Section 341
Commercial Code of Korea

Woong Shik Shin*

"Our challenge, then, is to roll up our sleeves and get to work. We will not make
the world perfect, but we can work hard at making it better, at making our system
serve its people better than any other." —Louis W. Cabot

I. PREFACE

The present Commercial Code of Korea was born in 1962 and went into effect on
January 1, 1963. (1) Unlike the old Commercial Code of Korea which was enacted under
both French and German influence, the present Korean Code had taken up the Anglo-
American laws, especially the American corporation law, as a model and made a drastic
change from the old approach.

There seem (2) to be four main considerations for such a shift. In the first place, Korea is
more closely associated with the United States and other common law countries in the inter-
national political and economic arena. In the second, the Anglo-American corporation law
is considered more effective and desirable for the pursuit of modern democracy and mass
capitalism. In the third, the Anglo-American spirit of regarding the juridical order of the
nation supreme, and its habit of looking at the Corpus Juris in concrete terms is valuable
as an instruction in new patterns of thought and action. And finally, in the present world
of international community, the movement toward a unification of law is highly significant.

* Chief Judge, Court Martial of Appeal, Ministry of National Defence.
Seoul National University (1964 BA. in LAW, 1966 MA. in LAW.) Yale University (1967 LL.M.)
University of Virginia (1969 S.J.D.) Oxford University (1970 D.E.D.)
(1) Law No. 1000 of 1962.
(2) Unfortunately, there is no legislative report on the present Commercial Code of Korea.
Since corporation law is of technical and international character, the movement would be most feasible in this field.

However, the best intention is quite dangerous and sometimes disastrous if not accompanied by knowledge and wisdom. The Anglo-American corporation law has been a dark continent to Korean lawyers and legal scholars since the beginning of the history of the Korean corporation law. Moreover, the present Code had been prepared quite hastily right after the May Military Revolution in 1961 in order to meet urgent necessities of the time. The draft of the Code passed the Revolutionary Cabinet on September 18, 1961 and after brief deliberation, it was carried through the Supreme Committee of National Reconstruction on January 20, 1962. These factors inevitably contributed to a poor start for the legislation and, as expected, the outcome was far from satisfactory. The Code is beset with incompleteness, unreasonableness and uncertainties which produce an inextricable confusion both to Korean businessmen and to foreign investors who wish to share in the advantages of Korean business conditions. The situation has further been aggravated by the fact that changes in economic life were so extensive and so rapid during the past ten years that the need to adjust the Code to changing economic circumstances has been ever more pressing and urgent. Truly, it is about the time to sit down and consider possible alterations and improvements. Unless some remedial measures are taken before too late it is clear that the spirit of the present Code cannot be maintained and the demands of the modern economic society cannot be satisfied. The following paper is one of the series of papers that will be contributed to this Journal to set a reformation movement on foot.

II. THE ACQUISITION BY A CORPORATION OF ITS OWN SHARES

A. The Nature of The Problem

Section 341 of the Commercial Code of Korea provides that a corporation cannot acquire its own shares or take them as pledge except in the following cases: (1) when the shares

(3) The history of the corporation law in Korea starts with the old Japanese Commercial Code of 1899 which was imposed by the Japanese Governor-General upon the Korean people after the Japanese occupation in 1910.


(5) I have received quite a few letters especially from the foreign investors who were complaining about such defective legislation. This was again confirmed through an interview with Attorney Jin Ouk Kim who is taking care of most of foreign investors' cases in Korea.
are to be amortized; (2) when the corporation is merged or consolidated with another corporation or the entire business of another corporation is transferred by sale; or (3) when the corporation finds no other means of executing its claims as a creditor except taking its own shares. Even in these exceptional cases, the corporation is required by Section 342 to take necessary procedures without delay to cancel or resell the acquired shares. The directors and officers who have violated this requirement are imposed a negligence fine of not exceeding fifty thousand won (₩50,000). *(6)* It should also be noted that Section 625, Item 2 of the Korean Commercial Code provides that the directors and officers who have illegally caused the corporation to acquire its own shares shall be liable to imprisonment for a period not exceeding five (5) years or to a fine not exceeding one hundred thousand won (₩100,000).

The reasonableness of this rule of general prohibition of share acquisition is quite doubtful and at least some modifications are necessary. Since there is no legislative report for the new Code, it is impossible to find out the exact reasons for this rule, but the following three considerations seem to have influenced its establishment: (1) the theoretical contradiction, (2) the *ultra vires*, and (3) the dangers of abuses. We will examine each of these considerations and then make some suggestions with proper discussions of various related problems.

**B. The Theoretical Contradiction**

The first consideration underlying the rule strictly prohibiting a corporation from acquiring its own shares is that the acquisition would be anomalous and repugnant to the general concept that a corporation cannot be a member of itself. An English judge once well expressed this notion by saying that “It (a corporation) cannot be registered as a shareholder to the effect of being debtor to itself for calls or of being placed on the list of contributories in its own liquidation.” *(7)* In Korea, where theory and logic is more revered than practical necessity, this reasoning seems to be highly persuasive. *(8)*

It is true that a corporation should not be allowed to subscribe to its own shares when they are newly issued, but the situation is different when the corporation acquires the shares thereafter. In the present economic society, the shares of a corporation, whether or not they are its own shares, once issued becomes securities that are freely and independently negoti-

---

*(6)* Korean Commercial Code, Sec. 635, Item 17.
able in the securities market. They become not only a means of raising funds for the corporate enterprise but also a means of creating an independent value in themselves. Once born into the economic society securities are sold and purchased just like any other sort of ordinary property. In fact, as capitalism reached it maturity, they commanded a great confidence as one of the most desirable forms of property from the aspect of future security.\(^9\) It is not contradictory for a corporation to acquire its own shares, as it would acquire any other property.

Furthermore, if the rule stems from the theory that it is illogical for a corporation to own a share of itself, the necessary consequence is that the corporation should be prohibited absolutely from taking its own shares. How can the exceptions to the rule provided in the Code be explained? The theory is itself inconsistent.

**C. Ultra Vires**

A second basis for the rule could stem from a limited notion of a corporation’s legal capacity. Since Section 34 of the Korean Civil Code provides that a juristic person has the capacity to become the subject of rights and duties only within the scope of the provisions of the laws under which it is created and of its articles of incorporation, and since there is no further provision in the Korean Commercial Code concerning the capacity of a corporation, it might be concluded that the corporation has no capacity to acquire its own shares unless expressly allowed in the articles of incorporation. This ultra vires consideration seems to be controlling in England.\(^{10}\) The leading case was *Trevor v. Whitworth*\(^{11}\) in which the court said that if the corporation acquires its own shares with a view to selling them again in the future, this would be an unauthorized speculation amounting to a trafficking in its own shares. On the other hand, if the corporation does not intend to reissue the shares, the purchase would be tantamount to an invalid method of reducing and liquidating the capital of the company, and thus the share acquisition is a violation of the company’s charter and ultra vires.\(^{12}\) Under this theory, the acquisition by a corporation of its own

---


\(^{11}\) 12 App. Cas. 499 (1887).

shares is ultra vires even though made in good faith with the consent of the shareholders and without any intention to defraud creditors. But it seems that shares could be forfeited, or surrendered, or received as a gift where no consideration is paid.

It is hard to understand why the capacity of corporations should be interpreted so narrowly that a corporation is possessed of only the powers expressly enumerated in its articles or the laws. The Section 34 addresses itself to the capacity of a juristic being in general and it is doubtful whether the section as it applies to the corporation should be construed to forbid the corporation, whose main purpose is doing business in the commercial arena, from purchasing its own shares merely because the corporation is also, formally, a juristic being. The corporation, though having the form of a juristic being, is, in substance, a business association regulated by the commercial law and should be distinguished from other juristic beings.

There seems no valid reason for confining the operation of the ordinary private business corporation only to those transactions expressly enumerated in the articles and excluding all others. It would be more suitable to the nature of a business operation that the corporation be presumed to have some additional implied powers usual in the course of business and necessary to carry out its expressed objectives. The purchase of its own shares, like the purchase of its own bonds or of shares of other corporations, should be said to be within the ambit of these powers.

The use of the doctrine of ultra vires to prohibit the corporation from acquiring its own shares is incorrect and misleading. It is necessary to distinguish between the capacity of a corporation to act in fact and the right of corporation to act with legal effect. The corporation, as we have discussed above, has the power to do any act connected with the expressed objectives of the corporate business, but it might not have the right to do such an act. The assertion that a corporation cannot purchase its own shares cannot spring from any lack of capacity on the part of the corporation or any lack of reasonable connection with the business objectives of the corporation, but must derive from its lack of the legal right to do so for some other reasons. To discuss the purchase by the corporation of its own shares in terms of the ultra vires doctrine is highly confusing. This is well illustrated by the fact that in the United States the early authorities simply followed the English doctrine of ultra vires; the prohibition for the share acquisition was based on the ground that

(13) 6 A Fletcher, Cyclopedia, Sec. 2847 (rev. ed. 1968).
such action produces special injuries to the corporate creditors and shareholders.\(^{14}\)

Ultra vires is a conclusionary term, and it is not a reason. To say that a corporation cannot do an act because it is ultra vires says absolutely nothing about why the act should not be done. That is why American jurisdictions gave up the mechanical use of the English doctrine, and gave reasons for the refusal to allow a corporation to acquire its own shares. To maintain that a corporation lacks legal capacity to do an act should be grounded on reasons reflecting legal policy. A blind adherence to ultra vires is like saying: “A corporation lacks legal capacity to do this act because it lacks legal capacity.”

**D. Legal Policy**

A third rationale for the rule is that the purchase by a corporation of its own shares should be prohibited because of its dangers of abuses; *i.e.*, because of its illegality rather than of its incapacity or of its theoretical contradiction. At least reasons are given to forbid corporate acquisition of its shares rather than mechanically claiming that it is ultra vires or theoretically absurd. An American judge once said in this connection, “If a corporation has received property into its treasury of the value of its authorized shares, that is no doubt subject to the vicissitudes of its enterprises, which will be represented by public knowledge of its success or of the value of its shares. If, however, it purchases its own shares, this affects neither the value of the other shares, the success of its enterprises, nor the amount of its apparent share capital. It is merely a method of secret distribution. It is a strange thing I think, that there have been cases which permit the practice, which seems to me to be inevitably mischievous commercially.”\(^{15}\)

The alleged danger of abuse of share purchase may be summarized as follows:

1. The purchase by a corporation of its own shares is tantamount to a form of distribution of its assets to shareholders; it depletes the net assets of the corporation and will impair the corporate capital upon which creditors have a right to rely if the purchase reduces the net assets below the marginal limitation of legal capital. No doubt the corporate capital contributed by the shareholders will be changed and sometimes diminished by expenditures incidental to business management or by business loss. All corporate creditors have fully been aware of this and they have no reason to object to such corporate activities. But the situation is different when the corporation purchases its own shares. Share reacquisition constitutes are turn of corporate capital to the shareholders. Creditors, who never expected such a return,


surely have a right to insist that the capital not be impaired by such activity. The shareholders should not be permitted to withdraw their original investment from the corporation leaving the creditors with a diminished security. It is for this very purpose that the reduction of corporate capital is to be effected only by the methods provided in the Code\(^{16}\) and corporate creditors must be given an opportunity to make an objection against the reduction,\(^{17}\) thereby preventing the reduced corporate capital from falling below the total amount of corporate debts and liabilities. If the share purchase is allowed, a factual reduction of corporate capital could be effected without following the elaborate statutory procedures.

(2) Not only are the interests of the creditors impaired by the share purchase, but it redounds also to the detriment of the existing shareholders. To allow the purchase by a corporation of its own shares makes it possible for the corporation to determine whose shares are to be bought; the determination of who can withdraw his investment at an advantageous price from the corporation in which he has lost confidence and of who must persevere in his investment despite his unwillingness.

The general rule is that the corporate losses and profits will be distributed equally among the shareholders.\(^{18}\) If the shares of a favored shareholder are purchased by a corporation and it has the effect of decreasing the corporate funds available for the corporate debts and thereby increasing the burden of the remaining shareholders, there will be a violation of the rule and the remaining shareholders surely should be allowed to protest against the share purchase. Money cannot be taken from the pockets of the remaining shareholders for the sole benefit of the retiring shareholder.

(3) The purchase by a corporation of its own shares may be utilized by the directors of the corporation to tamper with the voting control. It is true that the corporation’s acquisition of its own shares does not automatically effect a cancellation of the acquired shares, but it is clearly recognized that while the corporation retains its own shares, they may not be voted.\(^{19}\) Thus, by using the corporate funds to purchase some of the shares outstanding and to make them treasury shares, the directors can retire them from the voting arena, reducing the total number of votes and the number of votes required to constitute a majority. For example, the directors’ group who is now holding 49 out of 100 shares will become a group having 51 per cent of the total votes if the corporation purchases and holds 3 shares.\(^{20}\) Prior to the

\(^{16}\) Korean Commercial Code, Secs. 438 & 439.
\(^{17}\) Id. at Sec. 439, Par. (2) & (3).
\(^{18}\) Id. at Sec. 369, Par. (1) & Sec. 329.
\(^{19}\) Id. at Sec. 369, Par. (2).
\(^{20}\) Id. at Sec. 369, Par. (2).
purchase, the directors might have been ousted from control of the corporation by a combination of all the other shareholders, but after the purchase, any such combination is of no use and the directors can intrench themselves in power indefinitely so long as the 3 shares remain in the corporate treasury.

It may be said that when the shareholders invested in the corporate enterprise they could have foreseen that there would be a change in voting strength as the corporation embarked on its business operation and that a majority of the voting shares might fall into the hands of an unsympathetic group or person. But they expected that this change would be achieved only through the normal transfer of shares among individual shareholders. They would have never anticipated that the corporate funds contributed by themselves for management of business of the corporation would be diverted to purchase the corporation’s own shares for the personal interest of a certain faction in its voting control. And even if majority strength cannot be acquired in this way, the share purchase would surely bring about a change in the voting structure of the corporation on which shareholders relied when they joined in the venture.

In addition, the purchase by a corporation of its own shares makes it possible for the incumbent management to use corporate funds to buy out potential insurgents. The shareholders should not unfairly be deprived of their opportunity to hear from the insurgents concerning management of corporation. The following statement by Ford Macnaghten seems appropriate: “Who are the shareholders whose continuance in a company the company or its executives consider undesirable? Why, shareholders who quarrel with the policy of the board, and wish to turn the directors out; shareholders who ask questions which it may not be convenient to answer; shareholders who want information which the directors think it prudent to withhold. Can it be contended that when the policy of directors is assailed they may spend the capital of the company in keeping themselves in power, or in purchasing the retirement of inquisitive and troublesome critics?”

(4) If the shares are listed on a stock exchange or otherwise marketed, the purchase by a corporation of its own shares may be used in aid of stock speculation or even of stock mani-


(21) *In re Dronfield Silkstone Coal Co., Ltd.*, 17 Ch. D. 76, 50 L.J. Ch. 387 (1880); See, also, Note, Buying Out Insurgent Shareholders With Corporate Funds, 70 Yale L.J. 308, 316 (1960).
Section 341 Commercial Code of Korea

pulation. By purchasing extensively of its own shares and creating a “bull” market, the corporation can set a fictitious high value on its shares. This artificial value would mislead the investing public and in the long run would become a major cause of distrust of the corporate institution. Purchases made by the corporation at an inflated price would also impair the finances of the corporation and would be prejudicial to the remaining shareholders. Suppose the corporation goes on purchasing its own shares at a fictitious value without any definite success where general business conditions are depressing the market. What would happen to the corporate treasury and who would become the victims of such share purchases? Moreover, to allow the purchases could suppress a market warning sign of price weakness and would prevent the corporation from taking other possible curative measures under such circumstances. Nor does the purchase made at a price less than the real value of the shares seem beneficial to the corporation or to the remaining shareholders. It would be a mere speculation by the directors not with their own money, but with the funds to which all the shareholders contributed, and therefore basically worse than a speculation in the securities of other corporations. The investing public at large and the shareholders are always interested in a realistic price for the shares, and the corporation’s trafficking in its own shares would depress the stock market.

(5) The purchase by a corporation of its own shares would give rise to various difficult problems in accounting practices. The nature of treasury shares is ambiguous and leads to much bewilderment and fiction in accounting technique and procedure. This may be more so in a country like Korea where accounting practice is still in its development stage. It is uncertain whether the treasury shares may be considered as assets and it is also uncertain and arguable what factors should determine the valuation of the treasury stock. Even if these problems are solved in one way or another, there still remains the problems of how to treat the shares on the balance sheet in relation to the capital account and to the surplus account. This last problem may be summed up as follows.

(A) The effect on the capital and/or on the surplus available for dividends; (i) when the shares are purchased, (ii) when the shares are resold, (iii) when the shares are cancelled,

(B) The effect on the capital and/or on the surplus; (i) when the purchase price is less than the par value, (ii) when the resale price is less than cost, (iii) when the value of cancelled shares is less than cost, and,

(C) The effect on the capital and/or on the surplus; (i) when the purchase price is more than the par value, (ii) when the resale price is more than cost, (iii) when the value of
cancelled shares is more than cost.

The complexities and confusions involved in these problems may seem sufficient to justify denial of the right of the corporation to purchase its own shares.

It is true that there some understandable dangers of abuse in allowing a corporation to purchase its own shares. However, it is doubtful whether it is reasonable to prohibit share purchases completely even in the absence of facts and circumstances tending to show such dangers of abuse. Furthermore, the claimed dangers and abuses may have been exaggerated in practice. The considerations discussed above seem not so convincing as to justify the arbitrary total ban of share purchase. (23)

With respect to the assertion that the share purchase is an indirect and unlawful method of reducing the corporate capital and thereby impairs the cushion provided for the protection of the corporate creditors, it is sufficient to note that the share purchase does not necessarily bring about a reduction of corporate capital. The shares purchased would have their own value equal or similar to their cost, compensating for the money spent for the purchase, and, further, can be resold for immediate realization of the value, if necessary. (23)

Moreover, when the share purchase is made from an abundant surplus that has been accumulated by the corporation, the assertion becomes more doubtful. Surely no creditors could insist that they have an absolute right to ask the corporation to preserve such surplus intact for the satisfaction of their claims only.

Furthermore, it should also be noted that when the creditors are in a danger of being injured by an imprudent share purchase by the directors, they have enough other remedies (24) for their protection, and it is hard to understand why the extreme of a total prohibition is necessary. It is clearly an excessive sanction.

In addition, the merits of the prohibition fail utterly when there are no creditors of the corporation to be injured. (25)

(22) See, The Jenkins Committee, Cmd. 1749, Para. 177-186.
(23) An American Judge once wrote: "In some way, it (the corporation) had become the owner of these shares, not for the purpose of diminishing its capital stock, but for enjoyment as property. As such they stood upon its books, until in the regular transaction of business the stock was transferred to Conkling. The company had a right to hold it unextinguished and a right to reissue it." Danforth, J. in Vail v. Hamilton 85 N.Y. 453, 457-458, 20 Hun. 355, 358 (1878).
(24) Korean Commercial Code, Sec. 401.
(25) In Goldberg v. Peltier, 75 R.I. 314, 66 A.2d 107 (1949), the statute barred corporate purchase of its shares if capital be impaired, but the court held the provision inapplicable to a corporation without creditors.
The next argument was that the purchase by a corporation of its own shares is prejudicial to the remaining shareholders. However, the argument is really directed to the fact that the directors may use their power to defraud the remaining shareholders. Therefore, if no fraud or bad faith is involved on the part of the directors, it loses its justification. Moreover, it should not be forgotten that when there is fraud or bad faith on the part of the directors, the shareholders always have adequate remedies provided in the corporation law.\textsuperscript{(26)} In addition, if a corporation repurchases "treasury shares," i.e., shares which had previously been donated to the corporation and then resold, the argument cannot be sustained.\textsuperscript{(27)}

It was further argued that the share purchase makes it feasible for the directors to buy out corporate dissenting shareholders with corporate funds where they personally could not afford to do so. But that is not always harmful to the corporation unless accompanied by bad faith. Sometimes it is advisable as we shall observe later.

Another argument was that the share purchase is liable to induce a corporation to engage in stock manipulation or speculation involving risks that were not originally contemplated. However, this argument is not so convincing as to lead to a total interdiction, since a share purchase does not necessarily involve a trafficking in shares, and can be made for ancillary business purposes. There is no doubt that a share purchase to knock down occasional disturbances of share prices in the market is desirable, unless motivated by fraud or other improper ends. In fact, in the United States the practice of share purchase by corporations kept the mechanism of the securities market running during the panic of the American economy in 1929.\textsuperscript{(28)} A share purchase is subject to criticism only if the corporation is abusing its power to defraud the existing shareholders and the investing public. What is condemned is such an abuse only.

It was argued that the dubious nature of treasury shares gives rise to deceptive and manipulative accounting practices. But whatever validity this argument may have, it is directed to the problem of how to regulate accounting techniques and procedures, and not whether or not to deny the right to the corporation to purchase its own shares.

In addition to these considerations, it should be noted that the share purchase is often

\textsuperscript{(26)} The right to remove directors (Korean Commercial Code, Sec. 382), the derivative suit (Id. at Sec. 403), the injunction procedures (Id. at Sec. 403) the equal treatment of shareholders (Id. at Sec. 369. Par. (2) & Sec. 329), etc.

\textsuperscript{(27)} See, Simonds v. Noland, 142 Wash. 423, 253 Pac. 638 (1927).

useful and sometimes even necessary for the proper management of corporate business. Not infrequently, the corporation finds it desirable to acquire its own shares for the following business reasons.

A corporation may feel it necessary to accept its shares in cancellation of an otherwise uncollectable debt owed by a shareholder to the corporation, or to take them as collateral in satisfaction of a debt, or to effect a compromise of a disputed claim. In the absence of other assets with which the obligation could be paid, it would certainly be better for the corporation to take back its shares than to receive nothing at all. If the corporation takes them, it could at worst get the benefit of being released from its obligations as to the shares; for example, its dividend obligations. But in allowing such share acquisition it would be important to determine whether or not the debt is otherwise uncollectable.

A corporation may sometimes find it desirable to acquire its own shares through a gift or bequest, unless the donor is attempting to escape his subscription liability to the corporation by such a gift or bequest.

A corporation may also find it necessary to have the right to take its own shares when it receives them by virtue of a merger, consolidation, or distribution of the assets of another corporation.

It is desirable for a corporation to be able to purchase its own preferred or redeemable shares since these kinds of shares are akin to a corporate debt, and it is often advantageous for the corporation to purchase and retire them as soon as possible. It would, for example, allow the corporation to be free from interest-like payments of guaranteed dividends, and the corporation could have more unrestricted funds available for distribution to the common shareholders. The purchase could further provide a saving to the corporation, when it is made at a favorable price. The corporation may also feel it necessary to make individual purchases of redeemable shares toward the same end if redemption of the entire class at one time is financially infeasible. In addition, such share purchase make it possible for the corporation to obtain fresh capital more cheaply. If a corporation issued 10% preference shares at a time when interest rates were high, it may wish to pay off those shares when interest rates fall so that it can raise an equivalent amount of capital by issuing 5% preference shares. (29)

A corporation may wish to purchase its own shares to return the capital which is in excess of its wants when it has sold a part of its undertaking and intends to confine its future

(29) For more detail, see, Pennington, Company Law, p.150 (2nd ed. 1967).
activities to running the remaining part of its business. The shareholders who want to withdraw their investment from such corporation can sell their shares to the corporation, and the corporation retires the shares when it thinks appropriate. In United Kingdom, this method was very popular in the late's and early 1950's when corporations which carried on two or more different kinds of business were compelled to sell one of them to a public corporation\(^{(30)}\) under statutory schemes for nationalization\(^{(31)}\).

The share purchase is useful in order to dispose of the problems of so called fractional shares, often created as a result of merger, consolidation or stock dividends. While the shareholders may be given an option to take cash in place of fractional shares, this might result in undesirable consequences; tax considerations to both the shareholders and the corporation would at least come into play. Furthermore, the continued existence of fractional shares in the corporation would also create some troublesome problems such as whether the holders of fractional shares have a fractional vote, whether they are entitled to a fractional share of dividends, etc. These and other problems could easily be solved, when the corporation is allowed to acquire its own shares.

The purchase by a corporation of its own shares is also sometimes very useful in floating stock issues. The agreement to repurchase the shares if the shareholders wish to withdraw from the investment may entice otherwise reluctant investors. To give the subscribers the option to return the shares to the corporation within a certain limited time without loss on the part of the subscribers is obviously an excellent sales technique. This kind of agreement would also make it feasible for the corporation to borrow the names of famous shareholders and to advertise them, thereby promoting other share subscriptions and credit extensions, especially at the time of initial share issuance of a newly established corporation.

A corporation may sometimes feel it necessary to purchase its own shares in order to market its new stock or bond issue, or in order to stabilize market disturbances. While share purchase for the sole purpose of creating a fictitious market price may be undesirable, the use of the share purchase to establish a healthy market ability of shares is desirable from the corporation's perspect, albeit to a limited extent.

The share purchase is a desirable way to make it possible for the corporation to establish an employee stock option plan by agreeing to repurchase the shares of an employee who leaves the corporation\(^{(32)}\). To give employees a share of profits made from the corporate


\(^{(31)}\) Pennington, op. cit., p.156 (2nd ed. 1967).
business is a great incentive to the employees and is an aid to the corporation in securing their faithful service and performance. Through the scheme of share purchase, the corporation can easily procure the necessary shares to be distributed to the employees and can reserve the option in itself to repurchase them upon the termination of the employment contracts.\footnote{Husband & Dockery, Modern Corporation Finance, p. 237 (1952); Burtchett, Corporation Finance, c. 24 (1934); The English Companies Act 1948, Sec. 34 (1), Provisons (b) & (c).} The rarity of the employee stock option plan in Korea seems to be due mainly to the rule prohibiting share purchase. Note also that quite a few foreign investors in Korea wish to adopt an employee stock option plan as one of their management policy for the purpose of securing such faithful service and performance from their Korean employees, but the prohibition is making it difficult.

The purchase by a corporation of its own shares could help alleviate internal dissention among shareholders. In a closely held corporation, the structure of the business is, in substance, similar to that of a partnership, and differences over management of corporate affairs are likely to have disastrous results. The situation is further aggravated by the fact that there is usually no ready market established for the sale of shares of such corporation and that, in general, nobody wants to take a minority interest in a closely held corporation. The device of share purchase may be helpful in such a case. Under a share purchase arrangement, the dissenting shareholders could easily sell their shares and withdraw their investments, while the remaining shareholders would retain the ownership and control of the corporate enterprise. This device of share purchase could smoothly convert the ill corporation to a healthy one and could benefit all of the shareholders.

In the case of a publicly held corporation, it might be said that such use of the share purchase is not necessary because the shares of such a corporation are generally traded in the securities market, and the dissenters could easily sell out their shares. But still there may arise some situations in which it would be more advantageous to allow the corporation to purchase its own shares. For example, management may find it desirable to purchase shares because they have reasonable grounds to believe that some outsiders are trying to take over the corporation for improper purposes; \textit{e.g.}, milking the corporation through improvident dividends.\footnote{Such restraint of alienation on the shares distributed to the employees would not be in violation of Section 335 of the Korean Commercial Code; Forcases in the U.S., see, Frey, Morris & Chopper, Cases and Materials On Corporations, pp. 371-180 (1966).} Of course, there is a danger of abuse, and management should never be allowed

\footnote{A good example is found in \textit{Zahn v. Transamerica Corp}, 162 F. 2nd 26 (3rd Cir. 1947).}
to cause the corporation to purchase its own shares solely to perpetuate its control or to crush the challenge of insurgents. But it would not necessarily follow from this danger that the share purchase is always detrimental and must be prohibited. If the directors' prediction of fraud is reasonable and is supported by evidence from present or prior transactions, they may well be allowed to take a repressive measure.

In a closely held corporation, the share purchase could be of service not only to solve internal deadlocks, as we have seen, but also to keep the corporation closed. In some situations the shareholders regard themselves as copartners of the venture and desire to keep it closed or to have control over the entry of new members. In such cases, the share purchase would make it possible for the corporation to negotiate a stock repurchase agreement with each shareholder, thereby precluding him from selling his shares to outsiders and enabling the remaining shareholders to determine who shall be their new copartners. This consideration has a special significance in the present Korean economic circle. The foreign investors, when they invest in Korea, wish without exception to provide a stock repurchase program by the corporation in the articles of incorporation of the corporation to be established. It is, however, infeasible under the present Korean Code because of the prohibition. Some may thus argue that same objectives can be accomplished by way of a private contract between the foreign and Korean investors, that is, by providing a stock repurchase agreement in the joint venture agreement. Truly, such contract is possible and valid, but is entirely based on the individual investor's freedom of contract and subjected to the general rules of ordinary contract. The contract is enforceable only between the parties concerned and cannot have a binding effect on the third parties. Moreover, the situation in which the new corporation repurchases its shares from the Korean partners and that in which the foreign investors themselves repurchase the shares from the Korean partners have different legal implications from the point of the Korean Foreign Capital Inducement Law. (35) Whereas the former does not require an authorization or other approvals from the Korean Government since the corporation is a Korean corporation and the transaction is made between Korean nationals, the latter does require such authorization or approvals since the foreign investors are not Korean nationals. (36) The problem is further complicated when some of the foreign investors, for some reason, do not have enough money or do not want to invest more funds in Korea to repurchase the Korean partners' shares.

Sometimes a corporation finds it difficult to carry out a particular transaction beneficial to the corporation but involving a fundamental corporate change such as the sale of corporate assets, merger, consolidation, etc., because of objections from minority shareholders. Opposition could be eliminated without much difficulty by merely offering to the dissenters the privilege of being bought out by the corporation at an appraised value. In Korea, where there is no appraisal right of shareholders at the time of such drastic change, the share purchase would be of great value.

The recognition of the share purchase would also have a great significance for Korea in her national drive toward economic development. Korea is now encouraging the public shareholding as a positive means of raising national capital and of distributing profits from it equally among the people. For this purpose, the institution of "mutual funds" would be quite effective as is true in the United States and in other countries. The institution is particularly appealing to the small individual investors who do not have professional knowledge and ability to make a right share purchase and who wish to secure the advantage of a spread investment. However, only when a corporation is allowed to take its own shares, it is possible for such institution to operate as corporate organization. Otherwise, the more complicated medium of trust should be devised to achieve the same end, which has, in United Kingdom, led to a considerable confusion and waste of money and time. In this connection, it should also be mentioned that Korea is inducing foreign capital investment and that to legalize the acquisition by a corporation of its own shares would enhance the business attractiveness of the country. Quite often, foreign investors want to do business in Korea through their subsidiaries and for some reason, e.g., as a method of preserving control, wish to create cross and circular holdings with their parents or other subsidiaries. The prohibition of share purchase would not allow such corporate activity, and would, in the same manner,

---

(37) The number of corporations listed on the Korean Stock Exchange has been increased from 15 in 1963 to 50 in 1970, and the number of shareholders of those corporations from around 10,000 in 1963 to around 70,000 in 1970. (Data from the Korean Stock Exchange); For current development, see, The Cho Sun Il Bo, Sept. 2, 1971, p.2; For tax benefits, see, the Korean Corporation Tax Law, Sec. 22 and the Korean Income Tax Law, Sec. 27.


(39) See, Merriman, Mutual Funds And Unit Trusts-A Global View (1965); The total world funds at the end of 1964 were in the region of 30,000 million of net assets. Id. at p. (iii).

(40) Rosenliein & Merriman, Unit Trusts And How They Work (1937); Pennington, Company Law, C.31 (2nd ed. 1967); Jenkins Committee Report, C. IX, Cmnd. 1749.
hinder Korean corporations from establishing and operating subsidiaries in foreign countries.

In summary, it is true that the acquisition by a corporation of its own shares is, in practice, open to possible abuses. However, the mere possibility of abuse is not of itself sufficient to justify the arbitrary rule that a corporation cannot purchase its own shares irrespective of good purposes or results. No persuasive reasons are seen for objecting to the practice when it is made in good faith and without prejudice to the rights of the remaining shareholders or creditors. It has been made clear that the share purchase is often quite useful and valuable in the conduct of a corporate business. Moreover, discerning courts would, of course, prohibit the share purchase when made with bad faith or fraud or when it conflicts with well recognized and superior legal interests.

There seems to be nothing immoral or contrary to public policy in permitting share purchases. If it is argued that the share purchase is economically unproductive when a corporation is incorporated for the sole purpose of trading in its own shares, the answer is that merely permitting share purchase does not mean that a corporation may come into existence for the sole purpose of trafficking in its own shares.

The question of whether a corporation may be permitted to purchase its own shares to effectuate other legitimate business objectives is quite different from that of whether a corporation may be incorporated only to trade in its own shares. The practice of share purchase in the United States and other countries does not seem to have brought about such dire consequences or harmful effects as predicted by the opponents. On the contrary, it seems to have contributed greatly to the increase of elasticity in corporate activities. Of the fifty-two jurisdictions including the District of Columbia and Puerto Rico, all but ten have express statutory authorization for share purchase in the United States. Of the fifty-two jurisdictions including the District of Columbia and Puerto Rico, all but ten have express statutory authorization for share purchase in the United States.

The only question, then, becomes one of qualification in the right of a corporation to purchase its own shares; i.e., how to regulate it so as to reduce or eliminate the dangers of abuse. What is needed is the establishment of carefully drawn statutory regulations concerning the conditions under which the share purchase may be made, the source of funds available for the purchase, the status and legal nature of the shares after they are purchased, the effect of later resale or cancellation of the shares, the liability of directors for an improper share purchase, the remedies available to the shareholders or creditors in case of such

an abuse, the accounting techniques and procedures to be followed upon purchase, resale or cancellation, and other similar matters.

Some suggestions for these needed provisions are made hereafter with discussion of related problems.

E. Legal Requirements

1. Source of Funds

The capital stock in a corporation is a fund which was contributed by the shareholders for the planned corporate business as a substitute for their limited personal liability, and it constitutes the margin of net assets which is to be retained in the business. Although not a genuine trust fund, it is a safeguard, a basis for the corporation's financial operations, and is not to be dissipated or reduced by any voluntary action of the directors. Therefore, it is obvious that the share purchase must not be made out of capital stock, but must come from some surplus account. Even in the United States almost all jurisdictions follow this rule.\(^{(43)}\)

(1) Earned Surplus

If the share purchase is made out of earned surplus, neither the creditors nor the remaining shareholders can raise objection. The creditors most likely did not, and certainly should not, have extended their credit in reliance upon earned surplus as a safeguard for repayment, since capital stock is the only fund promised by the corporation to them for this protection.\(^{(44)}\)

As far as the remaining shareholders are concerned, it might be argued that the share purchase out of earned surplus would have the effect of decreasing corporate assets and of diluting their interest in the corporation.\(^{(45)}\) However, this argument is sustainable only when the share purchase is made at an unfair price. As long as the price paid does not exceed the amount which the other remaining shareholders would receive if the corporation were dissolved, no shareholders have grounds for complaint.

It is apparent that to allow the share purchase out of earned surplus does not mean that the purchase may be made at any price on whatever conditions. Most of American corporation

\(^{(43)}\) 6 A. Fletcher, Cyclopedia, Secs. 2848-2849 (rev. ed. 1968).

\(^{(44)}\) See, Hope v. Northwestern Mfg. & Cas. Co., 48 Minn. 174, 198, 50 N.W. 1117, 1140 (1892), "In as much as the capital of a corporation is the basis of its credit, its financial standing and reputation in the community has its source in, and is founded upon, the amount of its professed and supposed capital, and every one who deals with it does so upon the faith of that standing and reputation..."

\(^{(45)}\) Stevens, Corporations, p. 278 (1949).
statutes allow the share purchase out of earned surplus without and special qualifications.\(^{(46)}\)

(2) Capital Surplus

But if the share purchase is made out of capital surplus, the situation seems a little different, and divergent views may be suggested.

As far as the creditors are concerned, it still seems that they would have no legitimate objection to the share purchase made out of capital surplus. It would be hard for the creditors to maintain that they extended their credit in reliance upon paid-in surplus since they have no right to rely on any corporate fund except the pronounced legal capital stock.

As for the reduction surplus,\(^{(47)}\) it might be argued that the fund on which the creditors relied was the capital stock before its reduction and the corporation should be estopped from impairing this fund. But, in Korea, the reduction of capital stock cannot legally be made without the consent of the existing creditors,\(^{(48)}\) and once they have given their consent, it seems fair to say that they no longer have any ground to rely on the old capital stock.

With respect to the revaluation surplus, it might be argued that an asset write-up is, in substance, a capital write-down or a shrinking of a capital asset on which the creditors relied in extending their credits. Of course, if the asset write-up itself was unfair or illegal, it would result in the dilution of the creditors' interest in the capital asset; but that is an entirely different problem. So long as the asset write-up was fair and legal, the creditors cannot object since the capital asset was merely revalued to reflect its true worth. The amount of capital stock on which they relied when they extended credit was never changed, and the equivalent amount of asset is still there. Thus, even if the share purchase is made out of such revaluation surplus, the creditors would have no ground to protest against it.

The remaining shareholders, on the other hand, might have some grounds for objection to the share purchase from the capital surplus. It is clear that the paid-in surplus is nothing but a part of their original contribution and quite different from earned surplus. The shareholders should be assured of a limited guaranteed against improvident distributions of their original contribution.

The reduction surplus is also a part of shareholders' original contribution. It is merely a surplus which is, in reality, partly diverted capital. The sum of the shareholders' original

\(^{(46)}\) 6 A Fletcher, Cyclopedia, Sec. 2849 (rev. ed. 1968); ABA-ALI, Model Bus. Corp. Act, Sec. 5. Item 2.

\(^{(47)}\) Surplus arising from a reduction of stated capital, see, Korean Commercial Code, Sec. 459, Pars. (2) & (3).
investment is not equal to the reduced capital but to the plus the reduction surplus. The shareholders have a clear interest in having such surplus undisturbed.

As for the revaluation surplus, it might be argued that the shareholders would have no right to object for the same reasons discussed above with regard to creditors. But the main flaw of this argument lies in the assumption that shareholders are equivalent to corporate creditors, in relation to the corporate capital. The shareholders, of course, have an interest in the preservation of the corporate capital, but it does not follow that they may be treated in the same way or have the same interest in the corporation as creditors. The creditors have an interest in the corporation in money value according to the amount of their claim; their interest is constant and does not change whether there is inflation or deflation. On the other hand, the shareholders have an interest in the corporation, not in the money value of the amount of their investment but in the proportion of their shareholdings; their interest in the corporation is not constant and is affected by economic inflation or by asset write-up. The share purchase out of the fictitious surplus created by the asset write-up would surely cause the dilution of the shareholders' original interest in the corporate enterprise. Thus, as to the remaining shareholders, the share purchase made out of capital surplus is as detrimental as that made out of capital itself, and clearly has the effect of allowing a favored shareholder to withdraw his original investment. Therefore, the corporation should not be permitted to acquire its own shares out of capital surplus.

But this does not mean that the remaining shareholders have no freedom to give up a portion of their original contribution. It is suggested that the corporation should be able to purchase its own shares out of capital surplus, if authorized by the articles of incorporation, or by the affirmative vote of as many shareholders as is required to amend the articles.\(^{49}\)

(3) Exceptions

Although as a general rule the share purchase should not be allowed out of capital, there are a few occasions in which the purchase would not seem to be prejudicial to the rights of creditors or shareholders. In such cases, capital stock is or may be technically impaired, but this does not seem so vital as to prohibit share purchases.

(A) Redemption of Redeemable Shares

According to the Korean Code, redeemable shares can only be redeemed out of surplus.\(^{50}\)

\(^{49}\) To amend the articles of incorporation, more than two-thirds of the votes at a meeting attended by more than one-half of the total number of the issued shares are required. See, Korean Commercial Code, Sec. 434.

\(^{50}\) Korean Commercial Code, Sec. 345, Par. (1).
This requirement is too rigid.

As far as those creditors and shareholders who extended credits or made investments after the issuance of redeemable shares are concerned, there is no ground to object to the redemption of the shares even out of capital because, under the Korean law, treatment of redeemable shares and their subsequent redemption is required to be outlined in the articles of incorporation, (51) and in the share certificate. (52) And, therefore, the creditors and shareholders has full notice that the portion of capital represented by such redeemable shares may, if the corporation so decides, be treated as a loan to be paid off or refunded rather than as a permanent contribution to the business. This assumes, of course, that the price for the redemption is not higher than the redemption price stated in the articles.

However, concerning those creditor and shareholders who had already extended their creditor invested their money before the redeemable shares were issued, it might be argued that, since they did not have any prior notice, they should be entitled to protection against the redemption. But, firstly, the claim cannot be sustained with respect to the shareholders. Under the Korean Commercial Code, redeemable shares cannot be issued by the corporation unless so provided in its articles of incorporation. (53) The articles of incorporation in Korea can be adopted and/or amended only by a special resolution of the shareholders’ general meeting. (54) These requirements clearly furnish the shareholders an opportunity in advance to participate in the creation of redeemable shares and to become aware of their special position. Secondly, so long as the redemption price is not higher than the par value of the shares, the creditors and shareholders would have no reason to object to the issuance of redeemable shares or to their subsequent redemption because it is obvious that the amount of the original capital would not be affected by such corporate activities. The issuance of redeemable shares would increase the original capital and the redemption would decrease the original capital and the redemption would decrease the increased capital but only to the extent of the increase. If the shares are redeemable only at a premium over par, the redemption would decrease the increased capital by the amount of the total par value of redeemable shares plus the total premium, and consequently impair even the original in which the creditors and the shareholders are interested. Nevertheless the redemption may be allowed. Since the interest of the management

(51) Id. at Sec. 344, Par. (2) & Sec. 345, Par. (2).
(52) Id. at Sec. 356, Item 7.
(53) Id. at Secs. 344 & 345.
(54) Id. at Secs. 308-316 & Secs. 433-434.
of the corporation is generally identified with the common rather than preferred shareholders under the present corporate system, the corporation's option to redeem its preferred shares is most unlikely to be exercised if it would be prejudicial to the common shareholders or result in the impairment of the original capital. Furthermore, even if the redemption is allowed out of capital, the resultant impairment of the original capital would not be serious the impairment is at most to the extent of the premium only.

In addition, if the redemption is allowed only out of surplus, it would prevent a corporation from redeeming such preferred shares even with a view to retiring them at a lower dividend rate unless it had accumulated sufficient surplus, thereby making it impossible for the corporation to carry out a desirable and advantageous redemption operation, or force the corporation to carry out the operation in dribbles.

But this does not mean that the shares may be redeemed even if the corporation is insolvent or is rendered insolvent by the redemption or that such shares can be redeemed out of capital despite the fact that other surplus is available for the redemption.

The purchase of redeemable shares should be clearly distinguished from the redemption of redeemable shares in that the right or duty of the corporation to purchase does not arise from a provision in the articles of incorporation but results from a specific agreement between the corporation and the individual shareholder and furthermore may not relate to all the redeemable shares. The purchase of redeemable shares is nothing but an ordinary purchase of shares which is qualified by a general limitation that a share purchase should not be made out of capital. Some people argue that the purchase of redeemable shares may also be made out of capital as in the case of redemption, provided that the purchase price is lower than the redemption price, because such purchase would eliminate dividend and liquidation claims which have priority over those of the common shareholders.\(^{(55)}\)

There are three reasons why this view is incorrect. (1) It is not always true that the purchase of redeemable shares at a price lower than the redemption price is advantageous to the common shareholders, since the redemption price is not compulsory and is nothing but an option in favor of the corporation. (2) The purchase of redeemable shares even under such conditions does not seem to contribute much toward recuperation of an unprosperous corporation. Such purchase would further deplete corporate funds and make the corporation's

\(^{(55)}\) Dodd, Purchase And Redemption By A Corporation Of Its Own Shares: The Substantive Law, 69 U. Pa. L. Rev. 697, 725 (1941); 6 A Fletcher, Cyclopedia, Sec. 2837. 3 (rev. ed. 1968); Ballantine, op. cit., p.606 (1946); Kessler, op. cit., 28 Fordham 637, 653-656 (1958).
unprosperous state worse. (3) This problem seems more theoretical than real, for when such a purchase is likely to put the common shareholders in a position where a slight improvement in the corporate earnings would make it feasible to pay dividends, the holders of redeemable shares would not sell their shares at a discount from the redemption price since such a circumstance is an indication that the business of the corporation is improving. On the other hand, when the holders are willing to sell the shares even at a discount, the directors of the corporation would not buy them since such willingness on the part of redeemable shareholders is an indication that the business of the corporation is getting more unprosperous and since the business judgment of the directors would induce them not to purchase such shares. Therefore, the purchase of redeemable shares should be treated in the same way as the purchase of ordinary shares.

(B) Compromising Corporate Claims

It is reasonable to allow a corporation to take its own shares in order to collect or compromise indebtedness to the corporation whether the claim arises out of the subscription contract or out of some other contract or transaction, even though this would effect a technical impairment of capital, since in such a case the corporation would be saved from the greater loss of non collection. Sometimes the arrangement might necessitate small payments by the corporation to the debtor, but still the value of the acquired shares would be in excess of such payments plus indebtedness, and the shareholders and creditors would not be prejudiced at all. In the absence of other assets with which the debtor can pay the obligation, it would certainly be better for the corporation to take its shares in settlement of its claim then to obtain an unenforceable judgment. And the corporation would also be released from its dividend and liquidation obligations to the debtor-shareholder. In allowing this kind of practice it should be required that the debt be otherwise uncollectable. In the United States, such acquisition of shares is allowed uniformly as an extra-ordinary case.\(^{(56)}\)

(C) Elimination of Fractional Shares

There is no express provision in the Korean Code concerning the general treatment of fractional shares. But Section 443 of the Code provides in connection with the consolidation of shares that fractional shares must be sold at public auction, and the proceeds delivered to

\(^{(56)}\) 6 A Fletcher, Cyclopedia, Sec. 2857 (rev. ed. 1968); Joseph v. Raff, 82 App. Div. 47 (N.Y. 1903) held that the directors may accept the resignation of the corporate president, where they deem it conducive to the best interest of the corporation, paying him for his stock and back salary, together with a certain further sum as liquidated damages or consideration for his resignation.
the shareholders thereof in proportion to their shareholdings, unless the court allows a sale in a manner otherwise than at public auction. This provision may be used analogically to eliminate fractional shares which have resulted from transactions other than consolidation. Therefore, it is probably unnecessary for the corporation to purchase its own fractional shares in order to eliminate them.

However, since there is still a possibility that the fractional shares may not be sold at public auction, or that the bidding price is so low as to prejudice the interest of the shareholders, the corporation itself may desire to purchase the fractional shares. In such a case, the purchase by the corporation should be allowed even out of capital, since the court would be participating in the process and since the amount to be paid for the fractional shares would not be so great as to impair the right of creditors and shareholders. Furthermore, the creditors and shareholders would rather be benefited by the fact that such purchase would expedite the elimination of the fractional shares and prevent possible complicated litigation arising from the existence of fractional shares in the corporation.

(D) Buy-out of dissenting shareholders at the time of fundamental corporate changes

The so called appraisal right of shareholders(57) in the case of merger or consolidation or a sale or exchanges of assets other than in the regular course of business is not provided in the Korean Code, and the dissenting shareholders in Korea are not entitled to such a right. But if share purchase is permissible as a general rule, it would be possible for the corporation to provide such a right in the articles of incorporation or to offer such a right to the dissenting shareholders at the time of such fundamental changes.

The purchase could be made even out of capital because there would be no danger of prejudice to the creditors or the other shareholders so long as the corporation offers all shareholders the right to sell. A fundamental change in the Korean corporation law requires a special resolution of the shareholders meeting,(58) and the shareholders are always given a chance to be fully apprised of the situation and vote accordingly. Creditors under the Korean law are also given a chance to examine the proposal of a fundamental change and to object

---

(57) For the problem of the appraisal right, see, Skoler, Some Observation On The Scope Of Appraisal Statutes, 13 Bus. Law, 240 (1958); Comment, The Right Of Shareholders Dissenting From Corporate Combination to Demand Cash Payment For Their Shares, 72 Harv. L. Rev. 1132(1969); Henn, Corporations, Sec. 349 (1961); Frey, Morris & Chopper, op. cit., C. VIII (1966).
(58) Korean Commercial Code, Sec. 522. Par. (1) & (3) & Sec. 434.
(59) Id. at Sec. 530, Par. (3) & Sec. 232.
to the plan if they think their interest is going to be prejudiced.\textsuperscript{(59)} In short, both the shareholders and the creditors are afforded a chance to protect themselves, and, therefore, such purchase may be made even out of capital. The purchase would enable the corporation to enter into an advantageous merger or consolidation without being held up by minority dissenting shareholders.

2. Incidental Requirements

From the foregoing discussion, we may conclude that the purchase by a corporation of its own shares can be made out of earned surplus, out of capital surplus if authorized by the articles of incorporation or if approved by special resolution of the shareholders' meeting, and even out of capital in the above four extra-ordinary situations. The following limitations should be incorporated as additional safeguards:

(1) The share purchase should be made in good faith and without intent to defraud or injure other shareholders or creditors of the corporation. On some occasions, the purchase by lot or pro rate or otherwise may be required to offer all shareholders the opportunity to participate on equal terms.\textsuperscript{(60)} And all these requirements must be tested by the circumstances then existing.\textsuperscript{(61)}

(2) Earned surplus, capital surplus and capital should be used in that order to make the purchase. The corporation should exhaust its surplus before dipping into the capital amount.

(3) The share purchase should not be made when the corporation is, or would be rendered insolvent in either the equity or bankruptcy sense.\textsuperscript{(62)} The bankruptcy test requires the corporation not to dissipate its assets, through the share purchase, below a level equal to what it owes its creditors, and thus provides a minimal asset guarantee to the creditors of the corpo-


\textsuperscript{(61)} In this connection, an American case is noteworthy. In \textit{Winchell v. Plywood Corp.}, 324 Mass. 171, 85 N.E. 2d 313 (1949), an officer director of the corporation was permitted to exercise his option under a contract, made with the corporation seven years earlier, to sell his shares at any time to the corporation at book value despite the fact that the corporation was about to sell its assets and that the liquidation value of his shares would be less than book value. The court said, "The contract...had all the earmarks of an arms-length bargain and the judge found that the directors acted in good faith. Winchell's interest in the contract was not adverse to that of the corporation."; See, also, Note, Stock Repurchase Abuses And The Non Prejudice Rule, 59 Yale L. J. 177 (1950).

\textsuperscript{(62)} \textit{Finn v. Meighen}, 325 U.S. 300, 303, 89 L. Ed. 1624, 1626, 65 S. Ct. 1147, 1149 (1945), "Insolvency in the equity sense has always meant an inability of the debt or to pay his debts as they mature. Under the Bankruptcy Act it means an insufficiency assets at a fair valuation to pay the debts."; ABA-ALI Model Bus. Corp. Act, Sec. 2 (n).
ration. The equity test, which merely requires the corporation not to make a share purchase when there is a reasonable basis for believing that it would be unable to meet its debts as they become due, would not be a sufficient guarantee by itself, but if accompanied by a bankruptcy test it could provide an additional protection over the bare minimal asset guarantee by fixing the required level sometimes higher than that marked by the bankruptcy test.\(^{(63)}\)
The requirement of the insolvency test should be met not only at the time of the making of the contract to purchase the shares, but also at the time of its execution; that is, when payment is tendered for the shares. Otherwise, wily shareholders would be able to secure for themselves all the benefits of shareholders while the business prospers, and to come in as general creditors if the business fails.\(^{(64)}\) It is of rare occurrence that shareholders in a prosperous corporation expecting substantial dividends exchange their status for that of creditors. Rather, shareholders who know that, although the corporation has a theoretical surplus, it is actually in an unprosperous condition would attempt to rat the corporation while the ratting is hardly detectable.

Where the share purchase is to be paid for by a note, what would be the rights and obligations of the parties if the note, executed while the corporation was solvent, fell due after insolvency had occurred? Is the note holder to be denied the right to participate in the insolvency distribution as a general creditor? The answer is not so simple. Three situations must be delineated. First, when the note is given as a mere acknowledgement of a debt or to extend the period for the payment under the purchase contract, neither the holder of the note nor the corporation agreed to give or create any extra right or obligation with respect to the payment except the extension of time, and the holder of the note should be treated as an ordinary party to a purchase contract who merely has granted the postponement of the corporation’s payment for the shares until the note is due. Therefore, if the corporation becomes insolvent when the note matures, the note holder should not be entitled to the participation as a general creditor upon the distribution.

Second, when the note is given as collateral for the payment of the share purchase cont-

---

\(^{(63)}\) For same view, see, Md. Code Ann., Art. 23, Sec. 32 (c) (1953) and ABA-ALI Model Bus. Corp. Act, Sec. 5.

\(^{(64)}\) In one American case, Cross v. Beguelin, 252 N.Y. 262. 169 N.E. 378 (1929), it was held that the selling shareholders can enforce his claim on insolvency with other creditors, all of whom were directors who had approved of the repurchase agreement, and all of whose claims (for salaries) arose after the repurchase agreement was executed.
ract, the holder of the note would be deemed to have been given a further security. In case of insolvency, his claim should be accorded priority over those of other shareholders. But since he is still to be considered as a shareholder, he should not be allowed to come in as a general creditor.

Third, when the note itself is given as the payment of the purchase contract in discharge of the original debt, the answer is entirely different. Once a corporation gives a note as payment, the original debt is discharged, and the rights and obligations of the corporation and the note holder are newly established based solely on the issuance of the note. According to the Note Act in Korea, the rights and obligations of the issuer and of the payee are unconditional, independent of, and not affected by any contingency, the underlying rationale being that this will enhance the negotiability of the note in the commercial community. The only qualification is that the holder of the note cannot insist upon the benefit of this rule when he received the note knowingly to the detriment of the debtor. Therefore, unless the shareholder-seller took the note with the knowledge that the corporation would become insolvent when the note matured, he should be entitled to participation in the insolvency distribution as a general creditor. In such a case, whether the directors of corporation could be held for breach of duty because of the issuance of the note is another question, and is not investigated here. In the United States, the approach to this problem by the scholars and the courts seem to have confused three situations.

(4) The purchase by a corporation of its own shares should be fully disclosed to the investing public, whether or not the purchase was made in the open market. The purchase should be disclosed at least in the registration statement, annual reports and proxy statements.

However, the person who buys or sells shares to the corporation needs more protection than disclosure merely of the fact of purchase which will generally be revealed only after the transaction has been consummated. In this connection, Rule 10(b)-5 promulgated under the American Securities Act of 1934 is a good model for future Korean legislation. It is unlawful for any person in connection with the purchase or sale of any security to employ any device to defraud, to make any untrue statement of material fact, or to omit to state a material

(65) In Korea, the Note Act is separate from the Commercial Code.
(66) Korean Note Act of 1962, Sec 7.
(67) Id. at Sec. 17.
(68) Kessler, Share Purchase Under Modern Corporation Laws, 28 Fordham 637, 677 (1959); 6A Fletcher, Cyclopedia, Sec. 2859 (rev. ed. 1968).
fact necessary not to mislead the buyer or seller, and to engage in any act, practice, or course of business which would operate as a fraud or deceit upon any person. A corporation is forbidden from dealing in its own shares without adequate disclosure.

(5) The selling shareholder who was aware of the fact that the corporation was the purchaser and who had reason to believe that the transaction was unlawful should be made to disgorge what he received, in fairness not only to creditors but also to other shareholders. In dividends, the shareholder is a mere passive recipient, but, in a sale of his shares, he is an active participant. Dividends are essential to the proper functioning of modern capitalism and the recipient is only reaping the normal reward from his investment. The seller of shares on the other hand, is taking part in a transaction which would, even if the surplus existed, be the one tolerated rather than encouraged by the law.\(^\text{(69)}\)

3. Requirements for Gift or Bequest

It is obvious that a corporation may take its own shares by gift or bequest where no consideration is paid out of its assets in return. The corporation is not then releasing any liability for the unpaid balance of the subscription price nor returning any share capital, so that there is no possibility of creditors being defrauded. Moreover, there is no risk that other shareholders may be prejudiced since the shares are treated as if they had not been issued, and so the corporation’s profit will be apportioned amongst fewer shares, thereby receiving larger dividends. The corporation’s taking its own shares by gift or bequest merely adds value to the corporation and increases the protection for the creditors and the other shareholders. In such a case, the notion that a corporation has the power to acquire its own shares would alone be enough to allow the share acquisition. But, of course, the acquisition should at least be made in good faith for the benefit of the corporation and material facts should be disclosed.

F. Nature of Treasury Shares

When the corporation has reacquired its own shares, the shares have a peculiar status of being issued but not of being outstanding. They are neither cancelled nor restored to the status of unissued shares by the mere fact of their being reacquired. Such reacquired shares are generally termed treasury shares and have certain characteristics different from both outstanding shares and unissued shares.

\(^{\text{(69)}}\) Dodd, Purchase and Redemption by A Corporation of its Own Shares, 89 U. Pa. L. Rev. 697, 710–711 (1941).
Section 341 Commercial Code of Korea

Above all, treasury shares should not be counted for quorum purposes, nor should they be allowed to vote, because they are not "shares outstanding". They should not be permitted to participate in dividends or in asset distribution upon dissolution, because such participation would have no meaning at all. A corporation should be able to declare stock dividends out of treasury shares, without showing transfer from surplus to stated capital. In such a case, it seems desirable to require the corporation to give notice to the shareholders designating the dividends as a distribution of treasury shares and stating the amount which the corporation paid for their acquisition.

Concerning the accounting treatment of the treasury shares, diverse methods may be proposed from various view points. At least three principal methods of showing treasury shares on the balance sheet can be found. The first would list treasury shares as an asset at their cost just as any other assets acquired by the corporation for cash. Suppose that a corporation has the following capital structure:

Capital Stock (10,000 shares of ₩1,000 par value all of which are issued and outstanding) ₩10,000,000
Capital Surplus ₩1,000,000
Earned Surplus ₩1,000,000

in this case, the acquisition by the corporation with earned surplus of 100 shares at a cost of ₩150,000 would be treated on the balance sheet in the following manner:

<table>
<thead>
<tr>
<th>Treasury Shares (at cost) ₩150,000</th>
<th>Capital Stock (par value) ₩10,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other Assets ₩11,850,000</td>
<td>Outstanding ₩9,900,000</td>
</tr>
<tr>
<td>Treasury Shares ₩100,000</td>
<td>Capital Surplus ₩1,000,000</td>
</tr>
<tr>
<td>Earned Surplus ₩1,000,000</td>
<td></td>
</tr>
</tbody>
</table>

₩12,000,000

The second method would be to show the cost of treasury shares on the balance sheet as an unallocated deduction from the total shareholders' equity. Upon resale, any excess of

(70) Korean Commercial Code, Sec. 369, Par. (2): It has first been decided in the United States that directors cannot vote in respect of shares surrendered to the corporation. Atterbury v. Consolidated Copper Mines Corporations, 20 A. 2d 743 (1940).

proceeds over cost is considered paid-in surplus; any deficit of resale as compared to cost, a reduction in earned surplus. Using the same corporation as above, the effect of the purchase would be illustrated as follows:

Assets ....................... ₩ 11,850,000

<table>
<thead>
<tr>
<th>Capital Stock (10,000 shares of ₩ 1,000 par value, all of which are issued: 9,900 of which are outstanding and 100 of which are held as treasury shares............</th>
</tr>
</thead>
<tbody>
<tr>
<td>₩ 10,000,000</td>
</tr>
<tr>
<td>Capital Surplus .............................................. ₩ 1,000,000</td>
</tr>
<tr>
<td>Earned Surplus (of which ₩ 150,000 is restricted by purchase of treasury shares)........ ₩ 1,000,000</td>
</tr>
<tr>
<td>₩ 12,000,000</td>
</tr>
<tr>
<td>Less cost of treasury shares .................................. ₩ 150,000</td>
</tr>
<tr>
<td>₩ 11,850,000</td>
</tr>
</tbody>
</table>

The third method is to reflect the treasury shares through a reduction of capital stock with any excess over the pro rata portion of capital stock as a distribution of earned surplus.\(^{72}\)

Under this system reissuance of treasury shares is accounted for in the same way as the issuance of previously unissued shares; that is, the entire proceeds are credited to contributed capital. Should the cost be less than the pro rata portion of capital, the excess constitutes capital surplus. In the above example, the treatment would be as follows:

Assets ....................... ₩ 11,850,000

<table>
<thead>
<tr>
<th>Capital stock (10,000 shares of ₩ 1,000 par value, all of which are issued: 9,900 of which are outstanding, 100 of which are held as treasury shares ........................................</th>
</tr>
</thead>
<tbody>
<tr>
<td>₩ 9,900,000</td>
</tr>
<tr>
<td>Capital Surplus .............................................. ₩ 990,000</td>
</tr>
<tr>
<td>Earned Surplus .............................................. ₩ 960,000</td>
</tr>
<tr>
<td>₩ 11,850,000</td>
</tr>
</tbody>
</table>

Any accounting method should produce certainty and clarity. This is especially needed in a country like Korea where the system of share purchase is currently unknown. Upon examination, the second method seems to come closest to these goals, and is suggested for Korea.

The second accounting method reflects most properly the legal status of the shareholders’ equity accounts, whereas the other two methods either fail to do this at all or do it improperly. In the first method, the purchase has no effect upon the surplus account and the corpo-

\(^{72}\) This method is termed the “contraction of capital” method. Sprouse, op. cit., 59 Col. L. Rev. 882 (1959).
ration could still, in the example, have 2,000,000 surplus free for dividend distribution to its shareholders, which is undoubtedly misleading. This method has long been criticized in the United States. (73) The third method, though reflecting the logical economic interpretation of the transaction—the withdrawal of the original capital contribution and the distribution of a dividend out of earned surplus if the withdrawal exceeds that original contribution—has the immediate effect of reducing stated capital, capital surplus, and, if appropriate, earned surplus upon the share purchase, which would gain little legal support in Korea where such items are not to be reduced without complying with the legal requirements.

The second method seems to be very popular in the United States, (74) That is at least some indication that it is reasonable and has worked well in practice. If the method were introduced into Korea, Korean lawyers and accountants could easily find many American cases for their information and reference, and could simply follow the American cases until they fully understand the problem of accounting involved in the share acquisition.

Thus, the second method seems to be the most desirable accounting procedure. The method is summed up as follows:

1. Treasury shares are to be set up at cost, regardless of par or stated value. No surplus arises by the mere fact of the share purchase.

2. The cost of treasury shares is to be shown as a deduction from the total stockholders equity and the surplus is to be marked as restricted in the same amount so long as such shares are held as treasury shares.

3. Upon resale of the shares, the restriction will be removed and any excess of proceeds over cost will be considered paid-in surplus, while any loss as compared to cost will be a reduction from earned surplus. If the corporation in the above example resold the treasury shares for ₩160,000, the balance sheet would appear as follows: (75)

(73) See, supra, n. 71; Ballantine, op. cit., Sec. 262 (1946); This method is forbidden by the American S.E.C. Regulation S-X, rule 3.16.
(75) Under the contraction of capital method, the result would be as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>₩12,010,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Stock</td>
<td>₩10,000,000</td>
</tr>
<tr>
<td>Capital Surplus</td>
<td>₩1,050,000</td>
</tr>
<tr>
<td>Earned Surplus</td>
<td>₩960,000</td>
</tr>
</tbody>
</table>

| ₩12,010,000 | ₩12,010,000 |
Article

Assets............. ￦ 12,010,000

Capital Stock (10,000 shares of ￦1,000 par value all of which are issued and outstanding) ￦ 10,000,000

Capital Surplus........... ￦ 1,010,000

Earned Surplus............. ￦ 1,000,000

￦ 12,010,000

(4) Upon cancellation of the treasury shares and reduction of stated capital stock, the restriction will similarly be removed, and any premium paid for the shares over the par value will be deducted from the earned surplus, while any discount will be added to paid-in surplus. Taking the same example, the cancellation of treasury shares purchased at ￦ 150,000 will be shown on the balance sheet as follows:

Assets............. ￦ 11,850,000

Capital Stock (10,000 shares of ￦1,000 par value authorized shares, 9,900 of which are issued and outstanding) ￦ 9,900,000

Capital Surplus........... ￦ 1,000,000

Earned Surplus (reduced by the amount of premium)............. ￦ 950,000

￦ 11,850,000

(5) Neither the retention of reacquired shares as treasury shares, nor their subsequent resale for consideration, nor their distribution to shareholders, will effect a change in the stated capital stock of the corporation, although cancellation according to the formal procedure would, of course, reduce the stated capital stock.

G. Proposal

Sections 341 and 342 of the Korean Commercial Code are substituted for the following Sections:

Section 341 (Corporation's purchase and disposition of its own shares)

(1) A corporation may acquire its own shares (a) by gift, bequest, merger, consolidation, distribution of the assets of another corporation, or exchange of its shares, and (b) by purchase, as provided in this Section.

(2) A corporation shall purchase its own shares only to the extent of unreserved and unrestricted earned surplus available therefor. But, if authorized by the articles of incorporation, or by the special resolution of the shareholders' general meeting, a corporation may also purchase its own shares to the extent of unreserved and unrestricted capital surplus available.
Section 341 Commercial Code of Korea

(3) To the extent that earned surplus or capital surplus is used as the measure of the corporation’s right to purchase its own shares, such surplus shall be restricted so long as such shares are held as treasury shares, but upon disposition or cancellation of such shares, the restriction shall be removed, and any excess of proceeds over cost shall be considered capital surplus, whereas any loss, a reduction from earned surplus.

(4) Notwithstanding the foregoing limitation of Paragraph (2), the directors of a corporation may authorize the purchase of its own shares for the following purposes:

(a) To eliminate fractional shares or to avoid their issuance;
(b) To collect, release, or compromise in good faith a debt or claim owing to the corporation;
(c) To buy out dissenting shareholders at the time of fundamental changes in the corporate structure;
(d) To effect the retirement of its redeemable shares by redemption subject to the other provisions of this Code.

(5) A corporation shall in no event purchase its own shares if the corporation is insolvent, or if such purchase or payment would render it insolvent. For the purpose of this Paragraph, a corporation shall be deemed to be insolvent, if its debts exceed its assets taken at a fair valuation or if it is unable to meet its debts as they mature in the usual course of business.

(6) When a corporation purchases its own shares in violation of any provision of this Section, any shareholder or owner of shares who sells such shares with knowledge that the corporation is the purchaser and with knowledge of facts indicating the impropriety of the purchase is liable to the corporation or its receiver, or liquidator, to the extent of the payments received therefor.

Section 342 (Treasury Shares)

(1) Treasury shares shall not carry voting or dividend rights, and shall not be counted as outstanding shares for any purpose, nor as assets for the purpose of computing a surplus.

(2) Neither the retention of treasury shares, nor their distribution to shareholders or disposition for consideration shall change the stated capital stock.