VENTURE CAPITAL CONTRACTING UNDER THE KOREAN COMMERCIAL CODE: ADOPTING U.S. TECHNIQUES IN SOUTH KOREAN TRANSACTIONS

Eugene Kim†

Abstract: Because U.S. venture capital contracting techniques are well developed and highly effective, the appeal of adopting such techniques in venture capital transactions outside the United States is enormous to globally minded investors and legal practitioners. South Korea has yet to develop venture capital contracting practices as extensive as those found in the United States. In response to its burgeoning venture capital industry, however, South Korea will likely continue to adopt U.S. venture capital techniques in transactions governed by Korean corporate law. Such transactions can benefit the South Korean venture capital industry, leading to more profitable investments and financially successful companies operating on Korean soil.

Although the Korean Commercial Code ("KCC") is typically perceived as rigid and ambiguous, it provides a sufficient legal framework under which virtually all of the contracting techniques commonly used in U.S. venture capital transactions can be implemented with varying degrees of success. Because transactions that are impermissible under the KCC are generally regarded as null and void, the enforceability of U.S. techniques under Korean law requires strict statutory compliance. Certain notable differences therefore exist between venture capital contracting documentation in South Korea and the United States. While such differences further reinforce the overall desirability of adopting U.S. techniques in South Korean venture capital transactions, it does not follow that these techniques are without legal force or effect. With careful planning and drafting by legal practitioners, U.S. techniques can both achieve their desired effect and comply with all relevant KCC provisions.

I. INTRODUCTION

Venture capital† contracting in the United States can best be described as a complex, relational process in which the financial incentives of venture investors are aligned with the business interests of entrepreneurs through the

† M.P.A. 1998, School of International & Public Affairs, Columbia University; J.D. and LL.M in Asian & Comparative Law expected in 2005, University of Washington School of Law. The author would like to thank Professor Veronica Taylor and the Pacific Rim Law & Policy Journal editorial staff for support and guidance and Professor June-Sun Choi, Young Su Shin, and Young Jae Shin for their valuable comments. The author is also very grateful to Kenneth J. Lebrun. Any errors or omissions are the author's own.

† The term “venture capital” is defined as investment by persons or entities in “high-growth, high-risk, often high-technology firms that need [capital] to finance product or growth and that must, by the nature of their business, obtain this capital largely in the form of equity rather than debt.” Peggy H. Fu, Developing Venture Capital Laws in China: Lessons Learned from the United States, Germany, and Japan, 23 LOY. L.A. INT'L & COMP. L. REV. 487, 490 (2001) (quoting Bernard S. Black & Ronald J. Gilson, Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets, 47 J. FIN. ECON. 243, 245 (1998)).
use of highly intricate contracting techniques. U.S. venture capital contracting practices are well developed and have proven to be highly effective domestically. Accordingly, the appeal of adopting such U.S. techniques in venture capital transactions outside the United States is enormous, especially in countries where there is an active and sizeable venture capital industry.

In the year 2000, South Korea had more than 7,000 venture businesses, the highest number in the world outside the United States. Moreover, because of the percentage share of working adults employed in new firms, South Korea “can claim to be the most entrepreneurial country in the world.” As of June 2001, domestic and foreign venture capitalists and their funds invested over US$ 2.51 billion in 6012 Korean venture businesses.

Because of this explosive growth in investment opportunities in the South Korean venture capital industry, the effective adoption of U.S. venture capital contracting practices in South Korea could prove significant. While

---


3 Chemla, supra note 2, at 1-3; see generally George G. Triantis, *Financial Contract Design in the World of Venture Capital*, 68 U. CHI. L. REV. 305 (2001). In addition to an effective and viable commercial legal system, an active venture capital industry is defined as one that includes the following key traits: (1) the existence of large, independent sources of funding; (2) liquidity through active stock markets; (3) risk tolerance of the investors and entrepreneurs; and (4) labor mobility. See Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 NW. U. L. REV. 865, 880-93 (1997).


5 The term “venture business” or “venture company” in South Korea is technically used to refer to a small-and-medium size enterprise (“SME”) that has satisfied the relevant business requirements under the Act on Special Measures for the Promotion of Venture Businesses (“SMPVB”). SMPVB, Law No. 5381 (Aug. 28, 1997 as amended).


South Korea's venture capital contracting practices have yet to reach the degree of detail and complexity of those in the United States, various U.S. techniques have been increasingly utilized in major Korean venture capital transactions. Incorporating these techniques into venture capital transactions under Korean law can lead to more profitable investments and financially successful companies operating on Korean soil.

Strict statutory compliance with the Korean Commercial Code ("KCC")11, however, is the necessary predicate upon which the use of U.S. techniques depends. Without such compliance, no transaction is enforceable and binding under Korean law. While fundamental principles of U.S. corporate statutory and case law accommodate all of the contracting techniques commonly used in venture capital transactions,12 the extent to which U.S. venture capital contracting techniques can be implemented under the KCC statutory framework remains unclear. The KCC is generally perceived as ambiguous and rigid when compared to its U.S. counterparts, and what the KCC deems as impermissible is generally regarded as null and void.13

Despite limitations inherent in the KCC, this Comment asserts that the KCC provides a sufficient legal framework under which the most commonly

---


10 For instance, major Korean venture capital transaction agreements replicate the structure and content of those typically found in the United States (sample South Korean venture capital documents are on file with author).


This Comment focuses on the statutory provisions contained in Chapter IV of Book III that regulate the internal affairs and business transactions of Korean corporations, including those carried out by most entrepreneurial, startup companies. See Hyun Yoo, To Form a Stock Corporation in Korea: A Comparative Study with American Law, in BUS. LAWS IN KOREA 317, 319 (Chan-Jin Kim ed., 1988).

12 See Dent, supra note 2, at 1078-82. But see Douglas G. Smith, The Venture Capital Company: A Contractarian Rebuttal to the Political Theory of American Corporate Finance?, 65 TENN. L. REV. 79, 102 (1997) (stating that the structures of many venture-funded companies are not wholly dictated by the legal framework in certain cases); William W. Bratton, Venture Capital on the Downside: Preferred Stock and Corporate Control, 100 MICH. L. REV. 891, 894-95 (2002) (noting that U.S. case law is hostile to venture capital transactions and that an even-handed legal framework is necessary to deal with venture capital contract peculiarities).

13 See Sang Hyun Song, Stock Corporation in Korea, in INTRODUCTION TO THE LAW AND LEGAL SYSTEM OF KOREA 844 (Sang Hyun Song ed., 1983).

Close scrutiny of the relevant KCC provisions reveals that with careful planning and precise legal drafting the U.S. techniques employed in South Korean venture capital transactions can achieve their desired effect while complying with all relevant KCC statutory provisions. Inevitably, however, statutory compliance with the KCC will result in some notable differences between venture capital documentation in South Korea and the United States. While such differences may dissuade experienced investors and promising entrepreneurs from relying on the U.S. techniques when negotiating and structuring venture capital transactions in South Korea, such techniques are not necessarily without legal force or effect.

Part II of this Comment provides a primer on contractual rights and contracting techniques associated with convertible preferred stock, a predominant financing vehicle in U.S. venture capital investments.\footnote{See Steven N. Kaplan & Per Strömberg, Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts, NAT'L BUREAU OF ECON. RES. WORKING PAPER W7660, 13-14 (2000) at http://nber.org/papers/w7660 (last visited Feb. 1, 2004).} Part III explores the conceptual difficulties associated with implementing these U.S. venture capital techniques under the KCC. Part IV analyzes the eight major contracting techniques commonly used in U.S. venture capital transactions under the KCC:\footnote{The techniques can vary greatly from transaction to transaction. Despite great diversity in contracting techniques, several are fairly standard and hence are examined in this Comment. This Comment, however, does not discuss the validity or enforceability of terms or contents contained in such techniques. Rather, it focuses upon their overall form and mechanics and discusses whether they can be accommodated under the KCC.} (1) liquidation and dividend preferences; (2) conversion
rights; (3) anti-dilution adjustment provisions; (4) share transfer restriction provisions; (5) class voting rights; (6) supermajority voting rights; (7) redemption rights; and (8) tag-along/drag-along rights. This Comment concludes that all of these techniques can be accommodated in varying levels by the KCC.

II. VENTURE CAPITAL TRANSACTIONS IN THE UNITED STATES: CONTRACTUAL RIGHTS AND CONTRACTING TECHNIQUES ASSOCIATED WITH CONVERTIBLE PREFERRED STOCK

Venture capital transactions in the United States are characterized as complex business transactions involving "active investment in private companies with high growth potential."17 In a typical transaction, venture investors receive convertible preferred stock18 in exchange for making equity investments in entrepreneurial companies.19 Venture capital transactions in the United States in the past forty years have produced some of the world’s leading companies, including Microsoft, Intel, Apple, Federal Express, and Cisco Systems.20 In the year 2000 alone, the U.S. venture capital industry invested over US$ 90 billion in more than 5,000 transactions in the United States.21

Although the growth and size of this industry is impressive, the severe incentive problems that accompany financing of young entrepreneurial companies make these investments both difficult and risky.22 Generally speaking, the problems of moral hazard,23 information asymmetry,24 and

---

17 See Milhaupt, supra note 3, at 875 (quoting William A. Sahlman, Insights from the Venture Capital and the Oversight of Private Firms, 29 BUS. ECON. 35, 35 (1994)).
18 Convertible preferred stock is a form of equity security that is "exchangeable by its terms at the option of the holder, and under specified conditions, into another security, generally, but not always, into [common stock] of the same company." RICHARD T. McDERMOTT, LEGAL ASPECTS OF CORPORATE FINANCE 351 (1985).
20 Schmidt, supra note 2, at 2. Cf. KVC, supra note 8, at 4 (noting that successful and well-established Korean companies such as Mirae Electronics, Medison, Appeal Telecom, Daum Communication, Korea Link, and Jang Media were all beneficiaries of venture capital investment).
21 BAGLEY & DAUCHY, supra note 19, at 431.
23 The moral hazard is generally defined as the likelihood that one or both of the involved parties to an agreement will act contrary to the principles implied by the agreement. The entrepreneur and investors work together toward building a successful company and they are compensated for this teamwork. In the venture capital setting, the moral hazard problem is that the entrepreneur and investors have "an incentive to shirk," which is derived from "the inability to monitor [each other] perfectly and compensate [the entrepreneur and investors] on productivity." See D. Gordon Smith, Symposium, Team Production in Venture Capital Investing, 24 IOWA J. CORP. L. 949, 960-63 (1999).
managerial opportunism can engender deep-seated relational conflicts as well as create serious divergence in original expectations between venture investors and entrepreneurs.

To overcome such problems, the U.S. venture capital industry has developed both contractual rights and contracting techniques associated with convertible preferred stock. Contractual rights negotiated and obtained by venture investors are crucial because they allow investors to protect, manage, and ultimately liquidate their investments. Moreover, complex contracting techniques utilized by U.S. venture capitalists are vital to preserving these contractual rights in venture capital transactions. Such techniques are not only instrumental tools in aligning the economic incentives and business goals of investors and entrepreneurs, but are also highly effective legal mechanisms through which proper and necessary written documentation of a transaction can be accomplished.

A. Contractually Based Convertible Preferred Stock Rights Peculiar to the U.S. Venture Capital Industry Are Essential in Incentivizing Investors and Entrepreneurs

Venture investors essentially seek three types of rights when making convertible preferred stock investments: investor protection, management control, and investment exit. Each of these rights is essential in incentivizing investors and entrepreneurs.

First, investor protection rights moderately protect equity capital investments. They either provide downside protection in the form of a capital investment return in the event of company failure, or upside protection to ensure investors' full participation in any investment return. Information asymmetry can be defined as the condition where at least some relevant information is known to some but not all parties involved. In the venture capital context, information asymmetry can lead to inefficient business decisions or outcomes because the investors have less business information and technical knowledge than the entrepreneur. One reason is that the investors are "not involved in the day-to-day managing of the venture and will not have first-hand knowledge of how much time and effort the entrepreneur[s] are dedicating to the venture." See Manuel A. Utset, Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms, 2002 Wis. L. Rev. 45, 56-57 (2002).

25 The problem of managerial opportunism arises when an investor "sometimes promises to perform value-added services but later attempts to renegotiate this promise at a stage in the company's development when the entrepreneur has reduced bargaining power." See Smith, supra note 22, at 134-35.


27 See, e.g., Bratton, supra note 12, at 939-44; Bagley & Dauchy, supra note 19, at 445-46.

28 Bagley & Dauchy, supra note 19, at 446-48.
appreciation, should the company succeed.\textsuperscript{29} Examples of techniques used to implement investor protection rights include liquidation and dividend preferences, mandatory/optimal conversion rights, anti-dilution adjustment provisions (including pre-emptive rights), and share transfer restriction rights.\textsuperscript{30}

Second, management control rights permit venture investors to assert negative control over certain corporate affairs conducted by management.\textsuperscript{31} They also empower investors to manage and oversee major, substantive business operations as the company moves forward.\textsuperscript{32} In particular, contract negotiations for special supplemental voting rights\textsuperscript{33} entitle investors to assert veto-like control over certain corporate decisions and actions taken by the board of directors.\textsuperscript{34}

Third, investment exit rights entitle investors to liquidate their investments for profit.\textsuperscript{35} Depending on the company’s success, exercising such rights allows investors to sell their convertible preferred shares to the public in an initial public offering (“IPO”),\textsuperscript{36} to other outside investors, a potential buyer of the company,\textsuperscript{37} or even back to the entrepreneurs, or the company itself.\textsuperscript{38} In the United States, these investment exit rights are often negotiated and documented through contracting techniques generally known as registration rights,\textsuperscript{39} tag-along/drag-along rights,\textsuperscript{40} and redemption rights.\textsuperscript{41}

\textsuperscript{29} Id. at 445-47; see also Delaware State Bar Association, Special Feature, Seminar on New Ventures: Organization, Financing and Operations, 9 DEL. J. CORP. L. 253, 278 n.35 (1985).
\textsuperscript{30} See discussion infra Part IV.A.1-A.4.
\textsuperscript{31} Utset, supra note 24, at 61-62. For example, if the preferred stock investors possess certain class voting rights, the entrepreneurs cannot sell their enterprise to an outside third party or elect the board of directors without obtaining the approval of such investors. See Bagley & Dauchy, supra note 19, at 465-66.
\textsuperscript{33} See discussion infra Part IV.B.1-B.2.
\textsuperscript{34} See Kaplan & Per Strömberg, supra note 15, at 15-16.
\textsuperscript{35} See Gilson, supra note 32, at 1091.
\textsuperscript{36} Smith, supra note 23, at 972.
\textsuperscript{37} See Smith, supra note 12, at 131-32.
\textsuperscript{38} Id.; Gilson, supra note 32, at 1075.
\textsuperscript{39} This Comment does not analyze registration rights under the KCC. Registration rights are not discussed because the KCC contains no governing statutory provisions directly applicable to registration rights. The Korean Securities Act provisions and over-the-counter stock exchange rules are the main sources of rules and regulations governing how the investors structure and document the terms and conditions of investor registration rights. The full text of KOSDAQ Rules can be found at http://www.ksda.or.kr (last visited Feb. 2, 2004). See infra note 179 and accompanying text.
\textsuperscript{40} See discussion infra Part IV.C.2.
\textsuperscript{41} See discussion infra Part IV.C.1. In a less successful investment exit scenario, where a handsome profit cannot be realized, the investors typically exercise redemption rights to sell their preferred shares back to the entrepreneurs, usually four or five years after their initial purchase.
In theory, each of these contractual rights associated with convertible preferred stock help align the financial objectives of the investor with those of the entrepreneur by incentivizing efficient business behaviors as the venture business moves forward. Without such rights, most entrepreneurs would likely turn to friends and family for funds, and venture investors would be limited to simple, traditional forms of debt-like investment vehicles. Unlike traditional debt-like preferred stock issued by large, publicly-held companies, convertible preferred stock bearing contractual rights help create the necessary relational contract between investors and entrepreneurs.

B. U.S. Contracting Techniques Associated with Convertible Preferred Stock Are Indispensable in Completing Successful Venture Capital Transactions

To structure and document investors’ contractual rights in venture capital transactions, the U.S. venture capital industry has developed a unique set of complex contracting techniques associated with convertible preferred stock. Such techniques are employed in virtually all major U.S. venture capital transactions. The techniques most commonly used in U.S. venture capital transactions are: (1) liquidation and dividend preferences; (2) conversion rights; (3) anti-dilution adjustment provisions; (4) share transfer restriction provisions; (5) class voting rights; (6) supermajority voting rights; (7) redemption rights; and (8) tag-along/drag-along rights. Ensuring the overall success of a convertible preferred stock investment depends significantly upon the contracting parties’ effective use of such legal contracting techniques.

43 Klausner & Litvak, supra note 2, at 15.
44 See, e.g., Milhaupt, supra note 3, at 886.
45 See Bagley & Dauchy, supra note 19, at 445-66. In the United States, for example, the issuance of convertible preferred stock is specifically authorized by § 519 of the New York Business Corporation Law ("NYBCL"), N.Y. BUS. CORP. LAW § 519, New York State Assembly, New York State Consolidated Laws, available at http://assembly.state.ny.us/leg/?cl=13&a=6 (last visited Feb. 1, 2004), and by § 151(e) of the Delaware General Corporation Law ("DGCL"), DEL. CODE ANN. tit. 8, § 151 (Aspen Law & Business 2000).
47 Bagley & Dauchy, supra note 19, at 445-66, 471.
The overall function of these contracting techniques is two-fold. First, these techniques organize and preserve the carefully negotiated details of contractual rights between investors and entrepreneurs, and align the parties’ respective financial objectives and incentives. Their effective use is the first step toward establishing a direct and ongoing bilateral relationship between the investors and entrepreneurs. Second, the techniques allow the parties to easily document their respective rights in a formal written agreement.

Each technique takes the form of either provisions in the venture company’s articles of incorporation or contractual provisions in one or more shareholder agreements entered into by and among the entrepreneurs and investors. In the United States, the techniques are always structured and documented with respect to state corporation and federal tax laws. Similarly, they are enforced by the U.S. court system.

The following diagram illustrates venture capital contracting process in the United States:

48 See generally Gilson, supra note 32.
49 See Dent, supra note 2, at 1044.
50 See Bagley & Dauchy, supra note 19, at 445.
51 Id. In general, these techniques are a set of legal tools or devices by which the convertible preferred stock rights (i.e., investor protection, management control and investment exit rights) are defined and structured. The articles of incorporation and private shareholder agreements essentially constitute two principal legal methods used in documenting the techniques peculiar to U.S. venture capital contracting.

Certain techniques are not typically documented in a company’s articles of incorporation but will be established in one or more private contracts known as shareholder agreements. A shareholder agreement may appear in the form of: (1) stock purchase agreement; (2) registration rights agreement; (3) voting agreements; (4) investors’ rights agreement; (5) right of first refusal; and (6) co-sale agreement (as indicated by sample U.S. venture capital documents) (examples of such agreements are on file with author).


In light of their value to both investors and entrepreneurs, U.S. venture capital contracting techniques that structure and implement the contractual rights attached to convertible preferred stock would benefit the South Korean venture capital industry. A simple transplantation of U.S. techniques to South Korea is highly unlikely, however, because the U.S. techniques must fully comply with the pertinent KCC statutory provisions to have proper legal effect.54

The KCC poses at least three conceptual obstacles to the effective implementation of the U.S. techniques under Korean law. First, the KCC appears to insufficiently accommodate many of the complex contracting techniques found in U.S. venture capital transactions. Second, because statutory compliance with the KCC is mandatory, failure to do so may render U.S. techniques invalid and transactions that employ them

54 See supra note 11.
unenforceable. Lastly, although private contractual agreements can be used to contract around KCC provisions, their overall efficacy is uncertain.

A. The KCC Fails to Sufficiently Accommodate Many of the Complex Contracting Techniques Found in U.S. Venture Capital Transactions

Effective accommodation of U.S. techniques in South Korea is hindered by the KCC's Companies Law section, which is designed primarily to regulate large corporations. Venture enterprises or entrepreneurial companies are typically small, closely held corporations, which by their unique nature, conduct their affairs and transactions differently from their larger counterparts. Accordingly, the KCC appears ill-equipped to deal adequately with the complex contractual nature of U.S. venture capital transactions.

U.S. jurisprudence has accommodated the special needs of private, closely held corporations in several significant ways. First, U.S. courts have recognized the need for greater contractual freedom among shareholders of such corporations. Second, many U.S. states have statutory provisions designed specifically for closely held corporations. Such provisions contained in the so-called close corporation statutes permit private, closely held corporations “more flexibility in corporate governance” and “an increased degree of protection for minority shareholders.” The statutes effectively allow such corporations to carry out corporate activities or transactions that would otherwise be deemed invalid or unlawful.

Neither of these solutions, however, is available under Korean law. Many KCC provisions are silent with respect to the legal effects of U.S.

---

55 Interview with Junesun Choi, Professor of Law, Sungkyunkwan University, in Seattle, Wash. (Feb. 2, 2003) [hereinafter Choi interview]; see also Yoo, supra note 11, at 323-24 (stating that the KCC was implemented and revised in view of particular business-related requirements of modern stock corporations).
56 See Smith, supra note 12, at 103-04.
58 See, e.g., Galler v. Galler, 203 N.E. 2d 577, 27-28 (Ill. 1964) (noting that a “sound basis for [shareholder] protection [in a close corporation] is afforded by a . . . shareholder agreement securing the rights and obligations of all [shareholders]); Donahue v. Rodd Electrotype of New England, Inc., 328 N.E. 2d 505, 512 (Mass. 1975) (finding that a close corporation “bears striking resemblance to a partnership” in which shareholders are “dependent on one another for the success of the enterprise”).
59 CHOPER ET AL., supra note 57, at 698.
60 See Baruch Gitlin, When is Corporation Close, or Closely-Held, Corporation Under Common or Statutory Law, 111 A.L.R. 5th 207, 2a (2003 West Group).
techniques used in most venture capital transactions. As a result, the KCC statutory provisions relevant to venture capital transactions are likely to be interpreted as “unaccommodating” when compared to their U.S. counterparts.

B. Because Statutory Compliance with the KCC is Mandatory, Failure to Comply May Render U.S. Techniques Invalid and Transactions that Employ Them Unenforceable

Effective implementation of U.S. venture capital contracting techniques might also be problematic because such techniques require strict, mandatory compliance with relevant KCC provisions. Failure to fully comply with the KCC may render a corporate charter or shareholder agreement provision invalid and unenforceable. In direct contrast to the general U.S. policy toward greater contractual freedom in corporate law, the KCC’s statutory articles are generally mandatory or unconditionally binding unless provided otherwise in the statutory language.

Because most Korean venture businesses or entrepreneurial companies are likely to be formed as joint stock companies, any effective

---


62 Choi interview, supra note 55.

63 Id.

64 For a discussion of prominent U.S. scholarly works concerning greater contractual freedom in U.S. corporate law, see Symposium, Contractual Freedom in Corporate Law, 89 COLUM. L. REV. 1416 (1989) (containing seven articles written by well-known U.S. scholars including Frank H. Easterbrook, Daniel R. Fischel, Melvin Aron Eisenberg, Fred S. McChesney, Jeffrey N. Gordon, Roberta Romano, John C. Coffee, Jr.).

65 Song, supra note 13, at 844.

66 For instance, KCC Article 368 provides the following beginning clause: “[u]nless as otherwise provided by this Act or the articles of incorporation . . .” Such a clause has been construed as permitting the company’s articles of incorporation to provide optional or supplemental rules. Choi interview, supra note 55.

67 See June-sun Choi, The Organizational Structure of Stock Corporation in Korea: The Disparity Between Law and Practice, 22 KOREAN J. COMP. L. 1, 1,3 (Dec. 1994) (estimating that in 1991 over 90 percent of all South Korean companies (“JUSIK-HOESA”) were joint stock companies). See also Sang Hyun Song, Is Chusik Hoesa Better than Yunhan Hoesa for Foreign Investment?, in KOREAN LAW IN THE GLOBAL ECONOMY 586 (Sang Hyun Song ed., 1996) (stating that, relative to other corporate forms, joint stock companies maintain greater prestige in the Korean business community. Furthermore, Korean
implementation of the U.S. technique involving the company must strictly comply with the KCC's provisions governing joint stock companies. Accordingly, unlike a provision in a private shareholder agreement, a U.S. technique in the form of a provision in an articles of incorporation would be held unenforceable if it violated one or more governing statutory provisions of the KCC.69

Moreover, companies incorporated under Korean law cannot opt out of the KCC statutory framework.70 The KCC is the primary source of Korean corporate law,71 and is the main statutory body of law that governs and regulates the existence, organization, and conduct of profit-making companies.72 Just as a U.S. corporation is subject to the corporation law of the state where it is incorporated,73 virtually every corporate action or business-related transaction carried out by a joint stock company established on Korean soil is subject to the application of the KCC.74 As a result, most South Korean venture capital transactions must be implemented under the KCC or be subject to voidance.

C. Although Private Contractual Agreements Can be Used to Contract Around KCC Provisions, Their Efficacy is Uncertain

Because venture capital techniques in the United States are often implemented through private contractual shareholder agreements,75 Korean venture investors and entrepreneurs may, in a similar fashion, contract around mandatory KCC statutory provisions. The efficacy of private contractual agreements which run contrary to the KCC, however, is uncertain.

investors usually prefer the joint stock company form because of the widespread belief that it is more favorably received by the general public.).

68 In the United States, when venture capital techniques are documented as provisions in the company's articles of incorporation, the techniques must generally comply with the applicable state corporate law. See Dent, supra note 2, at 1078-82.
69 Song, supra note 65, at 843-44.
70 Choi interview, supra note 55.
71 See supra note 11.
72See Michael Dirkis, Company Law in Korea, in COMPANY LAW IN EAST ASIA 83 (Roman Tomasic ed., 1999).
73 With respect to corporate organization, governance, administration, and dissolution, Korean joint stock companies closely resemble U.S. stock corporations. Song, supra note 13, at 829.
74 See Yoo, supra note 11, at 319 (stating that this conclusion is derived from KCC Articles 3, 5, and 47). Alternatively, for foreign companies wishing to carry out business transactions in South Korea, Article 617 of the KCC reads: "a company incorporated in a foreign country shall, if it has established its principal office in the Republic of Korea or its main purpose is to engage in business in the Republic of Korea, be subject to the same provisions as a company incorporated in the Republic of Korea."
75 See BAGLEY & DAUCHY, supra note 19, at 445.
Enforceability of such contracts is currently questionable because the KCC is silent with respect to their validity.\textsuperscript{76} In direct contrast, U.S. law expressly permits the use of private contractual agreements among shareholders of closely held companies.\textsuperscript{77} Hence, a shareholder agreement made privately between entrepreneurs and investors in South Korea may be unenforceable under Korean law if it contravenes the mandatory statutory provisions.\textsuperscript{78}

Most Korean scholars, however, concede that there is a finite limit to the KCC's mandatory nature. Prominent Korean law professor Sang Hyun Song states:

\begin{quote}
[T]he systematic character of the [Korean] Commercial Code tends to support the theory that the rules are mandatory only in intra-corporate structure and only with respect to corporate action as such. Accordingly, then, although the law treats the rules of corporate control as generally imperative, it has at the same time little difficulty in holding that in their separate, non-corporate spheres, contract[ual] [agreements] between the parties are both valid and enforceable at least for damages.\textsuperscript{79}
\end{quote}

Accordingly, a particular contracting technique that would violate one or more KCC articles, if documented in the articles of incorporation, does not necessarily violate the KCC when made as part of a private contractual agreement.

Nevertheless, such a conclusion must be qualified. Most scholars agree that no legal effect may be given to contractual provisions found in a private shareholder agreement where the provisions' conflicting inconsistency with relevant KCC statutory articles essentially falls within the sphere of intra-corporate affairs or company structure.\textsuperscript{80} In particular, the

\textsuperscript{76} Yoo, supra note 11, at 349.
\textsuperscript{77} See, e.g., MODEL BUSINESS CORPORATION ACT, § 7.32 (American Bar Association 1999) [hereinafter MBCA] (detailing the character of shareholder agreements, permitting shareholders to create contractual voting agreements, and providing shareholders with the contractual right to negotiate agreements among themselves); DEL. CODE ANN. tit. 8, §§ 218, 354 (stating that "no written agreement among stockholders of a close corporation . . . shall be invalid on the ground that it is an attempt . . . by the shareholders . . . to arrange relations among [them] . . . and the corporation in a manner that would be appropriate only among partners").
\textsuperscript{78} For example, Professor Sang Hyun Song states, "contractual restrictions on share transfer seemingly violative of the [KCC] are not considered valid and enforceable by most Korean legal scholars." Song, supra note 13, at 843.
\textsuperscript{79} Song, supra note 13, at 844.
\textsuperscript{80} Choi interview, supra note 55. Although there is little or no research upon which to base this assertion, Korean scholars concur with this view. Id.
validity and enforceability of private shareholder agreements depends on whether the venture company is a party to the agreement and if any outside parties, including shareholders other than the investors and entrepreneurs, are affected by the agreement.81

In the Korean venture capital context, this is significant because investors and entrepreneurs often confront the dilemma of choosing the most appropriate documentation method for each particular technique used—either the articles of incorporation or separate private shareholder agreements. With enforceability hanging in the balance, it becomes paramount that legal practitioners in South Korea plan and draft venture capital agreements extremely carefully.

IV. UTILIZING U.S. TECHNIQUES IN SOUTH KOREAN VENTURE CAPITAL TRANSACTIONS: A BRIEF EXAMINATION OF THEIR EFFECTIVE ADOPTION UNDER THE KCC STATUTORY PROVISIONS

Despite the KCC's inherent limitations, virtually all of the venture capital contracting techniques commonly used in U.S. venture capital transactions can be accommodated in South Korea. The eight techniques commonly used to implement investor protection rights, supplemental management control rights, and investment exit rights in U.S. venture capital transactions should be carefully structured and drafted to conform with the relevant statutory provisions contained in the KCC.

A. Techniques Used to Implement Investor Protection Rights: Liquidation and Dividend Preferences, Conversion Rights, Anti-Dilution Provisions, and Share Transfer Restrictions

Investors usually seek to secure important protection rights relating to their convertible preferred stock investments.82 The common techniques used to structure and document such rights in the United States are: (1) liquidation and dividend preferences;83 (2) conversion rights;84 (3) anti-dilution adjustment provisions;85 and (4) share transfer restriction provisions.86 In South Korea, each of these techniques can be adopted to

81 Interview with Young Su Shin and Young Jae Shin, Attorneys at Law at the Korean law firm of Yoon & Yang, in Seattle, Wash. (Nov. 12, 2003) [hereinafter Shin interview].
82 See BAGLEY & DUCHY, supra note 19, at 446-49.
83 See discussion infra Part IV.A.1.
84 See discussion infra Part IV.A.2.
85 See discussion infra Part IV.A.3.
86 See discussion infra Part IV.A.4.
both protect investors' rights and simultaneously meet the KCC's statutory requirements.

1. Liquidation and Dividend Preferences

a. General treatment in the United States: liquidation and dividend preferences provide the most basic level of downside protection for investors

Liquidation and dividend preferences afford venture investors the most basic level of protection against investment failure. In the event of a liquidation or dissolution of the company, a liquidation preference requires that the preferred stockholders (i.e., the venture capitalists/venture capital investors) be given priority over the common stockholders (i.e., the entrepreneurs) for monetary payments upon a liquidation or dissolution of the company. In general, the liquidation preference becomes attached to the investors' preferred stock through the articles of incorporation.

A dividend preference allows the investors' convertible preferred stock to earn a dividend at some modest rate. Because virtually no dividend payments are declared by boards of directors in the venture capital context, however, the dividend preference reaps few benefits for the investors. The dividend preference only becomes meaningful when the investors obtain cumulative dividends, which are mandatory periodic dividends that accrue if unpaid. Adopting a cumulative dividend policy as part of the dividend preference ensures that the investors receive some rate of return on the investment even if the venture-backed company ultimately fails. In most cases, the dividend preference is standardized in the form of provisions in the articles of incorporation.

---

87 See Gilson & Schizer, supra note 52, at 883-85.
88 In the venture capital context, the definition of "liquidation" is "typically broad enough to include any sale of the business or sale of substantially all of the company's assets." Bagley & Dauchy, supra note 19, at 449.
89 Id.
90 Indicated by sample U.S. venture capital agreements (on file with author).
91 See Bagley & Dauchy, supra note 19, at 449-50. Typically, the dividend rate is set at six to eight percent per annum.
92 Id.
93 See Gilson & Schizer, supra note 52, at 882-83.
94 Bagley & Dauchy, supra note 19, at 450.
95 Id.
96 Indicated by sample U.S. venture capital agreements (on file with author).
b. Implementation under KCC: Article 344 gives proper implicit authorization for the use of liquidation and dividend preferences

Both liquidation and dividend preferences are available to investors under the KCC. Article 344 specifically provides that "a company may issue two or more classes of shares which are different in respect to their particulars as to the dividends of profits or interest or distribution of the residual assets." First, this language implies that the board of directors can set particular preferences for asset distributions in the event of liquidation. Second, the KCC specifically provides that convertible preferred stock, relative to the common stock, may bear dividends. Both dividend and liquidation preferences, as well as any adopted cumulative dividend preferences, should be included in the articles of incorporation.

With respect to dividend preference, however, Article 344 requires that a company set a minimum dividend in its articles of incorporation that will be granted to preferred stockholders. This minimum rule can be problematic should the parties adopt dividend preferences in the venture capital context because such dividend payments would force them to spend much-needed equity capital. At least one Korean scholar, however, argues that not all preferred stock with dividend preference must comport with this minimum requirement. Accordingly, under this scheme, the venture companies would not be subject to the minimum dividend rule where preferred investors instead obtain liquidation preferences.

Liquidation and dividend preferences should be implemented with care. Because the company is a party, the liquidation preferences should be in the articles of incorporation to have legal effect.

---

97 KCC, art. 344.
98 Id.
99 Id. But see Joongi Kim, Recent Amendments to the Korean Commercial Code and Their Effects on International Competition, 21 U. PA. J. INT'L ECON. L. 273, 305, n.168 (2000). Professor Kim states that liquidation preference has been of no practical use in South Korea because no preferred share distribution existed in the case of liquidation upon dissolution.
100 KCC, art. 344, para 1. See also Kim, supra note 99, at 306, n.169. Prior to the 1995 amendment to the KCC, dividend preferences for preferred stock offered minimal benefit because the dividend rate was typically determined by adding only one percent to the dividends typically given to common stock.
101 Choi interview, supra note 55.
102 KCC, art. 344, para. 2. See also Kim, supra note 99, at 306-07. The statutory imposition of minimum dividends on preferred shareholders seeks to increase the appeal of preferred stock and encourage higher dividend payments to preferred stockholders.
103 Kim, supra note 99, at 307.
104 Shin interview, supra note 81.
in a company’s charter would bind not only all shareholders, but also the corporation itself.\textsuperscript{105}

2. Conversion Rights

a. General treatment in the United States: conversion rights are crucial in allowing investors to liquidate their preferred stock investments

The right of conversion allows a shareholder to convert preferred stock into common stock.\textsuperscript{106} This conversion can occur either at the option of the shareholder or upon the occurrence of certain events (automatic conversion rights).\textsuperscript{107} The so-called “right to convert” gives investors common stock in exchange for forgoing their preferred stock upon some objective evidence of their investment’s success—usually the closing of an IPO that meets certain criteria.\textsuperscript{108} Such rights may also be automatically triggered by an affirmative vote of a majority or supermajority of the preferred stockholders.\textsuperscript{109} Upon conversion, the investors usually liquidate the new, converted shares of common stock in the public securities market for handsome profits.\textsuperscript{110}

b. Implementation under the KCC: conversion rights can be freely implemented, but must satisfy prescribed statutory requirements

Although conversion rights can be freely implemented in South Korea, the KCC imposes several important statutory requirements on convertible shares. Article 346 specifically requires that a company provide shareholders the statutory right to convert their shares of one class into shares of another class, if and when different classes of shares are issued.\textsuperscript{111} The same article also prescribes that the company’s articles of incorporation provide the following: the number and contents of the shares to be issued as a result of the share conversion, the conditions of the conversion, and the period when the conversion may be demanded.\textsuperscript{112} These requirements can represent a special challenge to legal practitioners in South Korea.

\textsuperscript{105} Id.
\textsuperscript{106} \textsc{Bagley & Dauchy}, supra note 19, at 455.
\textsuperscript{107} Id. at 455-56.
\textsuperscript{108} See Triantis, supra note 3, at 317-18.
\textsuperscript{109} \textsc{Bagley & Dauchy}, supra note 19, at 456.
\textsuperscript{110} See Smith, supra note 23, at 972.
\textsuperscript{111} See KCC, art. 346.
\textsuperscript{112} Id.
Using conversion rights under Korean law requires additional considerations as well. Article 348 provides that in the case of share conversion, "the issue price of such new shares shall be that of the shares which existed before the conversion." KCC Article 346(2) provides that a company should "reserve a sufficient number of shares to be issued in consequence of share conversion." Legal practitioners should also take notice of KCC Articles 347 through 350, which list other technical requirements related to share conversion. Without strict compliance with these articles, share conversions may be deemed null and void. Drafting efforts regarding share conversion rights in South Korean venture capital transactions should also take into account any current government regulation, as well as stock exchange and over-the-counter listing rules. The enforcement of such rules and regulations may affect the terms and conditions of conversion rights negotiated between investors and entrepreneurs.

3. Anti-Dilution

a. General treatment in the United States: anti-dilution techniques and preemptive rights provide modest protection against structural devaluation of convertible preferred stock investments

Anti-dilution techniques provide modest protection against possible dilution of venture investors’ convertible preferred stock. These techniques can be grouped into two broad categories: structural anti-dilution adjustments and preemptive rights. Structural anti-dilution adjustments are usually documented because they provide protection of investors’ preferred stock against share dilution caused by certain issuances of investors’ preferred stock. They ensure that—in the event of stock splits, reverse splits, stock dividends, and other recapitalizations—the number of shares of

---

113 KCC, art. 348.
114 KCC, art. 346, para. 2.
115 See KCC, art. 347-50.
116 Choi interview, supra note 55; Shin interview, supra note 81.
117 In case of an automatic share conversion on an IPO, there may be supplemental rules or regulations that govern the terms of automatic share conversion in South Korea. Shin interview, supra note 81. Similarly, in the United States, sales of converted common stock may be subject to certain exemptions under the U.S. Securities and Exchange Act of 1934. See Smith, supra note 12, at 138-40 and accompanying notes.
118 Shin interview, supra note 81.
119 See BAGLEY & DAUCHY, supra note 19, at 456-64.
120 Id. at 456-57.
common stock issuable upon conversion of the preferred stock represents the same percentage of ownership that existed prior to such recapitalization. Such adjustments also offer investors some price protection from subsequent issuances of preferred stock to other parties at a lower price than the investors initially paid.

A preemptive right entitles a shareholder to purchase his or her pro rata share in any new, subsequent share issuance to ensure that the original investors maintain their percentage ownership. This type of provision is typically a contractual provision in a venture capital shareholder agreement, but can be a provision in the articles of incorporation as well.

b. Implementation under the KCC: anti-dilution provisions are fully enforceable, while statutory preemptive rights can be overridden by the board of directors under limited circumstances

In South Korea, both anti-dilution adjustments and preemptive rights are available under the KCC. While the KCC does not provide specific provisions concerning structural anti-dilution adjustments, contracting parties in South Korea almost always set their particular terms and contents in the articles of incorporation or private contractual agreements.

Unlike U.S. corporation law, the KCC provides statutory preemptive rights. KCC Article 418 contains provisions designed to ensure that every shareholder has the right of preemption over new share issuances. The same article, however, provides an important qualifying exemption: that the company may—under provisions in its articles of incorporation—“make an allotment of shares to persons other than existing shareholders to the extent

---

121 Id.
123 See Bagley & Dauchy, supra note 19, at 458; see also Dent, supra note 2, at 1055.
124 See Bagley & Dauchy, supra note 19, at 458.
125 A preemptive right is not an inherent aspect of share ownership, but rather a right that may be granted or withheld by the articles of incorporation. See MBCA § 6.30. It provides that “the shareholders of a corporation do not have a preemptive right to acquire the corporation's unissued shares except to the extent [that] the articles of incorporation so provide.”
126 Choi interview, supra note 55.
127 KCC, art. 418. The article states that “each shareholder has the right to the allotment of new shares in proportion to the number of shares which [he or she] holds.”
128 Id.; Shin interview, supra note 81. KCC Article 418 is a further extension of the policy concept of shareholder equality under the Korean corporate law.
necessary for the achievement of the company's financial objective."129 Accordingly, the board of directors may override the statutory preemptive rights held by investors if such exemption language is specifically contained in the articles of incorporation. When the articles provide, the company management can issue and sell a substantial number of shares to third parties, thereby decreasing the existing investors' percentage of share ownership.

Venture capital investors in South Korea thus have statutory preemptive rights, unless the articles of incorporation provide otherwise. One way to eliminate statutory preemptive rights is to rely on a contractual provision in a private shareholder agreement and at the same time insert a charter provision providing for the elimination of any shareholder preemptive rights. This would allow the investors and entrepreneurs to decide among themselves which particular shareholders should have preemptive rights.130

4. Share Transfer Restrictions

a. General treatment in the United States: share transfer restrictions help control the identities of shareholders by requiring prior consent of investors in share sales

Virtually all venture capital transactions in the United States utilize share transfer restriction provisions to control the identity of the company's shareholders.131 Such provisions are essentially limitations or prohibitions on the persons or entities to whom shareholders may transfer their stock, "the time periods during which the stock may be transferred, or the manner in which the stock may be transferred."132

Prohibitions or restrictions on share transfers generally prohibit entrepreneurs from transferring or selling their shares without the prior

129 Id. at para. 2. This particular statutory exception might have been created in an attempt to prevent abusive practices of controlling shareholders—in forcing existing shareholders to buy new issuances or to minimize the risk of losing shareholding control of the company.
130 KCC Article 418(2) is likely to be immensely significant in the venture capital context because without this exemption a company may not be able to issue the necessary amount of preferred stock as requested by different, additional investors (from subsequent transactions or financings) due to the exercise of preemptive rights on the part of existing investors. Choi interview, supra note 55. Cf. Bagley & Dauchy, supra note 19, at 458 (describing how preemptive rights may give rise to such similar problems in the United States).
consent of all other shareholders, including the venture capital investors. Restrictions on share transferability typically appear in the form of provisions in a private shareholder agreement and are usually considered valid and enforceable in the United States.

b. Implementation under the KCC: because the KCC can trump contract principles, share transfer restrictions are of limited use

Share transfer restrictions may be of limited use in South Korea because KCC Article 335 provides that shares may be freely transferred to other persons. Although share transfer restrictions in a shareholder agreement are generally enforceable under the Korean Civil Code’s freedom of contract doctrine, the KCC can limit the overall effect of such provisions. For example, if an investor transfers his or her shares in breach of a contractual provision in such an agreement, and the transferee legally obtains the shares in accordance with relevant KCC provisions, the transfer in breach of the shareholder agreement is not prohibited under the KCC. While the investor who transfers his or her shares in violation of contractual transfer restrictions would be subject to potential shareholder claims for money damages, the transfer would not be unwound. Because the KCC in essence trumps contract principles, the overall effectiveness of private agreement-based restriction provisions are limited under Korean law.

If a private shareholder agreement is not used, and share transfer restrictions are instead adopted in the articles of incorporation, the KCC may impose conditional statutory restrictions on share transfers. KCC Article 335 provides that the articles of incorporation may adopt optional provisions

---

134 See McLlwraith, supra note 131.
135 See, e.g., MBCA § 6.27. See also Reed & Lajoux, supra note 132 (stating that their validity and enforceability are based on the assumption “that there is a valid business purpose for the restriction, the restriction is reasonably related to a business purpose, and no shareholder has been induced by deception or forced into agreeing to the restriction”); Lebrun, supra note 133, at 238 (stating that affixing “legends on share certificates indicating that the shares are subject to transfer restrictions” is “a technique commonly used in the United States to put potential transferees . . . on notice of such restrictions”).
136 See KCC, art. 335.
137 See Young Moo Kim & Joel A Silverman, Legal Forms of Doing Business in Korea, in BUSINESS LAWS IN KOREA 219 (Chan-Jin Kim ed., 1988); Shin interview, supra note 81 (stating that the Korean Securities Exchange Act requires that any valid and enforceable share transfer restriction provision be removed prior to the occurrence of an IPO).
138 Song, supra note 13, at 843.
139 Id.
140 Kim & Silverman, supra note 137.
stating that any transfer of shares must be approved by the board of directors. In contrast with a shareholder agreement, any share transfer made without obtaining the board approval would be unwound under Article 335, if such provisions and a separate board approval provision are stated in the company charter.

B. Techniques Used to Implement Management Control Rights: Class Voting Rights and Supermajority Voting Rights

U.S. venture investors also secure supplemental management control rights in addition to traditional statutory rights under applicable general state corporation law. The two most commonly used techniques include class voting rights and supermajority voting rights. These rights can be effected through either an amendment of the articles of incorporation or by creating separate contractual arrangements. Generally, such techniques confer a greater level of management control over the business affairs of the venture business on the investors. Both techniques are available in South Korea but their overall effectiveness can be limited under the KCC.

1. Class Voting Rights

a. General treatment in the United States: class voting rights protect investors by guaranteeing board representation or requiring their approval on corporate decisions

When parties negotiate a typical venture capital transaction, they may come to an accord that there will be certain matters for which the company must obtain the approval of the preferred stockholders (i.e., venture investors) voting as a separate class. Class voting rights in the articles

---

141 See KCC, art. 335, para. 1; see also KCC, art. 356 (stating that if the articles of incorporation provide for the approval of board of directors for share transfers, each share certificate issued must contain language indicating that any transfer of shares shall be subject to the approval of the board of directors).
142 See discussion infra Part IV.B.1.
143 See discussion infra Part IV.B.2.
144 See KCC, art. 335, para. 1; see also KCC, art. 356 (stating that if the articles of incorporation provide for the approval of board of directors for share transfers, each share certificate issued must contain language indicating that any transfer of shares shall be subject to the approval of the board of directors).
145 Id. at 223-24.
146 Id. at 224; BAGLEY & DAUCHY, supra note 19, at 464. These matters generally include board and shareholder approval of significant business-related transactions, the election of board of directors, and changes in the articles of incorporation that would adversely affect the preferred stock rights of the investors.
of incorporation are often used to guarantee the investors a certain level of representation on the board of directors.\textsuperscript{150} In addition, such rights provide a \textit{de facto} veto right in connection with certain corporate transactions where the investors would not have had the veto right had they voted with their preferred stock on an as-converted-to-common stock basis.\textsuperscript{151} Such rights can further protect preferred stockholders’ investment rights by requiring their approval in any adverse changes in the articles of incorporation.\textsuperscript{152}

b. \textit{Implementation under the KCC: class voting rights can only be exercised in limited circumstances}

Class voting rights are not expressly authorized in the KCC. Even if class voting rights are utilized, it is unclear whether class voting provisions are valid and enforceable under the KCC. Consistent with the principle of shareholder democracy under Korean corporate law, Article 369 states that “a shareholder shall have one vote for each share.”\textsuperscript{153} Although Article 344 governs the issuance of various classes of shares, it does not expressly delineate the respective voting rights for these classes.\textsuperscript{154} Because these silent provisions remain unclear, venture capital transactions in South Korea probably have an uncertain level of statutory support for voting rights among preferred stockholders compared to their U.S. counterparts.\textsuperscript{155}

KCC Article 435, however, strongly implies that such rights exist. This particular article makes class-based voting rights mandatory for holders of preferred stock under one enumerated circumstance.\textsuperscript{156} If a company has issued two or more classes of shares, class-based voting is required on any amendment to a company’s articles of incorporation that may be deemed prejudicial to such specific classes of shareholders.\textsuperscript{157}

\textsuperscript{149} Class-based voting rights are available under most U.S. state corporation laws. \textit{See}, e.g., \textsc{Del. Code Ann.} tit. 8, § 151(a) (noting that each class of stock may have “such voting powers, full or limited, or no voting powers,” as provided in the articles of incorporation).

\textsuperscript{150} Lebrun, \textit{supra} note 133, at 224.

\textsuperscript{151} \textit{Id. Cf. Bagley & Dauchy, supra} note 19, at 464 (stating that, on most general matters, the investors and entrepreneurs vote together as one class (i.e., one vote for each common share into which the preferred stock can be converted)).

\textsuperscript{152} \textit{See Bagley & Dauchy, supra} note 19, at 464.

\textsuperscript{153} \textit{See KCC, art. 369. But see MBCA} § 7.21(a) (providing that “except as provided by [this Act] or unless the articles of incorporation provide otherwise, each outstanding share, regardless of class, is entitled to one vote on each matter voted on at a shareholders’ meeting. Only shares are entitled to vote.”).

\textsuperscript{154} \textit{See KCC, art. 344.}

\textsuperscript{155} \textit{Choi interview, supra} note 55; \textit{but see} Lebrun, \textit{supra} note 133, at 226 (stating that the use of class voting rights in Japan is permissible under the Japanese Commercial Code, [SHOHO], art. 222-27).

\textsuperscript{156} \textit{See KCC art. 435, para. 1.}

\textsuperscript{157} \textit{Id. In the United States, there are similar analogous statutory provisions. Compare Del. Code Ann.} tit. 8, § 242(b)(2) \textit{with MBCA} § 10.04.
VENTURE CAPITAL TRANSACTIONS IN SOUTH KOREA

In the venture capital context, then, any change in the articles of incorporation which adversely affects existing investors’ preferred stock rights would require their separate approval in addition to the requisite, ordinary approval by all the shareholders of the company. This article, however, gives investors only partial protection because the separate approval of investors is not statutorily required for corporate matters not requiring an amendment to the articles of incorporation or other matters not deemed prejudicial to preferred stockholders.

2. Supermajority Voting Rights

a. General treatment in the United States: supermajority voting rights allow investors to have de facto rights over certain corporate decisions made by the company

Special voting provisions are commonly desired by venture investors in U.S. transactions. One prevalent type is known as a supermajority voting provision, which requires a higher-than-majority approval of either the shareholders or the board of directors on certain corporate actions taken by the venture business. Such supermajority provisions are typically used in stock redemptions exercised by the company, sales of substantially all of the company’s assets, a change-in-control merger, the election of a board of directors, and increases in the company’s authorized number of shares.

In venture transactions, the investors’ primary motivation for negotiating a supermajority provision is to “set the voting requirement of such approval at a level requiring [their] approval, thereby giving [them] a de facto veto right with respect to the specified corporate action.” Many state corporation laws in the United States permit the use of supermajority provisions for the shareholders and the board of directors. Typically,

---

158 This approval would presumably require the affirmative vote of no less than two-thirds of the voting rights of the investors present at the general shareholder meeting and of no less than one-third of the total outstanding shares of such class. See KCC, art. 435, para. 2.

159 Choi interview, supra note 55.

160 See Lebrun, supra note 133, at 226–27.

161 See id. at 226–27, 229; see BAGLEY & DAUCHY, supra note 19, at 465.

162 See Lebrun, supra note 133, at 226.

163 In the United States, the articles of incorporation may provide for a greater voting requirement for shareholders and the board of directors. See, e.g., MBCA §§ 7.27(a), 8.24(c); DEL. CODE ANN. tit. 8, §§ 141(b), 216.
supermajority voting provisions appear in the articles of incorporation.\textsuperscript{164} A shareholder agreement, however, may also contain such provisions.\textsuperscript{165}

b. Implementation under the KCC: supermajority provisions can be freely implemented, but may run the risk of being unenforceable if they take the form of private agreements

Supermajority voting rights provisions under the KCC are fully enforceable, but are less desirable if incorporated into a private contractual agreement. The KCC specifically allows the use of supermajority requirement provisions if and when provided by the articles of incorporation.\textsuperscript{166} With respect to the board of directors, Article 391 provides that voting requirements may be increased by the articles of incorporation.\textsuperscript{167} The default statutory rule requires that “[a] resolution of the board of directors shall be adopted by the presence of the majority of directors in office and the affirmative vote of the majority of directors present at the meeting.”\textsuperscript{168}

Such voting requirements can successfully be instituted at the shareholder level as well. Although Article 368 indicates that “resolutions shall be adopted . . . by affirmative votes of the majority of the voting rights of shareholders present thereat and of at least [one-fourth] of the total outstanding shares,” it provides that this default requirement can be overridden by the articles of incorporation.\textsuperscript{169} Accordingly, it is important for venture investors working within the KCC to properly structure and document supermajority provisions—at the shareholder and the board of directors levels—in the company’s articles of incorporation. One exception is found in KCC Article 374, where higher-than-majority voting requirements are mandated for certain statutorily enumerated corporate actions.\textsuperscript{170} For such actions, the KCC itself may be sufficient to protect investors’ equity interests.\textsuperscript{171}

\textsuperscript{165} See Lebrun, \textit{supra} note 133, at 229.
\textsuperscript{166} See KCC, art. 391; KCC, art. 368.
\textsuperscript{167} KCC, art. 391, para. 1.
\textsuperscript{168} \textit{Id.}
\textsuperscript{169} Id.
\textsuperscript{170} See KCC, art. 368. Statutorily enumerated actions include: the transfer of the entire or an important part of the business of the company, termination, alternation, or rescission of a lease contract or a profit-sharing contract, and the takeover of the entire or parts of business of another company. \textit{Id.}
\textsuperscript{171} Choi interview, \textit{supra} note 55.
Venture investors in South Korea should also consider whether supermajority provisions should instead take the form of provisions in a shareholder agreement. Investors in South Korea, similar to those in the United States, may find it desirable to rely upon private shareholder agreements to secure certain voting rights over certain corporate actions. For example, a provision requiring the approval of a particular investor might be better incorporated into a private shareholder agreement, as opposed to the articles of incorporation. On the other hand, duplicating supermajority provisions in the company charter is wise under Korean law because contractual provisions in a shareholder agreement are only valid and enforceable among the affected parties. The downside to using a private contractual provision is that in the event that voting provisions in a shareholder agreement are breached, only money damages are available to the injured party.

C. Techniques Used to Implement Investor Exit Rights: Redemption Rights and Drag-Along/Tag-Along Rights

Venture investors in the United States rely on several legal techniques when considering how they can “exit” their investments. The three most common techniques are redemption rights, tag-along/drag-along rights, and registration rights. With the exception of registration rights, the KCC

172 See REED & LAJOUX, supra note 132, at 499 (noting that voting agreements in Delaware are valid for ten years and can be extended any time within two years prior to expiration); see MBCA § 7.31 (explaining a shareholder’s right to enter into voting agreement allowing two or more shareholders); DEL. CODE ANN. tit. 8, § 218(c) (stating that “the shares shall be voted as provided by the agreement”).

173 For instance, provisions of either special approval of the investors or special elections of the board of directors (through which one or more venture investors secure membership to the board of directors) may be in a shareholder agreement as opposed a company’s articles of incorporation.


175 Shin interview, supra note 81.

176 Injunctive relief may be difficult to obtain from a Korean court. The most common remedy for such investors is monetary damages. Choi interview, supra note 55.

177 See discussion infra Part IV.C.1.

178 See discussion infra Part IV.C.2.

179 A registration right is the right to force the company to register the holder’s stock with a national securities exchange regulation office (in the United States, the Securities and Exchange Commission) so that the stock can be sold in the public securities markets. See BAGLEY & DAUCHY, supra note 19, at 467-70.

Venture investors usually demand a registration right so they can liquidate their stock and receive their ultimate return on their investments. See BAGLEY & DAUCHY, supra note 19, at 467. Although third party acquisitions and private stock sales provide means of strategic exit for venture investors, the most important and rewarding technique is the registration right via an IPO in a well-established stock market. See also Smith, supra note 12, at 129-31; Lebrun, supra note 133, at 231.
imposes statutory requirements on the use of each of these techniques. In South Korea, exercising redemption rights generally requires supermajority voting approval, but unlawful transactions will not be unwound. Drag-along/tag-along rights, on the other hand, are fully enforceable, but may require specific board approval.

1. Redemption Rights

a. General treatment in the United States: redemption rights can ensure that investors have a way to exit from their investments

In many venture capital transactions, venture investors require that redemption rights be attached to their invested preferred stock. Investors holding such redemption rights may force a company to repurchase its own preferred stock at some given price and date in the future. Redemption rights help ensure that venture capital investors will have a way to exit from their investment if the company fails.

Redemption of shares or a corporate repurchase of issued shares is widely practiced in the United States—most states authorize corporations to redeem or repurchase their own shares. The manner and propriety of share redemption, however, are subject to statutorily and judicially imposed restrictions. Today, U.S. law generally sanctions a share redemption if made “out of surplus or out of earned surplus,” [but] forbids it “only if capital is impaired or [such redemption] will impair capital.” For example, Delaware General Corporation Law § 160(a) prohibits any redemption of shares when “such purchase or redemption would cause any impairment of the capital of the corporation.” For venture investors, however, redemption rights may turn out to be virtually meaningless if the company

In South Korea, the overall stock market system has been improved greatly with the launch of KOSDAQ on July 1, 1996, a secondary over-the-counter stock market modeled after NASDAQ, the over-the-counter system in the United States. KOSDAQ was established primarily to support small businesses and venture firms specializing in the high-tech and biotechnology areas. See Hwa-Jin Kim, Living with the IMF: A New Approach to Corporate Governance and Regulation of Financial Institutions in Korea, 17 BERKELEY J. INT'L L. 61, 75 (1999).

180 See KCC, arts. 335, 341, 343.
181 See Smith, supra note 12, at 128-29.
182 See BAGLEY & DAUCHY, supra note 19, at 453-55.
183 See Smith, supra note 12, at 128-29 (noting that redemption rights may also serve as “valuable leverage” for the investors when dealing with the management over the course of the venture business).
184 See, e.g., DEL. CODE ANN. tit. 8, § 160; MBCA § 6.31(a).
185 McDERMOTT, supra note 18, at 540.
186 Id.
187 DEL. CODE ANN. tit. 8, § 160(a).
has no cash or limited capital at the time of redemption because a company may only use surplus capital to repurchase its own shares. 188

b. Implementation under the KCC: share redemption requires supermajority voting approval, but unlawful transactions would not be unwound

Although the KCC provides at least two different means for preferred stockholders to exercise redemption rights in venture capital transactions, redeeming venture investors in South Korea generally must meet certain statutory requirements. 190 One method for venture investors to redeem their shares is to force the company to purchase them with surplus capital. 191 However, investors are unlikely to redeem their preferred shares under this scenario because the availability of considerable distributable profits signifies that the company is successful and that the retention of their shares will be profitable. When relying on this method, investors must ensure that the price, time, and method of redemption are stated in the articles of incorporation—not in a shareholder agreement—prior to the redeemable preferred stock issuance. 192

In the more likely circumstance, where the venture company is unlikely to succeed, investors seeking to liquidate their investments will rely on the method involving reduction of capital. Redemption by this method is more stringent because it requires the affirmative vote of no less than two-thirds of the voting rights of the shareholders and of no less than one-third of the total outstanding shares. 193 In effect, investors force the company to reduce its capital by amortizing their preferred shares by means of purchasing and immediately canceling the shares with the approval of other shareholders. 194

---

188 See Bagley & Dauchy, supra note 19, at 453-55.
190 See generally KCC, art. 341. Article 341 provides that a company may not acquire its own shares except in the followings cases: (1) redemption of shares; (2) merger or acquisition of the entire business; (3) where it is necessary to do so in exercising the corporation’s rights; (4) fractional shares; and (5) shareholders’ right to request the company to redeem their shares. Id.
191 See Im, supra note 189, at 15.
192 See KCC, art. 345, para. 2.
193 See KCC, art. 343-2; KCC, art. 343.
194 See KCC, art. 342.
Under the KCC, however, share redemption transactions made without the requisite voting approval would still be regarded as valid and enforceable. Because the KCC does not expressly mention the legality of share redemptions made in violation of its statutory provisions, most scholars in Korea have vigorously debated their validity and enforceability.195 Nevertheless, Korean appellate courts have generally regarded “unlawful” redemptions as void, but have held that such transactions cannot be unwound.196 In such cases, the company’s officers and board members who caused or assented to such transactions are generally liable for damages, and the shareholders may, on behalf of the company, bring an action against such directors to claim damages.197

2. Drag-Along/Tag-Along Rights

a. General treatment in the United States: drag-along/tag-along rights can provide effective investment exit strategies for investors through private sales

Another method of investment liquidation is the private sale of the venture-invested company to third party investors.198 Two common techniques employed toward this endeavor are tag-along or co-sale rights provisions and drag-along rights provisions. Tag-along rights are contractual rights held by investors to sell their convertible preferred stock alongside the entrepreneurs’ common stock if the latter elect to sell their common shares to an outside third party purchaser.199 This can be an important investment exit strategy for venture investors owning a minority stake in the investment when a substantial portion of the common stock held by the entrepreneurs is being sold privately to an outside party. In contrast, drag-along rights essentially give venture investors the right to force the entrepreneurs to sell their common shares of the company should the investors decide to sell their preferred shares to an outside purchaser.200 In most U.S. venture capital transactions, these rights provisions often appear

195 Im, supra note 189, at 85-86.
196 Id.
197 Id. at 87.
198 Smith, supra note 12, at 131-32.
199 See Bagley & Dauchy, supra note 19, at 470-71.
200 Id. at 471-72 (emphasizing that drag-along rights are often fiercely resisted by the entrepreneurs and, if adopted, are usually not exercisable for a substantial period of time).
in the form of a shareholder agreement made between the entrepreneurs and investors. 201

b. Implementation under the KCC: drag-along/tag-along rights are fully enforceable, but may require specific board approval

While the KCC does not prohibit the use of drag-along and tag-along rights techniques, it imposes one important statutory restriction on outside sales of shares by existing shareholders. KCC Article 335 provides that a proposed transfer of shares must be approved by the board of directors within one month after such proposal, if and when a provision requiring board approval is provided in the articles of incorporation.202 Because the ultimate effect of drag-along and tag-along rights is essentially a share transfer, exercising such rights would fall under the rules stated in KCC Article 335. Where board approval is required, but the board refuses to approve a proposed share transfer, KCC Article 335-2 provides that a share transferor may request that the board designate an alternate purchaser of such shares.203 If the board fails to designate the purchaser, the transferor may transfer his or her shares as originally proposed.204

Accordingly, although drag-along rights and co-sale rights provisions are generally enforceable as a matter of private contractual agreement between entrepreneurs and investors,205 the negotiating parties should always verify whether a board approval provision exists in the company’s charter. Drag-along or co-sale transfers made without board approval would be deemed invalid and unenforceable if the provision exists in the company charter.206 Alternatively, the parties can circumvent the effect of Article 355 by amending the company’s articles of incorporation to remove any board approval provision.

V. CONCLUSION

Virtually all of the techniques commonly used in U.S. venture capital transactions can be implemented under the KCC. Although there are notable differences between venture capital contracting documentation in South

201 See Smith, supra note 12, at 128.
202 See KCC, arts. 335, 335-2, para. 2.
203 See KCC, art. 335-2.
204 See KCC, art. 335-3, para. 2.
205 Choi interview, supra note 55.
206 Id.
Korea and the United States, with thorough planning and careful drafting, the U.S. techniques can achieve their desired effect while complying with all relevant KCC provisions.

Legal compliance is crucial because the techniques serve a dual function. Not only do they legitimize convertible preferred stock rights afforded to investors, but they also align the investors' financial incentives with those of the entrepreneurs as the venture business moves forward. In other words, legal compliance promotes mutual trust and cooperation between investors and entrepreneurs and dissuades the parties from engaging in intentional acts of breach.

However, legal practitioners in South Korea will likely face numerous challenges. Because the KCC provisions are mandatory, successful implementation of U.S. contracting techniques requires strict adherence to its statutory requirements. Legal practitioners must therefore be cautious when implementing U.S. techniques in venture capital transactions governed by Korean law.

Where the KCC restricts or imposes limitations on the implementation of such techniques, private shareholder agreements may be used to the extent necessary to circumvent such statutory limitations. Reliance on private agreements should be more appealing when legal practitioners decide whether to document such techniques in the articles of incorporation or as part of separate shareholder agreements: greater contractual freedom is well suited to completing successful venture capital transactions. This method of documentation, however, has an inherent and peculiar downside under current Korean law, and thus requires sophistication and experience on the part of legal practitioners working on such transactions.