ARTICLES

CORPORATE GOVERNANCE FROM A COMPARATIVE PERSPECTIVE: SPECIFIC APPLICATIONS OF THE DUTY OF LOYALTY IN KOREA

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I. INTRODUCTION

A major concern in contemporary corporate law in the United States is the fiduciary obligations of corporate directors.[1] In the United States, corporate directors are fiduciaries who stand in a "distinct legal relationship"[2] with and thus owe "certain legally enforceable duties"[3] to the corporation and its shareholders.[4] Although the concept of fiduciary duties is difficult to

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1. John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1621 (1989) (stating that fiduciary duties are "corporate law's most mandatory inner core" in the United States). In the United States, for example, almost all textbooks on corporate law discuss the issues of fiduciary duties of corporate directors. *See, e.g.*, WILLIAM L. CARY & MELVIN ARON- EISENBERG, CASES AND MATERIALS ON CORPORATIONS 647-809 (7th ed. 1995).

2. 2 ARTHUR W. MACHEN, A TREATISE ON THE MODERN LAW OF CORPORATIONS, WITH REFERENCE TO FORMATION AND OPERATION UNDER GENERAL LAWS 1162 (1908). *See also* Note, *Liability of Directors for Negligent Mismanagement*, 82 U. PA. L. REV. 364, 366 (1934); Rudolph E. Uhlman, *The Legal Status of Corporate Directors*, 19 B.U. L. REV. 12, 16 (1939).

3. Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 927 (1983).

4. Justice Frankfurter stated that "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary?" SEC v.

define, fiduciary duties are generally divided into two broad categories:[5] the duty of care, which requires directors to act carefully in the management of business, and the duty of loyalty, which has been characterized as the duty of unselfishness;[6] also known as the duty of fair dealing.[7]

Under the duty of loyalty, directors owe their full loyalty and allegiance to the corporation.[8] This means that directors are obligated to act in the best interest of the corporation and its shareholders. Thus, the duty of loyalty is regarded as a device to reduce agency problems arising between corporate directors and shareholders.[9] In the United States, duty-of-loyalty concerns fall into three broad categories which might involve conflict of interest: (1) self-dealing, (2) executive compensation, and (3) corporate opportunity and competition with the corporation.[10]

Chenery Corp., 318 U.S. 80, 85-86, 63 S. Ct. 454, 458 (1943). In earlier British cases such as Percival v. Wright, 2 Ch. 421 (1902), directors are held to owe duties only to the corporation because the formalistic distinction between the corporation and shareholders won general acceptance at that time. J. C. SHEPHERD, THE LAW OF FIDUCIARIES 355-56 (1981). This distinction loses its ground today routinely. *See* Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919) (holding that directors have a duty to conduct the affairs of their venture for the exclusive benefit of the shareholders).

5. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1993) (stating that "duty of care and duty of loyalty are the traditional hallmarks of a fiduciary"); Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 17 (1989); Arthur R. Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporations*, 46 AM. J. COMP. L. 317, 331 (1998).

6. D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1406-07 (2002).

7. Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1271 (1999) (stating that "the duty of loyalty is a shorthand expression for the duty of fair dealing").

8. *See, e.g.*, Guth v. Loft, 5 A.2d 503, 510 (Del. 1939) (holding that "the rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest"); Litwin v. Allen, 25 N.Y.S.2d 667, 677 (Sup. Ct. 1940) (holding that "[i]t is clear that a director owes loyalty and allegiance to the company—a loyalty that is undivided and an allegiance that is influenced in action by no consideration other than the welfare of the corporation."). *See* GEORGE P. FLETCHER, LOYALTY: AN ESSAY ON THE MORALITY OF RELATIONSHIP 8 (1993) (stating that "[t]he minimal demand of loyalty is the maintenance of the relationship, which requires the rejection of alternatives that undermine the principal bond").

9. Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 427 (2001) (stating that "the duty of loyalty works primarily to prevent directors from indulging in more blatant forms of theft" which "reduces the economic value of the firm"). For detailed discussions of agency problems, see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

10. *See* ROBERT C. CLARK, CORPORATE LAW 142 (1986); Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 483 (2004).

In Korea, the 1998 amendment to the Korean Commercial Code adopted a "catchall" provision of the duty of loyalty by referring to U.S. law.[11] Newly amended Articles 382-3 expressly impose the duty of loyalty on directors.[12] Articles 388, 397, and 398 of the Korean Commercial Code were promulgated to provide guidance on specific conflict-of-interest situations and require of directors a duty to carry out their functions faithfully for the benefit of the corporation.[13]

U.S. corporate law and judicial decisions of the last century serve as a standard of what a director's duty of loyalty should be. From a comparativist's perspective, this Article uses the U.S. normative scheme of director's duties as a source for understanding limitations and advantages of Korean law. After U.S. and Korean legal rules are briefly introduced, U.S. legal rules will be compared with those of Korea, a country with a different corporate governance structure from the United States, in order to find what rules prevailing in the U. S. system are more evolved and efficient than those in Korea. Despite the order of provisions in the Korean Commercial Code, discussion of this Article begins with the self-dealing transaction, proceeds to executive compensation, and then discusses the corporate opportunity doctrine and competition with the corporation. This order corresponds with the duty-of-loyalty discourse utilized in many U.S. law texts.

II. FIDUCIARIES DUTIES VS. MANDATORY DUTIES

A. Fiduciary Duties under U.S. Law

The concept of fiduciary duties initially developed in the law of trusts.[14] It has served to safeguard the interests of entrustor

11. Craig Ehrlich & Dae-Seob Kang, *U.S. Style Corporate Governance in Korea's Largest Companies*, 18 UCLA Pac. Basin L.J. 1, 37 (2000) (stating that Korean law-makers intended to impose a duty equivalent to the duty of loyalty of U.S. law by newly incorporating article 382-3 into the Korean Commercial Code).

12. Article 382-3 of the Korean Commercial Code states that "[d]irectors shall perform their duties faithfully for the good of the company in accordance with the relevant acts, subordinate statutes and the articles of incorporation." Commercial Code [Com. Code] art. 382-3 (S. Korea).

13. 13 Com. Code arts. 388, 397-98 (S. Korea). The Korean statutory provisions focus on three types of conflict-of-interest paradigms. The purpose of Article 388 of the Korean Commercial Code is to set compensation for services of the directors to corporation without direct participation by the board of directors. *See infra* text accompanying notes 97-105. Article 397 is designed to prevent conflict of interest arisen from competition with the corporation. *See infra* text accompanying notes 124-32. A way for avoiding the self-dealing problem is provided in Article 398. *See infra* text accompanying notes 65-88.

14. 14 *See* Richard B. Dyson, *The Director's Liability for Negligence*, 40 Ind. L.J. 341, 341 (1965); Edward Rock & Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 Nw. U. L. Rev. 651, 655-57 (2002).

and beneficiary from overreaching by the trustee.[15] It has also extended its application to other areas of the law.[16] When a fiduciary relationship is created, some power is transferred from the entrustor to the trustee for the owner's sole benefit.[17] Owners do not participate directly in the management of the corporation. Instead the system of centralized management by directors in a fiduciary relationship to the corporation was established to promote flexibility in conducting business, specialization of corporations, and utility of expertise.[18]

The purpose of imposing fiduciary duties upon the directors and officers of a corporation is to ensure that the corporation is managed for the benefit of all shareholders.[19] A requirement that corporate directors act on behalf of the corporation stems from the separation of ownership and control,[20]which is designed to "economize on transaction costs."[21] Fiduciary duties work as a

15. Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 795(1983); Robert W. Hallgring, *The Uniform Trustees' Powers Act and the basic Principles of Fiduciary Responsibility*, 41 WASH. L. REV. 801, 802 (1966); SHEPHERD, *supra* note 4, at 12-13.

16. Frankel, *supra* note 15, at 796.

17. *Id.* at 809; Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425, 430 (1993); SHEPHERD, *supra* note 4, at 99-100.

18. Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 700 (1982).

19. Shepherd states: "Directors get most of their powers from shareholders .... The transfer of these powers is mainly indirect; that is, a director is elected to an office which carries with it, via corporate law, the articles, and practical realities, a range of powers .... Even aside from statutory considerations, these powers are clearly intended to be encumbered with a duty." SHEPHERD, *supra* note 4, at 352 (citation omitted). *See also* Calvin Massey, *American Fiduciary Duty in an Age of Narcissism*, 54 SASK. L. REV. 101, 101 (1990) (noting that "[t]he law of fiduciary obligation . . . originat[ed] in equity as a device to control abuse of confidence").

20. SHEPHERD, *supra* note 4, at 351-55.

21. Alison G. Anderson, *Conflict of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 759 (1978). Separation of control from ownership creates the principal-agent relationship between managers and owners, thereby reducing the high transaction costs that would accompany the participation of all the shareholders in the corporate decision-making process. If far-flung shareholders of a large publicly-held corporation attempt to participate all together in managerial decisions, insurmountable transaction costs are generated. *Id.* at 778-79. According to economic history, the separation was an inevitable result of the development of the modern capital markets and a wide dispersion of share ownership. *See* Mark J. Roe, *Foundations of Corporate Finance: The 1906 Pacification of the Insurance Industry*, 93 COLUM. L. REV. 639, 644 (1993) (reconsidering the economic theory of public corporations). Such dispersion therefore created a special body of managers to represent and administer the corporation without holding a sizable percentage of shares. Dispersion of ownership led to the delegation of authority of shareholders to the managers. H. E. Frech III, *Is Corporate Ownership Divorced from Control?*, *in* THE ATTACK ON CORPORATE AMERICA: THE CORPORATE ISSUES SOURCEBOOK 102, 103 (M. Bruce Johnson eds., 1978). Since the management of corporate affairs was handed over to directors, substantial portion of transaction costs has been reduced. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 309 (1983).

mechanism to reduce agency costs generated by agency relations.[22]

B. Mandatory Duties under Korean Law

Though the concept of management by a board of directors in Korean law stems from U.S. origin,[23] the legal nature of the relationship between a corporation and its directors is different then that in the U.S.

Article 382(2) of the Korean Commercial Code provides that the relationship between a corporation and its directors is governed by the provisions concerning mandates contained in the Korean Civil Code.[24]

As long as the principles of the law of mandates apply to the relationship between the directors and their corporation, they require the mandatories, who are defined as persons to whom legal mandates are awarded,[25] to serve on a gratuitous basis.[26] However, the statutory treatment of directors as mandatories does not quite coincide with reality. In practice, directors always re-

22. Agency costs represent the sum of (1) the bonding costs that agents incur when they try to assure their loyalty to their principals, (2) monitoring expenditures by principals in order to oversee the performance of agents, and (3) a residuum of loss which will in any event exist because their prevention is uneconomical. Jensen & Meckling, *supra* note 9, at 308.

23. Jae Y. Kwon, *The Internal Division of Powers in Corporate Governance: A Comparative Approach to the South Korean Statutory Scheme*, 12 Minn. J. Global Trade 299, 316-17 (2003).

24. Ehrlich & Kang, *supra* note 11, at 35. The Korean Commercial Code article 382(2) reads that "[t]he provisions relating to mandates shall apply *mutatis mutandis* to the relation between the company and the directors." Com. Code art. 382(2) (S. Korea). For the provisions relating to mandates, see Civil Code[Civ. Code] Part 3 Chapter 2 Section 11 (S. Korea). In the early history of U.S. corporate law, interestingly, there was the tendency to classify directors as mandataries. Norwood P. Beveridge, Jr., *The Corporate Director's Duty of Care: Riddles Wisely Expounded*, 24 Suffolk U. L. Rev. 923, 926-35 (1990). Many of the early cases of the United States "likened directors to mandataries." *Id.* at 935.

25. Black's Law Dictionary 973 (7th ed. 1999).

26. Civ. Code art. 686 (1) (S. Korea) (providing that "[i]n the absence of a special agreement, a mandatary may not demand remuneration from the mandator"). In the United States, the term "mandate" is defined as "[a] commission or contract by which one person (the *mandator*) requests someone (the *mandatary*) to perform some service *gratuitously*." Black's Law Dictionary, *supra* note 25, at 973 (emphasis added). In 1856, Justice Story defined a mandate as "a bailment of goods without reward, to be carried from place to place, or to have some act performed about them." Joseph Story, Commentaries on the Law of Bailments: With Illustrations from the Civil and the Foreign Law 172 (6th ed. 1856). As seen in nineteenth century American cases, mandataries were not compensated. *See* Dunn's Adm'r v. Kyle's Ex'r, 77 Ky. (14 Bush) 134 (1878); Citizens Bldg. Loan & Sav. Ass'n. v. Coriell, 34 N.J.Eq.383 (1881); Swentzel v. Penn Bank, 147 Pa. 140, 23 A. 405 (1892).

ceive a considerable amount of remuneration through special agreements.[27]

The mandatory relationship is a contractual relationship,[28] the content of which in large part is determined by the articles of incorporation, the bylaws, and corporate law.[29] As mandatories, directors may resign at any time,[30] and their directorships are terminated due to death, bankruptcy, or determination of limited capacity.[31]

Under the law of mandates, mandatories are only under a moral obligation to perform their roles carefully.[32] Thus, directors have the duty to conduct the business of the corporation with the standard of care of a good manager,[33] and the duty to perform their functions without compensation unless otherwise provided.[34] The degree of care required of the directors in performing their managerial functions is higher than that exercised in their personal business. This duty, which is a functional equivalent of the duty of care under the U.S. law, is usually called the *sonkwan* duty, which translates as "the duty of care of a good manager."[35]

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27. *See infra* note 97.

28. Continental civil law tradition remains in the State of Louisiana. According to Louisiana Civil Code article 2989, "[a] mandate is a contract by which a person, the principal, confers authority on another person, the mandatary, to transact one or more affairs for the principal." LA. CIV. CODE ANN. art. 2989 (West Supp. 2001).

29. However, as may be possible in small or closely held corporations, the content of the mandatary relationship, because of its legal nature, may be changed by contractual agreement between all the shareholders serving as mandators and the directors serving as mandataries. By the agreement, the authority to manage the corporation may be restricted.

30. CIV. CODE art. 689(1) (S. Korea) (providing that "[a] mandate may be rescinded by either party at any time").

31. *Id.* art. 690.

32. Mitsuo Kondo, *The Management Liability of Directors,* 20 L. IN JAPAN 150, 150-51 (Donald C. Clarke trans., 1987).

33. CIV. CODE art. 681 (providing that "[a] mandatary shall manage the affairs entrusted to him with the care of a good manager"); Ehrlich & Kang, *supra* note 11, at 35 (stating that a director should "manage the affairs entrusted to him with the care of a good manager"). In Japan whose legal system is very similar to that of Korea, "directors' conduct is governed by a duty of care, defined in relation to the [Japanese] Civil Code's mandate principles as the "care of a good manager." Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Contract, Culture, and the Rule of Law,* 37 HARV. INT'L L.J. 3, 16 n.60 (1996).

34. CIV. CODE art. 686 (S. Korea) (providing that, based on the principles of the law of mandates, directors are not entitled to demand any compensation unless an agreement has been made to the contrary). *Cf.* Wendell H. Holmes & Symeon C. Symeonides, *Representation, Mandate, and Agency: A Kommentar on Louisiana's New Law,* 73 TUL. L. REV. 1087, 1121 (1999).

35. The English word "*duty*" is a translation of the Korean word *"euimu."* The term "care" is translated into Korean word *"chueui."* The term "*sonkwan*" is a shorthand expression for "*sonkwan jueui*," meaning "care of a good manager."

The United States has established an extensive system of fiduciary duties, but there is no exact equivalent in Korea.[36] Like other Continental European Countries, the legal scheme of the duty of loyalty has not been well-formulated in Korea, even though Korea has a provision expressly imposing the duty on directors.[37] The slow development of the duty of loyalty can be explained by the scarcity of derivative lawsuits.[38]

There has been extensive theoretical debate over the significance of the duty of loyalty under the Korean legal system. As to whether the distinction between the two duties should be recognized under Korean corporate law, two competing views have developed.[39]

Some scholars believe that the duty of loyalty is one facet of the duty of care of a good manager, notwithstanding the existence of a "catchall" provision of the duty of loyalty in Korean law.[40] They have therefore concluded that a director's duties to refrain from wrongful self-dealing, as well as from influencing executive compensation and competing with the corporation, are derived from the duty of care of a good manager.

In opposition is an emerging view that believes that the duty of loyalty should be distinguished from the duty of care of a good manager.[41] The rationale supporting this view is that "[t]he duty

36. It is evidenced by the statement that "[t]he development of the concepts of trust and of fiduciary responsibility in Anglo-Saxon Law is too different from many continental legal systems." Willi Jochim, *The Liability of Supervisory Board Directors in Germany*, 25 INT'L L. 41, 56 (1991).

37. 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, 67 (1999) (opining that "[a]lthough Korean law recognizes the concept of managers' fiduciary duty of loyalty, it falls short of the standards set in American corporate law.") [hereinafter H. Kim]. *See also* LARRY C. BACKER, COMPARATIVE CORPORATE LAW: UNITED STATES, EUROPEAN UNION, CHINA AND JAPAN 1265 (2002) (stating that "[t]he civil law countries have not developed a focused and comprehensive law for the regulation of managers equivalent to the common law's duty of loyalty); Ángel R. Oquendo, *Breaking on Through to the Other Side: Understanding Continental European Corporate Governance*, 22 U. PA. J. INT'L ECON. L. 975, 1011 n.119 (2001) (stating that the duty of loyalty is "less developed in Germany," whose legal system has been a model for Korea).

38. Stephen J. Choi & Kon Sik Kim, *Establishing a New Stock Market for Shareholder Value Oriented Firms in Korea,* 3 CHI. J. INT'L L. 277, 285 (2002); H. Kim, *supra* note 37, at 67.

39. In Japan, whether the dichotomy of the duty of loyalty and the duty of care is recognized is an unsettled issue, too. Milhaupt, *supra* note 33, at 16 n.60.

40. *See, e.g.*, CHOL-SONG LEE, HOESABOB KANGEUI [LECTURES ON CORPORATE LAW] 591(11th ed. 2004) [hereinafter C. LEE] (ignoring the dichotomy of the duty of care of a good manager and the duty of loyalty).

41. This position is reinforced by a path-breaking Korean Supreme Court Decision. *See* Korean Supreme Court Decision of November 12, 1985, 84 Daka 2490. Though finding no legislative authority for and saying nothing about the justification for the dichotomy, the Korean Supreme Court stated that a breach of the duty of

of care of a good manager under the civil law is a less rigorous standard than the American concept of fiduciary duty"[42] and mandatory duties under Korean law are thus to be supplemented by the duty of loyalty. Under this view, it has been argued that Articles 388, 397, and 398 of the Korean Commercial Code have been designed to reach the duty of loyalty that is not covered by the literal language of the provisions of the duty of care of a good manager.[43] Furthermore, this view opined that statutory formulations regarding the duty of loyalty were adopted in 1998 by referring to U.S. law in order to avoid the misunderstanding of the taxonomy of the duties of directors.[44] In support of the view that the duty of loyalty differs qualitatively from the duty of care of a good manager, this Article is inclined to depart from the argument that the duty of loyalty is one special aspect of the duty of care of a good manager.

This Article attempts to explain why the duty of loyalty should be distinct from the duty of care of a good manager in Korea. The statutory differences between the liabilities for the breach of the two duties are twofold. The first difference is that a major concern of the duty of care of a good manager is merely the degree of care to be exercised by the directors in performing their functions as mandatories, while the duty of loyalty requires the directors to not put their personal interests ahead of those of the corporation.[45] Therefore, liability is not imposed upon directors for breach of the duty of care in the absence of negligence or bad faith, whereas negligence or bad faith is not a concern of the duty of loyalty.[46]

Second, when directors are in violation of the duty of care of a good manager, directors are liable for the loss caused by their acts and the amount of compensation is limited to the actual loss

care *or* the duty of loyalty is the very act the directors are liable for because of their neglect of duties (emphasis added). *Id.* So far, this is the only case reported expressly recognizing the distinction between the duty of care and the duty of loyalty. Ehrlich & Kang, *supra* note 11, at 36 (opining that "a duty of loyalty might be inferred from these provisions"); H. Kim, *supra* note 37, at 73 (opining that it has long been recognized that the corporate directors are under the duty of loyalty even before "the [Korean Commercial Code] did not explicitly provide for it.").

42. Christopher L. Heftel, Survey, *Corporate Governance in Japan: The Position of Shareholders in Publicly Held Corporations*, 5 U. HAW. L. REV. 135, 182 n.346 (1983).

43. Ehrlich & Kang, *supra* note 11, at 36 (opining that "a duty of loyalty might be inferred from these provisions"); H. Kim, *supra* note 37, at 73 (opining that it has long been recognized that the corporate directors are under the duty of loyalty even before "the [Korean Commercial Code] did not explicitly provide for it.").

44. DONG-YOON CHUNG, HOESABOB [CORPORATE LAW] 431-32 (7th ed. 2001).

45. *See* Kondo, *supra* note 32, at 150.

46. Byung-Tae Lee, Chusik hoesa ui isahoe chedo: Isa ui chiwi wa chaegim ul chungsim uro [The System of the Board of Directors of the Corporation] 103 (1986).

suffered by the corporation and third parties. However, the usual remedy for breach of the duty of loyalty includes the corporation's intervention in directors' conflict-of-interest situations such as those in the case of competition with the corporation,[47] as well as directors' compensation for the loss to the corporation.

III. SPECIFIC APPLICATIONS OF THE DUTY OF LOYALTY

A. Self-Dealing Transactions

1. *U.S. Law*

A self-dealing transaction is defined as a transaction between a director and his corporation.[48] Whether a director breaches the duty of loyalty is often at issue when a director directly or indirectly has a personal interest in the transaction. Because of the potential damage to the corporation, this kind of a transaction must be scrutinized more closely and precisely than a transaction not involving a director's interests. As a result the former strict Anglo-American common law rule was that any transaction between a director and his corporation was automatically voidable at the option of the corporation, regardless of the fairness of this decision.[49] Behind this rule, there was a rationale that a director's engagement in such a transaction prevents him from giving his full loyalty to the corporation.

Today the early common-law principle of automatic voidability has been eliminated in many state statutes,[50] although they still address the issue of conflict-of-interest transactions.[51] As to what those statutes now do, there are two possible interpretations. Under the first view, the purpose of those statutes is to validate an interested director transaction either if there is disclosure to, and approval by, a disinterested majority of the board

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47. *See infra* text accompanying notes 133-35.

48. Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 Cal. L. Rev. 393, 396 (2003).

49. Munson v. Syracuse, G. & C. R.R., 103 N.Y. 58, 73-74 (1886) (holding a contract between corporation and one of its directors voidable by the corporation without regard to its fairness); Henry Winthrop Ballantine, Ballantine on Corporations 170-71 (1946).

50. Harold Marsh, Jr., *Are Directors Trustees?: Conflict of Interest and Corporate Morality*, 22 Bus. Law. 35, 46 (1966) (explaining the purpose of adopting statutes which authorize conflict-of-interest transactions).

51. 1 American Law Institute, Principles of Corporate Governance: Analysis and Recommendations §5.02 reporter's note at 235-41 (1994) (describing safe harbor statutes) [hereinafter ALI]. For the history of the adoption of the statutes governing conflict of interest, Marshall L. Small, *Conflict of Interest and the ALI Corporate Government Project —A Reporter's Perspective,* 48 Bus. Law. 1377, 1377-80 (1993).

or a majority of shareholders, or if it is fair to the corporation.[52] By such validation, the transaction is immune from attack and the directors are isolated from personal liability.[53]

The alternative view, as expressed in *Fliegler v. Lawrence*,[54] is that the statutes "merely remove[ ] an 'interested director' cloud when [their] terms are met and provide[ ] against invalidation of an agreement 'solely' because such a director or officer is involved,"[55] but fail to provide a clear standard to take the place of the common-law rule.[56]

A representative statute dealing with transactions between a director and the director's corporation is Section 8.31 of the Revised Model Business Corporation Act that was adopted in 1984 [hereinafter the old RMBCA].[57] Section 8.31 of the old RMBCA is composed of subsections 8.31(a), (b), (c), and (d). Section 8.31(a) defines a self-dealing transaction and sets forth a statutory scheme to test for it. Indirect conflicts of interest are covered by Section 8.31(b). Sections 8.31(c) and (d) address the board and shareholder approval of conflict of interest transactions and also create a "safe harbor."

According to the old RMBCA §8.31(c), a quorum is present for the purpose of directorial ratification of the conflict-of-interest transaction when a majority of disinterested directors ratify the transaction. Under the old RMBCA, ratification requires the affirmative vote of the majority of disinterested directors or shareholders. Ratification, however, cannot validate a transaction which involves fraud,[58] undue overreaching,[59] or a waste of assets, even if the transaction is ratified under Section 8.31(a)(1) or (a)(2).[60] Ratification would not be effective unless there is an

52. Marsh, *supra* note 50, at 46.

53. *Id.* at 43-53.

54. 361 A.2d 218 (Del. 1976).

55. *Id.* at 222.

56. EDWARD BRODSKY & M. PATRICIA ADAMSKI, LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES AND LIABILITIES §3:2 (1984) (explaining the relaxation of the earlier strict rule).

57. In 1988, Section 8.31 of the old RMBCA was replaced with a new Subchapter F. However, Section 8.31 is dealt with in the text because Subchapter F has not won legislative popularity. Still, Section 8.31 and many states' statutory formulations of self-dealing transactions have a similar effect. JAMES D. COX ET AL., CORPORATIONS 210 (1997); Matthew G. Dore, *The Duties and Liabilities of an Iowa Corporate Director*, 50 DRAKE L. REV. 207, 255-56 (2002).

58. *See, e.g.*, Continental Sec. Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912) (stating that fraud is not ratifiable).

59. *See, e.g.*, Chambers v. Beaver-Advance Corp., 140 A.2d 808 (Pa. 1958).

60. Douglas M. Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable Corporate Directors*, 57 FORDHAM L. REV. 375, 393 (1988). *See, e.g.*, Schreiber v. Bryan, 396 A.2d 512 (Del. Ch. 1978) (holding that a waste of corporate assets can only be ratified by a unanimous vote of shareholders).

adequate disclosure of the material facts of the transaction and the director's interest.[61]

While the statute is silent, fairness is the most important requirement in modern self-dealing cases. As long as a self-dealing transaction is found to be fair to the corporation, nearly all courts uphold it.[62] The test for whether a conflict-of-interest transaction is fair to the corporation is summarized below:

> The fairness test consists of two components, fair price [or substantive fairness] and fair dealing. Fair price [or substantive fairness] is concerned with the substantive terms of the transaction and is satisfied by proof that the financial aspects of the transaction fall within a range that would be acceptable to unrelated parties. Fair dealing focuses on the process by which there terms are reached and is satisfied by proof that the negotiations surrounding the transaction were structured to replicate those that would take places between unrelated parties.[63]

In other words, where an interested director transaction is grossly unfair, courts are likely to determine that disinterested director approval or shareholder ratification will make no difference.

2. *Korean Law*

The Korean approach to the conflict-of-interest problem arising from self-dealing is provided for in Article 398 of the Korean Commercial Code, and differs from the method used in the United States. Under Korean law,

> [a] director may effect a transaction with the company for his own account or for account of a third person only if he has obtained the approval of the board of directors. In such case, the provisions of Article 124 of the Civil Code[64] shall not apply.[65]

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61. Old RMBCA §8.31(a)(2). *See, e.g.,* Goodman v. Futrovsky, 213 A.2d 899 (Del. 1965) (validating a transaction between two corporations on the ground that full disclosure of the arrangements was made in the prospectus, from which the shareholders most probably had full knowledge of the material facts and the director's interest in the transaction).

62. *See* David S. Ruder, *Duty of Loyalty-A Law Professor's Status Report,* 40 BUS. LAW. 1383, 1389 (1985).

63. Mitchell, *supra* note 17, at 445-46. *See also* Weinberger v. UOP, Inc., 457 A.2d 701, 711(Del. 1983) (holding that "[t]he concept of fairness has two basic aspects: fair dealing and fair price").

64. Under agency law principles, agents are allowed to serve two masters in certain circumstances. In Korea, agency law is embodied in the Civil Code. Article 124 of the Civil Code governs an agent's own contract and being an agent of both parties of a contract. *See* CIV. CODE art. 124 (S. Korea) (providing that "[w]ithout the consent of the principal, an agent shall not perform a juristic act for the principal to which the agent himself is the other party, or shall not become agent of both parties to one juristic act").

65. COM. CODE art. 398 (S. Korea).

This provision is intended to prevent conflicts of interest between directors and their corporation in order to protect the interests of the corporation.[66] The rationale for the provision is similar to that for the self-dealing rule of the United States.

It is generally agreed among Korean commentators that the self-dealing rule of the Korean Commercial Code is applicable to indirect as well as direct conflict-of-interest transactions.[67] The term "indirect transaction" can be defined as any transaction between the corporation and any party other than directors in which conflicts of interest arise. A typical example is a transaction where the corporation becomes a surety on an obligation of the directors to their creditors.[68] The above provision also covers transactions between corporations having a common director or common directors.[69]

As Article 398 states, corporate directors are required to obtain approval of the board of directors to transact on behalf of themselves or third parties with the corporation.[70] Any transaction between the corporation and its directors in which the interests of the corporation conflict with those of its directors requires the approval of the board of directors. The approval should be "made [on a case-by-case basis] by a majority of directors present in the presence of a majority of all the directors."[71] Interested directors cannot exercise their vote to approve the transaction. The rights of all directors who are members of the board of directors to approve it cannot be aggregately entrusted only to representative directors.[72] The approval must be obtained before the

66. In a partnership corporation or a limited liability corporation, a member may effect a transaction with the corporation on behalf of himself or a third party only when he has obtained the approval from a majority of other members. *Id.* arts. 199, 269. A director of a limited liability corporation can make this kind of transaction when the auditors of that corporation or all members, when the auditors are absent, approve such transaction. *Id.* art. 564(3). Furthermore, the provision of article 398 shall apply *mutatis mutandis* to other types of business organization like a mutual corporation. *See* INS. BUS. ACT art. 66(2) (S. Korea).

67. Korean Supreme Court Decision of January 15, 1974, 73 Da 955 (holding that indirect conflict-of-interest transactions were under the scope of the transactions provided in article 398).

68. CHUNG, *supra* note 44, at 440.

69. Korean Supreme Court Decisions of November 2, 1969, 69 Da 1374; December 12, 1984, 84 Daka 1591; and May 28, 1996, 95 Da 12101.

70. Before the enactment of Korea's own commercial code, the approval of "statutory auditors" was necessary for effecting self-dealing transactions. Wi-Du Kang, Hanguk Sangbobe Itseoseoui Yongmi Hoesabobui Gyesue Gwanhan Yongu [Influence of the Anglo-American Legal Traditions on the Korean Commercial Law] 85 (1980) (unpublished Ph.D. dissertation, Dong-A University, S. Korea) (on file with author).

71. COM. CODE art. 391(1) (S. Korea).

72. C. LEE, *supra* note 40, at 626. For the discussion of the status of a representative director in Korean corporate governance, see Kwon, *supra* note 23, at 328-30.

transaction has begun. A ratification cannot be employed in such a transaction because the status of the third party is unstable before the ratification of that transaction.[73] Even if no express provision requiring disclosure is found in the Korean Commercial Code, a director who is willing to enter into a transaction subject to this rule must disclose his personal interests in it.[74]

The approval by the board is not necessary unless there is a need to protect the corporation's interests.[75] For example, transactions which do not require the board's approval are: (1) performance of a preexisting obligation by a director to the corporation, or *vice versa*; (2) set-off of matured money debts; (3) a gift that is not subject to a charge from a director to the corporation; (4) a loan bearing no interest or retaining no security by a director to the corporation; (5) any transaction governed by general contract clauses such as insurance and savings; and (6) a transaction considered usual between the corporation and its customers such as a sale of a computer by a computer sales corporation to its directors.[76]

Where a director receives approval from the board of directors for a self-dealing transaction, the approval does not automatically mean that he is immunized from personal liability for damages suffered by the corporation. The director will be personally liable for the corporation's damages that result from such a transaction.[77] The reason for the liability is that he is still under the duty not to harm the corporation by exercising due care. Therefore, the effect of the board approval is limited to removing restrictions on a self-dealing transaction.[78]

If there are board members who attended the meeting and approved the transactions or did not express their dissent in the minutes, they are jointly and severally liable for damages to the corporation.[79] If a director does not obtain such approval, then he bears liability for the breach of statutory duty of a director.[80]

73. Korean law expressly requires "approval" and not "ratification." Ratification may encourage directors to engage in self-dealing transactions. If ratification is available, directors will enter into such transactions in anticipation of ratification after the transactions are made. The term "ratification" is defined as the confirmation of a previous act done. BLACK'S LAW DICTIONARY, *supra* note 25, at 1268. In other words, ratification serves as an *ex-post-facto* or after-the-fact defense against attack.

74. C. LEE, *supra* note 40, at 628.

75. Korean Supreme Court Decision of December 14, 1990, 90 Kahap 7297.

76. CHUNG, *supra* note 44, at 439.

77. *Id.* at 442.

78. *Id.* at 443.

79. COM. CODE art. 399(2)-(3) (S. Korea).

80. *Id.* art. 399(1).

Nothing is found in Korean corporate law which addresses whether a self-dealing transaction done without board approval is valid between the interested director and the corporation, and between him and *bona fide* third parties. Absent statutory clarification, one difficulty is found in protecting the corporation while at the same time continuing to honor the stability of a transaction as a fundamental tenet of the legal system. Therefore, a major concern is reconciling the protection of a corporation's interests with the promotion of the stability of the transaction. Korean legal scholars have proposed some compromised solutions to this dilemma. Three different solutions advanced for the validity of the transaction are as follows:

At one extreme, some commentators have developed a scholarly view that a transaction between the corporation and its director is void in the absence of the approval of the board, but third parties acting in good faith are protected by the provisions relating to *bona fide* acquisitions.[81] This view puts more emphasis on the protection of the corporation's interest than the stability of the transaction itself. If this position is sustained, all kinds of transactions are not fully secured because, for example, the Korean rule of *bona fide* acquisition is not applied to real estate transactions. (Namely, the Korean rule of *bona fide* acquisition governs only transactions regarding movables).

At the other extreme, there is a view that the validity of the transaction itself is guaranteed even if the transaction is not approved. In sharp contrast to the first view, full protection of the interests of the corporation is not made if this view is supported. To protect the corporation's interests, two modifications of the second view appear: (1) a director who undertakes a transaction without necessary board approval is subject to liability for damages to the corporation and may be removed from office by minority shareholders because of his misconduct,[82] and (2) by invoking an abuse of right doctrine,[83] or *exceptio doli*, the corpo-

81. *See, e.g.*, 1 KIUON TSCHE, SANGBOBHAK SINRON [NEW TREATISE ON THE COMMERCIAL LAW] 899 (14th ed. 2003). Article 249 of the Korean Civil Code, a main provision of *bona fide* acquisition, states that "[i]f a person who peaceably and openly was assigned a movable and had possession of it acting in good faith and without negligence, he shall acquire its ownership immediately even if the assigner is not a legal owner." CIV. CODE art. 249 (S. Korea).

82. *See, e.g.*, WON-SUN PARK & CHUNG-HAN LEE, CHONJONG HOESABOP [WHOLLY REVISED EDITION OF CORPORATE LAW] 298 (1979). The shareholders should have shares representing not less than three hundredth of the total number of issued shares. COM. CODE art. 385(2)-(3) (S. Korea).

83. The doctrine of abuse of rights is difficult to define and its nuances are different in different countries. However, it is a general understanding that under the doctrine, a person cannot exercise his individual rights with the intent of harming other persons, without any serious and legitimate interest in doing so. Julio Cueto-

ration prevents an interested director and a bad-faith third party from benefiting unjustifiably from the transaction.[84]

At an intermediate position, there is a sophisticated view that the transaction is void only between the corporation and the director involved, so it is effective with regard to third parties acting in good faith.[85] This position not only protects the corporation, but also ensures the stability of transactions by protecting good-faith third parties. This intermediate view is adopted by a majority of Korean corporate law scholars and reinforced by the Korean Supreme Court.[86] In such cases, the burden to prove the bad faith of third parties is imposed upon the corporation seeking to invalidate the transaction.[87]

In contrast with U.S. law, however, Korean law does not try to measure the "fairness" of a self-dealing transaction. Since Korean corporate law was enacted, the concept of fairness in self-dealing transactions has remained unaddressed.[88]

B. Executive Compensation

1. *U.S. Law*

The next context in which a conflict-of-interest issue may arise is executive compensation. Most state corporation statutes have explicit provisions addressing who sets the compensation for directorial services to the corporation. Section 141(h) of Delaware General Corporation Law, a typical executive compensation statute, provides that "[u]nless otherwise restricted by the certificate of incorporation or by-laws, the board of directors shall have the authority to fix the compensation of directors."[89] In most publicly held corporations in the United States, the power to authorize and monitor the levels, forms and amounts of executive compensation and the like are assigned to a board compensation committee composed of outside directors.[90]

Rua, *Abuse of Rights*, 35 La. L. Rev. 965, 971-74, 982-96 (1975). *See also* Civ. Code art. 3(2) (S. Korea) ("No abuse of right shall be permitted").

84. *See, e.g.*, Jung-Kap Suh & Nam-Kee Lee, Kaejong hoesabop [Revised Corporate Law] 360 (1989).

85. *See, e.g.*, Chung, *supra* note 44, at 443-44.

86. *See, e.g.*, C. Lee, *supra* note 40, at 629; Korean Supreme Court Decisions of October 31, 1973, 73 Da 954; October 11, 1994, 94 Da 24626.

87. Korean Supreme Court Decision of November 14, 1978, 78 Da 513.

88. The Korean Commercial Code does not have any provision addressing the test of fairness in a self-dealing transaction. Kon S. Kim, *Corporate Governance in Korea*, 8 J. Comp. Bus. & Cap. Mkt. L. 21, 31(1986) [hereinafter K. Kim].

89. Del. Code Ann. tit. 8, § 141(h).

90. Geoffrey S. Rehnert, *The Executive Compensation Contract: Creating Incentives to Reduce Agency Costs*, 37 Stan. L. Rev. 1147, 1150 (1985) (observing that most large public corporations have an independent compensation committee).

Taking into consideration the possibility of directors setting executive compensation for themselves, there is a potential danger of a conflict of interest.[91] If compensation paid to directors is not substantively fair to the corporation, it raises duty-of-loyalty issues similar to those arising from a self-dealing transaction by reducing equity interests of shareholders in the corporation.[92] The reason for treating unfair executive compensation as a self-dealing transaction is that direct or indirect involvement of directors in deciding compensation for themselves may lead to the same result as that of a self-dealing transaction since they are on both sides of the transaction. Executive compensation arrangements are therefore dealt with "as partly a product of the agency problem."[93]

In practice excessive compensation has sometimes been witnessed. Based on the presumption of the business judgment rule, courts are reluctant to examine whether executive compensation is excessive.[94] But if compensation amounts to spoliation or waste, the court will strike down the compensation.[95] To sum up, compensation is considered unfair to the corporation when "such remuneration [does not] bear a reasonable relation to the value of the services for which the [corporate] funds are applied."[96]

91. Susan L. Martin, *Platinum Parachutes: Who's Protecting the Shareholder?*, 14 HOFSTRA L. REV. 653, 673 (1986) (noting the directors' actual influence upon executive compensation); ROBERT A.G. MONKS & NELL MINOW, POWER AND ACCOUNTABILITY 164-77 (1991) (discussing the reality of director compensation); Monci J. Williams, *Why Chief Executives' Pay Keeps Rising*, FORTUNE, April 1, 1985, at 66, 66-68 (pointing out that in corporate practice, "the chief executive often has his hand in the pay setting process almost from the first step").

92. Eric W. Orts, *Shirking and Sharking: A Legal Theory of the Firm*, 16 YALE L. & POL'Y REV. 265, 322 (1998) (stating that "[e]xcessive executive compensation involves a type of self-dealing"). For the precise differences between compensation transactions and other interest-conflict transactions, see Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 457 (1993).

93. Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 846 (2002).

94. Mark A. Clawson & Thomas C. Klein, *Indexed Stock Options: A Proposal for Compensation Commensurate with Performance*, 3 STAN. J.L. BUS. & FIN. 31, 38 (1997) (stating that "executive compensation is not a matter conducive to judicial oversight"); Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937, 959-62 (1993) (pointing out that "courts have been highly reluctant to involve themselves in compensation disputes"); Edward M. Iacobucci, *The Effects of Disclosure on Executive Compensation*, 48 U. TORONTO L.J. 489, 495 (1998) (stating "courts are loathe to intervene in matters of executive compensation"); Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 581-89 (2001).

95. Roger v. Hill, 289 U.S. 582, 591 (1933) (no justification for the "payments of sums as salaries so large as in substance and effect to amount to spoliation or waste of corporate property").

96. Wyles v. Campbell, 77 F. Supp. 343, 347 (D. Del. 1948).

2. *Korean Law*

Executive compensation has been approached in a very different manner in Korea.[97] Under Korean law, direct participation of the board of directors or representative directors is not statutorily necessary for the establishment of the amount of director compensation.

Article 388 of the Korean Commercial Code provides that "[i]f the amount of remuneration to be received by a director has not been fixed by the articles of incorporation, it shall be fixed by the resolution of a general meeting of shareholders."[98] This is a mandatory provision. Therefore, any contrary provision in the articles of incorporation or the by-laws to Article 388 of the Korean Commercial Code is ineffective. According to the prevailing view among Korean corporate law scholars, however, shareholders, after fixing the total amount of compensation to be paid to all board members, may delegate the authority to set the amount of compensation for each individual director to the board or representative directors.[99]

With regard to executive compensation, there are substantial variations among Korean Supreme Court decisions. In a case decided on January 10, 1978, the Court held that a private compensation arrangement between a director and a representative director-shareholder holding 80 percent of the total amount of the outstanding shares could be a substitute for a resolution of the general meeting of shareholders.[100] It seems clear that the Court was influenced by what it saw as the representative director's dominance over the shareholders' decision-making process.

In a later case decided on November 27, 1979, with similar facts as above in which a representative director held two thirds of all the issued shares, thus minority shareholders could not command substantial support and could not prevail over the controlling shareholder's opposition, the Court negated the authority of the representative director-controlling shareholder to substitute his own arrangement for the shareholders' resolution on the issue of establishing the amount of executive compensa-

97. Under the continental law of mandate, directors serve on a gratuitous basis. In today's practice, however, directors usually receive compensation for their services. CIV. CODE art. 686(1) (S. Korea) (proving that "[i]n the absence of a special agreement, a mandatary may not demand remuneration from the mandator"); Korean Supreme Court Decision of March 31, 1964, 63 Da 715 (holding that a corporation is deemed to impliedly or explicitly agree upon the payment of remuneration to a director whenever a person is appointed and then serve as a director). *See supra* note 27.

98. COM. CODE art. 388 (S. Korea). A simple majority voting is necessary to pass a resolution at the shareholders' general meeting. *Id.* arts. 388, 415.

99. *See* C. LEE, *supra* note 41, at 526; K. Kim, *supra* note 89, at 30.

100. Korean Supreme Court Decision of January 10, 1978, 77 Da 1788.

tion.[101] The absence of any deliberative process at the shareholders' meeting rather than the reality that the representative director dominated the shareholders' resolution was the critical factor in the courts decision.

Of these two decisions, the latter is preferable to the former for the following reasons. First, there is the fear that the former decision might reinforce the desire of a controlling shareholder to benefit himself at the expense of the minority shareholders. A major danger related to the former decision is that private executive compensation might lead to conflict of interests when arranged in pursuit of the personal interests of the controlling shareholder.

Second, the former decision erodes the rationale underlying the Korean scheme of director compensation.[102] Notwithstanding the contrary holding in the former case, the Court in the latter case reaffirmed that the shareholders' meeting was the primary decision-making body with respect to executive compensation. The screening process at the shareholders' meeting required disclosure of all material information about compensation contracts, which at the very least might have had a chilling effect on the controlling shareholder's incentive to separate his own interests from those of the corporation and its minority shareholders.[103]

What these decisions remarkably demonstrate is that the Korean Supreme Court has paid attention only to the procedural aspects of fixing director compensation. The Court has made no effort to review any addressing the fairness of the transaction.[104] The Court had nothing to say, even though it could have dealt with this question critically. From the perspective of U.S. jurisprudence, these opinions are less than satisfying.

In brief, these decisions show that the responsibility of the Korean court has been to insure that the rules designed to safeguard the compensation process be enforced. However, the court's procedural guard does not mean that the Korean judiciary adopted the business judgment rule as developed in the United States.[105]

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101. Korean Supreme Court Decision of November 27, 1979, 79 Da 1599.

102. *See supra* text accompanying note 97.

103. *Cf.* Lynne L. Dalls, *The Control and Conflict of Interest Voting Systems*, 71 N.C. L. Rev. 1, 45 (1992) (stating that shareholders' voting demands disclosure prior to the beginning of a transaction).

104. Korean courts have never inquired into whether the standard of fairness as adopted by U. S. courts is appropriate in these cases.

105. Ehrlich & Kang, *supra* note 11, at 35 (noting that the Korean Commercial Code does not provide the business judgment rule as a defense and, as a result, there is no case decided on the Korean Supreme Court "which has exonerated a defendant" on the basis of the rule).

C. Corporate Opportunity and Competition with the Corporation

1. *U.S. Law*

Under the "corporate opportunity" doctrine, which is one aspect of the duty of loyalty, directors may not appropriate for themselves a business opportunity that rightfully belongs to their corporation.[106] Generally, four tests have been utilized to determine whether an opportunity belongs to the corporation: (1) the "interest or expectancy" test, (2) the "line of business" test, (3) the "fairness" test, and (4) the two-step test.[107]

The first test states that an opportunity is considered a corporate opportunity when the corporation has an "interest already existing [in it] or . . . an expectancy growing out of an existing right. . . ."[108] Under the second test, an opportunity is held to be a corporate opportunity if it is "so closely associated with the existing business activities of [the corporation], and so essential thereto. . . ."[109] Under the fairness test adopted by a Massachusetts court, as far as there is no "unfairness in [their] particular circumstances . . . [and therefore] the interest of the corporations [does not] call for protection,"[110] directors are not precluded from taking an opportunity that would be otherwise deemed to belong to the corporation. The fourth test was adopted in *Miller v. Miller*,[111] and combined the line of business test and the fairness test.

Appropriate remedies for the breach of fiduciary duty are the accounting of profits gained from the usurpation of the corporate opportunity[112] and the imposition of a constructive trust upon the wrongfully appropriated opportunity.[113]

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106. Guth v. Loft, 5 A.2d 503, 510-11 (Del. 1939).

107. For a detailed review of these four tests, see Pat K. Chew, *Competing Interests in the Corporate Opportunity Doctrine*, 67 N.C. L. Rev. 435, 455-65 (1989); Kenneth B. Davis, Jr., *Corporate Opportunity and Comparative Advantage*, 84 Iowa L. Rev. 211 (1999); Eric G. Orlinsky, *Corporate Opportunity Doctrine and Interested Director Transactions: A Framework for Analysis in an Attempt to Restore Predictability*, 24 Del. J. Corp. L. 451, 458-61 (1999); Eric Talley, *Turning Servile Opportunities to Gold: A Strategic Analysis of the Corporate Opportunities Doctrine*, 108 Yale L.J. 277, 289-96 (1998).

108. Largarde v. Anniston Lime & Stone Co., 28 So. 199, 201(Ala. 1900).

109. *Guth*, 5 A.2d at 513.

110. Durfee v. Durfee & Canning, Inc., 80 N.E.2d 522, 529 (Mass. 1948) (citing Henry W. Ballantine, Ballantine on Corporations 204-05 (1946)).

111. 222 N.W.2d 71 (Minn. 1974).

112. Klinicki v. Lundgren, 695 P.2d 906, 923 (1985) (affirming a decree ordering an accounting).

113. *Guth*, 5 A.2d at 510; Morad v. Coupounas, 361 So.2d 6, 10 (Ala. 1978) (imposing constructive trusts).

In addition to the corporate opportunity doctrine, corporate law deals with directors' competition with the corporation to which they owe a fiduciary duty.[114] If the rule of undivided loyalty is too strictly applied to directors, directors may be deprived of the freedom of enterprise and competent persons may be discouraged from serving in corporate directorships, which are generally on a part-time basis and often nominally compensated.[115]

However, the duty of loyalty prohibits situations where directors' competition with the corporation is likely to cause harm to the corporation.[116] Directors, during their service as such, are free to engage in independent competitive business, so long as they act in good faith and do not violate any fiduciary duty to the corporation.[117]

After termination, absent a valid non-competition agreement, directors are free to compete with their former corporation.[118] But they may not use trade secrets or other confidential information belonging to the former corporation.[119]

Like the self-dealing conflict-of-interest situation, if there is disinterested directors' approval or shareholders' ratification of such competition, conduct that would otherwise be barred because of the breach of fiduciary duties may be validated.[120] In seeking such approval or ratification, competing directors must first make full advance disclosure concerning the conflict of inter-

114. For the differences between the doctrine of corporate opportunity and the doctrine of corporate competition, see Jodi L. Popofsky, Note, *Corporate Opportunity and Corporate Competition: A Double-Barreled Theory of Fiduciary Liability*, 10 HOFSTRA L. REV. 1193, 1208-16 (1982).

115. Harry G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 628 (3d ed. 1983) (noting that if corporate directors independently compete with the corporation to which a duty of loyalty is owed, "equitable limitations" apply).

116. Atkinson v. Marquart, 541 P.2d 556, 558 (Ariz. 1975); Williams v. Stirling, 583 P.2d 290, 292-93 (Colo. App. 1978). *See also* Frank G. Newsman, *Formation of Competing Enterprise by Corporate Fiduciary*, 3 HOUS. L. REV. 221 (1965).

117. Chelsea Indus., Inc. v. Gaffney, 449 N.E.2d 320, 325, 326 (Mass. 1983); Md. Metals, Inc. v. Metzner, 382 A.2d 564, 569-71(Md. 1978) (stating that directors are not necessarily precluded from forming a competing business or purchasing necessary equipment for such a business prior to terminating their relationship with the corporation); Parsons Mobile Prods., Inc. v. Remmert, 531 P.2d 428, 433 (Kan. 1975) (stating that "[t]he essential inquiry on any charge of unfair competition is good faith"); Sci. Accessories Corp. v. Summagraphics Corp., 425 A.2d 957, 962, 964-65 (Del. 1980) (stating that directors are permitted to make arrangements or prepare to go into a competitive business before the end of their service to the corporation, provided no unfair or wrongful acts are committed in the course of such preparation).

118. *Parsons Mobile Products, Inc.*, 531 P.2d at 433.

119. *See* RESTATEMENT(THIRD) OF UNFAIR COMPETITION §42 (1995).

120. *See* 1 ALI, *supra* note 51, § 5.06 cmt. at 301-02.

est.[121] Remedies for bad faith competition include money damages[122] and injunctions to prevent further competition.[123]

2. *Korean Law*

The Korean Commercial Code provides:[124]

Article 397 (PROHIBITION OF COMPETITIVE BUSINESS)

(1) No director shall, without the approval of the board of directors, effectuate for his own account or for the account of a third person any transaction which falls within the class of businesses of the company or become a member with unlimited liability or a director of any other company whose business purposes are the same as those of the company.

(2) If any director has effectuated a transaction for his own account in contravention of paragraph (1), the company may, by the resolution of the board of directors, deem such transaction as effectuated for account of the company and if he has effectuated a transaction for account of a third person, the company may demand the pertinent director to transfer any interest accrued therefrom.

(3) The rights under paragraph (2) shall be extinct with the lapse of one year after the day on which such transaction has been effectuated.

This Article is designed to restrain directors from competing with the corporation. The reason why directors are to refrain from competition with the corporation is that directors are in a position to easily obtain confidential business and trade secrets from the corporation and thus undesirable situations may arise where, by taking advantage of their position, directors may seek benefits on behalf of themselves or third parties to the detriment of the corporation.

Directors are deemed to be in breach of this duty when they engage in a "transaction that falls within the class of business carried on by the corporation."[125] Any business activity may be dealt with as a "transaction. . . ." of Article 397, if (1) it is in the line of business specified in the objectives of the corporation set forth in the articles of incorporation and (2) at the same time, its beneficiaries are the directors who actually have performed it or the third parties whom the directors act on behalf of.[126] At this

121. *See id.* § 5.06(2).

122. Lincoln Stores, Inc. v. Grant, 34 N.E.2d 704, 708 (Mass. 1941).

123. ABC Trans Nat'l Transp., Inc. v. Aeronautics Forwarders, Inc., 379 N.E.2d 1228, 1236 (Ill. App. Ct. 1st Dist. 1978) (issuing a preliminary injunction).

124. This provision concerns stock corporations. The same reasoning will be applied to the other three types of business corporations. *See* COM. CODE arts. 198, 275, 567 (S. Korea).

125. COM. CODE art. 397(1) (S. Korea).

126. CHUNG, *supra* note 44, at 434-35.

point, it seems that this Korean statutory formulation serves as the functional counterpart to the legal doctrine of "corporate opportunity" and adopts "the line of business" test for determining whether directors breach their legal duty with regard to competition with the corporation.[127] However, the test of fairness has never been employed as a key factor in determining whether a director's competition with his corporation is struck down.

In addition, directors becoming members with unlimited liability or directors of any other corporation operating in the same line of business are prohibited for the same reasons associated with issues surrounding directors' competition.[128]

Corporate directors who engage in a transaction on behalf of themselves or third parties should make a full disclosure to the board of directors of any material facts of the transaction in order to obtain approval for the transaction. Matters of competition are considered material facts if they are useful in estimating the adverse impact of the transaction upon the corporation. These facts may, for example, include the name of the other party involved in the transaction, object, quantity, cost, and duration of the transaction.[129]

In order to gain approval, directors who become directors or personally liable members of any other corporation should disclose to the board of directors anything that indicates the contents of the business of the "other corporation" such as its kind, nature, scale and scope. The disclosure of material facts should be concrete enough for the board to determine in advance the effect of the transaction on the corporation.[130]

If a director has not obtained the board's approval, whether the other party to the transaction knew it was in contravention to the law or not is immaterial and the transaction itself is valid. However, the director is liable for damages to the corporation[131] and may be dismissed on the grounds of neglecting his duty.[132]

A transaction in which a director competes with the corporation is seen as made for the account of the corporation by exercising the corporations' *kaeibkwon* or "right to intervene." It is the prevailing scholarly view that even if the corporation exercises the right to intervene in the transaction, it is not as the party

127. K. Kim, *supra* note 88, at 30.

128. Korean Supreme Court Decision of November 2, 1990, 90 Ma 745.

129. CHUNG, *supra* note 44, at 435.

130. *Id.*

131. COM. CODE art. 399(1) (S. Korea).

132. *Id.* art. 385(1).

to the transaction.[133] Similar to the U.S. remedy of the constructive trust, the intervention imposes upon the director in question the duty to transfer the benefits of the transaction to the corporation.[134] In no event shall this right be exercised more than one year after the date on which the transaction was actually made.[135] Since Article 397 is a mandatory provision, it takes precedence over conflicting provisions in the articles of incorporation.

IV. THE REALITY OF CORPORATE GOVERNANCE: A BRIEF DESCRIPTION

A. Corporate Governance in the U.S.

One of the most salient characteristics of modern U.S. corporations is that they have a managerial hierarchy separate from corporate ownership.[136] Capital is not a *conditio sine qua non* of good managers. The separation, however, does not have a long history.

During the late nineteenth to early twentieth century, there appeared a tendency towards the separation of ownership and control of U.S. corporations.[137] This tendency was later described in Berle and Means's seminal book, *The Modern Corporation and Private Property*.[138] In discussing corporate development in the United States, they noted three functions in relation to enterprise: (1) the function of having interests in an enterprise; (2)

133. *See, e.g.*, C. Lee, *supra* note 40, at 620-21(arguing that the effect of the right to intervene is not to put the corporation in the same position as it had been in the first place).

134. *Id.*

135. Com. Code art. 397(3) (S. Korea). This is an absolute time period. *See* C. Lee, *supra* note 40, at 621.

136. *See generally* Alfred D. Chandler, Jr., *The United States: Seedbed of Managerial Capitalism*, in Managerial Hierarchies: Comparative Perspectives on the Rise of the Modern Industrial Enterprise 9 (Alfred D. Chandler, Jr. & Herman Daems eds., 1980).

137. *See* Adolf A. Berle, Jr., Power Without Property: A New Development in American Political Economy 59-76 (1959) (describing that "[t]he rise of the corporate system, with attendant separation of ownership from management due to concentration of industry in the corporate form, was the first great twentieth-century change").

138. The formal articulation of this phenomenon was put forth by Adolf A. Berle, Jr. and Gardiner C. Means. *See* Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property (1932). This book noted that "[o]wnership of wealth without appreciable control and control of wealth without appreciable ownership appears to be the logical outcome of corporate development." *Id.* at 69. They had the view that the divorce of ownership from control "destroys the very foundation on which the economic order of the past three centuries has rested." *Id.* at 8. Therefore, the ultimate purpose of their study was to warn against big business. They saw shareholders as victims of the separation. *Id.* at 119-25, 277-87.

that of having power over an enterprise; and (3) that of acting within an enterprise.[139] Before the industrial revolution, the owner fulfilled all three functions. During the nineteenth century, the third function was taken over by hired managers.[140] Berle and Means thought the separation an inevitable result of the modern capital markets and diffused share ownership.[141] As a result, "there are no dominant owners, and control is maintained in large measure apart from ownership."[142] The upshot of Berle and Means' work can be summarized by stating that the functions of ownership and control are separated in corporations: the ownership of the corporation lies in the hands of shareholders, whereas the management of corporate affairs is delegated to directors.[143]

B. Corporate Governance in Korea

The Berle-Means explanation of the modern corporation has not received world-wide acceptance.[144] It cannot account for the Korean corporate structure. While a management controlled corporation resulting from the separation between ownership and control represents the most prevalent form of enterprise in the United States, it neither is a popular corporate form nor takes its full shape in Korea. Unlike large U.S. corporations

139. *Id.* at 119.

140. *Id.* at 119-20.

141. Even minimal knowledge of modern financial theories aids in understanding the Berle-and-Means' study. As the development of the modern corporation continued during the late nineteenth to early twentieth century, huge amounts of capital were needed. Huge amounts of capital could only be raised through small individual holdings. Efficient risk-spreading made it easier to raise capital. Richard S. Ruback, *An Economic View of the Market for Corporate Control*, 9 Del. J. Corp. L. 613, 614 (1984) (explaining that "investors can minimize their risk . . . by holding well-diversified portfolios in which only a small fraction of their wealth is invested in an individual firm"). Small individual holdings resulted in a dispersal of share ownership and furthermore eliminated the incentive for shareholders to exercise effective control over corporate affairs. A small equity stake in the corporation through a wide dispersion of share ownership caused the individual owners' risk to be less. Berle, *supra* note 137, at 84-89; Frech, *supra* note 21, at 104. Shareholders are not always best at controlling management. Consequently, share-based control has been gradually superseded by managerial control. The result of the separation is that shareholders do not necessarily have the incentive to effectively manage business.

142. Berle, *supra* note 137, at 117.

143. The concept of the separation of ownership from control was recognized as part of the theory of the firm. Berle stated that "[t]he position of the owner has been reduced to that of having a set of legal and factual interests in the enterprise while the group which we have called control, are in the position of having legal and factual powers over it." *Id.* at 120.

144. *See* Eddy Wymeersch, *The Corporate Governance Discussion in Some European States*, in Contemporary Issues in Corporate Governance 3, 9 (D. D. Prentice & P. R. J. Holland eds., 1993) (regarding the separation between ownership and management as an Anglo-Saxon phenomenon).

where control is divorced from ownership, Korean counterparts represent a model where ownership and control are substantially unified.

There was no significant diminution of ownership control even as the Korean economy grew.[145] Generally, majority shareholders are composed of family members of the founders of the corporation and these shareholders make most of the decisions regarding the corporation's operations.[146] Thus, the so-called chaebol is an intriguing example of an enterprise group dominated by an extended kinship network.[147]

Korean owner-managers work for the corporation, and ultimately for their family, not for compensation. Except for possible majoritarian abuse, owner-managers have tried to reconcile corporate goals with family loyalty, without sacrificing efficiency. In terms of attitudes towards risk, there is a difference between owner- and management-controlled corporations.[148] The amount of managerial discretion is a function of ownership structure and is higher for owner-managers than for professional managers.[149] The managerial positions of owners are largely decoupled from their performance. They bear less risk of replacement than managers in management-controlled corporations.[150] The reason for

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145. Curtis J. Milhaupt, *Privatization and Corporate Governance in a Unified Korea*, 26 J. Corp. L. 199, 205 (2001).

146. Most large corporations in Korea are under the control of their owners, especially the founding family, in which the decision-making authority is centralized on its chairman. Choi & Kim, *supra* note 38, at 277. *See also* Katharina Pistor, *The Standardization of Law and Its Effect on Developing Economies*, 50 AM. J. COMP. L. 97, 123 (2002).

147. It should be noted that most large publicly held Korean corporations are affiliated with a business group, the so-called "chaebol." K. Kim, *supra* note 88, at 24-25 (stating that "most of the largest business corporations in Korea belong to one of [chaebols]"); Milhaupt, *supra* note 145, at 205 (stating that "South Korea's industrial structure is dominated by the chaebol groups"). An anthropologist writes that "the word *chaebol* is far less innocuous than *group* or *conglomerate*." ROGER L. JANELLI with DAWNHEE YIM, MAKING CAPITALISM: THE SOCIAL AND CULTURAL CONSTRUCTION OF A SOUTH KOREAN CONGLOMERATE 15 (1993) (emphasis in original). There are no clear guidelines on calling a conglomerate a chaebol. The term "chaebol" is not statutory. The chaebol is defined as "a group of formally independent firms under single common administrative and financial control, owned and controlled by certain families." Sea Jin Chang & Unghwan Choi, *Strategy, Structure and Performance of Korean Business Groups: A Transactions Cost Approach*, 37 J. INDUS. ECON. 141, 141(1988).

148. WILLIAM A. MCEACHERN, MANAGERIAL CONTROL AND PERFORMANCE 50, 55, 104-07 (1975).

149. *Id.* at 103.

150. *Id.* The rate of executive mobility in Korea is very low. The first reason for the low rate of mobility is that owners serve as managers. The second is that the market for executive services is not developed in Korea because of promotion within the corporation. *See* JANELLI, *supra* note 147, at 145; Sangjin Yoo & Sang M. Lee, *Management Style and Practice of Korean Chaebols*, CAL. MGMT. REV., Summer 1987, at 95, 103. For an overview of the market for executive services, see Detlev

the less risk is that the owner and manager are the same person.[151] As a result, owner-managers exhibit more risk-preference behavior than professional managers.[152] Likewise, the ownership and control structure of chaebols leaves the inside shareholders[153] bearing a substantial portion of the total risk associated with corporate decision-making. The founders of the chaebol are often considered the biggest risk-takers.[154] This stems from their larger stake in the organization.

What offsets the strengths that have so far enabled Korean corporations to develop is the divergence of interests between owner-managers and outside shareholders. In perfectly monitored owner-controlled corporations, maximization of the majority managing shareholders' interests does not come into conflict with that of outside shareholders. At a practical level, however, owner-managers do not always represent all shareholders' interests. Like professional managers, owner-managers are also exposed to moral hazards and opportunism. In an anthropological study, the owner-managers of Taesong, which was at the time a principal corporation in one of Korea's four largest chaebols, were characterized as managers in pursuit of their self-interest:

> Taesong's owner-managers guarded their appropriation of the chaebol's financial and human resources through coercive practices that also sustained or reproduced asymmetrical relations of power and economic privilege. . . . [T]hey conveyed the idea that the bourgeoisie had at their disposal powerful means for protecting their interests. . . . [Financial control measures] helped especially to insulate [their] privileged access to the conglomerate's capital from external challenges, especially by other shareholders but more generally by the public. Personal management . . . sought to contain resistance

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Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 236-38, 272-74 (1983).

151. ROBIN ROBIN MARRIS, THE ECONOMIC THEORY OF 'MANAGERIAL' CAPITALISM 3 (1967).

152. MCEACHERN, *supra* note 148, at 104, 108.

153. The term "inside shareholders" is used in this Article to mean managing majority shareholders or owner-managers who have far greater authority than other corporate constituencies. Therefore, "inside shareholders" and "owner-managers" are used interchangeably. Among shareholders of a certain corporation, those who are not classified as inside shareholders are named "outside shareholders."

154. Common Korean entrepreneur characteristics are:

> innate diligence, frugality, creativity, strong impellent force, sincerity and credibility, frontier spirit, preference for harmony among family members and employees, preference for stable and bureaucratic organization, top-down making decision, insensitive to changes in circumstances, nonscientific management, preference for management by family, and lack of formal education.

Sang M. Lee, *Management Styles of Korean Chaebols*, in KOREAN MANAGERIAL DYNAMICS 181, 185 (Kae H. Chung & Hak Chong Lee eds., 1989).

and challenges to managerial control by subordinates at all levels within the organization.[155]

The above statement suggests that the majority shareholders of this large publicly-held corporation thought of themselves as private owners. Owner-managers might overstep their bounds, since there is no well-established countervailing mechanism to ensure management accountability.[156]

V. CONCLUSION

Both U.S. and Korean corporations are required to monitor managerial performance. Effective monitoring is critical to the survival of a corporation.[157] Both in the U.S. and Korea, the law of directors' duty is designed to be an effective and economical device for encouraging proper conduct on the part of corporate managers. However, one basic element of the U.S. scheme of director duty of loyalty has lost all relevance in Korea's economic, social, and judicial environment.

The state statutes and the judicial decisions of U.S. courts show that fairness is a key criterion in defending or upsetting transactions where directors pursue self-interest. Under Korean law, however, interest-conflict transactions, fair or unfair, are automatically salvaged so long as disinterested directors or shareholders approve them.[158] The Korean judiciary has been insensitive to substantive law on interest-conflict transactions. As far as directors' self-interested transactions are concerned, the role of Korean courts is limited to procedural safeguards. Because the Korean courts are generally committed to the literal reading of provisions, they do not attempt to apply a fairness test to conflict-of-interest transactions without any statutory guidance.[159] To the degree that neither the Korean Commercial Code nor case law provides guidance in evaluating the substan-

155. JANELLI, *supra* note 147, at 124.

156. Joongi Kim, *Recent Amendments to the Korean Commercial Code and Their Effects on International Competition*, 21 U. PA. J. INT'L ECON. L. 273, 279-80 (2000) [hereinafter J. Kim].

157. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 303 (1983) (stating that "[p]roducing outputs at lower cost is in the interests of residual claimants because it increase net cash flows, but lower costs also contribute to survival by allowing products to be delivered at lower prices").

158. *Contra* Remillard Brick Co. v. Remillard-Dandini Co., 241 P.2d 66 (Cal. 1952) (holding that even approval by a majority of disinterested directors or shareholders does not make unfair self-dealing transactions valid).

159. Jae Y. Kwon, *An Isolation in Systems of Law: Differences Between the Commercial Codes of the United States and Korea*, 29 LOY. L.A. L. REV. 1095, 1102 (1996). *See also* Katharina Pistor et al., *The Evolution of Corporate Law: A Cross-Country Comparison*, 23 U. PA. J. INT'L ECON. L. 791, 833 (2002) (stating that "[c]ourts in civil law jurisdictions are more confined to the letter of law").

tive portions of conflict-of-interest transactions, the Korean approach to directors' conflict-of-interest transactions does not protect outside shareholders who are unable to control a corporation because of their small number of shares. The continued absence of law and judicial review on the fairness of these transactions is an important barrier to reducing agency problems between owner-managers and outside shareholders.[160] The limited role of the courts allows for more room for the pursuit of personal interests by owner-managers who participate in corporate management, concurrently having a controlling block of shares in the corporation.[161] This is to the detriment of outside shareholders since owner-managers control the procedural aspects of these transactions with their large number of shares.[162]

160. Milhaupt, *supra* note 145, at 206 (stating that "while prohibitions on self-dealing were in effect, the South Korean courts were virtually never utilized by minority shareholders to police these transactions").

161. J. Kim, *supra* note 157, at 285.

162. Amir N. Licht, *Legal Plug-Ins: Cultural Distance, Cross-Listing, and Corporate Governance Reform*, 22 BERKELEY J. INT'L L. 195, 213 (2004) (stating that "minority shareholders were indeed exploited by the chaebols' controlling families").