

Second, the decision has brought an end to the long-lasting political controversy surrounding the problem of judicial review, resulting in a profound political impact.

#### IV. Conclusion

As the debate on the institution of family law, as shown in this article, relates to the basic structure of Korean society, the surrounding controversy has not been restricted to a discussion among lawyers or academics. The controversy has become a concern for all of society. A legal institution prohibiting marriages on the basis of the geographical origins of the respective parties' surnames has proved highly controversial due to the history surrounding the issue and its origins in traditional ideology.

In the past, such debates were only carried out within the realm of legislative policy-making. Therefore, no particular view could necessarily surpass or prevail over another. However, the Constitutional Court has conclusively resolved some of the problems surrounding the controversy under the authoritative measure of the Constitution, settling the debate from a legal perspective. Despite such result, the controversy is yet unsettled in the social and political realms. In a sense, although the result is indicative of the conservative nature of family law, in general, the lingering debate may, in particular, be evidence of the lack of authority of the Constitutional Court.

## MATERIALS

### Lawsuit for Invalidating the Issuance of Convertible Debentures by Samsung Electronics

*Translated by Alfredo Eum\* and Steven Choi\*\**

#### Editor's Note

*Equity-linked securities such as convertible bonds (CBs) and bonds with warrant (BWs) have been widely issued by Korean companies. On some occasions, CBs and BWs have been issued to those close to the controlling shareholder on unduly favorable terms. In recent years, investors have become less forgiving of such practices and have sometimes resorted to legal recourse. A public interest organization known as the People's Solidarity for Participatory Democracy is at the center of this new trend. The following decision is the most recent, and perhaps the most controversial, of the lawsuits initiated by this NGO.*

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**Seoul High Court  
The First Civil Division**

**Case :**

98 na 4608  
Invalidation of Issuance of Convertible Debentures

**Plaintiff (Appellant) :**

Chang Ha-Sung

**Defendant :**

Samsung Electronics Co., Ltd.  
Yoon Jong-Yong, representative director

**Termination of Pleadings :**

April 28, 2000

**Judgment of Lower Court**

December 17, 1997, 97 kahap 12863  
Suwon District Court

**Judgment**

1. The appeal by plaintiff is dismissed.
2. The expenses related to the appeal shall be borne by plaintiff.

**Claim and appeal :**

The issuance of each new stock written on the attached list, which was carried out on September 29, 1997 by the defendant in response to the request for conversion of the convertible debentures (the list of convertible debentures on the attached sheet was published as of March 24, 1997), should be invalidated.

**Reasons :****I. Basic Facts**

The facts as stipulated below are accepted either on the grounds that neither party disputes such facts or on the grounds that the facts are supported by various evidence.

A. The plaintiff is a shareholder who owns 136 shares (common stock) of the stock of the defendant, while the defendant is a legal person listed on the Korea Stock Exchange - with production, sales, vicarious execution of collection of money and lease, service business etc., as its business functions. Presently the defendant's capital is 575,565,065,000 Won. The total number of issued shares is 115,113,013 (91,219,586 common shares, 23,893,427 preferred shares); the par value per share is 5,000 Won. Keon-Hee Lee was a large shareholder who owned 3.8% of the shares of defendant at the time the convertible debentures in question were issued. Jae-Yong Lee is the eldest son of Keon-Hee Lee. Like the defendant, Samsung Corporation (hereinafter referred to as Samsung) is a member corporation of the so-called "Samsung Group," of which Keon-Hee Lee is a large shareholder.

B. Regarding preemptive rights, the convertible debentures, and the resolution of the board of directors at issue, the articles of incorporation of the defendant provide as follows:

1. Preemptive Rights:

(a) Where a corporation issues shares or distributes share dividends, the corporation shall in principle allocate [to a shareholder] common shares for common shares and preferred shares for preferred shares in proportion to the shareholders' relative shareholdings. If necessary, however, the corporation may issue only one kind of shares in issuing shares for value or distributing share dividends. In such case, all shareholders are entitled to receive such shares or share dividends (Article 8 (5)).

(b) Concerning allocation of new shares, the corporation shall assign new shares in proportion to the shareholders' relative shareholdings in accordance with Article 8 (5). In case a shareholder waives or loses its preemptive rights, or in case the allocation

creates fractional shares, the shares shall be disposed of according to the resolution of the board of directors (Article 11 (1)).

(c) Despite the provision in the foregoing Article, the board of directors may allocate new shares to a non-shareholder in the following cases (Article 11 (2)):

In case new shares are issued by means of a public offering or issued to an underwriter in accordance with the Securities Exchange Act or other related laws (a.);

In case new shares are allocated to employees in accordance with the Capital Market Promotion Act (b.);

In case new shares are issued in the form of depositary receipts (DR) in accordance with the Regulation on Overseas Securities Issuance (c.);

## 2. Convertible Debentures

(a) The corporation can issue convertible debentures to a non-shareholder as long as the total par value of the convertible debentures does not exceed one trillion Won (Article 16 (1));

...

(c) . . . The conversion price shall be determined by the board of directors at the time of issuance, which must not be lower than the par value of the share (Article 16 (3));

(d) The conversion period is from the day following issuance to the day immediately preceding the date of repayment. However, this period can be adjusted pursuant to a resolution of the board of directors within the above period (Article 16 (4)).

...

## 3. Board of Directors

(a) The board of directors, consisting of the directors of the corporation, is responsible for adopting resolutions related to the material affairs of the corporation other than those matters set forth by the Korean Commercial Code ("KCC") or the articles of incorporation as matters to be resolved by the general meeting of shareholders (Article 28);

(b) Board meetings shall be convened by the chairman. The chairman, who decides on the meeting date, shall notify in writing or orally each director and auditor at least twelve hours prior to the scheduled meeting. However, if all directors and auditors

consent, the procedure for convening such meetings can be omitted (Article 30 (1));

(c) The resolution of the board of directors may be passed upon majority vote of the directors present at a meeting where at least a majority of all directors are present. A director with a special interest in the resolution shall not exercise his voting right (Article 31).

C. On March 24, 1997, the defendant issued a private placement of convertible debentures to Samsung and Jae-Yong Lee in the total amount of 60 billion Won: 15 billion Won to Samsung, and 45 billion Won to Jae-Yong Lee. The terms and conditions were as follows:

due date : March 24, 2002

conversion price : 50,000 Won

conversion period : from September 25, 1997 to March 24, 2002

interest rate : 7.0 percent per annum until March 24, 2002

According to the minutes of the board meeting, the meeting was held on March 24, 1997, and the directors had decided on the terms and conditions of the issuance, but did not decide on who would be the purchasers of the debentures. Other paragraphs related to the issuance of the convertible debentures are entrusted with the representative director. According to the minutes, although 32 directors out of the total 59 directors attended the meeting and affixed their seals on the minutes, four of the 32 directors were on overseas business trips.

D. Jae-Yong Lee (age 29) was studying abroad at the time the convertible debentures were issued. On March 28, 1997, Samsung issued a private placement of convertible debentures in the total amount of 30 billion Won (par value), which was purchased by Dongyang Merchant Bank, and on April 3, 1997, the defendant purchased from Dongyang Merchant Bank all of the above-mentioned convertible debentures issued by Samsung.

E. Before the issuance of the convertible debentures in question, during the period from October 1996 to February 1997, the defendant had been issuing bonds in the amount of approximately 10 billion Won per month. The defendant's net profit for

1996 was 165,155,481,000 Won, and its cash and bank deposits as of the end of 1996 amounted to 963,031,695,000 Won. For the first half of 1997, the net profit and the earned surplus were 123,208,433,000 Won and 4,092,165,477,000 Won, respectively. At the time of the issuance of the convertible debentures in question, there was no dispute, nor any sign of such dispute, over the control of the defendant.

F. The share price of the defendant at the time of the issuance of the convertible debentures in question was 56,700 Won per share, while the price of new shares issued on July 4, 1997 was 68,500 Won per share. On May 17, 1997, approximately two months after the date of issuance of the convertible debentures in question, the defendant issued convertible debentures overseas, the conversion price of which was 123,635 Won per share.

G. Both Jae-Yong Lee and Samsung exercised the right of conversion for all of their holdings of the convertible debentures on September 29, 1997. Jae-Yong Lee and Samsung acquired 901,243 common shares and 300,414 common shares, respectively. As a result, as of November 20, 1997, among the total 98,070,040 common shares issued by the defendant, Keon-Hee Lee, Jae-Yong Lee and Samsung owned 3.5%, 0.9% and 4.5%, respectively, and Keon-Hee Lee, together with his family and affiliates of the Samsung Group, controlled 24.8% of the shares of defendant.

## II. Allegations of Plaintiff

The plaintiff claims that the issuance of the convertible debentures was invalid and, accordingly, the issuance of the new shares issued as a result of the exercise of conversion right was also invalid. The plaintiff's arguments are as follows:

### A. Defect in Resolution of the General Meeting of Shareholders

As the convertible debentures can be converted into shares in the future by the exercise of the right of conversion, the issuance of convertible debentures to a non-shareholder is, in reality, not any different from granting a preemptive right to a non-shareholder. In consideration of the character of convertible debentures, the Korean Commercial Code ("KCC"), in principle, grants shareholders preemptive rights for

convertible debentures (Article 513 (2) of KCC). Issuance to non-shareholders is allowed either when the articles of incorporation provide for it, or when a special resolution be adopted at a general meeting of shareholders (Article 513 (3) of KCC).

In light of the requirements of the KCC, where the articles of incorporation allow convertible debentures to be issued to a non-shareholder/third party, the corporation must specify "the amount of convertible debentures to be issued, terms of conversion, conditions for the shares to be issued as a result of conversion, and the period for conversion" as provided for in Article 513 (3) of the KCC, and such specifications must be concrete and definite. Therefore, the relevant provision of the defendant's articles of incorporation, which comprehensively delegates to the board of directors the power to decide on matters relating to the issuance of convertible debentures, should be held invalid.

The articles of incorporation of the defendant simply provide for a limitation to the total par value of the convertible debentures as one trillion Won, and require that the conversion price not fall short of the share par value. The articles of incorporation also to the board of directors the decision-making power as to all other matters pertaining to the issuance of convertible debentures. Therefore, the relevant provisions in the articles of incorporation regarding the issuance of convertible debentures should be held invalid. Because such provisions must be deemed non-existent, the defendant, in order to issue convertible debentures to a non-shareholder, must have its shareholders adopt a special resolution concerning the amount of convertible debentures, terms and conditions of conversion and the identity of purchasers in accordance with Article 513 (3) of the KCC. As the defendant, nevertheless, did not issue the convertible debentures to the existing shareholders but to Jae-Yong Lee, a non-shareholder, without securing a special resolution of the general meeting of shareholders, the issuance should be deemed invalid.

### B. Infringement of Shareholders' Preemptive Rights and Right to Receive Equal Treatment

As convertible debentures can potentially be converted into shares, and shareholders are deemed to have preemptive rights under the KCC, shareholders should have the right to purchase convertible debentures in proportion to their shareholdings. Further, as the issuance of new shares in complete violation of

shareholders' preemptive rights is not a valid issuance, the issuance of convertible debentures executed in violation of shareholders' rights to purchase new shares should be held invalid.

### *C. Defect in the Resolution of the Board of Directors*

#### 1. Procedural Defects

The articles of incorporation of the defendant provide that the resolution of the board of directors shall be made in the presence of the majority of the directors of the corporation and by a majority approval of such directors present. Since the number of directors in the corporate registry was 59 at the time of issuance of the convertible debentures, not less than 30 directors should have been present at the board meeting in order to adopt a valid resolution. Among the 32 directors recorded as present at the board meeting in question, four directors were actually on an overseas business trip and could not possibly have taken part in the board meeting. Accordingly, the board meeting should be deemed not properly held due to the lack of quorum; and therefore, the issuance of the convertible debentures in question should be deemed invalid.

#### 2. Securing Control under the Pretext of Issuing Convertible Debentures

The board of directors may, in its discretion, issue convertible debentures according to business needs within the scope allowed by the articles of incorporation. But issuance of convertible debentures not for the purpose of securing necessary funds but for the purpose of strengthening or changing control of a large shareholder of the corporation is outside the scope of authority of the board of directors and should be held invalid. As the board of directors of the defendant decided to issue the convertible debentures for the purpose of strengthening the control of the Keon-Hee Lee family (large shareholders) over the defendant, which was despite the absence of an urgent need for funds, the resolution of the board of directors and the issuance of convertible debentures should be held invalid.

### *D. Issuance Made by Grossly Unfair Means*

Had the defendant issued the convertible debentures in question by public offering, it could have actually secured a greater amount of funds. But by issuing the convertible debentures to specific persons at an excessively low conversion price, the defendant inflicted a loss on itself and provided unjust gains to Jae-Yong Lee. Further, in issuing the convertible debentures to specific persons, the defendant should have notified or given a public notice in advance of the issuance to provide the shareholders with an opportunity to protect their interests by raising an objection to or enjoining the directors from issuing such convertible debentures. Since the defendant issued the convertible debentures in question without any prior notice to shareholders, the issuance of the convertible debentures should be held invalid.

## **III. Adjudication**

### *A. On the Assertion Regarding the Defect in the Resolution of the General Meeting of Shareholders*

According to Article 513 (2) of the KCC, if there is no relevant provision in the articles of incorporation concerning the total sum of convertible debentures, the terms of conversion, conditions for the shares to be issued as a result of the conversion, the period for conversion, the grant of preemptive rights to shareholders, and issuance to non-shareholders, the board of directors shall have the power to decide on such matters. According to Article 513 (3) of the KCC, if the relevant provision authorizing issuance to non-shareholders fails to provide for the amount of the convertible debentures to be issued, terms of conversion, conditions for the shares to be issued as a result of conversion or period for conversion, the corporation shall determine such matters of incorporation by a special resolution of the general meeting of shareholders. According to the above provisions, the board of directors is deemed to have authority to decide, in its discretion, on non-shareholder purchasers of convertible debentures unless otherwise provided for in the articles of incorporation. As there are no provisions in the articles of incorporation of the defendant concerning the issuance of convertible debentures by public offering or to specific persons or groups, it follows from the interpretation of the relevant provisions that the issuance of the convertible

debentures in question to Jae-Yong Lee and Samsung does not require a special resolution of the general meeting of shareholders, but a resolution of the board of directors. According to Article 513 (2) (vi) of the KCC, the board of directors must decide on the issuance of convertible debentures to non-shareholders. In identifying those non-shareholders, the corporation does not have to specify them by name, but must at least specify the concrete standards for selection. Adopting a resolution on the issuance of the convertible debentures, the defendant's board of directors mistakenly failed to reach any decision on the purchasers of the convertible debentures and simply delegated such authority to the representative directors. The plaintiff does not claim that this violation of law constitutes a defect which justifies the invalidity of the issuance, nor does the plaintiff regard it as material enough to render the issuance invalid.

Providing for the matters that Article 513(3) of the KCC requires to specify, . . . the articles of incorporation of the defendant delegate some matters to the board of directors. The articles of incorporation provide that the board of directors shall set the conversion price at share par value or higher. This provision should not be interpreted as grossly abstract or so broad a delegation that it should be held invalid. If the market price of a share frequently drops below par value, the corporation is more likely to be pressed for funds. If the articles of incorporation, in advance, specify the conversion price, the corporation might not be able to issue convertible debentures at the very time when it is urgently in need of funds.

Accordingly, the defendant's failure to secure a special resolution of the general meeting of shareholders for selling the convertible debentures to Jae-Yong Lee and Samsung and to determine the terms of conversion do not violate the relevant provisions of the KCC, and the plaintiff's attack on this issue is without merit.

*B. On the Assertion Regarding the Shareholders' Preemptive Rights and Right of Equality*

Article 513 (2) (v) of the KCC provides that if the articles of incorporation do not specify that existing shareholders may be granted the right to purchase convertible debentures or do not specify the amount of convertible debentures to be so issued, the board of directors shall decide on these matters. Also, Article 513-2 of the KCC provides that the shareholders with preemptive rights are entitled to purchase convertible debentures in proportion to their relative shareholdings. Given these

provisions, we find that the KCC does not guarantee shareholders the right to purchase convertible debentures.

Although the shareholders' right to purchase convertible debentures is not a right guaranteed by the KCC, such a right may be specified in the articles of incorporation. We will therefore examine whether or not the articles of incorporation of the defendant grant to the shareholders the right to purchase convertible debentures. As mentioned earlier, the articles of incorporation (Article 8, par. 5) do guarantee shareholders' preemptive rights, but do not specify the right to purchase convertible debentures. However, Article 16 (1) of defendant's articles of incorporation simply provides that the corporation can issue convertible debentures to non-shareholders to the extent that the total par value of the issuance does not exceed one trillion Won. Where the articles of incorporation grant shareholders preemptive rights, but do not specify a right to purchase convertible debentures, it may be fair to state that the shareholders have the right to purchase convertible shares since the convertible debentures can be converted into shares upon exercise of the conversion right. To the extent that the corporation can issue convertible debentures to non-shareholders, however, the shareholders' rights to purchase convertible debentures, we believe, are excluded. No evidence exists as to whether the authorized maximum amount has been exceeded by the issuance of the convertible debentures in question. We find therefore that defendant's board of directors could validly issue the convertible debentures in question irrespective of whether or not the purchasers are existing shareholders.

Accordingly, we reject the plaintiff's claim that the allocation of the convertible debentures to Jae-Yong Lee and Samsung resulted in an infringement of the shareholders' rights to equal treatment and their rights to purchase convertible debentures, which are based on the shareholders' preemptive rights.

*C. On the Assertion Concerning the Validity of the Resolution of the Board of Directors*

1. Procedural Defect

A board meeting does not necessarily have to be held with all the participants present at the same place, as long as it is fully guaranteed that the participants can communicate and discuss with one another without distortions, and that different

opinions can be accommodated. Directors in different places may thus hold a video-conference using multimedia facilities, and, depending on the circumstances, a director may participate in the meeting by telephone. According to the established facts, among the 32 directors recorded as having participated in the board meeting in question, four of the directors were abroad at the time. It is difficult to believe, as a matter of common experience, that all four of these directors had fully communicated and discussed the matters for resolution with the remaining 28 directors over the phone at the same time. The board meeting in question should therefore be regarded as not properly convened due to the lack of quorum, since the participants fell short of 30, which is the majority of the total 59 directors.

We now turn to the validity of the issuance of convertible debentures issued (i) by a representative director without a resolution of the board or (ii) on the basis of a resolution with a material procedural defect. Acknowledging that convertible debentures are in the nature of potential shares, we find that the issuance of convertible debentures is an external transaction or an act of implementing a business, but not an internal, organizational act. A resolution of the board of directors is merely a step in the decision-making process inside the corporation. Therefore, as long as the representative director who is authorized to represent the corporation has issued the convertible debentures, their issuance is not to be held invalid simply because the resolution of the board authorizing the issuance has a material defect or it simply does not exist.

According to one scholarly opinion, if the purchaser knows or has reason to know of the defect, the issuance should be held invalid. Even if we adopt this view, there is no evidence showing that Jae-Yong Lee or Samsung knew or had reason to know of the defect in the board resolution. (The plaintiff argues that since Jae-Yong Lee is the son of Keon-Hee Lee, who is in control of the defendant, the former knew or had reason to know of the defect. On the contrary, however, it will be more reasonable to presume that, in light of the family relationship, those managers including the representative director who carried out the issuance of the convertible debentures did not inform Jae-Yong Lee of the defect in the board resolution.)

## 2. On the Assertion Regarding the Protection of Control

. . . If, despite the absence of a business need, a corporation issues a substantial

amount of convertible debentures to a particular person in order to cause a change in control structure or to protect the existing controlling shareholders from an outside force by effecting a stock conversion, such issuance is an act beyond the scope of authority of the board of directors and representative directors, and the principles relating to a lawsuit for invalidating the issuance of new shares should apply. However, if the convertible debentures are issued to a non-shareholder, the exercise of the conversion right will inevitably result in a change in the ownership ratio of the existing shareholders. Issuance or purchase of convertible debentures may be undertaken for strengthening control in addition to simply seeking financial gain. Seeking this goal in connection with an ordinary issuance of convertible debentures should not be regarded as illegal. Therefore, application of principles governing a case brought for invalidation of the issuance of new shares to that of an invalidation of issuance of convertible debentures should be limited to cases where it is objectively clear that the issuance of the convertible debentures was undertaken only for the purpose of causing or blocking a change of control; for example, where a dispute regarding control is under way or is about to take place.

As indicated in the facts established above, there was no dispute (or sign of dispute) over control of the defendant at the time of the issuance of the convertible debentures in question. Keon-Hee Lee's control of the defendant was apparently stable given the size of the defendant and Keon-Hee Lee's shareholdings. The defendant has been procuring funds by occasionally issuing debentures aside from the convertible debentures in question. Compared with the size of defendant's capital, the size of the convertible debentures in question appears to be insignificant. Based on the foregoing facts, although we cannot say that the issuance of the convertible debentures was not at all related to the build-up of control, we find that it does not constitute a cause for invalidating the issuance in question. (On the contrary, it seems more likely that the issuance was intended to achieve an advance inheritance or donation of Keon-Hee Lee's wealth to Jae-Yong Lee.) The plaintiff's claim on this point is unfounded.

### *D. On the Assertion That the Issuance Was Made in a Grossly Unfair Manner*

1. Given the stock prices of the defendant at the time of issuance of the convertible debentures in question, the terms and conditions of such convertible debentures and their conversion price, it appears that the convertible debentures were issued at a

relatively low price. This fact may justify a shareholder's claim for injunctive relief prior to the issuance of the convertible debentures, a claim against directors for damages, or a claim against the purchasers of the convertible debentures in question for additional payment. It by no means justifies, however, invalidation of the convertible debentures already issued.

2. The current KCC does not require an advance notice or public announcement to the shareholders concerning the total amount of convertible debentures, issue price, terms of conversion, conditions for the shares to be issued as a result of conversion, and conversion period at the time of issuance. It may be acknowledged that such a legal deficiency should be remedied. But even when the board of directors has deprived a shareholder of an opportunity to exercise his right to enjoin by secretly and promptly issuing convertible debentures without making an advance public announcement of such matters, the issuance of the convertible debentures should not become illegal.

#### IV. Conclusion

Accordingly, the plaintiff's claim is dismissed. The decision by the lower court, which is the same in conclusion, is correct and the appeal by the plaintiff is dismissed as unfounded.

June 23, 2000

Presiding Judge Byun Dong-Gul  
 Judge Yoon Nam-Geun  
 Judge Yeo Sang-Won

#### The List of the Convertible Debentures

1. Issuer: Samsung Electronic Co., Ltd.
2. Name of the debentures : 140th privately offered convertible debentures without guarantee.
3. Type of debentures : bearer convertible debentures without guarantee.
4. Issue date and payment date : March 24, 1997.
5. Total amount of debentures issued : 60 billion Won.
6. Issuing conditions :
  - a. Issue price : 100 percent of admonishing amount on the debentures.
  - b. The total par value : one billion Won.
  - c. Interest rate : 7 percent per annum.
  - d. Interest payment method: deferred payment at the end of every business year (interest for the year of issuance is calculated by the number of days).
  - e. Redemption method for principal: redemption at the same time on March 24, 2002.
  - f. Guaranteed yield rate: 9 percent.
7. Paragraphs related to stock conversion :
  - a. Conditions pertaining to conversion
    - 1) Conversion ratio: 100 percent of par value.
    - 2) Conversion price: 50,000 Won.
  - b. Type of shares to be issued upon conversion: registered common stocks.
  - c. Period for conversion: from September 25, 1997 to March 23, 2002.

#### List of Stocks

1. 901,243 registered common stock issued based on the convertible debentures in the amount of 45 billion Won purchased by Jae-Yong Lee.
2. 300,414 registered common stock issued based on the convertible debentures in the amount of 15 billion Won purchased by Samsung.