

# The Business Judgment Rule: A Missing Piece in the Developing Puzzle of Korean Corporate Governance Reform

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## Abstract

*Following a currency crisis in late 1997 which caused widespread corporate failures, Korea enacted a number of legislations to improve the transparency of corporate governance structure. While laudable in their empowerment of minority shareholder rights, such laws nonetheless had a major flaw in that they did not provide countervailing protections for director discretion. Consequently, derivative suits seeking director liability rapidly multiplied, and in several high-profile cases directors were held accountable for enormous sums based on apparently mere errors in judgment.*

*Risk taking is the centerpiece of entrepreneurial capitalism. And directors bear the ultimate managerial authority for the corporation. However, by indiscriminately imposing personal accountability on directors for inherently risky business judgments, the current Korean laws undercut the fundamental purpose of a corporation, which is to maximize profit based on the principle of risk-and-return proportionality. This is worrisome given the current position of Korea in the global economy and its stated goal to upgrade its laws and institutions to a level that will be internationally competitive.*

*As a partial solution to this conundrum, this article proposes the adoption of the business judgment rule as developed in the Anglo-American jurisprudence. In its simplest form, the rule represents the court's reluctance to second-guess the business decisions of directors, absent loyalty issues. While the rule has many context-based variations, incorporating as a judicial doctrine the rule at least in its basic form*

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would be a valuable starting point for redirecting Korean corporate laws in the right direction. Incorporating the specific mechanics of the rule, such as the presumption-based shifting of the evidentiary burden and gradated standards of liability, requires an approach tailored to Korea's legal structure and traditions concerning director duties and liabilities. However, Korean judges have a wide discretion in statutory interpretation and should be able find innovative ways to bring the Korean corporate jurisprudence in substantial convergence with international norms.

For example, Articles 383-3 and 399 of the Commercial Code can be read to hold directors liable only in the case of an abuse of discretion or a grossly negligent performance of their duties. The court can also require that the plaintiff in a director liability suit to overcome the presumption of due care as well as establish the foreseeability of harm under Articles 390 and 393 of the Civil Code. These may not be complete solutions. However, given the current anti-business sentiment among the public and the consequent unlikelihood of a major statutory overhaul any time soon, such judicial approach probably would be the most practicable solution.

In sum, incorporating the business judgment rule into the current Korean corporate jurisprudence is both desirable and doable as a matter of both law and policy.

## I. Introduction

The batch of corporate governance legislations Korea adopted in response to the financial crisis in 1997 presents an interesting case study of a reform gone awry. They, like most other reforms, started with the best of intentions, namely, that of reinforcing institutional checks against management excess, widely perceived to be the main culprit for the unduly high debt ratio among Korean corporations and the subsequent contagion of corporate failures following the currency crisis. As a result, a host of checks-and-balances mechanisms were introduced, most notably an eased standing requirement for bringing a shareholder derivative action and the mandatory inclusion of outside directors in publicly listed corporations.

To the extent that such measures were intended as a way to raise the standard of Korean corporate governance to an “internationally competitive” level, as was the stated legislative objective, they were steps in the right direction. But a few critical elements went missing, perhaps due to fact that the measures were enacted in an overzealous drive to appease the investors and the general public in uproar as to the sorry condition of the management process in Korean corporations. Most importantly, the measures failed to include any mechanism to indemnify or otherwise protect the outside directors from frivolous lawsuits made possible by the very same reform package that called for the institution of outside directors.

Such oversight carries enormous practical implications. First of all, the number of derivative suits has rapidly multiplied following the enactment of the reform measures, with some judgments against the directors reaching astronomical heights in the monetary damages ordered. The situation is most likely to worsen with the ongoing infusion of a great deal more lawyers into Korean society and the introduction of class action systems. What this means is that Korean companies will be deprived of honest and competent directors precisely at a time when they are most needed. As it faces a set of ever tighter competitive pressures in the form of the international “scissor” effect, Korea needs all the help it can get, including aggressive managers who are willing to take risks in search of the optimal return. But the looming presence of litigation, coupled with the lack of any clear judicial standards to guide director behavior, threatens to create just the opposite effect.

Legal reform is a tricky business, especially when carried out in haste. And as it stands, the state of Korean corporate governance laws is like that of a half-formed

wing that does not quite fly and, by unnecessarily stifling the entrepreneurial spirit, even threatens to kill the goose that lays the golden egg. Korea therefore critically needs a countervailing set of director-friendly measures to restore the balance of corporate governance rules, or at least to prevent the well-meaning and hard-working directors from being unduly and indiscriminately punished along with the few bad apples.

One such measure this paper examines is the feasibility of adopting the business judgment rule as practiced in the Anglo-American jurisprudence. Of course, there are many other candidates for analysis. For instance, director indemnification statutes and the D&O insurance are also measures commonly used in other countries to protect the corporate directors.

However, the business judgment rule is the most interesting of the bunch. First, its nature as primarily a judicial doctrine poses an analytical challenge in that the likelihood of success for its incorporation depends largely on the “embeddedness” question of Korea’s statutory framework governing director duties and liabilities. In other words, a feasibility study must be first conducted to see whether and to what extent the business judgment rule will work within the constraints of existing Korean laws. This problem, as we shall see, becomes especially complicated given the structural differences between the Korean legal system, which is based on civil law traditions, and the Anglo-American common law, upon which the business judgment rule is premised. That some Korean judges are already experimenting with the notion of the business judgment rule makes a comprehensive analysis of its applicability that much more urgent.

This paper is structured along the following questions: (i) why Korea should adopt the business judgment rule; (ii) what are the statutory constraints on its formal adoption; (iii) to what extent has the rule been incorporated into Korean jurisprudence; and (iv) what further needs to be done. Accordingly, Part I of this essay outlines the uneven development of recent Korean laws on corporate governance and the reasons why director-protective mechanisms are necessary. Part II discusses the business judgment rule itself in terms of its content and rationales as commonly understood in the Anglo-American jurisprudence. Part III analyzes the embedded Korean statutory framework governing director duties and liabilities, with a particular view to the possible forms of resistance it may pose to the systematic adoption of the business judgment rule. Part IV examines the extent to which the business judgment rule has

already been incorporated into Korean jurisprudence. Part V explores the ways in which the judges may take a more active and innovative role in turning the rule into that of greater general applicability as well as a useful norm that can serve as a practical guideline for director activities.

## II. The Conundrum: Recent Korean Corporate Governance Laws

### A. *The Catalyst*

As many commentators have noted, the watershed event for Korea's recent drive for corporate reform was the Asian financial crisis, which overtook the Korean economy in the late 1997.<sup>1)</sup> Just as external shocks often provide the much-needed critical impetus to institutional reform, this crisis--commonly known as the IMF crisis for the role the International Monetary Fund played in imposing macroeconomic and structural adjustments on the Korean economy--was particularly noteworthy for its humbling effect on the proud nation long accustomed to double-digit annual growths and being touted as one of the most spectacular economic success stories of the postwar era.

Self-doubt crept into the national psyche, and with the ensuing contagion of corporate failures and the swift speed with which it was spreading, the public demanded to know what was going on and began to ask serious questions about the fundamental soundness of the way in which corporate management was being handled at Korea's leading companies.

It was not that similar questions had not been raised before. Amid academic circles and left-wing political movements, there had been long and intense debates about the *chaebol* question, as Korea's family-owned leading businesses that operate in the form of conglomerates are known.<sup>2)</sup> However, such debates tended to center around the

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1) See, e.g., Bernard Black et al., "Corporate Governance in Korea at the Millenium", 26 *J. CORP. L.* 546, 553-555 (2001); Joongi Kim, "Recent Amendments to the Korean Commercial Code and Their Effects on International Competition", 21 *U. PA. J. INT'L ECON. L.* 273, 273-277 (2000); Hwa-Jin Kim, "Living with the IMF: A New Approach to Corporate Governance and Regulation of Financial Institutions in Korea", 17 *BERKELEY J. INT'L L.* 61, 68-81 (1999).

2) See Hwa-Jin Kim, *supra* note 1, at 63-65.

distributive effects related to wealth concentration in the hands of the few, not necessarily on the transparency and efficiency of corporate governance *per se*. Yet, such bent had its own justifications in the sense that, after all, it is difficult to argue with success. Most of the Korean *chaebols* began from a humble origin, one of the most notable being the Daewoo Group, which was started by a recent college graduate taking over a sweat shop with a handful of sewing machines but in the short span of two decades transformed itself into the nation's third largest business and a major exporter of ships and automobiles, among others. To most Koreans, therefore, the *chaebols* were the engines of growth, if at worst a necessary evil. But when groups such as Daewoo went bust as a result of the IMF crisis, people began to demand not only explanations, but also radical reform.

Adding fuel to the shock was the outrage factor induced by a number of corporate bribery scandals. One of the most damning was the Hanbo scandal, which involved the son of Korea's then president as the master engineer of hundreds of million dollars worth of political slush funds built upon crates of cash delivered under the table from the country's leading businessmen, including Hanbo's chairman.<sup>3)</sup> That scandal brought to light a dark pattern of doing business in Korea, which would be confirmed scandal after scandal. That is, the company's top management would bribe public officials who wielded control over the largely government-owned banks so as to gain favorable loans, the public officials would funnel part of that money to politicians (who control their jobs) for the latter's election chests, and if the loans later turned problematic, more loans would be simply granted in what was essentially a taxpayer-funded bailout. But in the case of Hanbo, due to the balance-of-payment deficit induced by the currency crisis, bank cash reserves had simply dried up to keep the troubled company afloat.

The public, for obvious reasons, was not happy with the misuse of the corporate funds. There were ample media stories about such funds being used to support the apparently lavish lifestyles of the *chaebol* families, to speculate on non-business-related real estate or to finance an irresponsible "octopus-like" acquisition binge. That the corporate scandals came in the midst of a national campaign to fight the currency crisis by collecting gold from individuals did not help. Members of the public, some of

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3) See *Joongang Monthly*, January 1, 1998, at 56.

whom went so far as to donate wedding rings for the national campaign, were justifiably incensed and demanded accountability for such egregious mismanagement. This time, the manager-owner heads of the *chaebols* were the villains, no longer the mythologized heroes in the lore of Korean industrialization. The foregoing mark the psychological backbone of the corporate reform measures introduced in response to the IMF crisis.

But for the persistent and increasingly pervasive influence of foreign institutions, however, even the aforementioned scandals might have ended up as one-time happenings, as was often the case in the past, with a head roll and jail time for the few who were unfortunate enough to get caught. The foreigners, however, were a different breed, accustomed to a different set of norms and expectations. They also had significant bargaining power. The foreign lenders and credit rating agencies, which held the lifeline to Korea's much needed foreign reserves, were demanding more transparent accounting practices, including consolidated financial statements, more periodic reporting and stricter restrictions on inter-affiliate fund transfers and guarantees. In addition, the foreign institutional equity investors, which had acquired substantial equity holdings in Korean companies on the cheap thanks to the crisis and were practically moving the Korean bourse but wary of protecting their investments in the highly volatile market, were also equally adamant in demanding an institutional means to monitor the management and hold it accountable.

Strapped for foreign capital, eager to restore international investor confidence and, most importantly, desperate to appease the enraged voters at home, the Korean legislature acted quickly to enact a number of measures in a demonstration of its seriousness about corporate reform. But as we shall see, while laudable in intent, such measures had an uneven and limited focus, leading to a flood of derivative suits in which the directors, despite the best of their intentions, become too easy a target, often at enormous and unjustifiable personal costs.

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4) See, e.g., Black, *supra* note 1.

### *B. The Legislative Response*

The litany of Korean corporate reform measures enacted following the IMF crisis is well summarized elsewhere<sup>4)</sup>, and does not require a repeat in entirety. This article will discuss only those measures that relate directly to corporate governance, especially the rights of shareholders relative to the directors.<sup>5)</sup> Such measures include:

- For all companies listed on the Korea Stock Exchange, at least one-fourth of the members of the board of directors were required to be independent, outside directors. This percentage was raised to at least one-half for the largest listed companies (with assets KRW 2 trillion or more).<sup>6)</sup>
- The minimum shareholding level required to assert shareholder rights was reduced for (i) demanding removal of directors and auditors for malfeasance, statutory or charter violations, or gross negligence in the performance of duties,<sup>7)</sup> (ii) seeking an injunctive relief against a director who violates the statute or charter,<sup>8)</sup> (iii) initiating a derivative lawsuit, (iv) convening a general shareholder meeting,<sup>9)</sup> (v) inspecting the company's books and records,<sup>10)</sup> (vi) petitioning the courts to appoint and inspect the company's actions<sup>11)</sup> and (vii) demanding the removal of a liquidator.<sup>12)</sup>
- Shareholders may propose matters for consideration at a general shareholder meeting.<sup>13)</sup>

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5) Other sets of measures which may have equally important, if not greater, practical consequences relate to accounting standards, reporting requirements, takeover restrictions, board and shareholder meeting procedures, audit and nomination committees and statutory auditors. See Black, *supra* note 1, at 554-557.

6) See Republic of Korea, Securities and Exchange Act, art. 191(16) and the Presidential Decree thereunder, Article 84-23(1).

7) See Republic of Korea, Commercial Code, arts. 385(2) and 415.

8) See Republic of Korea, Commercial Code, art. 402.

9) See Republic of Korea, Commercial Code, art. 403.

10) See Republic of Korea, Commercial Code, art. 366.

11) See Republic of Korea, Commercial Code, art. 467.

12) See Republic of Korea, Commercial Code, art. 539(2).



- Shareholders may demand cumulative voting in the election of directors, unless otherwise provided in the company's charter.<sup>14)</sup>
- Shareholders may vote in writing at a general shareholder meeting without attending the meeting in person or by proxy.<sup>15)</sup>
- A fiduciary duty was explicitly added, requiring directors to "perform their duties diligently in the interest of the company in accordance with the statutes and the company's charter."<sup>16)</sup>
- Unofficial control persons who instruct directors on the conduct of the company's business or conduct such business in the name of a director or using a senior executive title are subject to the same duties and liabilities as directors.<sup>17)</sup>
- The meeting of the board of directors may be conducted by video conferencing.<sup>18)</sup>

Thus for the most part, the foregoing measures have had the effect of strengthening shareholder rights while adding burdens for the directors. To the extent that Korean shareholders now have what would be considered as basic shareholder rights in the U.S. corporations, it is certainly a commendable development. But now that the lowered standing requirement has opened the floodgate of derivative suits, where does that leave the directors? Given the large room of ambiguity of the current Korean law on director duties and liabilities and the ways in which such ambiguity has been manipulated in the past against the corporate directors to a punitive effect, one is left wondering why commensurate protections for the directors have not been introduced.

One thing is clear, though. While derivative suits seeking director liability have multiplied in recent years thanks to the foregoing so-called reforms, directors stand more vulnerable than ever to frivolous claims of misconduct since the current system of Korean corporate law has no explicit mechanism for distinguishing the good

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13) See Republic of Korea, Commercial Code, art. 363-2.

14) See Republic of Korea, Commercial Code, art. 382-2.

15) See Republic of Korea, Commercial Code, art. 368-3.

16) See Republic of Korea, Commercial Code, art. 382-3.

17) See Republic of Korea, Commercial Code, art. 401-2.

18) See Republic of Korea, Commercial Code, art. 391(2).

derivative suits from the bad, that is, claims alleging illegal, malevolent, abusive or grossly negligent managerial misconduct from those based on a mere error in business judgment of the kind that happens in a corporate boardroom anywhere in the world.

### *C. Spillovers from the Pandora's Box: The Reform's Unintended Consequences*

Due to a strict shareholding requirement to qualify for standing,<sup>19)</sup> derivative lawsuits were virtually non-existent prior to the IMF crisis. However, since the easing of such requirement pursuant to the amendments to the Korean Commercial Code in 1998, there have been 20 such suits, involving as defendants some of the most high-profile companies in Korea, such as Samsung Electronics, Hyundai Semiconductors, Daewoo Group and Korea First Bank (KFB).<sup>20)</sup>

Some of the cases imposed staggering sums of monetary damages on the defendant directors found to have breached their fiduciary duties. The KEB case, decided by the Korean Supreme Court in March 2000, found four directors jointly and severally liable for KRW 40 billion, even though the average total personal assets of such directors would amount to less than, at most, one-tenth of such amount.<sup>21)</sup> In addition, the Samsung case, decided in December 2001 and currently pending on appeal, imposed a joint and several liability of KRW 90 billion on 11 directors.<sup>22)</sup>

As discussed below, given that the Samsung case involved facts that amount to no more than ordinary negligence and questionable lines of reasoning by the court, the result seems quite outrageous, at least from the point of the Samsung directors under whose guardianship the company has become a leading international brand with record levels of profits for years following the decision.

Apart from the issue of whether the facts of the foregoing cases justify such astronomical damage amounts, the mere possibility of unlimited personal liability

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19) The pre-amendment requirement was the plaintiff shareholder or shareholders own a minimum of 5% of the outstanding shares of the corporation to have standing in a derivative litigation. The amendment lowered the standing requirement to 1% of the outstanding shares.

20) <http://www.peoplepower21.org/pec-suit.html>.

21) See Supreme Court of Korea Decision No. 2000 Da 9086 dated March 15, 2000. The appellate process in Korea is as follows: initial hearing at a District Court, appeal of the District Court ruling on legal and factual issues to the High Court, and appeal of the High Court ruling on legal issues only to the Supreme Court.

22) See Suwon District Court Decision No. 98 GaHap 22533 *en banc* dated December 27, 2001.

bodes ill on the chances of recruiting the top talent into the ranks of directorship for high-profile companies. Furthermore, given that Korean laws and most of the Korean corporate charters have yet to legislate any director indemnification statute and that the director and officer (“D&O”) liability insurance is far from the norm among Korean companies, the present status of derivative suits should work as an even more powerful disincentive to joining the top management of a Korean firm.

In fact, a byproduct of the recent spike in derivative litigation has been a boom for the D&O liability insurance business. The business had only one insured case with a total premium of KRW 2 million in 1996 but recorded 220 cases with a total premium of KRW 37 billion in 1999, or an average of KRW 168 million per head, at an 84-fold increase from merely three years ago.<sup>23)</sup> Based on these available numbers, it is strongly questionable whether the average medium-to-small Korean company may afford to pay the high premiums.

Thus the irony. The judge deciding in the Samsung case might have wanted to set a stern example for the rest of Korean companies by going after the best and biggest of them. The symbolic lesson may have been well served, but the practical effect of his decision has been to add a substantial cost factor to the average Korean company already burdened with the notorious ‘scissor’ effect, i.e., shrinking market share and profit margin from being squeezed from the labor-competitive countries like China and the quality-competitive countries like Japan.

The specter of derivative suits is likely to cause even more horror for the corporate directors in light of Korea’s current and prospective social climate. One, given the general anti-business sentiment following the (still ongoing) corporate bribery scandals, any broad-stroke director indemnification statute is likely off the legislative horizon. Two, the consumer(translated voter)-conscious Korean legislature is mulling enactment of even more pro-plaintiff legislations such as eased class action certification requirements in a step closer to turning the society into a litigation heaven.

In concert with this trend, the number of annually admitted Korean attorneys has risen to 1,000 by 2002 (from roughly 30 less than a decade ago), with less than 30% of them expected to find paying jobs in government or at relatively large law firms.<sup>24)</sup> It is anyone’s guess where the rest of them will end up, but it will be fair to forecast

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23) See *Donga Daily*, Feb. 19, 2000. In general, the company pays for the D&O insurance premiums.

24) See *Kyunghyang Daily*, January 7, 2002.

that a good number will turn to strike suits as members of the plaintiff's bar, especially when the potential monetary awards from director liability suits seem so lucrative. At least until now, most of the derivative suits have been represented by high-minded civic groups such as *Chamyeo-yondae* (in English, the People's Solidarity for Participatory Democracy), whose apparent primary motive at least thus far has been to set high moral examples for the rest of society to follow. With the arrival of the newly enlarged and financially driven plaintiff's bar, however, any company with a reasonably deep pocket will likely be a fair game.

Furthermore, a bill introducing class actions modeled after American law is likely to be enacted in 2004.<sup>25)</sup> The stated goal of such bill is to help force the chaebols to improve accountability, transparency and ethical behavior.<sup>26)</sup>

All of the foregoing may be creatures spilling from the Pandora's box opened up by the IMF crisis. And in retrospect, many commentators point to the crisis as an accident waiting to happen, a natural outcome for a society and economy that grew way too fast without having had the opportunity to sort through its priorities and resolve the many conflicts that arose in connection therewith.

Whatever the cause, however, a few things are clear. Under the founding principles of a corporation, the corporation is managed ultimately by its directors. In order for the directors to do their job properly, they need to act with broad discretion, or at least with the freedom from fear that their every move may be scrutinized and later punished in the court of law with potentially limitless personal liability. However, the present corporate governance law of Korea does not provide such protection. It did not do so before the crisis, and the crisis only made things worse, creating all the more reason for the adoption of the likes of the business judgment rule.

### **III. The Business Judgment Rule**

#### *A. The Rule*

A concept dating as far as 1742 in England and 1829 in the United States, the

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25) *Korea Economic News Daily*, September 26, 2003.

26) *See id.*

business judgment rule in its simplest form stands for the judicial reluctance to second-guess decisions by directors regarding the conduct of business.<sup>27)</sup>

Such judicial self-restraint takes the form of a presumption that business decisions are made by disinterested and independent directors on an informed basis and with a good faith belief that the decision will serve the best interests of the corporation.<sup>28)</sup> If directors are sued with respect to a business decision they have made in the course of performing their duties, the court will examine the decision only to the extent necessary to determine whether the plaintiff has alleged and proven facts that overcome the foregoing presumption.<sup>29)</sup>

If the presumption is not overcome, the business judgment rule dictates the court to stop the suit at that point and not go further to examine the substantive merits of the underlying business decision.<sup>30)</sup> If the presumption, however, is overcome, the court will evaluate the entire fairness of the transaction, including as to whether there was a fair dealing and a fair price.<sup>31)</sup>

### *B. The Rationale*

The business judgment rule is considered to be a standard of judicial review as opposed to a standard of conduct.<sup>32)</sup> In other words, the standard by which the directors will actually be held liable in the court of law is set at a much higher level than the “aspirational” code of conduct established under the fiduciary duties.<sup>33)</sup> To elaborate, the directors are deemed to have duties of care and loyalty as fiduciaries to the corporation. Under the duty of care, the directors are obligated to exercise the care that a person in a like position would exercise under similar circumstances; in the director’s context, such duty includes the duty to monitor, inquire and otherwise be informed

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27) See Dennis J. Block et al., *The Business Judgement Rule* 9 (1998)

28) See *id.* at 5.

29) See *id.*

30) See *id.*

31) See *id.* at 28.

32) See Melvin A. Eisenberg, “The Divergence of Standards of Conduct and Standards of Review in Corporate Law”, 62 *FORDHAM L. REV.* 437

33) See *id.* at 463.

about the nature of his duties.<sup>34)</sup> Under the duty of loyalty, the directors are obligated to avoid self-dealing, domination or other conflicts of interests situations that would interrupt the independent and objective decision-making by the director.<sup>35)</sup> Such obligations notwithstanding and absent loyalty issues, under the standard of liability imposed under the business judgment rule the directors will not be penalized unless they have committed a bad-faith or grossly negligent breach of the duty of care.<sup>36)</sup> In a normal tort action, the alleged tortfeasor would have been subjected to a much liberal standard of ordinary negligence with respect to his carelessness.

Why the divergence? As Melvin Eisenberg notes, the dichotomy is based on the court's recognition of the peculiar nature of a business judgment.<sup>37)</sup> Business judgments inherently involve risk-taking despite imperfect information.<sup>38)</sup> But if shareholders with the perfect hindsight are allowed to bring an after-the-fact litigation to punish the directors for mere errors in judgment, the directors will lose the incentive to act quickly and decisively for fear of personal liability. Such result would directly undermine the very purpose of corporate management, and it will especially be the case for directors of a modern corporation, beset with a flood of information and limitless competition that combine to require instant decision-making for corporate survival.

Some may raise the point that after-the-fact judgments are what a court does, and citing malpractice suits against lawyers or doctors, may argue that corporate directors should be no exception. However, in legal or medical malpractice suits, objective standards such as law or science are available in order to evaluate the merit of the defendant's judgment; no similar counterpart is available for business decisions.<sup>39)</sup> Suppose, as in a classic example provided by the American Law Institute, that directors of Acme, Inc. are faced with a decision whether to invest in an expensive technology to develop a new product. Further suppose that they decide not to invest due to cost considerations, but a competitor does so invest and develops a highly

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34) See Block, *supra* note 27, at 117-132.

35) See *id.* at 261-265.

36) See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985); *Aronson v. Lewis*, 473 A.2d 805, 812 n.6 (Del. 1984).

37) See Eisenberg, *supra* note 32, at 464.

38) See *id.* at 444.

39) See *id.*

successful new product that takes away Acme's market share to the point Acme is compelled to declare bankruptcy. Should the directors of Acme be held liable for their misjudgment? What if they decided to invest despite the cost, but ended up with a poorly received product, and Acme goes bankrupt because of it? The answer is no in both cases if either decision was made in good faith and after reasonable deliberation.<sup>40)</sup>

The business judgment rule, however, does not stand for the proposition of a no-liability regime for director actions. It merely suggests that judicial review be limited to the procedural elements of the director's decision-making *ex ante*, such as reasonable informedness, rather than the substantive merit of their decisions that can be evaluated only *post facto*.

This concern for fairness marks the primary defense of the business judgment rule. The rule also has other rationales. One, the rule ensures that the directors, not the shareholders, are in charge of managing corporate affairs, as is intended under the basic theory of a corporation.<sup>41)</sup> That is, when investors sign up to become shareholders by investing in equity rather than debt, they are in essence foregoing a stable stream of income for a riskier, but potentially higher rate of return.<sup>42)</sup> This means that, as fiduciaries to the corporation and by extension to its shareholding owners, directors have an obligation to seek a high rate of return for the shareholders, and in order to do so, should be given broad discretion to take necessary risks. Furthermore, shareholders have traded in the decision-making authority in exchange for the safety of limited liability.<sup>43)</sup> However, if shareholders are allowed to demand frequent judicial reviews of director decisions in the absence of the business judgment rule, the shareholders are essentially taking away such authority to the point of becoming the *de facto* corporate managers, despite the implied deal not to for reasons of limited liability.<sup>44)</sup> This means that the directors, having neither the discretion nor the incentive to do their job right and furthermore stuck with potentially boundless personal liability, will have no choice but to be risk-averse. But such an outcome would precisely be against the

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40) See American Law Institute, 1 Principles of Corp. Governance 4.01(c) cmt. f, illus. 1 (1992)

41) See Block, *supra* note 27, at 17. See also William M. Fletcher, *Fletcher Cyclopedia of the Law of Private Corporation* §1037 (2003).

42) See Fletcher, *supra* note 41, §1037.

43) See *id.*

44) See *id.*

shareholders' self-interest because if a passive investment management is what they wanted, they should have bought debt instead. Thus, the business judgment rule protects not just the directors, but ultimately the shareholder interests as well.

Two, there are other means to check director behavior and protect shareholder interests. For one, shareholders of publicly traded corporations can simply exit by selling their shares on the market.<sup>45)</sup> As for shareholders of a closed corporation to whom such option is often unavailable, they can at least vote the directors out of their jobs.<sup>46)</sup> Further, if directors do a bad enough job, the chance increases that their corporation will be an acquisition target, in which event they will more likely than not find themselves out of a job.<sup>47)</sup> In addition, directors may also be given stock options so that their interests will align with the shareholders.<sup>48)</sup> In short, thanks to the availability of the foregoing market-based mechanisms, the business judgment rule will not create a moral hazard under which directors take reckless actions unmindful of the consequences of their actions.

Third, the business judgment promotes an efficient use of the court's resources.<sup>49)</sup> Without the rule, the shareholders (or more precisely the plaintiff's bar) will have a greater incentive to flood the court with derivative suits, and the court is already operating under the constraints of scarce resources.<sup>50)</sup> Furthermore, the judge is not an expert on corporate management. But if the court is used as a forum to assess the merit of every minor business judgment, it will soon convert into a "super-boardroom" funded by taxpayer's money, a role the court should hardly be playing and in any event would not be doing a good job at.

### *C. The Mechanics*

As for specific applications, the business judgment works in two ways. One is the allocation of the burden of proof as noted above. First, the plaintiff has the burden of

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45) *See id.*; *see also* Peter V. Letsou, "Implications of Shareholder Diversification on Corporate Law and Organization: The Case of the Business Judgment Rule", 77 *CHI.-KENT L. REV.* 179 (2001).

46) *See* Fletcher, *supra* note 41, §1037.

47) *See id.*

48) *See id.*

49) *See* Block, *supra* note 27, at 15.

50) *See id.*



proof that would be sufficient to overcome the presumption, and once the presumption is overcome, the defendant has to prove the entire fairness of the transaction.<sup>51)</sup> Such allocation appears to be designed to maintain procedural equity by dividing the evidentiary burden evenly between the parties while attempting to avoid frivolous lawsuits by imposing the burden first on the plaintiff. In practical terms, however, since the plaintiff always bears the initial burden of proof, the real teeth of the business judgment rule can be said to lie in the graduated substantive standards of liability tailored to the fiduciary duty at issue or to the stage of litigation.

To elaborate, the plaintiff shareholder initially has to prove a breach of the defendant director's fiduciary duty, either with respect to the duty of care or the duty of loyalty, to a level the court will be persuaded to impose liability. Proving a breach of the duty of loyalty offers no special hurdle since the relevant standard here is the preponderance of evidence, the ordinary evidentiary threshold used in any civil litigation. However, proving a breach of the duty of care presents quite a difficult challenge since gross negligence, rather than the ordinary negligence required under ordinary tort actions, has to be found.

Why the dichotomy? While the duties of loyalty and care both have roots in the traditional duties of a trustee charged with guarding other people's money (often involving the life savings of orphans and widows), the American courts seem to acknowledge the fact that in modern corporations the fiduciary should be given a broader discretion in making business judgments and therefore have loosened the traditional duty of prudent investment.

At any rate, once the plaintiff proves a breach of either fiduciary duty, the defendant has to prove the entire fairness. Entire fairness is an exacting standard that requires proving facts to the *court's* satisfaction, rather than on the basis of an objective guideline (other than the case-specific and therefore inherently vague 'fair dealing' and 'fair price' standards).<sup>52)</sup> Thus, while not necessarily true in all cases, the type of judicial standard of review (preponderance, gross negligence or fairness) applicable has often been known to be "outcome-determinative."<sup>53)</sup>

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51) *See id.* at 19.

52) *See Block, supra* note 27, at 30.

53) *See id.* at 33.

### *D. Analysis*

The business judgment rule is not without its critics. For one, attacks have been levied on the Delaware Supreme Court's inconsistent application of law to facts with respect to the gross negligence standard in the duty of care context. For instance, the court in the representative case of *Smith v. Van Gorkom*<sup>54)</sup> has been widely criticized for finding gross negligence on facts closer to being ordinary negligence in light of the prevailing corporate practices then.<sup>55)</sup> However, in the more recent case of *Brehm v. Eisner*<sup>56)</sup>, the court apparently returned to the traditional view of the business judgment rule by grounding the gross negligence standard in the notion of rationality-rather than reasonableness and reaffirming that gross negligence should not be found where the defendant directors have acted with a "rational business purpose" unless their actions amounted to a breach of the substantive duty of care, or "waste", equivalent to a gift of corporate assets or a transfer thereof for an egregiously low consideration.

Another criticism of the rule has focused on the ambiguity surrounding the scope of judicial review in the context of entire fairness, arising due to a lack of objective standards to determine how that burden may be met.

It is noteworthy that the criticisms are levied mostly at the rule's applications, but seldom at its policy rationales. Even with respect to the applications, the business judgment rule offers a far clearer set of guideline to establish the norms of expected director behavior than the current Korean law does. For instance, even under the worst-case situation of *Van Gorkom*, all the directors have to do in the context of a sale of their company are: retain outside experts, review the transaction documents and take the time to ask questions on the background and pricing of the deal.

Likewise, in determining the advisability of incorporating the business judgment rule into the Korean context, it is difficult to anticipate an opposition to it on a policy basis. Like its American counterpart, Korean economy too is a market economy that awards high risks with high rewards. Directors of Korean companies too are the designated top managers of their respective corporations and they too try to maximize the rate of return for the shareholders despite having to work with inherently imperfect

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54) 488 A.2d 858 (Del. 1985).

55) See, e.g., Eisenberg, *supra* note 32, at 448.

56) 746 A.2d 244 (Del. 2000).

information. Few in number and unassisted by law clerks, Korean judges too are overworked and are by no experts in making business decisions.

But as stated before, the tough question concerning the business judgment rule is not why, but how and where. In the spirit thereof, the next sections will review the current regime of Korean laws governing director duties and liabilities and explore the ways in which judicial activism may be used to re-interpret the statutes to incorporate the key elements of the business judgment rule.

## **IV. The Quagmire: A Review of the Current Korean Statutory Framework**

### *A. Introduction*

Can the business judgment rule make it into Korean law? The short answer is: yes, but difficult. This is because the Korean law, as it stands, poses resistance at a number of levels: systemic, doctrinal and textual.

The most obvious is at the systemic level. The Korean legal system is based on civil law traditions, having borrowed from Japan and Germany. One central feature of the continental system is the supremacy of the codified statute, to the exclusion of the judicially developed common law. On the positive side, such a system allows for, at least in theory, a uniform application of the law by eliminating the chance that contradictory rulings among different judges can each turn into authoritative law. But on the negative side, where the statutory language is ambiguous or inconsistent, the system has no ready mechanism to clarify the law where it is elusive. Such problem becomes even more severe in cases like Korea, where statutory definitions or legislative intents are seldom spelled out or published.

Under the civil law systems, the role of the judge is also precarious. On the one hand, they are not bound by precedents, even those coming from higher courts, and therefore are afforded wide discretion in performing their job, whose primary feature is to decide whether a given set of facts amounts to a statutory violation. On the other hand, precisely because their decisions are not binding, there is little incentive for the judge to expound on legal arguments or incorporate new doctrines. In fact, the legal reasoning in most Korean cases amounts to little more than verbatim recitations of the

statutory language.

Hence, a structural problem stands before the future of the business judgment rule in Korea. That is, the judges do not have the incentive to carefully lay the logical building blocks for the rule, and even if some of them wanted to, they may be ignored by the rest. However, all is not lost. If carefully reasoned and backed by sound policy, a precedent can still serve as a persuasive authority, which will be particularly true if coming from the Korean Supreme Court, whose justices have a great say on the personnel decisions for all judges in Korea. Furthermore, powerful ideas go a long distance, even on their own. The judges do not have to explicitly state so, but may still incorporate good ideas into their final decisions. Thus, the inherent structural bias notwithstanding, the business judgment rule still has a fighting chance to work its way into Korean jurisprudence.

More problematic are the doctrinal challenges interlaced into Korean laws governing director duties and liabilities. More aptly put, the problem is the lack of specialized doctrines tailored for the specific context of corporate directors. Hence, the directors become subject to the same evidentiary and liability rules that apply in any tort action. While such rules may promote equity in the general setting, they do a terrible job in the director liability context, particularly given the real of threat of frivolous derivative lawsuits. And since such rules for the most part are explicitly integrated into current Korean statutes, on practical terms they represent the tightest constraints on the incorporation of the business judgment rule.

Another problem has to do with the textual ambiguity of much of the Korean law governing director liability. While such ambiguity may serve as a flexible cover for incorporating the specifics of the business judgment doctrine, it also works as a slippery anchor when trying to firmly dock the doctrine.

The foregoing sketches some of the major problems with the current director liability regime in Korea. But as noted before, there are solutions, i.e., by way of principled and innovative judicial interpretations of the statute. But to appreciate the solution, one must first understand the problem. In spirit thereof, we turn to a review of the relevant Korean laws governing corporate directors and some of their major shortcomings.

## *B. The Basic Legal Framework*

### 1. Powers of Directors

Under the Commercial Code, the directors of a Korean corporation have expansive powers. While the powers of shareholders are limited to those specified in the corporate charter, which usually does not amount to much, the Commercial Code reserves the following matters exclusively for the board decision: disposition and transfer of major corporate assets, borrowing a substantial sum of money, the hiring and firing of senior management, and the opening and closing of branch offices.<sup>57)</sup> The shareholders, however, retain the authority to elect and remove directors at a general meeting of shareholders.

One apparently peculiar attribute of the Korean directors is their statutorily explicit authority to monitor each other. It is the power and duty of the board as a whole to supervise individual directors<sup>58)</sup>, a director may compel at any time that information on how other directors are performing their duties be reported to the board,<sup>59)</sup> and each director in fact has to make a quarterly report to the board on his job performance.<sup>60)</sup>

But such provisions can be understood in light of the fact that they target primarily the representative director. The representative director is a dominant figure in a Korean corporation, often being its founder and largest shareholder. He also has the statutory authority to represent and bind the company in its external relations, and in practice is responsible for making all the day-to-day executive decisions, not unlike the director in a U.S. corporation who doubles up as the chief executive officer and board chairperson. Given his influential role, it makes sense that the representative director be subjected to substantial scrutiny by the board<sup>61)</sup>, although it may be a case of poor

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57) In addition, the directors are deemed to have certain exclusive authorities not subject to shareholder approval. They include the rights to approve restrictions on the transfer of shares, convene the general meetings of shareholders, approve a self-dealing by a director, approve financial statements, and issue corporate bonds. Chul-Song Lee, *Treatise on Corporate Law [hoisabeop-gangui]* 538 (2003).

58) See Republic of Korea, Commercial Code, art. 393(2)

59) See Republic of Korea, Commercial Code, art. 393(3)

60) See Republic of Korea, Commercial Code, art. 393(4)

61) Under the statute, the board elects one of the directors as the representative director, although in practice the

draftsmanship that the statute does not distinguish the representative director from all the other directors in defining their respective duties and therefore the latter are subjected to equal board scrutiny as well as equal duties and related liabilities as the representative directors.

A question can be raised as to whether such equal treatment is fair to the outside directors who play a substantially limited role. It is a fair question, but touches upon a phenomenon not uncommon. For example, in the United States, the inside and outside directors face the same fiduciary duties and liabilities. A more poignant question would be whether the system affords the outside directors due protections, such as in the form of the business judgment rule, which would soften the potential unfairness. Korea does not, and that adds all the more reason for it to adopt the likes of such rule.

## 2. Directors' Duties

Benchmarked against the U.S. fiduciary duties of care and loyalty applicable to corporate directors, the Korean duty of loyalty is relatively robust. Under the Commercial Code, the directors may not compete with the corporation by taking corporate opportunities or by serving as a director or senior officer in another corporation engaged in the same line of business<sup>62)</sup> or engage in self-dealing.<sup>63)</sup> The directors also must keep confidential the company's trade secrets<sup>64)</sup>, monitor other directors in their performance of duties,<sup>65)</sup> report to the board on a quarterly basis,<sup>66)</sup> and report immediately to the statutory auditor or audit committee any matter that may cause serious harm to the corporation.<sup>67)</sup>

A problem of underdevelopment, however, plagues the duty of care component. It is not that the Korean statute does not provide for one. In fact, it provides two. First, under Article 382 of the Commercial Code, which defines the director's relationship to the

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representative director is elected by the board from its members.

62) *See* Republic of Korea, Commercial Code, art. 397.

63) *See* Republic of Korea, Commercial Code, art. 398.

64) *See* Republic of Korea, Commercial Code, art. 382.4.

65) *See* Republic of Korea, Commercial Code, art. 393(2).

66) *See* Republic of Korea, Commercial Code, art. 393(4).

67) *See* Republic of Korea, Commercial Code, art. 412.2

corporation as that of a trustee fiduciary and imputes to the director the duties applicable to such fiduciary under the Civil Code, the director has a duty to “carry out the business entrusted to him with the care of a good custodian and in accordance with the original intent of such entrustment.”<sup>68)</sup> In addition, under Article 382-3 of the Commercial Code, which was added in 1998, the director has a duty to “perform his duties diligently in the interest of the corporation and in accordance with laws and the corporate charter.”

These are fine words, but either provision is devoid of any substance. Part of the problem is systemic in that, as discussed previously, Korean statutes are seldom accompanied by published legislative intent or formal definitions. And thus far, partially due to the relatively recentness of director liability litigations, the Korean courts have provided little meaningful guidance on how to apply said provisions.

First of all, to dissect the meaning of the Article 382 duty of care (incorporating the language from Article 681 of the Civil Code), it is unclear what would be the “original intent” of the entrustment applicable to corporate directors, other than perhaps, as may be inferred from Article 382.3, to act in the interest of the corporation in accordance with applicable laws and the corporate charter. The nature and amount of “care” that is required is also unspecified.

Furthermore, the function of the Article 382-3 duty of diligence is also unclear. Some commentators argue that such duty was intended as the duty of loyalty found in Anglo-American jurisprudence, by noting that the Korean term for diligence, *choongsil*, may on a stretch be interpreted as meaning loyalty.<sup>69)</sup> However, given that the duty of loyalty component has been robustly expressed in Korean statutes as noted above, it is questionable whether the duty of diligence adds any substance. The majority view among Korea’s legal scholars is therefore that the duty of diligence serves to merely emphasize for the director the importance of exercising care and diligence in the performance of their duties.<sup>70)</sup>

A mystery remains, though, as to the nature of the care and diligence required under the Commercial Code. Further, one is left wondering whether, based on a strict reading of both provisions, acting within the scope of authority specified under the laws and the corporate charter and in the interest of the corporation should not satisfy

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68) See Republic of Korea, Civil Code, art. 681.

69) See Hyung-Rak Jung, *Treatise on the Commercial Code*[*sangbeop gangui*] 831-834 (2001).

70) See *id.*

the statutory duties of care and negligence.

To be fair, the lack of substance in the duty of care element is not a problem endemic to Korea only. Even the Delaware courts, probably the most experienced and influential source of American corporate law, did not specify substance for the duty of care until 1963,<sup>71)</sup> and the debate is still brewing as to its proper content.<sup>72)</sup> However, Delaware at least offers the minimum guideline of informedness, which can be used as a practical standard of conduct by corporate directors in most situations involving active decision-making.<sup>73)</sup> Korea does not. Furthermore, as we shall see shortly, since the Korean liability regime is skewed heavily against the directors, they are indeed squeezed into a place between a rock and a hard place, lacking guidance on how to act and easily punished for honest errors made while acting in the dark as well as for good decisions that turn out badly due to no fault of their own.

### 3. Director Liability

Under the Commercial Code, the directors may be held jointly and severally liable for harm suffered by the corporation<sup>74)</sup> or by third parties.<sup>75)</sup> Such liability applies equally to the representative director and any “unofficial control person” who indirectly controls a director.<sup>76)</sup> Liability is imposed personally on the directors at fault, and in the event the action in question was taken pursuant to a board resolution, on those directors who voted for the resolution<sup>77)</sup> or whose names are not recorded in the corporate minutes as having voted against to the resolution.<sup>78)</sup>

In a derivative action a director may avoid liability to the corporation if the shareholders unanimously approved his action.<sup>79)</sup> No such exemption is available in third party actions. As for remedies, while monetary damage is available in both types

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71) See Lyman Johnson, “Rethinking the Business Judgment Rule”, 24 *DEL. J. CORP. L.* 787, 794 (1999).

72) *See id.*

73) *See id.* at 805.

74) *See* Republic of Korea, Commercial Code, art. 399(1).

75) *See* Republic of Korea, Commercial Code, art. 401(1).

76) *See* Republic of Korea, Commercial Code, art. 401-2

77) *See* Republic of Korea, Commercial Code, art. 399(2)

78) *See* Republic of Korea, Commercial Code, art. 399(3).

79) *See* Republic of Korea, Commercial Code, art. 400.



of action, injunctive relief may be granted only in derivative actions and to the extent that the corporation faces a threat of “irreversible harm.”<sup>80)</sup>

For both derivative and third party actions, there are two avenues by which a director liability action may be brought. One is through the Commercial Code, which specifies separate causes of action for the derivative and third party suits. The other is through the “illegality” claim under the Civil Code, which applies uniformly to both types of suits but involves different elements, evidentiary rules and statutes of limitation from those required under the Commercial Code. Unfortunately, however, as discussed below, none of the foregoing causes of action is logically coherent or conducive to a procedurally and substantively equitable outcome.

#### a) The Commercial Code Cause of Action

Under Article 399 of the Commercial Code, directors may be held jointly and severally liable to the corporation for (i) a violation of the laws or the corporate charter, or (ii) a dereliction of the directorial duties.<sup>81)</sup> While apparently short and simple, this provision is home to many analytical and practical pitfalls.

First, there is some debate over whether a violation of the laws or the corporate charter constitutes a *per se*, or strict, liability.<sup>82)</sup> While the majority of commentators agree that it does, the minority view is that the defendant director should not be held liable if he could prove that such violation was not due to an intentional or negligent misconduct of the director.<sup>83)</sup>

This dispute stems from the issue of whether the liability provisions of the Commercial Code are subsumed in their entirety by the contractual breach provisions of the Civil Code. As noted above, under Article 382(2) of the Commercial Code, a director is deemed to have a contractual relationship to the corporation as its trustee, and a breach of contract is governed by provisions of the Civil Code.<sup>84)</sup> One such relevant Civil Code provision is Article 390, which states: “If the obligor does not

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80) See Republic of Korea, Commercial Code, art. 402.

81) See Republic of Korea, Commercial Code, art. 399(1).

82) See Jung, *supra* note 69, at 846.

83) See *id.*

84) See Republic of Korea, Commercial Code, art. 382(2).

perform in accordance with the terms of the contract, the obligee may sue for damages, unless such non-performance is not due to an intentional or negligent misconduct of the obligor.”<sup>85)</sup> Thus, the argument goes that, if for instance a director violated a statutory provision because of lack of knowledge of such provision, the violation was neither intentional nor negligent (given that in Korea ignorance of the law does not necessarily constitute negligence) and the director therefore should not be held liable. But the issue remains unresolved in yet another illustration of the underdeveloped nature of Korean statutes on director liability.

Furthermore, what to make of a ‘dereliction of duties’ is inherently unclear since the scope of director duties remains largely undefined, particularly with respect to the duty of care. And since it is undetermined how much care a director should exercise, the same applies to determining when a breach of such duty occurs, similar to the classic “chicken or egg” dilemma.

This problem is actually made worse in actual litigation due to the court’s unfiltered importation into director liability suits of the Civil Code provisions on evidentiary rules and the notion of foreseeability.

The default rules of evidence governing Korean civil litigations are based on the Learned Hand notion that between the plaintiff and the defendant, whoever has the lesser burden of proof, as measured by informational access or proximity to the source, is made to bear the evidentiary burden. Furthermore, under Article 390 of the Civil Code, the defendant obligor (in our case, the director) has the burden of proving the absence of an intentional or negligent act on his part in connection with the alleged breach.<sup>86)</sup> Combined, what this means is that the defendant director has the burden of establishing not only what his duties are, but also that he did not breach such duties and further that there was no fault on his part with respect to a possibly non-existent duty that he probably did not commit.

This outcome would have been comedic but for the unfairness to the director. Ironically, however, such rule is justified under a notion of equity that the court, as an active guardian of the “weak”, should correct for any informational asymmetry between litigants. The rule may make sense as a general principle of law; however, in the context of director liability suits where the rules of the game are virtually non-

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85) *See* Republic of Korea, Civil Code, art. 390.

86) *See* Republic of Korea, Civil Code, art. 390.

existent, the evidentiary rule unduly has an outcome-determinative effect by placing an exorbitantly heavy burden of proof on the defendant director.

The foreseeability issue is an even greater hurdle. Under Article 393 of the Civil Code, damages arising from a breach of contract are limited to the “ordinary and normal” limits, provided that in the case of damages “caused by special circumstances” the obligor shall be liable only if he “knew or could have known” of such circumstances.<sup>87)</sup> Again, the evidentiary rule operates so that the defendant director has to establish not only the existence of the intervening special circumstance, but also that he lacked actual or imputed knowledge thereof.

The foreseeability provision is problematic on several points. First of all, it is unclear whether the provision adds any practical value. This is because the notion of negligence already incorporates the concept of foreseeability under Korean law, and therefore if negligence is established in the course of litigation as a matter of law and fact, there is no role for foreseeability to play in assessing the amount of damages. The provision also has little applicability as to an intentional act since such notion involves a belief that a result was substantially certain to occur.

The foreseeability provision is also unduly unfair to the defendant director. One, there is no reasonableness qualifier. Therefore, the director can be on the hook for failing to anticipate even the most remotely possible contingency. Two, the notion of foreseeability by necessity drags judicial scrutiny into the consequences of the director’s decision, or its substantive merit. Thus, his *ex ante* cover is blown by any *post facto* slip no matter how reasonable a director’s precautionary measures may be in the eyes of equity.

The latter point contradicts the principal underpinning of the business judgment rule, which is that the court should be reluctant to second-guess the substantive merit of the director’s business decision, as measured by its consequences.

In fact, as will be discussed below in greater detail, there have been some efforts by the Korean court to adopt the main thrust of the business judgment rule by dictating that a review of whether a director has met his fiduciary duties of care and diligence be “process-oriented” rather than “result-based.” Such stance would have worked if Article 399 on director liability were the only concern. However, by operation of Article 393, which requires a review of the consequences of the director’s decision for

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87) See Republic of Korea, Civil Code, art. 393.

the purpose of foreseeability analysis, the judicial approach does not quite reach its intended effect.

The Korean statutes do provide for certain saving graces. However, in each case, they leave much to be desired. One saving mechanism concerns the shareholder ratification of director actions, as mentioned above. However, since such ratification requires a unanimous approval, including that of the suing shareholder, the provision has little practical value.

Another comes in the form of mitigated damages under Article 765 of the Civil Code, which provides that (i) if damages from a contractual breach are not caused by an intentional or grossly negligent act, and further if the payment of such damages would create a substantial hardship on the defendant in terms of maintaining his livelihood, the defendant may petition the court to reduce the amount of such damages, and (ii) the court may so reduce based on considerations of the relative economic conditions of the litigants as well as the cause of such damages.<sup>88)</sup>

Article 765 is certainly better than nothing. However, it comes too little too late in the game. In a society like Korea where face counts much, substantial damage in the form of an irreversible stigma is already done to the defendant director at the point that he is found to have negligently or intentionally abandoned his fiduciary duties. The problem is especially severe given that outside directorship is often doled out as an honorary position. Furthermore, a finding of liability under the Civil Code also takes a real bite in the sense that it can be used for any criminal proceedings against the director and under Articles 191-16(3), 54-5(4) and 191-12(3) of the Korean Securities Exchange Code, a person convicted of criminal acts punishable by imprisonment may be barred from serving as an outside director of a publicly traded company for two years.

#### b) The “Illegality” Cause of Action

Under Article 750 of the Civil Code, a person who harms another person in the course of an “illegal” act involving an intentional or negligent conduct is liable for the resulting damages.<sup>89)</sup> Article 750 establishes a conceptual framework that is nearly equivalent to a tort action in Korea. The scope of an “illegal” act here is all

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88) See Republic of Korea, Civil Code, art. 765.

89) See Republic of Korea, Civil Code, art. 750.

encompassing. It includes not only a statutory or regulatory violation, but also an immoral or unethical act that is against Korea' "public policy." Essentially, the scope of its application is as pleases the presiding judge.

Technically, therefore, under the Article 750 illegality claim a double jeopardy situation may befall a director who has successfully defended himself in a liability action brought under the Commercial Code causes of action. In practice, however, such situation seldom happens if a motion for joinder is filed with the court, although there is no precedent that would require the granting of the joinder motion in such cases.

The illegality claim does provide certain practical advantages to the plaintiff. First, the statute of limitations for an illegality claim may run longer than that of a Commercial Code cause of action in that the former allows the statute to run until the later of 10 years from the occurrence of an illegal act or three years following the discovery thereof<sup>90)</sup> whereas the latter cuts off the running at 10 years following the act in question.<sup>91)</sup> Second, the illegality claim allows for restitution as an elective remedy in the case of corporate defamation although it is not clear precisely what actions the defendant must take in order to restore the good name of the corporation.

One offsetting feature of an illegality suit is that the burden of proof, at least as a default rule, lies entirely with the plaintiff. However, as has been seen before, such advantage may not mean much in practice given that there is no legal bar to prevent the judge from exercising his discretion to shift such burden to the defendant if the defendant has relatively better access to information than the plaintiff.

In short, the illegality cause of action under Article 750 unnecessarily places an additional layer of burden on the defendant director.

#### 4. Liabilities to Third Parties

Under Section 401 of the Commercial Code, a director, together with other directors and the corporation, may be held jointly and severally liable to third parties for harm caused by the negligent performance of his duties if such misfeasance rises to the level of gross negligence or an intentional act.<sup>92)</sup>

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90) See Jung, *supra* note 69, at 854.

91) See Jung, *supra* note 69, at 851.

This provision is based on the policy rationale of preventing directors from “thinly capitalizing” the company to the harm of outside parties who are at an informational disadvantage with respect to the company’s financial status. However, as is the case with a good portion of Korean corporate law, Section 401 is based on an antiquated notion of equity. In other words, while the policy may have made sense in the pre-IMF corporate Korea when the company’s founder coupling as the largest shareholder and representative director practically ran a one-man show while it was virtually impossible for a minority shareholder to bring a derivative suit due to strict standing and other requirements and the lending banks who were acting largely under government directives performed little financial due diligence, such policy no longer carries the same merit in today’s world of outsider directors, shareholder activism and international credit rating agencies.

For one thing, the law is now aimed at the wrong target. If the corporate veil should be pierced for reasons of deliberately thin capitalization or improper commingling of assets, the beneficiaries, namely the owners of the corporation, should be on the hook, not the directors who are merely working at their behest. Granted that there may be a substantial overlap between the two, especially in the case of closely held companies. But even so, there should be at minimum some kind of liability protection for the outside directors of a public corporation who work for a fixed pay and own little equity in the company.<sup>93)</sup>

Another possible justification for third party liability is that it will deter director misbehavior in caving to unfairly biased equity-holder demands vis-a-vis the creditor. However, directors are principally fiduciaries of the corporation and its shareholders, not of outside parties. But by effectively imposing a competing fiduciary duty for the benefit of outside parties, Section 401 creates an inherent conflict of interests for the directors in contravention of the basic principles of corporate law.

Can Section 401 be justified by the fact other countries also have at least indirect mechanisms for holding directors accountable for harm to a third party? For instance, in the U.S., the corporation is directly liable to the third party, but it may seek indemnification from the directors for such harm if it was due to bad faith or gross negligence on the part of the director. However, the answer is still no since there is a

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92) See Republic of Korea, Commercial Code art. 401.

93) See Eisenberg, *supra* note 32, at 445.

critical difference between the U.S. system and Korea's Section 401. In the former, the notion of gross negligence is firmly founded on the protection of the business judgment rule. In Korea, the business judgment rule is still in its nascent form and does not yet provide the court with useful guidance for weeding out the truly grossly negligent or bad-faith decision-making process from a mere error in business judgment that unfortunately results in much harm to the corporation or to third parties. Therefore, in Korea it is possible for a director to be held liable for corporate debt even if the director was merely doing his job as a director in approving such loans and did it in the best interest of the corporation. In fact, that is precisely what the Korean Deposit Insurance Corporation, which like its U.S. counterpart insures a certain amount of bank customer deposits, is aiming to do on behalf of banks holding bad corporate debt. In the U.S., however, such suits would be dismissed at the outset under the rubric of the business judgment rule.

In this light, even the well-intentioned standard of gross negligence under Section 401 for third party claims (but not necessarily for derivative claims) may create perverse consequences. This is because in anticipation of the unprincipled shootout which is the current status of the director liability suits in Korea, directors will grapple at any available line of defense, and one such defense useful in establishing the lack of gross negligence is an act in compliance with common customs and usage. In other words, the directors will have an incentive not to be more daring than their counterparts in other corporations, contrary to the intent behind the Section 401 gross negligence standard in encouraging an acceptable level of risk taking for corporate directors.

Section 401 has another curious aspect in that it penalizes a "negligent performance" of directors' duties, but not a violation of the statute or corporate charter, as is the case in the provision governing liability to the corporation. Does the omission reflect the legislative intent to further reduce the scope of director liability in the case of third party liability (in addition to the gross negligence standard)? If so, the policy justification is unclear. For instance, the legislature could have gone the other way and limited director liability to a statutory or charter violation, which would have made more intuitive sense. At any rate, such omission represents yet another glaring hole in Korea's director liability jurisprudence and calls for judicial, if not legislative, repair.

In sum, the defects of the Korean statutes on director duties and liabilities can be summarized as a classic case of the blind leading the blind. First, there is no statutory

guidance or safe harbor as to the level and scope of care and diligence the director should exercise to avoid future litigation. Second, even if there were some guidance, under the broad-based liability regime that spans both the Commercial Code and the Civil Code, the director could be dragged into court on virtually any ground that may be construed as illegal or negligent, barred only by the creativity of the plaintiff's lawyer and the mercy of the court. Third, once in litigation, the defendant directors have no effective weapon to fend off the charge of negligence, since they have the burden of proving that they did not fail in providing for every foreseeable contingency. Fourth, there is no cap on the amount of damages, and each director is jointly and severally held liable.

Given this statutory backdrop on the director duties and liabilities, the role of the judiciary becomes even more important in protecting the directors from frivolous suits. The next section reviews the extent to which the rule has found its place in Korean jurisprudence and highlights some ways for incorporating the rule more systematically.

## **V. Suggestions: A Case for Further Judicial Osmosis of the Business Judgment Rule**

There are a number of ways to protect the corporate directors from frivolous shareholder litigation. The cleanest and most powerful among them would be by means of director protection statutes as found in most American states. For instance, Section 102(b)(7) of the Delaware General Corporation Law authorizes the adoption by shareholders of the charter provision "eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director," provided that such provision may not apply to (i) "any breach of the director's duty of loyalty to the corporation or its stockholders," (ii) "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law," (iii) "unlawful payments of dividends or unlawful stock purchases or redemptions," and (iv) "any transaction from which the director derived an improper personal benefit."

While a detailed analysis of the exact mechanism is beyond the scope of this essay, adoption of a similar legislative measure would not be inconsistent with the current statutory provisions of the Korean Commercial Code. The problem, though, is whether



there is a sufficient political will to make its enactment possible in the foreseeable future.

But the prospect is bleak. The recent corporate reform measures were adopted in the midst of an anti-corporate mood following the IMF crisis. Even to this date, corporate scandals involving huge sums of bribery and consumer fraud make headlines almost on a daily basis, and valid questions remain as to whether such practices are indeed leftovers from a bygone era, or a legacy that continues to be popular. Given the egalitarian bent in current Korean society, big businesses were never in favor in Korea; the recent and still ongoing rounds of corporate scandals make things worse. Even if a proposed legislation is narrowly constructed in the mode of Section 102(b)(7) of the DGCL, it is likely to face a broad-based skepticism and critics will jump on any such measure as an unfair loophole for the criminally rich. Briefly put, a prophylactic approach such as statutory reforms appears to be out of question for the time being.

Another director-protective mechanism would be the D&O insurance. Unfortunately, however, this market approach will be priced out for most medium-to-small businesses in Korea. To begin with, the pool of enterprises is not large enough in Korea to allow precise measurement of risk or support a volume discount in insurance premiums. Furthermore, given the recent string of judgments against the corporate directors in the sums of tens of millions of dollars, the insurance premiums have skyrocketed. At the same time, the medium-to-small businesses are the ones that have to take the most risks and therefore, need the director liability insurance the most. But such risk profile will likely raise the premium for them, most often out of the price range they could afford.

In short, a more tailored and less expensive mechanism is needed to protect the Korean directors. And in that regard, the judicial approach best fits this profile. First, because of the highly selective appointment process based largely on academic performance and their choice to serve as judges despite the higher salary in the private sector, judges in Korea command wide respect for their intellectual competence and moral integrity. Therefore, their decisions, even those that seem to go against the grain of popular sentiment, are likely to face less resistance, certainly less than any legislative approach. Second, although the Korean precedents do not have a binding effect, the judges' decisions, if they are carefully reasoned, will work as a persuasive authority on future rulings. Third and most importantly, some of the Korean judges have already embraced the notion of the business judgment rule at least in its crude, primitive form. Therefore, there is at least a pre-existing framework into which the rule

can be incorporated.

An examination of the Korean precedents that discuss the business rule yields two general observations. First, the precedents for the most part have been lower court rulings. Therefore, while they do not have much persuasive power yet, as they are appealed to higher courts, as is often the case, the precedents are likely to increase in significance. The second observation is that most of the precedents have involved as defendants the directors of depository institutions. This is because one of the most active plaintiffs has been the Korean Depository Insurance Corporation, which has been suing banks and other financial entities for improvidently lending money to near-insolvent corporations, despite the safety and soundness principle governing depository institutions. One exception among the prominent cases is the case against the directors of Samsung Electronics, which case is currently pending at the High Court.

Thus, even where the court decisions appear to incorporate the main points of the business judgment rule, it is difficult to posit that such precedents apply to the non-financial companies with equal force since they are diluted by the special concerns for financial institutions arising out of the safety and soundness principle.

Furthermore, in terms of actual application, the business judgment rule has faced a primitive, unprincipled approach. The prime case in point is the Samsung case.<sup>94)</sup> That case, the lower court found the directors liable based on sets of facts that decidedly involved ordinary negligence. On one set of facts, which involved the board of directors approving the acquisition of a financially troubled company with the stated business purpose of diversifying into an apparently promising new line of business, which company was later resold at a loss due to the IMF crisis despite having received a substantial sum of additional capital investments, the Suwon District court found a breach of the fiduciary duties of care and diligence in part because (i) the directors should have foreseen the downturn in the business cycle in the industry to which the company belonged and therefore should have decided against the acquisition, and (ii) the defendant directors failed to prove that they had adequately informed themselves of all the necessary information for deciding the business merit of the question because they should have paid more attention to the financial statements in order to anticipate that the target company was unlikely to turn profitable within a foreseeable time frame.

Another set of facts in the Samsung case involved the board's decision to buy the

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94) See Suwon District Decision No. 98GaHap22533, *en banc* dated December 27, 2001.

stock of a company and later resell this stock to an affiliate at a price substantially lower than the purchase price. Here, the court also found a breach of fiduciary duties because the sale price approved by the directors was based on what the court determined to be an erroneous valuation method, despite the fact that (i) such valuation method was required by law at the time of sale and (ii) the directors relied on a reputable accounting firm for the calculation of the sale price.

Either matter involves the kinds of facts that would have been dismissed at the pleading stage in a U.S. court proceeding.

In the Samsung case, it is also noteworthy that in both matters, the court took trouble to analyze the financial statements of the target company in order to recommend a way to read between the lines (the first set of facts) and to evaluate the merit (or the lack thereof) of a commonly accepted valuated method by commenting on esoteric issues such as whether the book or fair market value should be used in valuing dormant real estate of a company. Again, such endeavor is something that would have been forestalled at the outset in a U.S. court proceeding for reasons of the relative expertise of the court and the efficient allocation of judicial resources.

Of course, it will be unfair to evaluate the wisdom of a Korean court's decision purely by analogy to a hypothetical ruling in a U.S. court. However, the Samsung decision clearly and directly contravened the underlying policy rationales of the business judgment rule, and a defender of the ruling in that case has the burden to provide a countervailing justification, either in terms of law or policy. Apparently there was none, and this is a case where even the opponents of the business judgment rule concede that the court has gone too far.<sup>95)</sup>

The Samsung case notwithstanding, the Korean courts, especially at the lower trial level, have referred to the business judgment rule in their decisions. Although these decisions mostly involved facts of lending decisions by financial institutions, it will be worthwhile to quote some of such discussions to gain a context on where the business judgment rule stands in the current jurisprudence of Korea as well as to grasp a sense of direction of what to expect next.

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95) Joo-Young Kim, "People's Solidarity for Participatory Democracy", Q&A session at a symposium on the limits of the authority and liability of corporate directors sponsored by Korean Depository Insurance Corporation on September 18, 2003

1. Korean Supreme Court Case No. 2000da9086, decided on  
March 15, 2002<sup>96)</sup>

This Supreme Court case involved a claim that the officers of a commercial bank did not diligently perform their fiduciary duties to their corporation when they made a lending decision to a company that later became insolvent. Here, the court ruled that, with respect to a business judgment on lending, an officer of a financial institution who has conducted the loan analysis “in good faith, for the best interests of the company, in accordance with proper procedures and on the basis of reasonable information in light of the circumstances and the officer’s position” would be deemed as lying “within the permitted discretions” and having fulfilled his fiduciary duties unless there was a “clearly unreasonable” misconduct in the performance of his duties. To determine whether there was a “clearly unreasonable” misconduct, the court noted that a comprehensive review of the relevant facts and circumstances, including the terms and conditions of the loan agreement, the loan size, repayment plan, the security for the loan, and the debtor company’s asset profile, management history and the growth potential of company operations.

The court also noted that the officers and directors of a depository institution have a special duty to the public for the purposes of maintaining a sound and safe financial system, harboring at least a seed of doubt as to whether the aforementioned duties apply to officers and directors of a financial institution only. However, as to the hypothetical argument that the ruling here applies only to officers rather than directors, the majority view among commentators is that the same duties apply equally to directors and senior-ranking officers of a corporation.

2. Seoul High Court Case No. 2001na59417, decided on November 14, 2002<sup>97)</sup>

This appellate decision by the High Court involved a dispute over the lending limit

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96) Quoted from Bok-Gi Hong, “The Duties of Directors and Applications of the Business Judgment Rule [*isa-ui uimoo-wa kyungyongpandan-ui wonchik*]”, presented at a symposium on the limits of the authority and liability of corporate directors sponsored by Korean Depository Insurance Corporation on September 18, 2003 (manuscript on file with author).

97) Quoted from Hong, *supra* note 96, at 43.

set by a merchant bank. The court noted that while the directors of a financial institution have fiduciary duties that go beyond those applicable to a non-financial company, there were significant overlaps between them. One such overlap is that a director in making a business judgment should diligently obtain “easily accessible” information that may serve as the basis of the business judgment and should not make a “reckless or arbitrary” decision without first obtaining such information. The court noted that to the extent that the director acted in accordance with the foregoing precepts, he should be deemed to have acted within his discretion under the statute and the charter.

Most importantly for the business judgment rule, the court posited that the management of an enterprise inherently involves risk-taking, and therefore if a representative or other director made a judgment and executed such judgment within the bounds of reason applicable to an executive of a corporation, the director should not be held liable for harm subsequently suffered by the corporation as a result of such judgment on the grounds that the director violated his fiduciary duty of care.

3. Seoul High Court Case No. 2003na12672, decided on July 23, 2003<sup>98)</sup>

In a sign of deference to the Supreme Court where similar facts are involved, the High Court quoted the language of the above-referenced Supreme Court case almost verbatim in specifying the duties of the officers of a financial institution.

4. Daegu District Court Case No. 99kahap13533, decided en banc on  
May 30, 2000<sup>99)</sup>

This case included a language remarkably similar to that found in the 2002 Seoul High Court in regards to the evaluation of a business decision on the basis of *ex post* facts. Given that the present case was heard before a lower trial court, this incidence demonstrates the power of persuasion among the Korean courts, despite the lack of a formal binding effect by a precedent.

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98) *See id.* at 46.

99) *See id.* at 41.

5. Jeonju District Court Case No. 99kahap6639, decided en banc on February 14, 2003 <sup>100)</sup>

In yet another tribute to the business judgment rule, the ruling in this case was noteworthy in that it distinguished a breach of the fiduciary duty of care from a mere error in business judgment. As for the relevant factors in making the distinction, the court here specified a list that for the most part was incorporated into later rulings by higher and other lower courts, including the economic situation at the time of the business decision, the loan size and security, the special circumstances of the business involved and the procedures taken by the directors and officers in reaching their business decisions.

As examined above, the current Korean jurisprudence seems to be receptive towards the business judgment rule, at least in its primitive form. However, there are still several deficiencies that require correction. The most glaring of them is the lack of a decision by the Korean Supreme Court that declares the applicability of the business judgment rule to non-financial corporations. Currently, a counterargument is possible on the technical grounds that all of the major cases decided so far that discuss the business judgment rule have involved financial corporations where special duties apply to the directors and officers under the principle of safety and soundness.

The Korean Supreme Court could stamp out such counterarguments by taking an unequivocally affirmative stand for the broad application of the business judgment rule. While even a decision by the Korean Supreme Court will not have a formal binding effect, its stature, coupled with its vested authority to oversee the personnel decisions of the lower court judges, i.e., promotional matters, should certainly carry much weight in influencing the future decisions of the lower courts.

Other actions that should be taken by the courts, especially the Korean Supreme Court, are as follows:

- Distinguish between the breach of the fiduciary duty of care from a mere error in business judgment. The former should be punished; the latter should not. The court can effect this principle by refusing to

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<sup>100)</sup> *See id.* at 44.

evaluate the merit of a business judgment by the *post facto* consequence of such judgment.

- Add substantive muscle to the fiduciary duties of care and diligence. For instance, the Delaware courts treat reasonable informedness as a safe harbor in meeting the requirements of the duty of care. A similar approach should be taken by the Korean courts. If reasonable informedness is not the appropriate threshold for its lack of statutory foundation, the courts can use an alternative concept found in Article 382-2 of the Commercial Code, which is the director's authority to act within the discretion granted under the statute and the corporate charter. Thus, to the extent that the director does not abuse such discretion, the court should consider exempting him from liability for an alleged violation of fiduciary duties of care and diligence.
- Hold directors liable for breaches of the duties of care and diligence only upon finding of gross negligence. Article 401 of the Commercial Code already codifies such a threshold for third party claims. While Article 401 of the Commercial Code does not expressly state what type of negligence a director should be accountable for, it does not specify "ordinary" negligence and therefore the judge has room to judicially institute the concept of gross negligence.
- Hold fast to the default rules of evidence. Under the default rules of evidence, the plaintiff in a civil litigation has the burden of proof for purposes of both pleading and persuasion. No exception should be made in derivative litigations for reasons director's superior access to information. Such exception may have made sense in the days where the plaintiff shareholder was also burdened with a harsh standing requirement. However, with the ease of such restriction following the post-IMF crisis reforms, the threat of frivolous strike suits has become real. In light of this development, procedural equity demands the restoration of the default rules of evidence in derivative litigation.
- As a counterbalance, construe strictly any violation of the director's duty of loyalty to the corporation or any knowing violation of the law. Such approach strikes at the heart of the problems for Korean corporations, namely the misappropriation of corporate funds in the

form of bribery, embezzlement and commingling, without chilling the risk-taking activity of the corporate directors, which is governed by the fiduciary duties of care and diligence.

The foregoing list is not meant to be comprehensive. But at least, they will be steps in the right direction in the sense that the law should no longer serve as a disincentive against the corporate directors from doing their job and fulfilling their fiduciary obligations to the corporation at the same time.

## V. Conclusion

The Korean law on corporate governance is still a puzzle in development. As such, it is still missing critical pieces, among which director-protective mechanisms such as the business judgment rule stands as one of the most prominent. There is no question that legal reform is a dynamic process. But given the nature of path dependency, it is also a time sensitive matter that will much benefit from the correction of its flaws as early as possible.

And that is why judicial activism desperately becomes important with respect to the systematic incorporation of the business judgment rule into Korean law. This is particularly so in light of the fact that, as media-tainted villains, the corporate management is likely to be orphans in the legislative process and therefore requires the intervention of the judges who carry a constitutional mandate to afford equal protection of the law (in terms of both letters and the spirit) to all, including the corporate directors.

Given the structural or other constraints of the Korean statutory framework and the civil law tradition that effectively marginalizes the role of the judiciary, judicial activism in Korea is a formidable task.

However, where there is a will, there is a way. Further, given the porous language of the relevant statutes, the Korean judges have ample room to maneuver. It is time for them to make their mark on history, even if this means taking a firm stand against the wave of populist sentiment.