needless to say, they may try to meet the 100% shareholding requirement for the consolidated tax return system and thus have an incentive to squeeze-out minority shareholders.

2. Protection of Minority Shareholders

a) Infringement of Shareholders' Property Rights

Despite rationales and motives for squeeze-outs from the point of view of controlling shareholders, the danger of the squeeze-out transaction for minority shareholders can be great. There is a potential conflict of interests in a squeeze-out transaction.

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[16] See KIM/CHOI, *supra* note 5, Table 4.

[17] M. HABERSACK, Der Finanzplatz Deutschland und die Rechte der Aktionäre, ZIP 2001, 1230, 1231.

[18] Legislation and Judiciary Committee of the National Assembly of Korea, Legislative Objective of Korean Commercial Code Reform Bill, Bill No. 1801566, 21 October 2008, Art. 360-24.

[19] The consolidated tax return system took effect on 31 May 2010.

The first controversial issue for the protection of minority shareholders is whether a squeeze-out is unconstitutional. This point has been raised by plaintiffs in lawsuits to enjoin squeeze-outs, claiming the unconstitutionality of squeeze-outs under Art. 14[20] of the Federal Constitution of Germany (*Grundgesetz;* GG). In Germany, however, the Federal Constitutional Court of Germany (*Bundesverfassungsgericht*; BVerfG), ruled in the so-called *Feldmühle* decision in 1962 that Art. 14 of the GG should not exclude the squeeze-out of minority shareholders, against their will, from companies. In citing its precedents,[21] the BVerfG declared in the decision of 2007[22] that the limitation of the property rights of minority shareholders through a squeeze-out was not unconstitutional, provided that the minority shareholders were adequately compensated. According to the logic of BVerfG, the provisions concerning squeeze-outs (§§ 327a–327f) are in line with Art. 14 of the GG. The BVerfG also stated that two prerequisites are crucial for the protection of minority shareholders in terms of the constitutionality of a squeeze-out: adequate compensation and an effective legal remedy. The BVerfG held that these were satisfied in the squeeze-out provisions under the GCC.

By contrast, the unconstitutionality of a squeeze-out has not been debated yet among Korean legal commentators. Only the Seoul Central District Court, in an *obiter dictum,* suggested that the right of controlling shareholders to squeeze-out may restrict the property rights (Art. 23 para. 1 of Constitution of Korea) of minority shareholders, and the rights of the former should be restricted for public welfare (Art. 37 para. 2 of Constitution of Korea).[23] In following the reasoning of the BVerfG, basically, the Korean squeeze-out regime can also be constitutional, since it provides several safeguards for minority shareholders, such as adequate compensation, a device to enjoin a squeeze-out, and sell-out rights. Yet this does not mean that the Korean regime does not suffer from any defects working to the detriment of minority shareholders, as discussed later.[24]

In sum, both in Germany and Korea the provision of squeeze-outs is considered constitutional. Minority shareholders' ownership rights are considered an element of property rights under the Constitution, but the restriction of these rights is constitutional when the degree of restriction is considered legitimate. Whether the restriction is legitimate depends on adequate compensation for minority shareholders.

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[20] Under Art. 14 Federal Constitution of Germany, property and the right of inheritance is to be guaranteed.

[21] BVerfG, 23 August 2000, BvR 68/95; BVerfG, 23 August 2000, BvR 147/97, DStR 2000, 1659.

[22] BVerfG, 30 May 2007, 1 BvR 390/04, DStR 2007, 1177.

[23] Seoul Central District Court, 11 June 2015, 2014GaHap578720.

[24] See at IV.3.

b) Minority Shareholders' Rights

While squeeze-outs have several rationales on the part of controlling shareholders, they also give rise to situations in which agency problems occur between controlling shareholders and minority shareholders. A squeeze-out is, by its nature, a conflicting transaction, since whether to execute it and all its conditions, including the share price of sale and the timing of its execution, are determined by controlling shareholders. Thus, it is crucial to assure that the rights of minority shareholders are not expropriated by controlling shareholders.

To control the agency problem and protect minority shareholders, many jurisdictions have adopted a set of legal strategies,[25] which the KCC has adopted as well. These are divided into two subsets, which we can call "decision rights" and "exit rights." The first, most familiar, strategy is the power of minority shareholders to intervene in squeeze-out transactions, which includes both *ex ante* and *ex post* components. A GSM has *ex ante* power to approve a transaction. Minority shareholders can file a claim *ex post* contesting the validity of a shareholders' resolution ratifying a squeeze-out transaction, arguing that the price of a sale was not fair.

The second strategy, the exit right, is the right to sell out; it is the *quid pro quo* for the minority shareholder in relation to the squeeze-out right of the controlling shareholder. These strategies for the protection of minority shareholders will be dealt with in more detail below.

III. The Regulatory Framework on Squeeze-outs and Sell-outs in Korea

1. General

This section briefly overviews the rules on squeeze-outs and sell-outs in Korea. While most European Member states, including Germany, have incorporated 'takeover' squeeze-out and 'corporate' squeeze-out, as mentioned before, only the latter type of squeeze-out and sell-out rules is stipulated in Korea (Arts. 360-24–360-26 KCC).

The Korean government's Ministry of Justice (MOJ) proposed a reform bill[26] to amend the KCC in 2008, which included new provisions on squeeze-outs and sell-outs. The proposed provisions were implemented in part to respond to the lack of an efficient squeeze-out device. Before the enactment of corporate squeeze-out legislation, controlling shareholders, in practice, had to use less effective measures to compel minority shareholders to sell, consist-

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[25] See VAN DER ELST et al, *supra* note 4.

[26] Bill No. 1801566, 21 October 2008.

ing of a tender offer by the controlling shareholders and a subsequent voluntary delisting by listed companies. But whether squeeze-outs can be completed successfully by engaging in these two steps has been uncertain because of the risk of minority shareholders' refusing to sell their shares. Since the proposed provisions were designed to facilitate efficient transactions on the part of controlling shareholders, these were not so controversial. The proposed provisions concerning squeeze-outs and sell-outs were passed with minor modifications and took effect on April 14, 2011.

The KCC provides for squeeze-outs (Art. 360-24 KCC) as well as sell-outs (Art. 360-25 KCC). A controlling shareholder that holds 95% or more of shares, either alone or together with entities under its control, may require the remaining minority shareholders to sell their shares against their will to the former, but only with a proper business purpose. The squeeze-out plan must be approved in the GSM, where controlling shareholders must explain the squeeze-out plan, including their shareholdings, the purpose of the squeeze-out, and other details. Minority shareholders must sell their share to controlling shareholder within two months after controlling shareholders ask them to sell their shares. If the minority shareholders do not agree on a fair price presented by controlling shareholders, the court, finally, will determine the sale price.

To balance the interests between the controlling shareholder and minority shareholders, the KCC facilitates the right of sell-out for minority shareholders. Minority shareholders also have the right to demand that their shares be redeemed by the controlling shareholder (Art. 360-25 KCC). The conditions under which the minority shareholders can exercise the sell-out right mirror those of the squeeze-out right.

The particular requirements and procedures for squeeze-outs will be described in more detail in the following section. Rules on the scope of application – excluding the requirement of having a business purpose (*infra* 2.) – and those on the transfer of shares (*infra* 5.) to controlling shareholders are also applied to the right of sell-out. Needless to say, the provision on approval at a shareholder meeting (*infra* 3.) is not necessary in the case of the right of sell-out.

2. *Scope of Application*

a) *Types of Companies Covered*

The provisions on squeeze-outs and sell-outs are applicable to all stock companies and are not restricted to listed ones. Although a controlling shareholder's right of squeeze-out is an unfamiliar device in corporate law, in Korea, it has not been argued whether to apply this exclusively to non-listed companies. However, in most cases, the provisions are likely to be applied to non-listed companies, since a company with a controlling shareholder level meeting the 95% threshold could have already been delisted, pursuant to the List-

ing Regulation of Korean Stock Exchange.[27] Since only 'corporate' squeeze-outs are incorporated into the KCC, the squeeze-out and sell-out procedures are not required to be tied to a preceding tender offer.

b) The 95% Threshold

(1) The Controlling Shareholder

The squeeze-out procedure under the KCC can start when a shareholder holds 95% or more of the shares in a company. The threshold of 95% need not necessarily be satisfied by a single entity. In calculating the 95% threshold, the controlling shareholder's shares can include the shares of a subsidiary[28] controlled by the controlling shareholder (Art. 360-24 para. 2 KCC). If a parent company has multiple subsidiaries, all shares of each subsidiary are aggregated to the shareholdings of the parent. Likewise, when one natural person (individual) owns more than 50% of shares in a company, all shares held by the person and the company are aggregated when calculating the 95% threshold.

One tricky problem regarding the 95% threshold is how to interpret the term *holding on her or his account* under Art. 360-24 para. 1of the KCC. First, commentators are divided on the meaning of the phrase "on her or his account." The prevailing opinion from Korean legal scholars is that it does not depend on "a nominal shareholder in the register of shareholders of the company, namely, a record owner," but on "a beneficial owner."[29] Second, the term *holding* is to be interpreted as actual ownership. Thus, where a person has been delegated to exercise shareholders' rights, the delegated shares are not aggregated to her or his shareholdings. Likewise, when a person joint-

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[27] For example, according to the KRX provision on delisting, a company can be delisted when the requirement of stock distribution has not been satisfied for two years. When the total number of the stocks held by general shareholders is less than 10% of the outstanding stocks, a company may be delisted, with an exception when the total number of general shareholders is two million or more. The term *general shareholders* means the shareholders of a company, excluding the largest shareholder and significant shareholders noted in Art. 9 para. 1 (ii) CMA.

[28] Under the KCC, the parent-subsidiary relationship is defined by formal shareholdings. If company A holds more than 50% of the shares in company B, A is deemed to be a parent of B (Art. 342-2 para. 1 KCC). The notion of a subsidiary is expanded to include companies in which the subsidiary or the parent and the subsidiary jointly hold more than 50% of the shares (Art. 342-2 para. 3 KCC).

[29] K. KIM/H. RHO/K. CHUN, *Hoesabop* [Corporate Law] (Seoul, 2016) 845 (in Korean); O. SONG, *Sangbopgangui* [Lectures on Commercial Law] (Seoul, 2016) 858 (in Korean). In contrast, one scholar argues that shares should be registered in the name of the controlling shareholder and, in addition, that the shareholder should own "on her or his account." See H. RHO, Sell-Out Rights of Minority Shareholders in the Revised Korean Commercial Code of 2011, *Inkwon gwa Jungui* Vol. 429 (November 2012) 123 (in Korean).

ly exercises the shareholding rights of two or more shareholders, these additional shares are not added to her or his shareholdings.

(2) Classes of Shares

In calculating the 95% threshold, the KCC does not differentiate among the classes of shares. One could well argue whether non-voting shares should not be included. Under the KCC, however, when a specific provision does not explicitly condition that only shares with voting rights should be included in calculating a certain threshold, all classes of shares are generally counted without regard to voting rights. Accordingly, non-voting shares are also added up together to calculate the threshold.[30] The KCC does not explicitly explain whether a squeeze-out and sell-out can be invoked on a class-by-class basis when several classes of shares have been issued. The same explanation mentioned above applies to this point.

(3) Treasury Shares

A particularly intriguing problem arises regarding treasury shares without voting rights under Art. 369 para. 2 of the KCC. Scholars are divided on whether the number of treasury shares is added up when calculating the threshold.[31] Recently, this issue was dealt with in the Supreme Court of Korea's decision.[32] The case at issue did not arise from a squeeze-out, but from a sell-out by two minority shareholders. As the threshold is a common requirement of both squeeze-out and sell-out, the decision could set an important precedent for how to treat treasury shares when interpreting the threshold.

A non-listed company, *The CD Networks Stock Corporations,* issued 14.3 million shares. Of those shares, the defendant, *The CD Networks Stock Corporations'* parent company and two plaintiffs owned 12,149,768 shares (84.96%) and 6,869 shares (0.048%), respectively. The number of treasury shares was 1,879,468, which amounted to 13.14% of the total. The plaintiffs asked the defendant to buy their shares pursuant to Art. 360-25 of the KCC, contending that the defendant was a controlling shareholder with a shareholding of 98.1% of the company. The principal contention urged by the plaintiffs was that the treasury shares of the *CD Networks Stock Corporations,* the subsidiary of the defendant, were held by the defendant, the parent company.

[30] KIM et al, *supra* note 29, 845; RHO, *supra* note 29, 130; SONG, *supra* note 29, 858.

[31] Some scholars argue that treasury shares should not be taken into account. KIM et al, *supra* note 29, 844; one scholar argues that treasury shares can be counted on as the shares of a subsidiary pursuant to Art. 360-24 para. 2. SONG, *supra* note 29, 859.

[32] Supreme Court, 14 July 2017, 2016Ma230; Seoul High Court, 25 January 2016, 2015Ra418.

The defendant argued that treasury shares should be excluded in calculating its shareholdings. Contrary to the defendant's assertion, the Seoul High Court held that the defendant was the controlling shareholder of the company. The court's first reason was that the treasury shares were held on account of the parent company, so the shares should be added to the shareholdings of the defendant. Furthermore, the court ruled that excluding treasury shares in the threshold calculation would have inequitable results, since a potential controlling shareholder could exercise the right of squeeze-out by purchasing the treasury shares and the 95% threshold would be reached, while minority shareholders could not exercise a sell-out right unless the potential controlling shareholder purchased the treasury shares. The Supreme Court of Korea upheld the Seoul High Court's decision, as it reasoned that the KCC does not explicitly exclude the treasury shares when calculating the 95% threshold.

Although this solution has some superficial appeal, there are some problems with it, as discussed in detail later.[33]

(4) Equity-Related Securities

The KCC does not explicitly describe how to treat equity-related securities, such as convertible bonds, bonds with warrant, and naked warrants, whereas the CMA – with regard to the 5% rule to block shareholders or to a tender offer – explicitly refers to the application of these securities.

In general, these securities appear not to be taken into account when calculating the threshold, as they are not identical to shares. But what if the bondholders exercise their options during a shareholder meeting? Since the 95% threshold should be acquired at that time, the newly issued shares to the holders are to be counted when calculating the threshold. This may lead to uncertainties as to whether the threshold of a squeeze-out is reached or not because fulfilling the requirement depends exclusively on the holders' will.

A related question is whether a controlling shareholder of 95% shares can ask bondholders to sell their bonds. One could argue that these holders can be forced to sell their bonds, since a controlling shareholder could not otherwise achieve the purpose of a squeeze-out. Despite the appeal of this argument, it is not followed, since it is not certain that the KCC does not explicitly permit it. Accordingly, the same above-mentioned uncertainty is inherent when a company has issued options.

These questions are not debated among Korean scholars. Some commentators briefly argue that these securities should not be included as 'shares' because they do not fall under the KCC's 95% threshold, as defined under Art. 360-24 KCC. As discussed later in depth, however, this raises some complicated issues.[34]

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[33] See *infra* at IV.2.c)(3).

c) The Business Purpose

The KCC explicitly says that a controlling shareholder can exercise a squeeze-out only to accomplish a business purpose (Art. 360-24 para. 1). In contrast, under the KCC, the sell-out right can be invoked without such a purpose (Art. 360-25). This is reasonable, since a minority shareholder will typically not have any business purpose, and it would be absurd, superfluous, and excessive for her/him to fulfil the requirement.

3. Approval at a Shareholders' Meeting

A squeeze-out transaction should be approved by resolution at the shareholders' meeting before a controlling shareholder requests minority shareholders to sell their shares (Art. 360-24 para. 3). This requirement is modelled after § 327a GCC and is a unique feature of the German and Korean regimes. Several German commentators[35] have criticized this requirement, suggesting that since a controlling shareholder already owns 95% of the shares, then a squeeze-out proposal is sure to pass and the procedure of approval is unnecessary.

This point has not yet been hotly debated in Korea. A squeeze-out is an exceptional device that permits a controlling shareholder to expel minority shareholders against their will. Hence, minority shareholders are given a last chance to voice their opinions. Furthermore, minority shareholders can obtain all the relevant information[36] concerning the squeeze-out, including a publicly certified appraiser's evaluation on the determinants of the price and the adequacy of the price. Information on guarantees of payment for minority shareholders is also presented (Art. 360-24 para. 4). Whether this explanation is cogent will be discussed in detail later.[37]

4. The Procedure for Determinants of a Sale Price

a) Providing Relevant Information

Assuring adequate compensation plays a crucial role in protecting minority shareholders when they are being squeezed out. The KCC provides several provisions in this regard. First, the written notice of the shareholders' meeting is to provide minority shareholders with sufficient and adequate information regarding the relevant factors on which the sale price is set by the controlling shareholder. This includes information on how a price is set, namely the method of valuation to be used, and information on the adequacy of the price,

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[34] See *infra* at IV.2.c)(3).
[35] See, e.g. M. HABERSACK, *supra* note 17, 1230.
[36] KIM et al, *supra* note 29, 847.
[37] See *infra* at IV.2.d)

with reference to the obligation to use a publicly certified appraiser, such as a public accountant or accounting firm.

A controlling shareholder is to explain the aforementioned information at the shareholders' meeting (Art. 360-24 para. 4 (iv)). Under these provisions, a controlling shareholder has to make sufficient disclosures to minority shareholders to facilitate informed decisions by the latter.

b) Guarantee of Payment

Second, the matter of the payment guarantee for minority shareholders should be explained in the document of notice for convening the shareholders' meeting (Art. 360-24 para. 4 (v) KCC). What the guarantees mean is not explicitly described under the KCC. A certificate of deposit balance, loan agreement with a bank, or purchase of guaranty insurance policy may be the case. In practice, the requirement of a payment guarantee may not be that problematic, since a controlling shareholder invoking a squeeze-out is sure to prepare for payment to complete the transaction.

c) Determinants of a Fair Price, Judicial Appraisal Procedure

(1) Steps for Determining the Sale Price

Third, the KCC sets the procedure for determining a sale price (Art. 360-24 paras. 7–9). The procedure is similar to that of a general appraisal right for shareholders when dissenting in regard to fundamental changes of a company (Art. 374-2 KCC). The sale price is to be determined through an agreement between a controlling shareholder and minority shareholders. In the event that the two parties fail to reach an agreement on the sale price within 30 days of the receipt of the request for sale, each party may file a petition for determining the sale price in court. In other words, the judicial appraisal procedure can be initiated by a controlling shareholder and any minority shareholder. The court is to determine a fair price, taking into account the company's assets and other circumstances.

(2) Valuation

Even if the KCC sets forth the above-mentioned provisions and explicitly states a fair price, valuation is the most difficult task. The KCC does not provide what a fair price is or how shares are to be valued. Two fundamental questions are thus still left to be answered: 1) Which valuation method is applied? 2) In listed companies in particular, how should the reference period for the pre-squeeze-out stock price be calculated? Furthermore, one could well wonder, even without any guidance on valuation, whether the courts are really well-positioned to engage in the tricky task of valuation.

(a) Statutory Valuation Methods

The unique feature of the Korean approach towards valuation is that the statute prescribes the guidelines for listed companies. Namely, with regard to the merger ratio, method, and appraisal rights arising from fundamental corporate changes,[38] such as mergers, corporate divisions, and a sale of business, the special provisions for listed companies in the CMA and CMA Enforcement Decree (hereinafter referred to as "Decree") provide guidelines in terms of determining a fair price.[39] This paper only briefly touches on these guidelines and other relevant issues since the valuation issue is dealt with in detail by other co-authors of this book.

In the case of a merger between listed companies, with reference to the day preceding the earlier of either the date when the resolution of the board of directors is made for the merger or the date when the merger contract is concluded, the value is determined by discounting or adding up to 30%[40] of the average of the closing prices (referring to the closing prices effectuated in the securities market) with regards to the following items (Decree Art. 176-5 para. 1 (ii)): (a) the average closing price for the most recent month, (b) the average closing price for the most recent week, or (c) the closing price on the most recent date. The average closing price under items (a) and (b) is to be calculated by the volume weighted average of the closing prices. On the other hand, in the case of a merger between a listed company[41] and a non-listed company, the price is established as follows: (a) with regard to the former listed-company, the price under Decree Art. 176-5 para. 1 (i);[42] and (b) with regard to the latter non-listed company, the average of the weighted average of the asset value and earnings value.

In the case of an appraisal right of shareholders that dissent to fundamental corporate changes, CMA Art. 165-3 and Decree Art. 176-7 para. 3 prescribe three steps for determining the purchase price of shares. First, it is to be determined by reference to an agreement between shareholders and the company. Second, if an agreement is not reached between the parties, the price is to be determined by the method prescribed by the Decree based on the transaction price of the stocks traded on the securities market. The price is to be calculated

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[38] For detailed explanations of several corporate transformations or changes, see E. ROCK/P. DAVIES/H. KANDA/R. KRAAKMAN/W. RINGE, Fundamental Changes, in: Kraakman et al. (eds.), *supra* note 3, 171.

[39] CMA Arts. 165-4, 165-5; Decree Arts. 176-5, 176-6, 176-7.

[40] In the case of a merger between affiliated companies, the discount or the premium percentage is lowered to 10%; Decree §§ 176-5 para. 1 (i).

[41] Of course, companies listed on the KONEX are excluded (CMA Decree § 176-5 para. 1 (ii)).

[42] When the price under Decree Art. 176-5 para. 1 (i) falls short of the value of assets, the price may be the value of assets.

in the following manner. In cases in which the stocks are traded on the securities market, it is the average of the prices calculated by any of the following methods: (a) the average of the final quotations of the stocks traded on the securities market and disclosed on a daily basis for two months[43] before the day immediately preceding the date the resolution of the board of directors is made, weighted by trading volume by real transactions; (b) the average of the final quotations of the stocks traded on the securities market and disclosed on a daily basis for one month before the day immediately preceding the date the resolution of the board of directors is made, weighted by trading volume by real transactions; and (c) the average of final quotations of the stocks traded on the securities market and disclosed on a daily basis for one week before the day immediately preceding the date when the resolution of the board of directors is made, weighted by trading volume by real transactions. However, in cases of stocks for which transactions are not made on the securities market, the price is the average of the weighted average of the asset value and earning value. This is the same price as that of non-listed companies.

Third, if any party dissents to such price determined by the second step, the party may file a petition requesting a fair price determination by a court.

(b) Basic Issues

This peculiar way of making a valuation in Korea raises three challenging questions: The first concern is the fact that the statute postulates guidelines for a fair price may be problematic, since the price is to be determined not by statute but through an agreement between the relevant parties.

With regard to this question, it should be noted that the guideline is provided mainly for the protection of minority shareholders, who stand inferior to controlling shareholders when negotiating the purchase price. These statutory guidelines have the advantage of clarity. In contrast, they have disadvantages as well, since a company or a controlling shareholder can select a particular time for execution of the transaction or manipulate the market price to make the market price favourable. As seen later, in the case of a squeeze-out, unlike an appraisal right, minority shareholders are supposed to sell their shares involuntarily at a particular time when a controlling shareholder prefers.

The second question is concerned with whether such guidelines, especially the provision regarding appraisal rights (Art. 165-5 CMA), can be applied to the squeeze-out transaction. This issue has not yet been widely discussed in Korea. In a listed company which a controlling shareholder has 95% of the

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[43] Of course, this period can be adjusted if any adjustment to a trading reference price is made due to ex-dividends or ex-rights during the same period, and the day immediately preceding the date of the resolution of the board of directors comes after at least seven days from the date when the ex-dividends or ex-rights occur. The same is true of (b), in the text below.

shareholdings,[44] how to determine a fair price is unsolved. For a listed company, one might argue that the provision on appraisal procedures under the CMA can or should be applied to squeeze-out transactions as well. Likewise, for non-listed companies, whether a valuation method regarding appraisal procedures can be applied to the squeeze-out is not dealt with. The Supreme Court of Korea[45] declared in a decision on a case of appraisal rights, brought by dissenting shareholders dealing with the sale of a business, that the court should use several commonly recognized valuation methods, such as the market value approach, the asset value approach, and the earning value approach. According to the decision, three factors, including earnings, the market price of shares, and asset value, are taken into account. The contours of this decision were followed by another decision of the Supreme Court that concerned an appraisal case brought by dissenting shareholders in a merger case.[46]

Should or can the Supreme Court's decision apply also to cases in which a controlling shareholder or minority shareholders exercise the right of a squeeze-out or sell-out, respectively? According to a decision by the Seoul Southern District Court, the answer could be partly in the affirmative. In 2014 this district court announced the first decision on a case of squeeze-out in Korea.[47] The controlling shareholder, *Hanhwa Insurance Co*. holding 99.99662% of *the Hanhwa Asset Management Co*. requested the remaining 14 minority shareholders to sell their shares at $18 per share, determined by the discounted cash flow (DCF) method. The court upheld the controlling shareholder's petition, citing the precedent of the Supreme Court case mentioned above.[48]

By contrast, a Seoul High Court decision applied a different method in a case concerned with squeeze-out.[49] The controlling shareholder, *Samsung Insurance Co.* holding 96.27% of *the Samsung Asset Management Co*. applied basically the same method postulated in the Korean Estate and Gift Tax Code (EGTC) (Art. 63 para. 1 (i)), which uses a weighted average method that considers earning value and asset value. Using this method, the controlling shareholder added a 30% premium to the computed price. The high court accepted the controlling shareholder's approach, while rejecting the plaintiffs' argument that the DCF method should be applied. Prior to this decision, the Seoul High Court had been concerned with a case on sell-outs, but not with the one on squeeze-outs, and had already rendered a decision that applied the same method postulated in the Korean EGTC.[50]

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[44] See *supra* at III.2.a).

[45] Supreme Court, 23 November 2005, Ma958, 959, 960, 961, 962, 963, 964, 965, 966.

[46] Supreme Court, 24 November 2006, 2004Ma1022.

[47] Seoul Southern District Court, 26 June 2014, 2014BiHap43.

[48] Supreme Court, 23 November 2005, Ma958, 959, 960, 961, 962, 963, 964, 965, 966.

[49] Seoul High Court, 26 August 2016, 2015Ra694, 695, 696.

[50] Seoul High Court, 25 January 2016, 2015Ra418.

As of December 2016 only three lower court decisions have been made concerning valuation cases on either squeeze-outs or sell-outs. These decisions all supported the price and the method that the controlling shareholders presented, even if the courts were divided on the valuation method. One notable fact is that the Seoul Southern District Court supported the DCF method, while most Korean courts have seldom applied it and have even rejected it. Recently, one decision has been announced by the Supreme Court in a sell-out case that upheld the decision of the Seoul High Court (2015Ra418).[51]

The third question relates to the uncertainty about which method can or must be applied to a company, once listed, but delisted at the time of executing a squeeze-out following a tender offer. In such a case, the issue about whether the same price presented by the bidder can be presumed fair has not been discussed. Regarding how to determine a purchase price, two alternatives may provide answers. One is to determine the price by using the guidelines of appraisal rights. The other is to use a bid price, which is presented by the bidder under some conditions. However, it should be noted that no prescribed provision in Korea can assure that a bid price is fair, since a squeeze-out related to a tender offer has not yet been introduced. As a matter of fact, invoking a squeeze-out in a listed company is barely conceivable because of listing regulations standards, which stipulate that a company will already be delisted if the shares of general shareholders amount to less than 10% of all shares.

Another complicated question relates to the reference period. The EGTC considers net earnings value during the most recent three-year period (Art. 63 para. 1 (i)). But how to set the reference period is a tough question. The Seoul High Court ruled that the price should basically be set on the date when a controlling shareholder makes a request to minority shareholders, but the date when shareholders approve the plan of squeeze-out may also be acceptable. This rule appears to be plausible. Yet notwithstanding this plausibility, the problem, which involves a controlling shareholder manipulating the time of executing the squeeze-out, remains unsolved. As no statutory guideline has been established for valuation in connection with squeeze-outs and sell-outs, a clarified rule on a fair price needs to be developed by the Supreme Court in the near future.

[51] Supreme Court, 14 July 2017, 2016Ma230. The minority shareholders in the case before the Seoul High Court, 2015Ra694, 695, 696, appealed to the Supreme Court, but the case was dismissed for not complying with procedural requirements prescribed under the Civil Procedure Act (Arts. 427, 442).

5. Transfer of Shares

a) Payments

The most salient, controversial, and unique feature of the Korean provision lies in the time of the transfer of shares. Under Art. 360-26 para. 1 of the KCC, the transfer of the shares is considered to have been made at the time when a controlling shareholder pays a minority shareholder the sales price for the shares. It means that the ownership of the shares that a controlling shareholder asks a minority shareholders to sell automatically changes when the controlling shareholder pays the minority shareholder. Under the KCC, where a controlling shareholder and a minority shareholder do not reach an agreement pursuant to Art. 360-24 para. 7, the minority shareholder is likely to refuse to be paid, although the controlling shareholder is willing to pay. In such a case, the controlling shareholder cannot make the payment, and the minority shareholder still owns the shares. Moreover, a controlling shareholder may be in a troublesome situation in which she or he cannot for various reasons contact a minority shareholder. Suppose that a controlling shareholder does not know who the shareholder is or does not know the shareholder's address; or suppose that a minority shareholder stays abroad for a long time. In such cases, there is the possibility that a controlling shareholder could not accomplish her or his purpose of holding 100% of shareholdings.

b) Public Deposit System

Due to the drawbacks mentioned above, the KCC provides another path for completing a squeeze-out transaction for a controlling shareholder. In cases where the minority shareholder to whom the sales price is to be paid is unknown to a controlling shareholder or the minority shareholder refuses to receive the payment, that is, the sales price, the controlling shareholder may publicly deposit the funds with a public depositary office in a district court. In such cases, the transfer of the shares will be deemed to have been made to the controlling shareholder on the date of the public deposit (Art. 360-26 para. 2). This rule is similar to a public deposit regime under the Civil Code (Art. 487).[52]

At first glance, this rule appears to be appealing, but it is very complicated and troubling problems can arise from this rule as well. First, from the minor-

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[52] Art. 487 KCC was modelled after Art. 372 GCC on deposits *(Hinterlegen),* which states, "Money, securities and other documents as well as valuables may be deposited by the obligor for the obligee with a public authority intended for this purpose if the obligee is in default of acceptance. The same applies if the obligor cannot fulfil his obligation or cannot do so with certainty for another reason that is in the person of the obligee or as the result of uncertainty, not due to negligence, as to the identity of the obligee" (this translated version is provided by the German Federal Ministry of Justice and Consumer Protection).

ity shareholders' point of view it is problematic, since even without any consent and against their will their shares will be deemed transferred to a controlling shareholder.

Second, on the part of a controlling shareholder there is a considerable risk that she or he may not acquire the ownership. This is because some public depositary offices have refused a controlling shareholder's request for deposit. Suppose a situation in which a controlling shareholder presents $10 per share while minority shareholders think their stocks might be worth $14 per share, with the result that minority shareholders refuse to receive the cash payment. Practitioners have related that public depositary officers have rejected a controlling shareholder's petition for deposit when a minority shareholder opposes the price. This practice of the public depositary officer is understandable considering the Supreme Court's decision that a public deposit is valid only when a "full amount of total liabilities" is deposited.[53]

This provision was introduced to facilitate the completion of a squeeze-out as early as possible for a controlling shareholder, but legislative improvements are still needed.

IV. Comparative Analysis: the Similarities and Differences

1. General

This section contains an analysis of the current Korean rules on a supermajority type of squeeze-out, primarily in comparison with the German model that the KCC is based on. In addition, this paper examines the feasibility of the supermajority type and compares alternative devices for expelling minority shareholders with a squeeze-out.

A review of Korean rules reveals that they bear similarities to the German ones in a few aspects. Although the laws on the books in both jurisdictions look similar on the surface, in reality they probably function in different ways. Moreover, the Korean rules may not function well, since some uncertainties in interpreting the relevant provisions pose obstacles to implementing a squeeze-out in practice. Despite those similarities, also significant differences exist between the KCC and the GCC. In this section, these similarities and differences between the two jurisdictions are discussed, but detailed explanations of the German rule are not presented,[54] except for brief descriptions of the main points when necessary for the analysis.

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[53] Supreme Court, 26 July 1996, 96Da14616.

[54] For English-language articles discussing German corporate squeeze-out rules, see ELST et al., *supra* note 4, 391; C. KREBS, Freeze-Out Transactions in Germany and the U.S.: A Comparative Analysis, German Law Journal Vol. 13 No. 8 (2012), 941.

The KCC provides alternative ways to squeeze out minority shareholders, such as cash out-mergers, short-form mergers, comprehensive share exchanges for cash, and fractional shares resulting from reverse stock splits. By comparing these techniques with squeeze-outs, some drawbacks of the squeeze-out device can be explained. To cope with this, this paper explores some solutions and legislative measures.

2. *Similarities*

a) *The Companies Covered*

Corporate squeeze-out rules apply to not only non-listed companies but also listed companies under both the KCC (Art. 360-24) and GCC (§ 327a). Some German commentators have argued that the corporate squeeze-out rule should be applied only to a listed company[55] in which a controlling shareholder holds 95% of shares through either a takeover or mandatory bid. However, in the end, the GCC did not limit the application to listed companies (without a detailed explanation) because rules on squeeze-outs are still needed in non-listed companies as well.[56]

By contrast, this issue has not been hotly debated in Korea. The handful of cases mentioned above[57] have all concerned non-listed companies. In the process of enactment, dissenting arguments were not raised in regard to the covered companies. At the time, the 2008 reform of the KCC on squeeze-outs did not even consider whether to limit the scope, as tender offer type of squeeze-out had not been introduced in Korea. As described above, the motives and rationales for squeeze-outs existed for non-listed companies. Moreover, a delisted company previously listed on the stock exchange for a long time often needs a squeeze-out device.

As mentioned above, it also should be noted that invoking a squeeze-out in a listed company is, in fact, seldom conceivable.[58] It is because pursuant to the listing regulations for the Korean Stock Exchange, a company with a controlling shareholder is already delisted.[59]

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[55] See H. FLEISCHER, Das neue Squeeze-out, ZGR 2002, 757, 770 et seqq.; M. HABERSACK in: Emmerich/Habersack, Konzernrecht, 9th ed. 2008, 174; HABERSACK, *supra* note17, 1235. For a brief description of the discussion, see J. KOCH in: HÜFFER/KOCH, Aktiengesetz, 12th ed. 2016, § 327a marg.no. 7.

[56] See P. MÜLBERT, Abschwächung des mitgliedschaftlichen Bestandsschutzes im Aktienrecht, in: Habersack/Hüffer/Hommelhoff/Schmidt (eds.), Festschrift für Peter Ulmer (Berlin 2003) 438.

[57] See *supra* at III.4. Seoul High Court, 25 January 2016, 2015Ra418; Seoul Southern District Court, 26 June 2014, 2014BiHap43; Seoul High Court, 26 August 2016, 2015Ra-694, 695, 696.

[58] See *supra* at III.4.c)(2).

b) Preceding Tender Offer

Both in Korea and Germany, squeeze-outs and sell-outs can be executed without having to be tied to a preceding tender offer. In Germany, it was disputed whether a corporate squeeze-out should be tied to the preceding tender offer or mandatory bid.[60] This argument is related to issue mentioned above.

Again, by contrast, this question has not yet even been raised in Korea. The KCC is concerned with only corporate law matters, not with those of capital market law or takeover law. The MOJ in Korea is in charge of the KCC, while the Financial Services Commission (FSC), the financial supervisory body, regulates capital market issues, including takeovers, and is in charge of the CMA. As the two acts fall under different departments, these departments are seldom involved in the process of enactment and work together in perfect harmony. Consequently, when revising the KCC, the MOJ and its subcommittee often have not considered matters concerning the CMA.

In the near future, whether to tie corporate squeeze-outs to preceding squeeze-outs should be discussed more deeply. As for now, only two things should be noted. Indeed, if a squeeze-out is tied to a preceding tender offer, a fair price for minority shareholders can be more easily found. For minority shareholders without any way to recognize whether the threshold of 95% has been reached,[61] one could well argue that a squeeze-out should be tied to a tender offer. However, the need for a squeeze-out still exists in the absence of a preceding tender offer. The way in which a controlling shareholder has acquired the 95% does not matter in light of the rationales and motives of controlling shareholders.

c) Triggering the Threshold of 95%

(1) Controlling Shareholder and Controlled Entity

The triggering threshold is 95%. The wording differs slightly between the KCC and GCC. The GCC requires a controlling shareholder *(Hauptaktionär)* holding 95% of share capital *(Grundkapital)* to acquire the remaining shares. While the KCC explicitly adds up the subsidiaries' shares, shares of non-subsidiary-affiliates are not counted. For a "natural person," the shares of a company controlled by the person are counted, on the condition that the person alone owns 50% or more of the controlled company. As mentioned above, "holding […] on account of […]" is required, but exercising control-

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[59] A company in which the shares of general shareholders amount to less than 10% of all shares is in principle delisted, with one exception.

[60] For an academic who answers this question in the affirmative, see HABERSACK, *supra* note 17, 1235.

[61] With some exceptions (the 5% rule and others), disclosure of the shareholding of each shareholder is not required under the KCC and the CMA.

ling power over an entity is not enough to add in the shares of the controlled entity under the KCC. For instance, suppose a company X, where M, M's husband, and the other minority shareholders own 50%, 48%, and 2%, respectively. In such a case, the KCC threshold is not reached, as 48% of shares are not deemed to belong to M. For another instance, imagine a company Y, where the shareholders are N, N's subsidiary O, N's non-subsidiary but affiliate P, and another minority shareholder. Each owns 50% (N), 40% (O), 8% (P), and 2% (minority shareholder), respectively. Likewise, the threshold requirement is not met.

Conversely, the GCC appears to provide more flexibility when interpreting the 95% threshold. When calculating the threshold, GCC Art. 16 para. 2 and Art. 16 para. 4 are applied (§ 327a para. 2). Accordingly, the shares of affiliates can also be added in to calculate the threshold, thereby allowing the controlling shareholder to meet the threshold more easily.

(2) Classes of Shares, Non-Voting Shares

In Korea, according to the prevailing view, the KCC does not differentiate among classes of shares, although the relevant provision does not explicitly say this. However, § 327a para. 1 GCC explicitly terms the denominator as 'share capital' *(Grundkapital),* so it is clear that when calculating the threshold, all shares are added, irrespective of voting rights. Non-voting preferred shares are also added in.

(3) Treasury Shares

As described above,[62] the question whether to include treasury shares should be discussed in depth. Korean scholars' views are divided. Unlike the scholars, there has been only one decision on the matter, in which the court declared that treasury shares are to be taken into account.[63]

In Germany, the prevailing opinion is that all shares are included when calculating the 95% threshold. Concerning treasury shares, several scholars hold the view that treasury shares must be deducted from the denominator.[64] According to this view, the treasury shares of a relevant company, under § 327a para. 1 GCC, are not considered to be the shares of a controlling shareholder. The German Transformation Act (*Umwandlungsgesetz;* UmwG), addressing mergers between parent companies and subsidiaries *(Konzern-*

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[62] See *supra* III.2.b)(3).

[63] Supreme Court, 14 July 2017, 2016Ma230; Seoul High Court, 25 January 2016, 2015Ra418. As of 31 December 2016, the case is pending before the Supreme Court of Korea (2016Ma230).

[64] FLEISCHER, *supra* note 55, 775; H. KOPPENSTEINER, Kölner Kommentar zum Aktiengesetz, 3rd ed. 2004, § 327a marg. no. 6; G. KRIEGER, Squeeze-out nach neuem Recht: Überblick und Zweifelsfragen, BB 2002, 53, 54.

verschmelzungen), explicitly states that the treasury shares of the transferring company – i.e. the target company – should be deducted when calculating the threshold (§ 62 para. 1 sent. 2 UmwG). In lieu of a similar relevant provision, the prevailing view is that the same is true of a corporate squeeze-out. Pursuant to GCC §§ 327a and 16 para. 2, treasury shares (eigene Anteile) should be deducted when calculating share capital *(Grundkapital),* as in the case of an integration *(Eingliederung),* after which the threshold of squeeze-out was modelled.[65]

These German scholars' views and the GCC's regulations are not in line with the rule announced by the Supreme Court of Korea.[66] The Seoul High Court's reasoning that treasury shares have to be deemed as belonging to the controlling shareholder is problematic and is not easy to support. According to the court's decision, a controlling shareholder can easily exercise the right of squeeze-out through making the management of the target company buy treasury shares with company funds. Based on the facts in the decision, by deducting treasury shares from all shares, the threshold was met, since the controlling shareholder owned 97.82% of the outstanding shares, excluding treasury shares, in its own name and in its account. The court should have used more plausible logic.

The case mentioned above is concerned with sell-out rights. Thus, the court presumably could have given considerable thought to the protection of minority shareholders. The threshold requirement, however, matches that of a squeeze-out and of a sell-out. Once a rule has been declared, it could be easily applied to other cases – including a squeeze-out case. According to the Supreme Court of Korea's logic, when a controlling shareholder, a parent of a subsidiary holding only 50% of shares, wants to squeeze-out minority shareholders, it can do so easily after acquiring additional shares with the company's money.

Such situations, indeed, may arise under the KCC's new share repurchase regime. In Korea, since the 2011 revision of the KCC, share repurchases from profits and earnings are permitted. Listed companies and non-listed companies may acquire their own shares with profits and earnings distributable to shareholders, as determined under Art. 462 KCC (Art. 341 para. 1 KCC). A company may keep the repurchased shares, since it is not required to dispose of them. Indeed, in practice, some companies reportedly keep the repurchased shares for some reason. In sum, under the KCC (thanks to the Supreme Court of Korea's decision), a shareholder with only 50% of shares currently has an incentive to execute a squeeze-out using a treasury share regime.

The situation in Germany is very different. First, the GCC does not prescribe a sell-out right. Thus, a situation hardly arises in which treasury shares

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[65] FLEISCHER, *supra* note 55, 775; HABERSACK, *supra* note 55, 153.

[66] Supreme Court, 14 July 2017, 2016Ma230.

are to be deemed as shares of a controlling shareholder for the protection of minority shareholders. Furthermore, unlike in Korea, share repurchase is strictly prohibited (§ 71 GCC). Thus, it is hard for a controlling shareholder to misuse the right of a squeeze-out with treasury shares.

Looking at the overall rules concerning treasury shares mentioned above, the KCC should have clarified the requirement for meeting the threshold to prevent it from being misused by shareholders.

(4) Stock Lending

Pursuant to the KCC, a controlling shareholder has to maintain the threshold level at least from the date of the shareholders' meeting until the date of the request to sell.[67] How long the shareholder has maintained the threshold is not relevant. The shareholder is also allowed to acquire shares even in the very short term to reach the threshold of 95% with a view to invoking a squeeze-out. Controlling shareholders, as prescribed under Art. 360-24 para. 2, need to own 95% of all shares or to hold them on account. Yet the term "holds (or owns) […] on account of […]" under Art. 360-24 para. 1 raises a tricky problem.

A related question can be posed in the area of stock lending. Suppose shareholder X with 33% of shares lends all his shares to shareholder Y with 63% of shares through a stock lending agreement, under which the former retains dividend and preemptive rights as regards new shares and the latter attains ownership of X's 33% of shares. In such a case, the question of who owns the 33% shares in terms of Art. 360-24 para. 1 is complicated. If Y is deemed to own the shares, Y can exercise rights of squeeze-out as a controlling shareholder.

The Federal Supreme Court of Germany (*Bundesgerichtshof; BGH*) announced a decision on this question in 2009[68] concerning squeeze-outs under § 327a GCC. The plaintiffs (the minority shareholders) contested the validity of the shareholder resolution, which approved the plan for a squeeze-out. They brought a rescission suit (§ 243 GCC) and a nullity suit (§ 241 GCC). The BGH rejected the plaintiffs' argument. The BGH declared that reaching the threshold of 95% through securities lending *(Wertpapierdarlehen)* did not lead to the invalidation of the shareholder resolution, nor did it constitute an abuse of the rights of a controlling shareholder.

This decision is problematic and even surprising. According to the decision, the threshold could be very easily reached, and shareholders acting in concert could squeeze out other minority shareholders whenever they preferred to. The threshold under the GCC might be more flexible and more easily met than in Korea. It may be undesirable to permit a squeeze-out in the

[67] B. SINGHOF in: Spindler/Stilz, AktG, 3rd ed. 2015, § 327a marg. no. 18.

[68] BGH, 16 March 2009, II ZR 302/06, DStR 2009, 862.

above-mentioned case. If controlling shareholder Y had not been an affiliate of the lender X, and X had not been a founder or a director of the defendant, would the consequence have been different?

(5) Equity-Related Securities

Equity-related securities may not be included when calculating a threshold as prescribed in Art. 360-24 KCC. However, the provision does not encompass two potential questions that equity-related securities and bonds raise.

One question is whether the bonds that a potential controlling shareholder holds and other bondholders hold are to be taken into account when calculating the threshold. The other question is whether a potential controlling shareholder holding 95% of shares can force bondholders to sell their bonds or whether the controlling shareholder should buy those bonds. As described above, Korean scholars only state that the bonds are not regarded as 'shares' under Art. 360-24. However, this explanation is not enough to answer the questions raised above.

A controlling shareholder who is willing to execute a squeeze-out should continue holding 95% of the shares from the time of notice of the shareholder meeting until the date requesting minority shareholders to sell their shares. Of course, the controlling shareholder should hold a 95% threshold from the moment of the shareholder meeting. In the meantime, if convertible bondholders (Art. 513 KCC) or exchangeable bondholders (Art. 469 para. 2(ii) KCC) exercise the right of conversion or the right of exchange, respectively, the question is whether they will acquire new shares or treasury shares,[69] respectively. If these bondholders are able to purchase company shares, the controlling shareholder's shareholdings may fall below the 95% threshold. Therefore, shortly after a squeeze-out is finished, the controlling shareholder might have to initiate another squeeze-out. In addressing these questions, one could find multiple answers. One answer, as some scholars argue, is that Art. 360-24 must be interpreted strictly and such bonds must not be taken into consideration. This view focuses on the statutory word, 'share'. However, if bondholders exercise their options during the squeeze-out transaction, a controlling shareholder inevitably has to initiate another squeeze-out. The other answer is that a controlling shareholder can acquire the bonds for cash as well.

There has been a similar debate over these questions in Germany, where the GCC does not explicitly describe how to treat bondholders.[70] The view of commentators is divided in a way similar to the answers above. The prevail-

[69] Under the KCC, the holder of an exchangeable bond can exchange the bond for treasury shares of the company which issued the bond (§ 469 para. 2 (ii) KCC, § 22 para. 2 KCC Decree).

[70] See FLEISCHER, *supra* note 55, 775; KRIEGER, *supra* note 64, 61.

ing view is that, in principle, the rights of bondholders change into claims of compensation rights against a controlling shareholder.[71]

In Germany, with regard to integration *(Mehrheitseingliederung)* (§ 320 GCC), the BGH[72] announced in the decision of *Siemens/Nixdorf* in 1998 that if the rights of all options amount to less than 5% of the share capital *(Grundkapital),* then a cash settlement would be taken into account. Commentators argue that this rule can be applied to a squeeze-out.[73] Accordingly, if the rights of all options amount to less than 5% of the share capital, then bondholders have the right to get cash for their bonds.[74]

This answer appears to be appealing, as it is flexible in addressing bondholders. However, this author doubts whether the KCC would allow such a solution in Korea without any instructions. Thus, one could argue that this answer is insufficient. A legislative improvement regarding share-related securities – one that includes how to differentiate between bonds for which the rights of all options have been exercised and those not exercised at the time of shareholder meetings – is needed urgently.

d) Approval at the Shareholders' Meeting

A squeeze-out plan has to be approved at the GSM under both the KCC and GCC. This is a very peculiar requirement in these two jurisdictions, since most jurisdictions do not require it. In general, for a controlling shareholder with 95% of shares, the agenda of a squeeze-out would surely be approved at the GSM. Both jurisdictions do not even require a supermajority vote; only a simple vote is needed. Hence, on the surface, the shareholders' approval requirement seems problematic or unnecessary.[75] The requirement may come from the traditional approach of both jurisdictions, where one of the main strategies for the protection of minority shareholders is to provide them with a voice at the GSM.

The shareholders' approval requirement functions not only in providing a decision right to minority shareholders but may also serve in one of following roles. First, as mentioned, minority shareholders can acquire all the relevant information about a squeeze-out. At the shareholders' meeting, they can pose questions and get answers on relevant conditions, especially the sale price

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[71] For a discussion, see FLEISCHER, *supra* note 55, 776.

[72] BGH, 2 February 1998, II ZR 117-97, NJW 1998, 2146; ZIP 1998, 560.

[73] FLEISCHER, *supra* note 55, 777.

[74] KRIEGER, *supra* note 64, 61.

[75] As mentioned above, in Germany the views on the requirement of shareholder meeting's approval have been divided. For commentators arguing for this requirement, see KOCH, *supra* note 55, § 327a marg. no. 12; Ehricke/Rothe, DStR 2001, 1120, 1127. For dissenting commentators, see HABERSACK, *supra* note 17, 1237 et seq. In Japan, for the same reason, a shareholder resolution is not required (§ 179 Japanese Company Code).

and payment. Second, shareholders can respond collectively as a group if they appear at the meeting. They can be more powerful as a group; individual shareholders have to negotiate one-on-one with a controlling shareholder. Third, when a plan of squeeze-out is approved by a shareholder resolution, minority shareholders have another powerful weapon, the opportunity to contest the validity of a shareholder resolution. Suppose that minority shareholders are concerned about the requirements of a squeeze-out; in particular, suppose the threshold is not met or they do not think the price is fair. In such instances they can bring a lawsuit contesting the validity of the shareholder resolution, even though, of course, this lawsuit is not reliable in some situations. Unlike in Germany, under the KCC, shareholders can bring this lawsuit even when they find the price unfair.

In addition, the requirement of a shareholder resolution in Germany plays a very salient role, since the shares of minority shareholders are deemed to be transferred (§ 327e GCC) by the shareholder resolution and its registration with a commercial registry.

e) Guarantee of Payment

In Korea, the guarantee of payment for minority shareholders should be explained at the shareholder meeting (Art. 360-24 para. 4). This might have been modelled after § 327b GCC. But this requirement is needed less in the KCC than in the GCC. As described later, under the GCC the transfer of shares is automatically made upon the registration of a shareholder resolution with a commercial registry. In theory, actual transfer can be made even without payments to the minority shareholders. In contrast, under the KCC the transfer is not made upon the registration of a shareholder resolution. The registration of the shareholder resolution concerning a squeeze out is not required and probably would not be done without a relevant provision on squeeze-out registration. The transfer of shares is made only by a payment or public deposit. Thus, the guarantee of payment requirement is of less importance than in Germany.

f) Procedure for Determination of the Share Price

The procedure for determining the sale price appears to be approached in a similar way in both jurisdictions. As a first step, a controlling shareholder presents a price. Next, the controlling shareholder and minority shareholder negotiate. If the latter disagrees on the bid price, the court ultimately determines it in an appraisal procedure.

As will be seen later, the difference is that an outside expert is involved in determining the price in Germany.

3. *Differences*

a) *Substantial Requirements*

Under the KCC, a "business purpose" is required to invoke a squeeze-out. By contrast, the GCC does not prescribe any substantive requirement. A squeeze-out transaction forces minority shareholders to sell their shares against their will. One might question whether a business purpose should be required to invoke a squeeze-out. Despite the differences in the statutes, the question arises in both jurisdictions.

In Germany, it is acknowledged that an additional objective requirement is not necessary.[76] Although the term "business purpose" is explicitly prescribed, it should not be interpreted so strictly. Since the statute balances the interests between a controlling shareholder and minority shareholders through requirements such as the 95% threshold and shareholder approval, additional requirements are unnecessary. In general, since a squeeze-out is deemed to have a business purpose, this statutory difference between the two jurisdictions is not as great as it appears in reality.

b) *Review of the Controlling Shareholder's Bid price*

In Korea, a bid price is assessed by controlling shareholder-picked auditors, whereas court-appointed auditors (experts) assess it in Germany. The court-appointed experts examine the relevance of the valuation methods and the adequacy of the price. Who picks an auditor matters in valuation. Since a controlling shareholder-picked auditor is paid by the shareholder, the auditor probably determines a more advantageous sale price for the controlling shareholder. Minority shareholders have no choice but to either accept the bid price, or to file a petition for determining a fair price. Since a fair price may not be secured at the first step, the Korean regime may be less favourable for minority shareholders than German one.

c) *Transfer of Shares*

As far as the transfer of shares, the differences are most striking between Korea and Germany. The two jurisdictions differ in the way the ownership of shares is changed. Namely, the question is when and how the minority shareholder's share is transferred to the controlling shareholder. In brief, for the Korean regime (as explained in detail above), the shares are transferred to a controlling shareholder when the minority shareholder is paid. The exceptions are when a controlling shareholder does not know who the minority shareholder is or when consent to the sale price is not obtained. In such cases,

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[76] BGH, 16 March 2009, II ZR 302/06, DStR 2009, 862; KOCH, *supra* note 55, § 327a marg. no. 14; KRIEGER, *supra* note 64, 53; SINGHOF, *supra* note 67, § 327a marg. no. 24.

the controlling shareholder is entitled to make a public deposit to a public depository office at a court. However, some courts do not allow public deposits due to the problem of partial deposits,[77] which can occur when a minority shareholder disagrees on the price.

As described in detail above,[78] this public deposit system is a controversial problem in Korea. The deposit system causes concerns for both parties. On the one hand, for controlling shareholders, squeeze-out procedures can be considerably protracted, even for 10 years. Thus the public deposit system may discourage controlling shareholders from choosing a squeeze-out regime to expel minority shareholders. On the other hand, for minority shareholders, despite opposing the price presented by a controlling shareholder, they assume the risk of losing ownership of shares because the courts may accept the deposits made by the controlling shareholder.

Under the Korean approach, the time of transfer of shares depends on either the payment to each minority shareholder or a public deposit to a public depositary office for each minority shareholder. Consequently, the time of transfer of ownership varies for each minority shareholder.

In Germany, by contrast, owners of all shares owned by minority shareholders are transferred to the controlling shareholder upon the registration of the shareholders' resolution concerning a squeeze-out with a commercial registry (§ 327e para. 3 GCC) and without any actual conveyance of shares. In such cases, the share certificates *(Aktienurkunden)* for such shares of minority shareholders will, prior to their delivery to the controlling shareholder, constitute *only* the right of compensation. This means that the position of *former* minority shareholders is converted to solely creditor status, and if they transfer the certificates to others, the latter are not shareholders but creditors with a right of compensation (§ 327e para. 3 GCC). Consequently, neither the former minority shareholders nor the latter can exercise the rights of shareholders. As of the registration of a shareholder resolution, the controlling shareholders can exercise rights as shareholders of the shares that the minority shareholders owned prior to the registration. Since former minority shareholders lose their position as shareholders, they cannot bring a lawsuit contesting the validity of the shareholder resolution.[79] A similar approach is found in § 320a GCC, which prescribes the integration process *(Eingliederung).*

As described above, there is a significant difference between Korea and Germany in the way the transfer of shares of minority shareholders is determined. Although the KCC is modelled after the GCC as far as requiring a shareholder resolution for a squeeze-out, the former did not follow the latter regarding the time of the share transfer. Why Korea took this unique ap-

[77] Supreme Court, 26 July 1996, 96Da14616.

[78] See *supra* III.5.

[79] K. LANGENBUCHER, Aktien- und Kapitalmarktrecht, (3rd ed., Munich 2015), 447.

proach is noteworthy. In cases in which shareholders oppose a fundamental corporate change, such as a merger, division merger, or business sale, the dissenting shareholders can exercise an appraisal right under the KCC (Arts. 374-2, 522-3, 530-11 para. 2). In such cases, whether the dissenting shareholders lose their positions as shareholders has been disputed in Korea. Some argue that the shareholder still retains the position of shareholder, while others argue that the dissenting shareholder's position changes to that of a creditor.[80] The latter view is reasonable in that the dissenting shareholder can receive cash for the sale price but should not exercise shareholders rights, such as the right to dividends. A similar question can arise in the case of a squeeze-out. Therefore, the KCC has explicitly prescribed the definite time of the transfer of shares.

Nonetheless, the problem still exists under the KCC. When two parties do not agree on the price, a petition for determining the sale price may be brought due to the drawback of the public deposit system.

Compared to the Korean approach, the German one appears to be more appealing, since all minority shares are deemed to be transferred at one time.[81] The German approach could be criticized because the transfer of minority shareholders' shares takes legal effect with the registration, even without a controlling shareholder's declaration of acquisition or actual payment to minority shareholders. However, the German approach is reasonable,[82] since it can create legal certainty and clarification[83] in consummating a squeeze-out. The German approach treats a squeeze-out in the same way as other fundamental corporate changes, such as mergers and integrations. Indeed, a squeeze-out is a transaction between a controlling shareholder and each minority shareholder. Still, it involves the fundamental reorganization of a company. In short, from a legal policy viewpoint, it may be better for Korea to follow the German approach. This is because a fair compensation matters most for minority shareholders.

d) Protection of Minority Shareholders

(1) Remedies for Minority Shareholders

Minority shareholders can bring two different kinds of lawsuits against a squeeze-out procedure. First, both in Korea and Germany, minority shareholders that disagree on the sale price can initiate an appraisal proceeding. Second, minority shareholders can bring a lawsuit contesting the validity of a

[80] KIM et al, *supra* note 29, 837.

[81] The Japanese Company Code (JCC) also takes a similar approach, under which shares are transferred on a specific date (§ 179-2 para. 1 (v)).

[82] HABERSACK, *supra* note 17, 1236.

[83] KRIEGER, *supra* note 64, 58.

shareholder resolution (an SR lawsuit) approving the squeeze-out. With respect to the second option, two marked differences are found between the two jurisdictions.

What is potentially important is a difference in the effect of a pending SR lawsuit.[84] Under the GCC, a squeeze-out becomes effective only after the registration of the shareholders' resolution with a commercial registry (§ 327e para. 3 GCC). Under German law, very small minority shareholders can challenge the shareholders' resolution, thereby bringing the squeeze-out to a halt. If a lawsuit is filed with respect to shareholders'resolution to be registered, the court in charge of registration may, and often does, suspend the registration until the judgment becomes finalized (§§ 381, 21 FamFG).[85] An SR lawsuit has the potential to block the implementation of a shareholders' resolution and creates significant hold-out leverage for minority shareholders.[86] The German legislature attempted to ameliorate this problem by adopting a new provision that allows the court to go ahead with the required registration even in the middle of a lawsuit; this is called a "Freigabeverfahren" (release procedure).[87] Pursuant to this procedure, companies are able to overcome the standstill and consummate the squeeze-out despite the pending SR lawsuit, provided that the court rules upon special motion that the SR lawsuit is obviously without merit or that the disadvantages for the defendant company resulting from the standstill outweigh the disadvantages for the minority shareholder plaintiffs or that the plaintiff has owned less than EUR 1,000 of share capital of a company (§§ 327e para. 3, 319 para. 6, 247 GCC).

By contrast, Korean law does not require registration as a prerequisite to a squeeze-out taking effect. Although a minority shareholder can bring an SR lawsuit, it does not hold up the squeeze-out procedure.

The second noteworthy difference lies in the defects for which an SR lawsuit can be brought. In Korea, a minority shareholder can bring an SR lawsuit for any substantive defects including inadequate compensation. By contrast, a squeeze-out cannot be enjoined because of allegedly inadequate compensation in Germany (§§ 327f GCC). Contesting compensation is initiated solely by the appraisal procedure, which is governed by the German Act on Appraisal Proceedings (*Spruchverfahrensgesetz;* SpruchG).

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[84] For a more detailed explanation of this point, see KIM/CHOI, *supra* note 5, 236.

[85] Gesetz über das Verfahren im Familiensachen und in den Angelegenheiten der freiwilligen Gerichtsbarkeit (BGBl. I 2008, 2586).

[86] M. WINTER, Die Anfechtung eintragungsbedürftiger Strukturbeschlüsse de lege lata und de lege ferenda, in: Habersack/Hüffer/Hommelhoff/Schmidt (eds.), Festschrift für Peter Ulmer (Berlin 2003), 699.

[87] Regarding the impact of the provision on abusive SR lawsuits, see, e.g., BAUMS/DRINHAUSEN/KEINATH, Anfechtungsklagen und Freigabeverfahren. Eine empirische Studie, ZIP 2011, 2329; BAYER/HOFFMANN, "Berufskläger" in der aktuellen rechtspolitischen Diskussion, ZIP 2013, 1193.

With regard to a remedy for shareholders, it may be better for Korea to follow the GCC. Namely, from a legal policy viewpoint, contesting compensation is to be initiated not by an SR lawsuit, but solely by the appraisal procedure. This is because it is a fair compensation that matters for minority shareholders, and blocking remedies, such as SR lawsuits, should be granted as sparingly as possible.

(2) Sell-Outs

Unlike the GCC, the KCC provides another device for the protection of minority shareholders: sell-out rights (Art. 360-25 KCC), modelled after UK Companies Act of 2006 (Sec. 979 et seq.). The general requirements, such as the threshold of 95% for invoking the right, are the same as in squeeze-outs, with the exception of there being no need for a shareholder resolution or business purpose.

4. The Feasibility of Squeeze-outs and Other Alternatives in Korea

Until now, the squeeze-out device has not been so popular in Korea. Only a few decisions have been announced in lower courts. But it would be a hasty to conclude that the squeeze-out device is not feasible or useful. Since no reliable empirical data on the practical application of squeeze-outs is available, the feasibility can be evaluated partly through comparing the squeeze-out device with other alternatives for eliminating minority shareholders, and thereby creating a 100% parent company, or for integrating two companies.

In Korea, a squeeze-out is not the only way to eliminate minority shareholders. Other techniques are available: fractional shares resulting from reverse stock splits (capital reduction), short-form mergers, and comprehensive share exchanges may also operate as squeeze-outs. This paper will focus mainly on newly adopted techniques, such as cash-out mergers and comprehensive share exchanges for cash.

a) Cash-out Mergers

The cash-out merger is a recently adopted device that took effect in 2012 (Art. 523 para. 5 KCC). Suppose that target company T's shareholders are forced to receive cash instead of acquiring company A's shares. The general requirement is as follows: in both companies, a special resolution at the shareholder meeting is needed. However, there are two exceptions. T's shareholder approval is not required in a short-form merger (Art. 527-2 KCC), while A's shareholder approval is not required in a small-scale merger (Art. 527-3 KCC). Dissenting shareholders in both companies have appraisal rights, with the exception that the right is not available to A's shareholders in a small-scale merger.

With a mixture of short-form mergers and cash-outs, minority shareholders easily divested of their positions as shareholders in both companies.

b) Comprehensive Share Exchange for Cash

This device was more recently introduced in the KCC (Art. 360-3) and took effect in 2016. While in the case of ordinary share exchanges target company T's shareholders are entitled to receive the shares of acquiring company A in return for their shares, with this device. T's shareholders are forced to receive cash for shares. T's shareholders are forced out from both companies. Share transfer of T's shares is made comprehensively, so individual notification or delivery of ownership is not required. Namely, the transfer is done collectively, even if individual shareholders oppose the shareholder resolution. The requirements are the same as in a merger. T's shareholders can exercise appraisal rights (Art. 360-5 KCC).

From the practitioner's perspective, this device, a means to form a parent-subsidiary relationship, is considered a better idea for controlling shareholders in Korea.

c) Similarities and Differences among Alternatives

Table 3 explains the similarities and differences among the three devices, apart from questions of taxation. With some exceptions, minority shareholders have a voice in the transaction. But a minority shareholder's voice is of no use in a squeeze-out, since the shareholder resolution is sure to pass.

Table 3: Similarities and Differences among Alternative Squeeze-out Devices

	Squeeze-out	Cash-out	Share Exchange for Cash
Shareholding of Controlling Shareholders	95% or more shares, irrespective of voting rights	1/3 of outstanding shares with voting rights	1/3 of outstanding shares with voting rights
Shareholder Resolution in Target	An ordinary resolution	A special resolution except short-form merger	A special resolution except short-form merger
Taking Effect of the Transaction	Uncertainty due to the public deposit problem	Registration in a commercial registry	The determined date of share exchange

For controlling shareholders, the minimum shareholding requirement is most strict for invoking a transaction or for passing a shareholder resolution. Moreover, with a mixture of the short-form and small-scale type, comprehensive share exchanges for cash and mergers do not even require approval or the holding of a shareholders' meeting. Furthermore, the other two devices

take effect through registration or are deemed completed on a specified date. It means that these transactions take effect at a single time, irrespective of each shareholder's consent. This functions in a most favorable way for controlling shareholders, so they have an incentive to use this technique.

However, a controlling shareholder who is willing to invoke a squeeze-out has to assume the risk that the squeeze-out may be considerably protracted, especially due to the drawback of the public deposit system. Consequently, in a squeeze-out, a controlling shareholder may in some situations not achieve its aim of removing a minority shareholder. But it is too early to conclude that the squeeze-out device is not feasible. A squeeze-out can be invoked not only by the parent company of a target company but also by a natural person or management who wants to manage a company more cost-effectively. In a company with bitter internal discord between a controlling shareholder and minority shareholders, a squeeze-out is the only way to solve these feuds.

V. Conclusion

A review of Korean squeeze-out rules reveals that both similarities and differences between Korea and Germany exist. The following is a thematic summary of this paper.

Squeeze-out rules under the KCC, modelled after German law, have some factors in common with the GCC. First, squeeze-outs do not have to be tied to a tender offer. This is reasonable in Korea, as Korea did not introduce takeover type of squeeze-outs. Second, the triggering threshold in both jurisdictions is 95% of all shares. The GCC appears to provide more flexibility in interpreting the 95% threshold than the KCC does. Regarding the 95% threshold, several complex questions arise: whether treasury shares are included when calculating the threshold; how to treat equity-related securities and stock lending. These problems have not been dealt with in depth in Korea, but as squeeze-outs have become popular, there must surely be some uncertainty surrounding them in practice. Third, for the protection of minority shareholders, the KCC and the GCC require shareholder approval on squeeze-outs – a factor that most jurisdictions do not require. This requirement can fulfil a function for the protection of minority shareholders in several ways.

Ironically, the same requirement of a shareholder resolution functions differently in the two jurisdictions. Compared to Korea, the shareholder resolution in Germany plays a salient role: shares are deemed to be transferred through the shareholder resolution and are registered with a commercial registry. The role of shareholder resolutions is a key difference between the KCC and the GCC. The transfer of shares is one difference that appears to have a

big impact on the feasibility of a squeeze-out regime. While the public deposit system raises tricky problems, the German approach appears to be more appealing, as all minority shares are deemed to be transferred at a single time – thereby creating legal certainty and clarification in consummating a squeeze-out. It may thus be better for Korea to follow the German approach. The second difference lies in the remedies for minority shareholders. While minority shareholders in Korea can bring an SR lawsuit against any defects - including inadequate cash compensation-, a squeeze-out in Germany cannot be enjoined because of alleged inadequate compensation. Here again, it may thus be better for Korea to follow the GCC's approach, since from a legal policy viewpoint, blocking remedies such as an SR lawsuits must be granted as sparingly as possible. This is because the essential concern is paying fair compensation to minority shareholders.

Because of the drawbacks of the public deposit system, squeeze-outs carry the risk of longer delays for controlling shareholders than alternative techniques for expelling minority shareholders. It is expected that a squeeze-out will make it easier for a controlling shareholder to expel minority shareholders. To balance the interests of a controlling shareholder and those of minority shareholders, the KCC has introduced several provisions, such as shareholder approval and the public deposit system. However, these do not appear to function well and may lead to protracted squeeze-out transactions.

In short, although modelled after German law, the squeeze-out rule under the KCC does not follow important German rules. Three important points should be addressed, and it may thus be better for Korea to follow the GCC's approach. First, the transfer of all shares should be at a single time, based on registration with a commercial registry. Second, the relevant public deposit rule must be revised. Third, disputes over a fair price must be solved *exclusively* through an appraisal remedy, not by an SR lawsuit.

Is the Regime of Japanese Squeeze-out of Minority Shareholders Constitutional?

Eiji Takahashi[*]

I. Introduction 271
II. The Debate in Japan 272
1. The Companies Act of Japan and Squeeze-out of Minority Shareholders – The Influence of German Legislation 272
2. Companies Act Reform and the Introduction of the Special Controlling Shareholder's Squeeze-out Right..273
III. The German Federal Constitutional Court's Decision on Minority Shareholder Squeeze-out 276
IV. Analysis of Japanese Law...277
1. Shareholder Rights and the Constitutional Protection of Property........................277
2. The Constitutionality of the Special Controlling Shareholder's Squeeze-out Right Under Companies Act Article 179 et seq...............................277
3. The 'Protection of Vested Rights' Angle...280

I. Introduction

In 2014, the Amendment to the Companies Act introduced a squeeze-out right for shareholders holding 90% or more of shares, known as the special controlling shareholder. The subject of significant controversy, it faced strong opposition when it first came up for discussion at the Justice System Reform Council. Concerns have also been raised as to the constitutionality of the squeeze-out regime during Diet deliberations of the 2014 Amendment Bill, and in academic literature both before and after the reform passed into law.

This Article proceeds as follows: section II. provides an overview of the debate over the squeeze-out regime in Japan thus far. section III. introduces the jurisprudence of the German Federal Constitutional Court on the constitu-

[*] The auther wishes to thank Mr. Alan K. Koh, LL.M. (Boston), Research Associate of CALS, who kindly edited my paper. Note: Except where otherwise stated or evident from the context, legislation referenced are Japanese legislation, and references to article numbers are to the Companies Act of Japan *(Kaisha-hō),* Law No. 86 of 26 July 2005, as amended by Law No. 90 of 27 June 2014.

tionality of squeeze-outs in Germany. Finally, in section IV., I will consider the constitutionality question in the context of Japan's constitutional order and draw some conclusions.

II. The Debate in Japan

1. The Companies Act of Japan and Squeeze-out of Minority Shareholders – The Influence of German Legislation

Debate over a squeeze-out regime is not new – it had previously occurred during the process leading up to the enactment of the Companies Act 2005. One of the catalysts for the debate was the fact that Germany had earlier enacted its own squeeze-out regime as part of the 2001 reforms to the Stock Corporations Act *(Aktiengesetz)*.[1] The salient provisions of Germany's regime are as follows:[2]

"*§ 327a Transfer of Shares for Cash Compensation*
(1) 1 The shareholders' meeting of a stock corporation or of partnership limited by shares may resolve upon request of a shareholder holding 95 per cent of the share capital (principal shareholder) the transfer of the other shareholders' (minority shareholders') shares to the principal shareholder against the payment of adequate cash compensation. […]

§ 327b Cash Compensation
[…]
(3) Before the shareholders' meeting is convened, the principal shareholder must deliver to the management board the declaration of a credit institution authorized to operate within the territorial scope of this law by which the credit institution guarantees the performance of the principal shareholder's obligation to pay the minority shareholders the set cash compensation for the transferred shares immediately after registration of the transfer resolution.

§ 327c Preparation of the Shareholders' Meeting
[…]
(2) […] 2 The adequacy of the cash compensation shall be reviewed by one or more expert auditors. […]
[…]

§ 327e Registration of the Transfer Resolution
[…]
(3) 1 Upon registration of the transfer resolution in the commercial register, all shares of the minority shareholders shall be transferred to the principal shareholder. […]

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[1] E. TAKAHASHI, *Doitsu kaishahō gaisetsu* [Principles of German Corporate Law], (Tōkyō 2012) 434.

[2] The translated provisions that follow are excerpted from Aktiengesetz [AktG] [Stock Corporation Act] as of 18 September 2013 (Ger.) (translated by Norton Rose Fulbright, October 2013) at <http://www.nortonrosefulbright.com/files/german-stock-corporation-act-109100.pdf>.

§ 327f Judicial Review of the Compensation
[…] 2 If the cash compensation is inadequate, the court […] shall set the adequate cash compensation."

The influence of the German regime is apparent in the Draft Principles on the Modernization of Corporate Law issued by the Corporate Law Subcommittee of the Justice System Reform Council on 22 October 2003. This document called for further consideration of 'whether a regime that grants a shareholder holding over 90% of the voting rights the right to buy out[3] other shareholders should be created'.[4]

2. Companies Act Reform and the Introduction of the Special Controlling Shareholder's Squeeze-out Right

a) Debate in the Justice System Reform Council

The key provisions of the special controlling shareholder's squeeze-out regime introduced by the Companies Act reform of 2014 are as follows.[5]

"A shareholder who either directly or indirectly owns 90% or more of a stock company's shares ('special controlling shareholder') may demand the company's other [minority] shareholders *sell* all of their shares for cash consideration (Article 179(1)). When making the demand, the special controlling shareholder must specify the *amount* of cash consideration, *when the shares will be acquired from those being squeezed out ('selling shareholders')* and other conditions of acquisition (Article 179-2(1)).

The demand must be approved by the directors *or board of directors* of the company (Article 179-3(1), (3)). Where approval is given, the company must give notice to the selling shareholders *either directly or through public notification* (Article 179-4, Companies Act; Article 161(2), Book Entry Transfer of Bonds and Shares Act[6]).

For the period beginning on the date of notice or public notice and ending six months after the date of acquisition, the company must *make a document* available *for inspection during business hours by selling shareholders* at its registered headquarters specifying the special controlling shareholder's identity and other information (Article 179-5, Companies Act). After *the shares have been acquired,* the company must, without delay, make *a document specifying the number of shares acquired and other relevant information* available at its registered headquarters for inspection by selling shareholders during business (Article 179-10).

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[3] For clarity, this is the right of the 90% controlling shareholder to compel the other shareholders to sell their shares to that same shareholder.

[4] *Kaishahōkaisei ni kansuru yōkōshian* [Draft Principles on the Modernization of Corporate Law], in: *Kaishahō no gendaika ni kansuru yōkōshian no ronten* [Issues on the Draft Principles on the Modernization of Corporate Law], Bessatsu Shōji Hōmu 271 (2004) 131.

[5] The following is not a direct translation of the statutory provisions, but rather of a summary of those provisions. For the original summary (in Japanese), see E. TAKAHASHI, *Kaishahō gaisetsu* [Principles of Corporation Law], (3rd ed., Tōkyō 2015) 267 ff.

[6] Law No. 75 of 27 June 2001.

Notice or public notice to selling shareholders is deemed to be at the time the demand for sale was made (Article 179-4(3)). The date of acquisition is the date specified in the conditions of acquisition (Article 179-9(1)).

Selling shareholders may apply for an injunction restraining the acquisition where the demand is in violation of statute or regulation, or where consideration is significantly inadequate and there is a risk that the selling shareholders would be *disadvantaged* (Article 179-7(1)). Selling shareholders may apply for judicial appraisal of the acquisition price during the period beginning twenty days before date of acquisition and ending on the day before date of acquisition (Article 179-8(1)). Shareholders and corporate officers[7] of the company at the date of acquisition may apply for a declaration of nullity of the acquisition within six months after the date of acquisition (Article 846-2)."

During the legislative process, the following points came up for debate in the Corporate Law Subcommittee of the Justice System Reform Council.[8] First, it was suggested that shareholders subject to the squeeze-out should be granted the opportunity to ask substantive questions and express their views to the controlling shareholder, as is the case under German law.[9] A second suggestion was to create a sell out regime[10] that would be complementary to the squeeze-out regime. The proposal reasoned that minority shareholders would be protected if they had the option of selling their shares to a controlling shareholder who had come to hold 90% or more of the shares. The third suggestion was to exclude companies for which share valuation would be difficult, or those with share transfer restrictions on all issued shares, from the scope of the squeeze-out regime based on a concern for potential abuse of the squeeze-out regime to get rid of minority shareholders at undervalued price.[11]

The third suggestion elicited the following responses. First, in companies with a special controlling shareholder holding 90% or more of the shares, it is meaningless for minority shareholders to remain as shareholders in a company provided that there are safeguards to ensure that appropriate consideration is paid in exchange for their shares. Second, as other extant cash out regimes[12]

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[7] This term includes directors, statutory auditors, and other officers.

[8] Responsible for what eventually became the 2014 Reforms, this Corporate Law Subcommittee is not the same as the one responsible for the enactment of the Companies Act referred to in *supra* note 4.

[9] Minutes of the 12th Meeting of the Corporate Law Subcommittee, 6 *(H. Kansaku)*.

[10] A note on terminology: the 'sell out' right in the Japanese context follows UK usage: see e.g. Explanatory Notes to the Companies Act 2006 (UK), para. 1242. For avoidance of doubt, it refers to the right of minority shareholders to be bought out by the controlling shareholder.

[11] Minutes of the 18th Meeting of the Corporate Law Subcommittee, 2 et seq. *(M. Saitō)*, Minutes of the 20th Meeting of the Corporate Law Subcommittee, 49 *(Y. Itō)*.

[12] 'Cash out' refers to other corporate law regimes such as the (once prevalent) reverse stock split that can be used to achieve squeeze-outs. For a concise introduction to the reverse stock split equivalent in Japan, see A. K. KOH, Appraising Japan's Appraisal Remedy, The American Journal of Comparative Law 62 (2014) 417, at 424–425.

apply to companies with share transfer restrictions, in the interests of legal consistency, it would not make sense to carve out an exception especially for companies with share transfer restrictions for all shares.[13] The view that it would be difficult to justify an exception for such companies soon became mainstream,[14] and it was ultimately adopted by Corporate Law Subcommittee.[15]

b) Debate in the House of Councillors Committee on Judicial Affairs

At the 16th meeting of the 186th Diet of Japan House of Councillors[16] Committee on Judicial Affairs[17] held on 20 May 2014, the constitutionality of the special controlling shareholder's right of squeeze-out came up for debate.

Former Minister for Justice and Opposition Councillor Toshio Ogawa argued that it would be oppressive of a 90% controlling shareholder to purchase the shares of the remaining 10% in the minority against their will. He further argued a lack of public interest, given it is a private matter whether the controlling shareholder gets rid of minority shareholders he does not like.[18] Then-Minister of Justice Tanigaki Sadakazu responded by arguing that squeeze-outs benefit the public by increasing the speed and flexibility of corporate management. Rejecting the Opposition's proposal to amend the reform bill by guaranteeing fair consideration for squeezed out shareholders, the Minister pointed out that the Opposition's proposal would contradict the corporate law principle that shareholders rank after creditors in priority.[19] The Chief of the Civil Affairs Bureau of the Ministry of Justice took the view that minority shareholders in special controlling shareholder squeeze-outs would be adequately protected with existing rules, such as the requirement for board approval, and the possibility of judicial appraisal or even injunctive relief where the share consideration is grossly inadequate.[20]

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[13] Minutes of the 18th Meeting of the Corporate Law Subcommittee, 2 *(M. Maeda)*.

[14] Minutes of the 18th Meeting of the Corporate Law Subcommittee, 5 *(T. Fujita)*.

[15] Minutes of the 20th Meeting of the Corporate Law Subcommittee, 51 (Chairman *S. Iwahara*).

[16] The House of Councillors is the upper house of the bicameral Japanese Diet.

[17] Translation from Committee on Judicial Affairs, House of Councillors Website, <http://www.sangiin.go.jp/japanese/joho1/kousei/eng/committ/list/l0065e.htm>. The committee handles not only 'judicial affairs' strict sense, but also 'matters under the jurisdiction of the Ministry of Justice'. *Id.*

[18] Minutes of the Committee on Judicial Affairs, 186th Diet, No. 16, 5 (*T. Ogawa,* DPJ).

[19] Minutes of the Committee on Judicial Affairs, 186th Diet, No. 23, 7 (Minister of Justice *S. Tanigaki,* LDP).

[20] Minutes of the Committee on Judicial Affairs, 186th Diet, No. 16, 5 (Civil Affairs Bureau Chief *T. Miyama*).

c) Debate After the Companies Act Reform

The debate over the constitutionality of the special controlling shareholder continued after the reform bill was passed. The requirement of board approval for a squeeze-out, touted as a safeguard for minority shareholders, was criticized as being insufficient to ensure the squeeze-out regime's constitutionality because directors could be removed without cause by an ordinary resolution of the shareholder meeting (Article 339).[21] Also, if Japan were to introduce a squeeze-out regime as many European jurisdictions had done, but without the corresponding sell out rights for minority shareholders, only majority shareholders would have a unilateral right of purchase. Minority shareholders are left in the precarious position where the 90% controlling shareholder can expropriate them as and when he pleases. As only majority shareholder interests are given weight, the regime lacks balance. It is also severely doubtful whether the present regime adequately protects the property rights of shareholders who had been shareholders since before the reform.[22]

III. The German Federal Constitutional Court's Decision on Minority Shareholder Squeeze-out

In the May 30, 2007 decision of the Federal Constitutional Court of Germany, the court applied the principle of proportionality *(Grundsatz der Verhältnismäßigkeit)* in reviewing the constitutionality of the minority shareholder squeeze-out regime. The court held that the regime satisfied the principles of proportionality and full compensation under constitutional law and therefore did not infringe upon the constitutional protection of property rights as guaranteed under Article 14 of the Basic Law of the Federal Republic of Germany.[23] However, the court left open the question of whether it would be sufficient in the family-owned company context for the law to provide only for compensation of the squeezed out minority shareholder's property interest.[24]

[21] T. SEKI, *Shiten: Kokkai ga 'oshiuri' wo kyoyōsuru rippō wo shitara?* [Viewpoint: What If the Diet Made 'Forced Purchase' Permissible by Legislation?], Shiryōban Shōji Hōmu 371 (2015) 3.

[22] S. IWAHARA et al., *Zadankai: Kaisei kaishahō no igi to kongo no kadai* [Panel Discussion: The Significance of the Companies Act Reform and Future Issues], in: Sakamoto (ed.), *Ritsuan tantōsha ni yoru heisei 26 nen kaisei kaishahō no kaisetsu* [Draftsman's Commentary on the 2014 Companies Act Reform], Bessatsu Shōji Hōmu 393 (2015) 33 (Comment by *Y. Masao*).

[23] BVerfG, 30 May 2007, 1 BvR 390/04, NZG 2007, 587.

[24] BVerfG, 30 May 2007, 1 BvR 390/04, NZG 2007, 587 at para. 26.

IV. Analysis of Japanese Law

1. Shareholder Rights and the Constitutional Protection of Property

Shareholder rights in Japan should be understood as falling under the constitutional protection of property rights as guaranteed under Article 29 of the Constitution of Japan. Shares are the embodiment of shareholders' respective interests in the company,[25] and these membership rights are a variant of the rights of ownership.[26] The Supreme Court of Japan has recognized rights under the Forestry Act and profits from securities trading as property rights within the meaning of Article 29.[27] It would therefore be irrational to only exclude shares from the ambit of Article 29. Should shares be denied constitutional protection as property, there would be no limits on corporate law legislation. The Supreme Court has laid down the following principles to govern a constitutional review of the laws regulating property rights. First, a regulatory measure only violates Article 29(2) of the Constitution where the legislative purpose is clearly inconsistent with public welfare, or where the means of regulation are either unnecessary or irrational in light of the regulatory objectives. Second, to determine whether regulation of property rights is consistent with public welfare within the meaning of Article 29(2), the court will balance the purpose, necessity, and content of the regulatory measure with the type and nature of the property right to be restricted under the regulatory measure, and the extent of the restriction.[28]

2. The Constitutionality of the Special Controlling Shareholder's Squeeze-out Right Under Companies Act Article 179 et seq.

Applying the principles laid down by the Supreme Court, I will now consider the issue of whether the special controlling shareholder's squeeze-out right can withstand constitutionality review.

The first inquiry concerns the compatibility of the regime with the 'public welfare'. Under Article 29(2) of the Constitution, 'public welfare' refers to the 'interests of society as a whole'. This is not restricted to the 'public interest', but also encompasses anything that increases the wealth of society in

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[25] K. ŌSUMI/H. IMAI, *Kaishahōron – Jō kan* [On Corporate Law, Vol. 1], (3rd ed., Tōkyō 1991) 292.

[26] K. ŌSUMI, *Watashi to shōjihanrei* [Commercial Law Precedents and Me] (Tōkyō 1976) 132.

[27] Sup. Ct. G.B. 22 April 1987, 41-3 Minshū, 408; Sup. Ct. G.B. 13 February 2002, 56-2 Minshū, 331 (available at <http://www.courts.go.jp/app/files/hanrei_jp/285/052285_hanrei.pdf>).

[28] Sup. Ct. G.B. 22 April 1987, 41-3 Minshū, 408; Sup. Ct. G.B. 13 February 2002, 56-2 Minshū, 331; Sup. Ct. 27 November 2006, 222 Saibanshū Minji 275; Sup. Ct. 15 July 2011, 65-5 Minshū, 2269.

general. A regime that creates an increase in private benefit, so long as it increases the wealth of society as a whole, is compatible with 'the public welfare' even if it does not itself possess a public character.

The squeeze-out regime makes it possible for minority shareholders holding 10% or less to be removed from the company, and for the company to become a wholly owned subsidiary. Through this method, flexible management with a view to the long term becomes possible, and as a wholly owned subsidiary, the company no longer requires decisions to be made by shareholder resolution thus increasing the speed of decision-making. Additionally, after squeeze-out, the company can save costs that would otherwise have been incurred by shareholder meetings, such as the delivery of notice of shareholder meetings and venue rental.[29] Therefore, as the squeeze-out regime benefits the 'interests of society as a whole' through benefiting the 100% parent (the erstwhile special controlling shareholder), the legislative purpose is compatible with public welfare as defined in Article 29(2) of the Constitution.

The second point concerns the nature of the share. Shares in listed companies have a special characteristic in that the smaller the percentage of the shareholding, the smaller the possibility of influencing company management for that shareholder becomes, further highlighting the 'property' aspect of the share. However, as was hinted at by the Federal Constitutional Court of Germany in their decision on the constitutionality of squeeze-out rights,[30] in family-owned companies it is meaningful and significant that a shareholder has the opportunity to exercise his right to ask questions at a shareholder meeting (Article 314) even if he owns only a single share.[31] Japan's squeeze-out regime only requires board approval, and does not call for a shareholder resolution (Article 179-3(1), (3)). We have seen that there were calls during the legislative process objecting to including companies with share transfer restrictions on all their shares into the squeeze-out regime. However, as the squeeze-out regime that ultimately came into force does not restrict its scope to public companies, there is an increased danger for shareholders not to the liking of corporate management in family-owned companies would be squeezed out and deprived entirely of any right to speak at shareholder meetings. On this point, under the current regime the means adopted are inappropriate for achieving the regulatory objective, and therefore vulnerable to challenge as irrational legislation in contravention of Article 29(2) of the Constitution.

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[29] S. IWAHARA, *Kaishahōsei no minaoshi ni kansuru yōkōan no kaisetsu IV* [Commentary on the Draft Principles on the Reform of the Companies Act Regime (Part IV)], Shōji Hōmu 1978 (2012) 39.

[30] See section III.

[31] Minutes of the 12th Meeting of the Corporate Law Subcommittee, 6 *(H. Kansaku)*.

Third, squeezed-out minority shareholders bear the entire risk of the special controlling shareholder's insolvency. By contrast, under German law, the special controlling shareholder must have a bank guarantee for minority shareholders' claims for payment.[32] This is another factor in favor of finding Japan's squeeze-out regime unconstitutional.

Fourth, in contrast with German law, the Japanese regime does not provide for review of the adequacy of cash consideration by court-appointed special auditors.[33] It is unlikely that the squeeze-out regime would be found unconstitutional on this difference alone, given that the final decision on the quantum of consideration is left to the court following non-contentious litigation procedure.[35] However, as there is still uncertainty over the standards used for appraising unlisted shares in Japan,[35] there is a risk that minority shareholders would be compelled to sell their shares undervalue due to the lack of judicial expertise in valuation matters. The absence of court-appointed valuation experts may therefore be a factor contributing to a finding of unconstitutionality in the context of squeeze-outs in unlisted companies.

Fifth, there are no disclosure obligations imposed upon special controlling shareholders when exercising their right to squeeze-out. As information relevant to share valuation such as the development of new products and the acquisition of patents would not be subject to disclosure, minority shareholders face the risk of a forced sale at an undervalue.[36]

Sixth, other squeeze-out regimes such those in the UK,[37] Germany,[38] and the EU[39] do not stand alone; they are paired with a regime of minority shareholder's sell out rights. Japan is unique amongst developed corporate law jurisdictions in providing for only a squeeze-out regime – sign of a biased legislative program focused solely on the interests of major shareholders.

It is clear from the above that Japan's current special controlling shareholder's right to squeeze-out minority shareholders under the Companies Act

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[32] See § 327b para. 3 AktG.

[33] Compare § 327c para. 2 sent. 2 AktG.

[34] For a brief analysis of non-contentious litigation procedure (in the context of the dissenting shareholder's appraisal remedy) see KOH, *supra* note 13, 427 et seqq.

[35] E. TAKAHASHI/H. FLEISCHER/H. BAUM, Unternehmensbewertung im Recht der Aktiengesellschaft: Ein japanisch-deutscher Rechtsvergleich [Corporate Valuation in Stock Corporation Law: A Comparison of Japan and Germany], Journal of Japanese Law 36 (2013) 32–35.

[36] K. SHIBATA, *Kabushikitō uriwatashi seikyū seido: Sono kokkaku to mondaiten* [The Squeeze Out Regime: Structure and Problems], Hōritsu Jihō 87 (3) (2015) 35 et seqq.

[37] Companies Act 2006, ss. 974–991 (U.K.).

[38] Wertpapiererwerbs- und Übernahmegesetz (WpÜG) [Securities Acquisition and Takeover Act], §§ 39a–39c (Ger.), available at: <http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/wpueg_en.html?nn=2821360>.

[39] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on Takeover Bids, Arts. 15–16.

(Articles 179 et seq.) is clearly biased in favor of majority shareholder interests and fails to give sufficient regard to the interests of minority shareholders who may be expropriated under the regime. As such, it cannot be said that its constitutionality is beyond doubt.

In his leading treatise, Professor Egashira observed that a squeeze-out of minority shareholders in the context of internal conflict within a closely held stock company may be 'an act of the special controlling shareholder for an improper purpose' and therefore subject to injunction (Article 179-7 Companies Act) as an abuse of right (Article 1 para. 3 Civil Code).[40] Egashira's interpretation has its merits: it is consistent with the principle that where legislation is subject to multiple interpretations, the preferred interpretation is one that incorporates constitutional values and leads to a finding of constitutionality.[41] However, in practice the circumstances under which a court would enjoin a special controlling shareholder's exercise of his squeeze-out right as an abuse of right are likely to be extremely limited. Therefore, I argue that the mere possibility of an injunction is insufficient to guarantee the constitutionality of the regime as a whole.

Avoiding a finding of unconstitutionality behaves the legislature to amend the current squeeze-out regime to increase protection for minority shareholders. As a matter of balance, a corresponding sell out right for minority shareholders should be introduced. Finally, under current law, minority shareholders in family-controlled, closely-held stock companies can be expropriated without any opportunity to speak at a shareholder's general meeting. This is unacceptable, and argues for an exception from the current squeeze-out regime for companies with share transfer restrictions on all shares.

3. *The 'Protection of Vested Rights' Angle*

The constitutionality of the special controlling shareholder's squeeze-out regime under current law can be challenged for reasons other than whether the regime itself is unconstitutional. It is clear that the legal status of minority shareholders has been adversely affected by the introduction of this regime as shareholders who would otherwise have been able to remain in their compa-

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[40] K. EGASHIRA, *Kabushikikaishahō* [The Laws of Stock Corporations], (6th ed., Tōkyō 2015) 281. H. FUKUSHIMA, *Tokubetsu shihaikabunushi no kabushikitō uriwatashi seikyū* [The Squeeze Out Right of Special Controlling Shareholders], in: Toriyama/Fukushima (eds.), *Heisei 26 nen no kaishahō kaisei no bunseki to tenkai* [2014 Companies Act Reforms: Analysis and Development], Kinyū Shōji Hanrei, Special Issue 2461 (2015) 73.

[41] Professor Kōji Satō defines this principle (which may be somewhat awkwardly translated as 'the principle of constitutionally-compatible interpretation') in the following terms: "The law should be interpreted in a way that is compatible with the Constitution so as to maintain the consistency of a [legal] system with the Constitution at its pinnacle." K. SATŌ, *Nihonkoku kenpōron* [Japanese Constitutional Theory] (Tōkyō 2011) 651.

nies can now be squeezed out. Under Japanese constitutional law, the issue of 'protection of vested interests' arises when a legally-protected vested position is adversely affected by a legislative change.[42] In a departure from past jurisprudence,[43] a recent Supreme Court case[44] did not provide support for wide legislative discretion when dealing with whether tax legislation that imposed ex post changes to property entitlements is compatible with the constitutional protection of property (Article 29, Constitution of Japan). In light of the Supreme Court's shift in approach, it is possible that quite apart from the question of whether the current squeeze-out regime is itself constitutional, there is another avenue of attack under the 'protection of vested interests' theory. It suggests that the legislature does not enjoy wide discretion when introducing legislation that harms vested interests, and the fact that the current squeeze-out regime harms the vested interests of minority shareholders is a weighty factor towards a finding of unconstitutionality.

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[42] J. SHISHIDO, *Kenpō: Kaishakuron no ōyō to tenkai* [The Constitution: Application and Development of Interpretative Theories], (2nd ed., Tōkyō 2014) 156 et seqq.

[43] Sup. Ct. G.B. 27 March 1985, 39-2 Minshū, 247.

[44] Sup. Ct. 22 September 2011, 65-6 Minshū, 2756.

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