THE HOLDING COMPANY STRUCTURE: BALANCING CHAEBOL AND MINORITY SHAREHOLDER INTERESTS

Yong Bum Lee*

Since the Asian Financial Crisis of 1997, the South Korean law has consistently allowed and promoted the establishment of holding company structures. The holding company structure facilitates investments and divestitures, simplifies external contributions, and increases transparency in corporate governance. On the other hand, a typical holding company transition concentrates control in the hands of chaebol families, raising concerns regarding minority shareholder interests. This paper explores how the legal landscape, business considerations, and diverging incentives benefit chaebols at the cost of minority shareholders and sets forth suggestions to better balance the promotion of holding company structures and protection of minority shareholder interests.

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INTRODUCTION

In South Korea, corporate governance scholars approach their calling from a different angle to their counterparts in the United States. Corporate governance scholars in the United States and the larger West frequently ask how to better align management with ownership interests, and more recently, the proper role of activist and institutional shareholders. While underlying themes overlap, South Korean corporate governance challenges are often framed as protecting minority shareholder interests from the conduct of the founding family, frequently referred to as “chaebols.”¹

Economic context has a strong influence on the definition of corporate governance challenges. The South Korean narrative of transformative industrial growth started soon after World War II, which left the country in ruins. The South Korean government executed “guided capitalism,” in which the government channeled private sector activity towards selected export-oriented industries.² The government exerted influence primarily by controlling the allocation of financial resources: after seizing power through a coup in 1961, President and former Army General Park’s regime nationalized all South Korean banks, resulting in government control of institutional credit.³ The nationalized banks served as both a carrot and a stick. On the one hand, the government channeled institutional credit to export-oriented industries such as heavy and chemical productions, meaning that companies that diverted from this government agenda did not have access to credit. On the other hand, the government awarded favorable terms of credit to the companies that conformed to its agenda. Almost all of today’s South Korean conglomerates began operations in one of such export-oriented industries during this period, under government sponsorship.

The government’s sponsorship of companies in selected industries did not end here, as the growing South Korean companies were facing stiff competition from abroad. To allow these companies to grow in size and compete against established foreign enterprises, the

¹ Chaebols are families that amassed incredible wealth by founding and operating conglomerates based in South Korea. Well-known examples are families of the Samsung Group, Hyundai Group, SK Group and LG Group. One of the most notable features of the South Korean economy is its concentration of economic power in chaebols. For example, revenue of the 10 largest chaebols accounted for 67.8% of South Korea’s GDP, as of 2017. Rachel Premack, South Korea’s Conglomerates, Sage Business Researcher, (August 21, 2017).
² Michael Patrono and Murat Doral, ‘Chaebol and Korea’s Industrial Finance’, 5 Journal of Global Initiatives: Policy, Pedagogy, Perspective 87 (2010). I use the term “government” throughout this paper to refer to concerted efforts of the executive and legislative branches of South Korea. Concerns relating to separation of powers are not within the scope of this paper.
³ Id. Privately owned commercial banks were re-established in the mid-1980s.
government instituted import barriers and, more importantly, laws that allowed circular corporate contributions. The allowance of circular contributions was critical to achieving chaebols’ growth and conglomerate. To illustrate, take Company A founded by Ace, a first generation chaebol. Chaebol Ace owns 51% of Company A shares, and Company A has $100 of capital. Ace effectuates Company A’s $50 participation in a newly formed Company B’s stock issuance so that Company A now owns a controlling stake in Company B. Similarly, Ace effectuates Company B’s $30 participation in a newly formed Company C’s stock issuance so that Company B now owns a controlling stake in Company C. Finally, Company C participates in an increase in capital by Company A by contributing $10. The result here is that Company A’s capital increased by $10 without any real contribution, as the $10 originated from Company A, moved through Companies B and C, and returned. Ace has also struck gold because Ace now controls not just Company A, but also Companies B and C. Because Companies A, B and C theoretically have $190 of capital while there is only $100 of real capital, bankruptcy of one company can initiate a domino effect.

At a basic level, most modern South Korean conglomerates are outgrowths of the late twentieth century circular contributions described above. A salient feature of these conglomerates is that ownership and management are not separated. The impact that this management structure has on companies’ performance is unclear. While an external manager will often bring more expertise and rationality, an owner-manager may take a longer-term view. From a minority shareholder perspective: an owner-manager is a shareholder by

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5 Note that chaebol Ace’s interest in Company A increases due to the final capital contribution by Company C. Ace now controls 54.55% of Company A, while starting with only 51%. Furthermore, up until the Asian Financial Crisis of 1999, the South Korean government also allowed mutual contributions where two companies contribute capital to each other. Mutual contributions are simply circular contributions with only two nodes, making the hypothetical transaction easier, more effective and less time consuming from chaebols’ perspective.

6 Notwithstanding the example of chaebol Ace, it is simply not feasible for one family (and related persons) to have absolute control over a conglomerate by owning more than 50% of shares. Nonetheless, chaebols do exert control over their conglomerates with substantial shares. For example, in 2017 the Chaebol families of the 10 largest conglomerates in South Korea owned only 2.5% of conglomerate shares, on average. However, they exercised control over 58.3% of shares. In the context of ownership vis-à-vis management, ownership refers to the shares that chaebols actually own. See infra note 63.

definition and will want to maximize shareholder value, but she is also a shareholder of other companies in the conglomerate and may create more value for herself by transferring wealth. What role does the holding company structure play in this struggle?

I. THE HOLDING COMPANY STRUCTURE

To be sure, the incredible success of chaebols played an integral part in South Korea’s explosive economic growth in the late twentieth century. Perhaps for that reason, it is rarely suggested that chaebols be ousted from management and replaced by external managers. This attitude may also reflect fear of economic downturn, which would inevitably follow the failure of conglomerates. In any case, the holding company structure is often discussed as a step forward, towards harmonizing the interests of chaebols and other shareholders.

I.A. HISTORY AND NATIONAL POLICY

Holding companies are a recent phenomenon in South Korea. In 1986, the Monopoly Regulation and Fair Trade Act ("Fair Trade Act" or "FTA") was amended to prohibit the establishment of holding companies. This change reflected the growing concern that holding company structures could facilitate and accelerate the concentration of economic power. Some scholars argue that the Japanese Antimonopoly Act’s prohibition on holding companies served as a model for this change, as four conglomerates dominated Japan’s economy and South Korea seemed to move towards this structure.

The Asian Financial Crisis of 1997 tested the financial strength of South Korean conglomerates, and many failed. Under the government’s favorable credit terms and domestic protection, chaebols had made poor and aggressive investment decisions; the phantom nature of chaebols’ capital also accelerated the crisis. As a result, many chaebols faced the need for divestiture through mergers & acquisitions and restructuring. To facilitate this process, the

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9 There were important differences between chaebols and Japanese conglomerates, commonly referred to as “zaibatsu.” Crucially, zaibatsus developed around internalized banks, allowing them to source their own capital. Chaebols initially relied on the government for credit because the government nationalized all banks. In addition, zaibatsu developed under a holding company structure while Chaebols formed an intertwined web of capital contributions that did not resemble a pyramid. During the allied occupation of Japan after World War II, the United States led the liquidation of zaibatsu to democratize Japan’s economy. Inclusion of a provision in Japan’s Antimonopoly Act prohibiting holding companies was a similar effort. Japan repealed this provision in 1997.

10 Patrono and Doral, supra note 3.
government amended the FTA in 1999 and 2000 to allow the establishment of holding companies under specific conditions.\textsuperscript{11} The South Korean Fair Trade Commission ("FTC") justified this change by explaining that the holding company system helps the divestiture of non-core businesses, promotes mergers & acquisitions across conglomerates of different cultures and simplifies external capital contributions, among other benefits.\textsuperscript{12} Since then, government policy has moved gradually and continuously towards relaxing restrictions related to establishing holding company structures.\textsuperscript{13}

Despite the government’s efforts to promote the holding company structure, many chaebols are still reluctant due to the complex process and high costs associated with the transition. The LG Group’s successful transformation after a three-year effort culminating in 2003 demonstrated feasibility, but this is not representative of chaebols’ sentiments. As of 2016, only eight of twenty-seven chaebol conglomerates, as defined by the FTC, had transitioned into holding company structures.\textsuperscript{14} However, the government’s efforts have had a more meaningful impact from a broader perspective considering both chaebol and non-chaebol companies. The total number of holding companies in South Korea has approximately doubled from 2010 to 2017, growing from 96 to 193.\textsuperscript{15}

\textsuperscript{11} Some scholars argue that the South Korean government also modeled this change after Japan’s repeal of its prohibition on holding companies in 1997. Japan repealed its prohibition under the rationale that holding companies are unlikely to be used to establish conglomerates moving forward, that corporations should have the option to benefit from the positive aspects of holding company structures, and that anti-monopoly regulation can be selectively enforced against holding companies resulting in excessive market power concentration. Byung Gwon Kim, ‘Chaebol Reform and Holding Company Structures’, Saesayon Briefing (2012).

\textsuperscript{12} Id.

\textsuperscript{13} Two major policy (and resulting legal) changes are representative of this trend. First is, of course, the change to allow the establishment of holding companies in 1999, following the Asian Financial Crisis. The second major change took place in 2007, when the relevant requirements were significantly relaxed. For example, the debt-to-equity ratio ceiling for the holding company was raised from 100% to 200%, while the subsidiary company shares holding requirement was lowered from 30% and 50% to 20% and 40% for public and private subsidiaries, respectively. The specific legal requirements relevant to holding companies are discussed in more detail below. See discussion infra Part I.B.; see also note 24.

\textsuperscript{14} Hoon Kil Choi, ‘Only Eight Chaebols Transition to Holding Company Structure…Policy ‘Not Effective’” E-Daily News (November 2, 2016).

The FTC defines conglomerates as a group of companies that have total assets of and above KRW 10 trillion and are effectively controlled by the same person (and related persons). The control requirement can be satisfied by meeting any of the following:

- Shares held: largest shareholder with 30% or more voting power
- Exercise of control: person elects half of board members, person substantially impacts core business decisions, two companies share board members or other key personnel, or business dealings indicate that two companies are parts of a larger conglomerate

The FTC raised the asset requirement from KRW 5 trillion to 10 trillion in 2016. \textit{Fair Trade Act Enforcement Ordinance}, Art. 3 Para. 1-2 (R.O. Korea).
I.B. THE LAW

Under the South Korea law, a holding company is defined as a company that controls the business of subsidiaries through the holding of shares as its main business, where the President is to determine an asset base requirement and the method by which main business is to be determined.\textsuperscript{16} Currently, the asset base requirement is KRW 500 billion and the main business requirement is met if shares of subsidiaries make up 50% or more of the company’s assets.\textsuperscript{17} A newly formed or transitioned holding company must be reported to the FTC.\textsuperscript{18}

A company does not elect to be treated as a holding company. By the words of relevant regulation, a company is a holding company if it meets the legal requirements, and does not have the right to opt out.\textsuperscript{19} Of course, it is doubtful that a company with KRW 500 billion assets would not notice that half of that value is made up of subsidiary shares, although there are concerns that fluctuations in the stock market with regards to subsidiary shares may create uncertainty at the margins.

The primary legal requirements relevant to a holding company and its subsidiaries are summarized in Table 1 below.

\begin{table}[h]
\begin{tabular}{|c|c|c|c|c|c|c|c|c|}
\hline
\hline
Ordinary holding companies & 84 & 92 & 103 & 114 & 117 & 130 & 152 & 183 \\
\hline
\hline
Financial holding companies & 12 & 13 & 12 & 13 & 15 & 10 & 10 & 10 \\
\hline
% Change & - & 8.33 & (7.69) & 8.33 & 15.38 & (33.33) & 0.00 & 0.00 \\
\hline
Total holding companies & 96 & 105 & 115 & 127 & 132 & 140 & 162 & 193 \\
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\hline
\end{tabular}
\end{table}

\textsuperscript{15} The following table shows the number of holding companies in Korea registered (legal requirement) with the FTC and yearly increases over the past eight years. Note that the distinction between ordinary holding companies and financial holding companies is an outgrowth of the separation of commerce and banking. The two different groups are subject to different requirements, and this paper focuses on ordinary holding companies.

\textsuperscript{16} Fair Trade Act, Art. 2 Para. 1 (R.O. Korea).
\textsuperscript{17} Fair Trade Act Enforcement Ordinance, Art. 2 (R.O. Korea).
\textsuperscript{18} Fair Trade Act, Art. 8 Para. 1 (R.O. Korea).
\textsuperscript{19} Fair Trade Act Enforcement Ordinance, Art. 2 (R.O. Korea).
### Table 1: Legal requirements relevant to holding company and subsidiaries

<table>
<thead>
<tr>
<th>Holding Company</th>
<th>Subsidiary</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Own KRW 500 billion assets, of which at least 50% must be subsidiary shares</td>
<td></td>
</tr>
<tr>
<td>- Hold at least 20% of shares of public subsidiary and at least 40% of shares of private subsidiary</td>
<td></td>
</tr>
<tr>
<td>- Can’t hold shares of affiliated companies other than subsidiaries (i.e. can’t hold shares of subsidiaries of subsidiaries)</td>
<td></td>
</tr>
<tr>
<td>- Can’t hold over 5% of shares of non-affiliated companies</td>
<td></td>
</tr>
<tr>
<td>- Can’t have both financial and non-financial subsidiaries</td>
<td></td>
</tr>
<tr>
<td>- Debt-to-equity ratio below 200%</td>
<td></td>
</tr>
<tr>
<td>- Subsidiary can only hold shares of sub-subsidiary, sub-subsidiary can only hold shares of sub-sub-subsidiary, and so on</td>
<td></td>
</tr>
<tr>
<td>- Subsidiary must hold at least 20% of shares of public sub-subsidiary and at least 40% of private sub-subsidiary</td>
<td></td>
</tr>
<tr>
<td>- Sub-subsidiary must hold 100% of sub-sub-subsidiary</td>
<td></td>
</tr>
<tr>
<td>- Mutual contributions are prohibited</td>
<td></td>
</tr>
</tbody>
</table>

The prohibition on having both financial and non-financial subsidiaries is part of a larger policy of separating banking and commerce. In part, this policy can be tracked back to the Park regime’s nationalization of banks to exert influence on the private sector.²¹ The modern rationale for separating banking and commerce places emphasis on the protection of household and other savings, and relatedly, preventing irresponsible investments by companies that may occur if they had access to cheaper, internalized credit. Accordingly, there are parallel laws that govern the separation of banking and commerce generally, outside of the holding company context.²²

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²⁰ *Fair Trade Act*, Art. 8 Para. 2-3 (R.O. Korea).
²¹ Patrono and Doral, supra note 3.
²² See, e.g., *Banking Commerce Separation Act*, (R.O. Korea).
It is worth noting the provisions that similarly aim to prevent irresponsible behaviors of chaebols. The hard ceiling on debt-to-equity ratio is one example.\(^\text{23}\) This ceiling prevents holding companies from meeting the subsidiary shares holding requirement by taking on excessive debt.\(^\text{24}\) The subsidiary shares holding requirement attempts to reconcile the difficulty of raising the capital to own large amounts of shares of multiple mature companies (albeit within a conglomerate structure), many of which are already public companies, with the risk of unwarranted concentration of control in chaebols through repeated corporate contributions down the holding company pyramid. The holding requirement is also an attempt to align the incentives of the holding company shareholders, notably chaebols, with minority shareholders of subsidiaries.

I.C. MAGIC OF TREASURY SHARES

A chaebol’s transition into a holding company structure involves two discrete types of activities: dividing large companies into separate entities through spin-offs as needed (with the purpose of placing one entity as a subsidiary of the other), and organizing a complex web of public and private companies into one pyramid structure. While various business justifications may exist for the former activity, applicable outside of the holding company context, it has a special significance within this context.\(^\text{25}\)

When a company separates into two separate entities through a spin-off, the shareholders receive shares of the new entity in proportion to their shares of the original company. When the company owns treasury shares, it also receives shares of the new entity according to this proportion. These shares undergo a magical transformation here: because they are now shares of a different entity, not treasury shares, their voting power regains vitality. While this is standard in any spin-off, to understand the magical impact of the treasury shares, one must view it in conjunction with the larger transaction.

\(^\text{23}\) The debt-to-equity ratio requirement was relaxed from 100% to 200% in 2007 as part of a larger effort to promote the transition of chaebols into holding company structures. Another change that happened at this time was the relaxation of the holding requirement related to subsidiary shares, from 50% and 30% for public and private subsidiaries, respectively, to 40% and 20%. See supra note 15.


\(^\text{25}\) For example, separating one company into two entities through a spin-off allows each new entity to focus on different core business sectors, deploy different business strategies or meet varying capital needs. The spin-off may also be in response to antitrust issues or a hostile takeover bid (divestiture of crown jewel). All of these reasons are not limited to the holding company context.
Assume that a chaebol wants to conduct a spin-off to make one entity a holding company and the other a subsidiary. The revived treasury shares are almost certainly not sufficient for the holding company to satisfy its holding requirement (20% if public subsidiary, 40% if private) and so the holding company must acquire more subsidiary shares. The holding company thus conducts a public tender to purchase subsidiary shares by issuing new shares of itself. Because shareholders generally prefer to hold shares of operating companies rather than holding companies, it is unlikely for non-chaebol shareholders to trade in subsidiary shares for an equivalent value of holding company shares. On the other hand, chaebols are likely to take part in this exchange because a substantial ownership of the holding company gives them, derivatively, control over the entire conglomerate.

In summary, transition into a holding company structure increases a chaebol’s control over the conglomerate on multiple levels. When the chaebol exchanges its subsidiary shares for holding company shares, it is focusing its capital on one company that in turn controls the other; this impact is amplified by other shareholders’ lower participation in that exchange. Revived treasury shares that are now shares of the subsidiary, held by the holding company, further increase the chaebol’s control, who now sits on top of the holding company pyramid.

26 In fact, it does not matter if the two entities are a holding company and subsidiary, a subsidiary and a sub-subsidiary, a sub-subsidiary and a sub-sub-subsidiary, and so on. As long as the two entities are linked and on successive levels in the ultimate pyramid structure (as they invariably will be), the same holding requirement applies and the analysis following this footnoted sentence stands.
27 Fair Trade Act, Art. 8 Para. 2 (R.O. Korea).
28 Of course, the holding company can also offer cash to purchase subsidiary shares, but there is little reason for it to do so. By issuing new shares, it incurs no capital and reduces the risk of violating the 200% debt-to-equity ratio requirement.
29 Shareholders generally prefer shares of operating companies rather than holding companies because holding companies have no operating assets or predictable cash flow. For holding companies (or conglomerates) with diversified subsidiaries or less than majority ownership of such subsidiaries (lack of control), there is often a holding company discount under the assumption that a holding company will struggle with oversight. Theoretically, a shareholder will prefer an operating subsidiary with the discount and be indifferent without the discount.
30 The statement that control over the holding company is equivalent to control over the conglomerate applies with equal force to any shareholder, chaebol or not. The key difference, however, is that non-chaebol shareholders have almost no chance at amassing a substantial share of the holding company. On the other hand, a chaebol would start with a substantial share of the original company, translating into substantial shares of both split entities.
31 Of 54 holding company transitions by public companies since 2001 (as of July 2017) through the spin-off and public tender combination, majority shareholders’ ownership of holding companies has increased by
There are a number of proposed bills in the South Korean legislature to stop the magic of treasury shares. Notable proposals approach the magic of treasury shares from different angles. One proposal requires companies to permanently retire treasury stocks before it can pursue a spin-off to establish a holding company structure. Another proposal nulls the voting power attached to the subsidiary shares that a holding company would receive in this transaction. Both of these proposals only apply to conglomerates as defined by the FTC, which are also prohibited from making mutual contributions. A third proposal bans the allocation of shares of a spun-off subsidiary to a holding company based on its treasury shares. How these proposals fare in the legislature will have an important impact on how chaebols assess transitioning into the holding company structure moving forward.

II. IMPACT ON CHAEBOLS

One of the considerations that drove changes in national policy towards holding company structures is how such a policy change would affect important stakeholders. Of course, chaebols and their conglomerates are crucial considerations. We have seen how the government has aimed to shape chaebols’ decisions from a policy perspective. Now we turn to the chaebols’ perspective to detail the interplay among the changing policy, business

<table>
<thead>
<tr>
<th>Company name</th>
<th>Treasury (%)</th>
<th>Company name</th>
<th>Treasury (%)</th>
<th>Company name</th>
<th>Treasury (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Doosan (Doosan)</td>
<td>23.24</td>
<td>Cheil Worldwide (Samsung)</td>
<td>11.96</td>
<td>Hanwha (Hanwha)</td>
<td>6.01</td>
</tr>
<tr>
<td>CJ Korea Express (CJ)</td>
<td>22.74</td>
<td>Naver (Naver)</td>
<td>10.90</td>
<td>Hyundai Motors (Hyundai)</td>
<td>5.89</td>
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<tr>
<td>Keumho Petroleum (Keumho)</td>
<td>16.70</td>
<td>Hyundai Greenfood (Hyundai)</td>
<td>10.64</td>
<td>LG Household and Health Care (LG)</td>
<td>5.43</td>
</tr>
<tr>
<td>Samsung C&amp;T (Samsung)</td>
<td>13.79</td>
<td>Samsung electronics (Samsung)</td>
<td>7.54</td>
<td>Hotel Shilla (Samsung)</td>
<td>5.37</td>
</tr>
<tr>
<td>SK Telecom (SK)</td>
<td>12.55</td>
<td>KCC (Samsung)</td>
<td>6.85</td>
<td>Hyosung (Hyosung)</td>
<td>5.26</td>
</tr>
</tbody>
</table>


Separately, the potential magical impact of the treasury shares can be gleaned from the following data on treasury shares of companies within conglomerates with assets of KRW 5 trillion or more. The relevant chaebol group’s common name is provided in parenthesis after the company name.

32 Id.
33 Id.
34 See supra note 16.
35 Kim, supra note 31. A related fourth proposal bans the sale of treasury shares to a third party for the purpose of acquiring support in an upcoming transaction, including transition to a holding company structure.
considerations and the broader legal landscape.

II.A. INTERPLAY WITH BUSINESS CONSIDERATIONS

The impact that relaxed requirements related to holding company structures has on the business calculus is ambiguous. Stated differently, there are significant benefits and drawbacks associated with transitioning such that companies have come to different conclusions about its merits. Generally, the South Korean government has had some success in that the annual growth in the number of holding companies consistently accelerated over the past 8 years, with just over 20% growth from 2016 to 2017.\(^{36}\) However, chaebols have been much more hesitant to take part in this trend.

Many potential benefits to a business of transitioning into a holding company structure mirror the factors that led the South Korean government to change its policy. Notably, a holding company structure facilitates business investments and divestitures. Since a holding company is shaped like a pyramid where capital flows through a conglomerate in a linear fashion, as opposed to a complex web (as a result of circular and mutual contributions), any one part of that group can be separated much more easily.\(^{37}\) This divestiture may be motivated by a number of business reasons, such as a change in strategy at the conglomerate level, unfavorable performance of the subsidiary to be separated, or even restructuring. When a particular subsidiary consistently underperforms, a conglomerate with a holding company structure can eliminate the risk of such unfavorable performance affecting other companies within the conglomerate by quickly divesting the subsidiary.\(^{38}\) In any case, the ease of divestiture facilitates greater and more effective investments. New subsidiaries will attract greater investments because the associated downside risks are mitigated. The holding company can also serve as a control tower of information and expertise flowing throughout the conglomerate to help subsidiaries utilize capital more effectively.\(^{39}\)

Relatedly, the holding company structure supports the development and execution of

\(^{36}\) Supra note 17.

\(^{37}\) Eom, supra note 10.

\(^{38}\) Note that such a risk of financial strains of one company starting a domino effect throughout a conglomerate is particularly relevant for conglomerates with circular and mutual contributions among themselves, because such contributions spread “phantom” capital throughout the conglomerates that in fact do not exist. The Asian Financial Crisis was aggravated by this phenomenon. Prohibiting the circular nature of circular and mutual contributions would alleviate, although not eliminate, this domino risk. See discussion supra Part I.A.

\(^{39}\) Eom, supra note 10.
conglomerate-wide strategies by centralizing decision-making. All companies within the conglomerate can benefit from not only a reduction in repetitive costs associated with decision-making, but also potential synergies created by coordinating decisions across the conglomerate. A transparent holding company structure where branches are distinguished primarily by business sector allows clear allocation of capital and responsibility, and accordingly, evaluation of performance.

Finally, transition into a holding company structure generally increases the controlling shareholder’s control over the holding company and indirectly over the conglomerate. Minority shareholders prefer not to participate in the holding company’s tender offer to exchange subsidiary shares for newly issued holding company shares. Furthermore, treasury shares transform into subsidiary shares held by the holding company. By definition, chaebols and their related parties are controlling shareholders of conglomerates in South Korea where ownership (at founding) and management are not separate. Therefore, conglomerates are frequently managed to suit the interests of their respective chaebols, who are likely to perceive the prospect of increased control due to holding company transitions as favorable.

On the other hand, there are downsides that weigh against these benefits of holding company structures from the conglomerate’s perspective. First, the holding company transition is simply expensive. The holding company must undergo FTC scrutiny to be registered. A spin-off transaction, which is often used to separate one company into a holding company and an operating subsidiary, entails costs associated with creating a new entity and, if appropriate, taking the new entity public. The holding company may have to incur significant costs to satisfy the holding requirement, as will other subsidiaries with

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40 Id.
41 Id.
42 See discussion supra Part I.C.
43 Concerns related to minority shareholder interests inevitably arise where management interests are one and the same with chaebol interests, and not shareholders generally. This conflict manifests itself as wealth transfer from minority shareholders to chaebols (controlling shareholders), primarily in transactions motivated to increase chaebol control over the entire conglomerate. One context in which such transactions occur repeatedly is when there is a management transfer within the chaebol family. Wealth transfer transactions are less frequent during the management lifetime of a particular individual because chaebol management is seldom challenged in South Korea. The implications of minority shareholders’ wealth transfers in holding company transitions are discussed in more detail below. See discussion infra Part III.
44 Fair Trade Act, Art. 8 Para. 1 (R.O. Korea).
regard to their own subsidiaries in the pyramid structure. The holding company is also subject to asset basis and main business requirements. Furthermore, the holding company will likely incur additional costs moving forward, such as those related to personnel and office space.

The possibility of a holding company discount in stock valuation will weigh against transitioning into a holding company structure. This is particularly relevant because chaebols’ interests are often concentrated in the holding company to indirectly maintain control over the entire conglomerate. Faced with the tradeoff between devaluation and control, chaebols may choose to avoid the former in the absence of any imminent risk to the latter.

Finally, and perhaps most importantly, a holding company cannot have both financial and non-financial subsidiaries. This critical issue has held back many conglomerates that have well-performing financial and non-financial subsidiaries, such as the Samsung Group, from making the transition. By contrast, the LG Group transitioned into a holding company structure by divesting its financial subsidiaries, including LG Investment and Securities and

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45 The subsidiary shares holding requirement is 20% for public subsidiaries and 40% for private subsidiaries. Fair Trade Act, Art. 8 Para. 2 (R.O. Korea). Due to this heavy burden, conglomerates that make this transition raise capital by issuing new holding company shares, although this is not always the case.

46 The asset basis requirement is KRW 100 billion and the main business requirement is satisfied if subsidiary shares make up 50% of the holding company’s assets. Fair Trade Act Enforcement Ordinance, Art. 2 (R.O. Korea).

47 The holding company discount may occur for a variety of reasons, including shareholder preference for operating companies that produce regular cash flow or lack of absolute control over subsidiaries if the holding company does not own more than 50% of subsidiaries’ shares. See supra note 31.

48 Fair Trade Act, Art. 8 Para. 2 (R.O. Korea).

49 In April and July 2017, the Samsung Group publicly announced that it will not pursue transition into a holding company structure. Currently, Samsung C&T owns approximately 19.3% and 4.6% of shares of Samsung Life Insurance and Samsung Electronics, respectively. These two companies in turn functionally serve as holding companies for Samsung’s financial subsidiaries and non-financial subsidiaries, respectively. The Lee family (Samsung chaebol) owns substantial stakes in only Samsung C&T, Samsung Life Insurance and Samsung Electronics. If the Samsung Group were to pursue transitioning into a holding company structure, the most appropriate candidates for a holding company (or from which a holding company spin-off transaction would originate) would be Samsung Life Insurance and Samsung Electronics, because Samsung C&T would entail completely divesting of one of the financial or non-financial branches. Even so, pursuing holding company structures using Samsung Life Insurance and Samsung Electronics would entail immensely costly transactions to separate any interests across the two branches. Among other considerations, this was presumably a significant factor in the Samsung Group’s decision. See Se Jin Jung, Samsung Electronics Foregoes Holding Company Transition, Korea IT Times (April 28, 2017), http://www.koreaittimes.com/news/articleView.html?idxno=68960; see also Da Hyun Choi, ‘Samsung Life Insurance Vice President Declares Holding Company Transition Detrimental to Management’, EBN News (July 18, 2017), http://www.ebn.co.kr/news/view/901371.
LG Card.\textsuperscript{50} In between the two extremes, the SK Group transitioned into a holding company structure to find itself sanctioned following its failure to fix the violation of the banking-commerce separation provision of the FTA.\textsuperscript{51}

\textbf{II.B. INTERPLAY WITH THE TAXATION LANDSCAPE}

Recognizing that mere relaxed restrictions on establishing holding company structures makes the balance of expected benefits and costs ambiguous at best, the South Korean government made several changes to the taxation landscape to tip the scale towards transitioning. These changes in taxation provide benefits to two groups: holding companies and their shareholders.

First, holding companies receive tax relief with respect to its dividend income from shares of subsidiaries. If the holding company owns 40\% or 80\% of public or private subsidiary shares, respectively, all dividend income from those subsidiary shares is exempted from holding company taxation.\textsuperscript{52} If the holding company does not satisfy the holding requirement, the exemption is reduced to 80\%.\textsuperscript{53} There is a reduction in this tax exemption amount tied to debt interest paid by the holding company, such that taxable basis is restored up to the amount of debt interest paid.\textsuperscript{54}

Facially, this tax exemption purports to limit or approximate taxation to the standard double taxation of corporation income—once each at the corporate and shareholder levels.\textsuperscript{55} However, a chaebol’s primary objective for transitioning into a holding company structure is to reinforce control over its conglomerate. This objective would be defeated by selling holding company shares. This means that the chaebol is unlikely to divest its interest or subsidiary dividends in the holding company moving forward, where the chaebol has likely


\textsuperscript{51} The FTA provides a two-year grace period for divestiture of shares held in violation of the banking-commerce separation provision if those shares were held before transitioning into a holding company structure. The SK Group completed its transition on August 3, 2015 with both financial and non-financial subsidiaries. The SK Group failed to correct this defect by August 3, 2017. On February 1, 2018, the FTC issued an order for the SK Group to divest its interest in SK Securities (financial subsidiary) and to pay a fine of KRW 2.961billion. See Won Suk Han, ‘FTC Fines SK Group KRW 2.961 Billion’, \textit{The Korea Securities Daily News} (February 1, 2018), http://www.ksdaily.co.kr/news/articleView.html?id=xno=65128.

\textsuperscript{52} \textit{Corporate Tax Act}, Art. 18 Para. 2 (R.O. Korea).

\textsuperscript{53} Id.

\textsuperscript{54} \textit{Corporate Tax Act Enforcement Ordinance}, Art. 17 Para. 2 (R.O. Korea).

\textsuperscript{55} Compare 26 U.S.C. §243(a).
amassed substantial control.\textsuperscript{56} In other words, the shareholder-level taxation of subsidiary corporate income may be deferred indefinitely although the income has effectively left the corporate solution.

Second, holding company shareholders can defer capital gains tax related to the exchange of subsidiary shares for holding company shares until those holding company shares are disposed of, if this exchange was motivated by the holding company’s need to satisfy the holding requirement of subsidiary shares.\textsuperscript{57} Mirroring the discussion above, a chaebol typically transitions for conglomerate control and is highly unlikely to divest its holding company shares in the future. Although this tax relief is technically a deferral, it is likely to provide a functional exemption for chaebols.

Both tax relief provisions discussed above were executed with automatic expiry to promote and expedite the establishment of holding company structures.\textsuperscript{58} Both provisions’ expiry dates were extended four times and are now set to the end of 2018.\textsuperscript{59} The temporary nature of this tax relief, in conjunction with the hike in asset base requirement from KRW 100 billion to KRW 500 billion, has contributed to the sharp growth in the number of transitions to holding company structures in the past few years.\textsuperscript{60}

\textbf{III. IMPACT ON MINORITY SHAREHOLDERS}

In sum, minority shareholders of chaebol conglomerates constitute a much greater stake in the conglomerates than do the chaebols. According to the FTC, as of 2017, chaebol families of the 10 largest chaebol conglomerates in South Korea owned only 2.5%, on average, in the conglomerates over which they exercised control.\textsuperscript{61} However, accounting for

\begin{footnotesize}\textsuperscript{56} See discussion supra Part I.C.\textsuperscript{57} \textit{Tax Relief Restriction Act}, Art. 38 Para. 1 (R.O. Korea).\textsuperscript{58} Kyung Kyu Na, ‘Analysis of Recent Increase in Holding Companies in Korea’, Weekly Korea Development Bank Report, 8 (2017).\textsuperscript{59} Id.\textsuperscript{60} The total number of holding companies in South Korea increased every year at an accelerating pace, over the past eight years. From 2016 to 2017, the number of holding companies grew by over 20%. See supra note 17.\textsuperscript{61} The following table shows chaebol family shares and internally controlled shares (term used by FTC to denote sum of chaebol family shares, cross-conglomerate shares held by subsidiaries, board member shares, treasury shares and shares held by non-profits attributable to the chaebol family) of the 10 largest chaebol conglomerates in South Korea over the past 12 years. The broad pattern of chaebol families holding small amounts but controlling their conglomerates through internally controlled shares remains unchanged, but internally controlled shares have grown substantially. One possible reason for this is the consolidation of control through holding company transitions.\end{footnotesize}
other shares over which the chaebol families exercised indirect control, the families influenced 58.3%, on average, of their conglomerate shares.\textsuperscript{62} This still leaves a significant amount of non-chaebol interests that must be protected from chaebols who act as both majority shareholders and management. Now we identify areas in which a conflict may occur between chaebol and minority shareholder interests and analyze how traditional safeguards of minority shareholder interests function in the holding company structure.

**III.A. CONFLICT BETWEEN CHAEBOL AND MINORITY INTERESTS**

Potential conflict between chaebol and minority shareholder interests is especially relevant in the holding company context, where a typical transition concentrates control of the holding company (and derivatively the larger conglomerate) in the chaebol’s hands. Thus without a means to identify and prevent abuse of this control, the merits of the holding company structure remain questionable.

With or without transition into the holding company structure, a chaebol family will have varying levels of interest in the companies constituting its conglomerate. The family will experience a greater ascension of wealth if those companies in which it owns a greater interest perform better at the cost of other companies in which it owns a smaller interest. This will amount to a transfer of wealth from the shareholders of the latter company to the shareholders of the former; while the benefit is not limited to the chaebol family, given its substantial ownership stake, the chaebol has both the capacity and incentive to drive this wealth transfer.\textsuperscript{63} Of course, a holding company transition that further strengthens the chaebol’s control will amplify its capacity and incentive.\textsuperscript{64}

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<td>Chaebol family %</td>
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<td>Internally controlled shares %</td>
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\textsuperscript{62} Id.


\textsuperscript{64} This is not to say that the transactions related to a holding company transition are necessarily an unfair transfer of wealth from minority shareholders to the chaebol family. They are not: the minority shareholders
The standard manifestation of such a wealth transfer is through the transfer of business opportunities or the execution of unfair business dealings. Assume that a chaebol conglomerate includes company A, in which the chaebol family owns a significant interest, and company B, in which the chaebol family owns only a minimal interest. Further assume that the chaebol family is able to exert indirect but determinative influence on the decisions of company B through shares of related parties. Under the chaebol family’s control, company B may transfer favorable business opportunities to company A or grant company A uncompetitive business contracts, such that company A benefits at the expense of company B. As a result, the chaebol family and other shareholders of company A would experience a wealth transfer from the non-chaebol shareholders of company B.

Such wealth transfers are not limited to the ordinary operations of companies. Wealth transfers also frequently occur when the chaebol family attempts to strengthen its control over the conglomerate, often triggered by the need to transfer management authority to the next generation of the family. To illustrate, assume again that companies A and B belong to a chaebol Conglomerate. The chaebol family owns significant shares of company A, and company B owns significant shares of other key companies in the conglomerate. By merging companies A and B when A is temporarily overpriced and B is temporarily underpriced, the chaebol family can increase its interest in key conglomerate companies without significant capital outlay. Assuming that the price changes of companies A or B were not true have equal opportunity to participate in all stages of the transaction, including the exchange of operating subsidiary shares for newly issued holding company shares. Minority shareholders generally do not participate at this stage, and the chaebol family increases control over the conglomerate as a result. This, of course, sets the stage for unfair transfers of wealth on separate occasions.

65 This is not an unreasonable assumption. For example, as of 2017, the 10 largest chaebols in South Korea had only 2.5% family shares of their conglomerates but exerted control over 58.3%. See supra note 63.

66 An alleged example of such a wealth transfer involves the Samyang Group. Samyang Foods is a subsidiary of the Samyang Holding Company and makes purchases from other companies that are lower in the Holding Company pyramid structure. In a pending investigation, prosecutors allege that these purchases are underpriced and amount to a wealth transfer driven by the chaebol family, which owns significant shares of the holding company and Samyang Foods. See Hae Sun Lee, ‘Investigation into Samyang Business Opportunity Transfer Turns on Whether Chaebol Family Unfairly Exercised Control’, PoliNews (February 22, 2018), http://www.polinews.co.kr/news/article.html?no=347676.

67 This narrative was alleged concerning the merger of Samsung C&T and Cheil Industries in 2015. Many argue that this transaction was designed to increase family shares in anticipation of the transfer of management from Kun-Hee Lee (father) to Jae-Yong Lee (son). At the time of the merger, Samsung C&T held substantial shares of other Samsung companies, Samsung C&T’s shares were at an all-time-low, and the Samsung heir held substantial shares of Cheil Industries. Elliot management challenged the merger ratio as a shareholder of Samsung C&T, but the board’s decision was approved by shareholder vote. See Min Young Cha, ‘Samsung C&T-Cheil Worldwide Merger Approved … Elliot Proposal Rejected’, Energy Economy News (July 17, 2017), http://www.ekn.kr/news/article.html?no=148041.
reflections of their values going forward, a wealth transfer from the non-chaebol shareholders of company B would be funding the increased control of the chaebol family.

**III.B. PROTECTION OF MINORITY INTERESTS**

The incentive and capability that chaebol families have to conduct wealth transfers from minority shareholders also turn on the protections that police such behavior. Internal and external mechanisms can protect minority shareholder interests. Internal mechanisms include executive incentive alignment and board oversight; external mechanisms include regulatory scrutiny, challenge by institutional and minority shareholders, lawsuits and markets for corporate control and executives. The most relevant controls under the chaebol structure, where management and ownership are not separated, are regulators, board members, institutional shareholders, and other minority shareholders.

Minority shareholders primarily rely on regulators to provide a robust protection mechanism. The current FTA and related regulations allow the FTC to require detailed reporting from companies and investigate them for potential unfair business dealings within a conglomerate if a chaebol family owns 30% or 20% of any public or private company, respectively, within that conglomerate. Unfair business dealings, including transactions at a price other than the expected result of an arms-length negotiation, are proscribed.

Furthermore, if a company is subject to FTC scrutiny under this provision and its internal business dealings amount to 30% or more of revenue, then any shareholder of that company with 3% or more shares is subject to gift tax for its allocable portion of the unfair

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69 Other control mechanisms like executive incentive alignment or markets for corporate control and executives are largely irrelevant because chaebols often hold top management positions and exercise control over majority shares. See supra note 63.

However, a different control mechanism may attempt to restore the relevance of such mechanisms. For example, in June 2003, Sovereign Asset Management brought a proxy vote to oust chaebol, chairperson of the board and chief executive officer Tae Won Choi of SK Global (Now SK Networks). At the time, Tae Won Choi was incarcerated for accounting fraud but Sovereign’s challenge nonetheless failed. If it had succeeded (and Tae Won Choi was replaced by an external manager), executive incentive alignment would have regained relevance as an internal control mechanism. See Dae Sung Kim, ‘Remember Sovereign’s Management Participation Demand from April 2003?’, *Global Economic News* (October 17, 2017), http://news.g-enews.com/view.php?ud=201610141736141941720_1&md=20161017063000_J.

70 *Fair Trade Act*, Art. 23 Para. 2 (R.O. Korea); Fair Trade Act Enforcement Ordinance, Art. 36 Para. 1 (R.O. Korea).

71 Id.
business dealings amount.\textsuperscript{72} While the FTC’s regulatory scrutiny and this gift taxation similarly aim to deter unfair business dealings, the former is a preventative measure that may lead to punitive sanctions, while the latter is simply a reinterpretation of the unfair business dealing as a gift to ensure appropriate taxation of wealth ascension.\textsuperscript{73}

Under the holding company structure, it is probably easier for the FTC to identify unfair business dealings because subsidiaries are organized under a transparent and simple hierarchical pyramid, often grouped by business sectors. Furthermore, the consolidation of chaebol shares in the holding company reduces the chaebol’s need to engage in wealth transferring transactions before a generation change; if the chaebol needs greater control over the conglomerate, its primary means of doing so will be purchasing holding company shares in the open market. A merger with any subsidiary will risk the holding company status and the many benefits that accompany it.\textsuperscript{74} It is worth noting that the FTC has consistently employed bright-line rules in determining what companies fall under its regulatory scrutiny.\textsuperscript{75} Chaebols often tread very close to this line.\textsuperscript{76}

Non-chaebol board members and shareholders have not had meaningful impact on chaebol subsidiaries’ decisions or protection of minority interests, for different reasons. Board members of chaebol conglomerates have questionable independence with respect to not only management but also the controlling shareholder, because management and ownership are one and the same. Generally, boards have not functioned as a check to decisions made and executed by chaebol managers.\textsuperscript{77} Minority shareholders have also had limited influence on company decisions due to the hesitation of key institutional investors to support shareholder activism by opposing chaebol management.\textsuperscript{78}

\textsuperscript{72} Inheritance and Gift Taxation Act, Art. 45 Para. 3 (R.O. Korea).
\textsuperscript{74} See discussion supra Part II.
\textsuperscript{75} See, e.g., note 72. A company falls under the FTC’s regulatory scrutiny if the relevant chaebol family owns 30% (20%) of any public (private) company within that conglomerate.
\textsuperscript{76} For example, the LG Group chaebol family holds 19.9% of Pantos (LG subsidiary), thereby freeing itself from regulatory scrutiny of wealth transfer transactions involving private subsidiaries. FTC Commissioner Sangjo Kim has noted that many chaebol families reduce holdings of public subsidiaries to 29.9% to reach the same result. The FTC is considering lowering the regulatory threshold for public subsidiaries from 30% to 20%. See Hee Jeong Kim, LG Chaebol Shares of Pantos at 19.9%, Just Missing Regulatory Threshold, Women Consumer News (June 16, 2017), http://www.wsobi.com/news/articleView.html?idxno=49340.
\textsuperscript{77} See generally Eugene Kim and Ah-Jeong Kim, ‘Reforming Chaebol Boards is a Big Job: Here’s How it Can Happen’, The Korea Herald (February 13, 2018),
IV. SUGGESTIONS FOR REFORM

Having seen the impact that transitioning into a holding company structure can have on chaebols and minority shareholders, we now turn to how the current law on holding companies can be changed to better achieve policy objectives. To be clear, various objectives have guided past and current governments to fine-tune the law: providing transparency in corporate governance, facilitating investments and divestitures, preventing further concentration of economic power, and preventing unfair transfer of wealth. While the degree of success of any objective is inherently contextual, we have seen that protective mechanisms to prevent unfair wealth transfer are far from robust. Therefore, the goal of this section is to outline ways of modifying the law on holding companies to maintain the current trend of transitions while ensuring that internal and external controls can better function to protect minority shareholder interests.

IV.A. LIMITATION ON HOLDING COMPANIES’ ISSUANCE OF NEW SHARES

Chaebols strengthen control over their conglomerates by concentrating their ownership interests in the holding company. Several factors amplify chaebols’ control in this process, including the magic of treasury shares and relatively lower participation of non-chaebol shareholders in tender offers by the holding companies to purchase subsidiary shares.

In any case, the ability of the holding company to issue new shares is critical to the consolidation of conglomerate control in the hands of chaebols. Holding companies are subject to a debt-equity ceiling of 200%. While the policy objective of this ceiling is to ensure the financial integrity of holding companies and prevent excessive conglomeration


78 For example, Elliot Management’s proxy fight against Samsung C&T’s management regarding the merger of Samsung C&T and Cheil Worldwide turned on the vote of the National Pension Service, which voted for management. Many institutional investors inside and outside South Korea frequently follow the National Pension Service’s decision. It was later alleged (but not proved) that the National Pension Service agreed to the merger despite knowing that it would cause a loss for itself because Vice Chairman Jae-Yong Lee of Samsung C&T (chaebol) exerted political influence through President Park (later impeached). See Jeong Soo Kwak, ‘National Pension Service Minutes Raise 4 Unsettling Questions on its Vote for Merger of Samsung C&T and Cheil Worldwide’, Hangyeoreae News (November 22, 2016), http://www.hani.co.kr/arti/economy/economy_general/771377.html. See supra note 67.

79 See discussion supra Part III.B.

80 See discussion supra Part II.

81 See discussion supra Part I.C.

82 Fair Trade Act, Art. 8 Para. 2 (R.O. Korea).
using debt, the ceiling also creates an artificial incentive to rely on newly issued equity. Of course, this assumes that the holding company does not hold sufficient cash or treasury shares with which it can satisfy the subsidiary holding requirement. In the context of transitions, where the holding company is newly established for the sole purpose of consolidating chaebol interests and managing subsidiaries, such assumptions are not unreasonable.

Theoretically, the issuance and exchange of new holding company shares for subsidiary shares is not problematic because all existing subsidiary shareholders have an opportunity to participate. The diverging interests of chaebols and non-chaebol shareholders, however, lead to disparate results. The chaebol participates, and non-chaebols do not. The chaebol transforms its subsidiary interests into holding company shares, the holding company takes on the chaebol’s previous subsidiary interests, and the non-chaebol shareholders find their subsidiary interests subject to increased chaebol control.

In effect, new stock issuance by the holding company in this context functions as a third-party allotment. New stock issuance for third-party allotment is strictly regulated to protect minority shareholder interests from management and controlling shareholders’ abuse of control. At the most basic level, third-party allotments must be authorized by law or by the articles of incorporation. An example of legally authorized third-party allotment is stock options for the issuing company’s directors, auditors and employees except those who are also controlling shareholders of the company. If authorized by the articles of incorporation, the authorizing language must be sufficiently limiting about the scope of third parties, type, number of shares to be issued and other details that may be of interest to existing shareholders. Finally, to be valid, third-party allotments must be necessary to achieve management objectives, including integration of new technology or improvement of capital structure.

The consolidation of control in particular shareholders is not within the authorized boundaries of third-party allotments. While acquiring subsidiary shares is necessary for the holding company to achieve management objectives, third-party allotment is an inappropriate

83 See discussion supra Part I.C.
84 Id.
86 Id.; Commercial law, Art. 542 Para. 3 (R.O. Korea).
88 Commercial law, Art. 418 Para. 2 (R.O. Korea).
means to do so. Unchecked issuance of new shares erodes the effectiveness of the debt-equity ceiling in ensuring financial integrity of the holding company.\footnote{See \textit{Fair Trade Act}, Art. 8 Para. 2 (R.O. Korea).} Furthermore, current law specifically prohibits third-party allotments to directors or employees who are also controlling shareholders; this is precisely the case in chaebol conglomerates where chaebols are controlling shareholders who hold or influence key board and management positions. At a minimum, minority shareholder interests must be protected by prohibiting issuance of new holding company shares in exchange with existing subsidiary shares, which is functionally equivalent to a third-party allotment of holding company shares to chaebols.

**IV.B. GRADATION ON TAX RELIEF FOR HOLDING COMPANY DIVIDEND INCOME**

Currently, holding companies receive 100\% or 80\% tax exemption from subsidiary dividend income, subject to adjustment related to debt interest paid by the holding company.\footnote{See discussion supra Part II.B.} This tax exemption scheme is part of a larger effort of the South Korean government to promote transition into holding company structures.\footnote{Id.} The government can attempt to produce greater incentives for transitions by introducing finer gradations within this scheme, but it should also adjust the scheme downward to reflect the reality that chaebols are unlikely to divest their holding company shares.

By creating more steps within the current scheme with growing tax exemption percentages, the government can produce greater incentive for conglomerates to initiate transition into the holding company structure, and over time, for holding companies to move further along the steps to own greater proportions of subsidiary shares. If the 40\% and 80\% threshold for public and private subsidiaries under current law represents the South Korea government’s targeted level of subsidiary ownership by the holding company, steps can be formed beneath these figures with accordingly lower exemptions. One can also imagine other schemes with steps both below and above the current threshold.

It is important to understand that the tax exemption aims to create incentive for holding company transitions by reducing tax in excess of the standard double taxation, once each at the corporate and shareholder levels.\footnote{Id.} That is, the exemption scheme reduces an existing
disincentive to create corporate layers. To that end, the government should consider extending the dividends tax exemption to lower ownership levels, with accordingly lower exemptions. For example, in the United States, all intercorporate dividends receive a deduction of 50%, 65% or 100%, if one corporation owns 20%, more than 20% but less than 80%, or 80% of another corporation, respectively.\(^{93}\) To the extent that administrability of this gradated tax relief scheme is a concern, the South Korean government can condition tax exemption benefits on satisfaction of an affirmative duty of the holding company to demonstrate the required ownership during the relevant period.

Finally, chaebols concentrate their conglomerate interests into holding companies primarily to obtain control, which means they are unlikely to sell holding company shares. This understanding warrants a downward adjustment of the tax exemption scheme because the standard double taxation is unlikely to occur. The elimination of the tax exemption scheme is not an appropriate answer to this inconsistency between the policy of double taxation and chaebols’ tendency not to divest holding company shares, for at least two reasons. First, the tax exemption scheme is set up to achieve not only double taxation but also promotion of holding company transitions. Second, holding companies are not wholly owned by chaebols. Rather, existing non-chaebol shareholders will receive and retain holding company shares pursuant to spin-offs that typically precede holding company transitions, and double taxation with regard to these shareholders warrants tax reduction for subsidiary dividends at the holding company level.\(^{94}\)

**IV.C. LIMITATION OF CAPITAL GAINS DEFERRAL FOR DISPOSITION OF SUBSIDIARY SHARES**

Shareholders of subsidiaries who exchange their shares for holding company shares are granted deferral of capital gains tax if such exchange was conducted by the holding company to satisfy its subsidiary holding requirement.\(^{95}\) Similar to the tax relief provisions, this policy is in line with the South Korean government’s objective of increasing holding company structures.\(^{96}\) This deferral disproportionately benefits chaebols who have strong incentives to favor holding company shares, while non-chaebols who have incentives to favor operating

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\(^{93}\) 26 U.S.C. §243(a). Note that this provision covers all intercorporate dividends, not just those from subsidiaries to holding companies.

\(^{94}\) See discussion supra Part I.C.

\(^{95}\) *Tax Relief Restriction Act*, Art. 38 Para. 1 (R.O. Korea).

\(^{96}\) See discussion supra Part II.B.
subsidiaries do not enjoy this benefit. Since chaebols are unlikely to divest holding company shares, this deferral functions as an exemption to capital gains earned from subsidiary shares.\textsuperscript{97} Such capital gains should be recognized at disposition, which is the standard recognition event.

If the South Korea government’s sole objective is to accelerate holding company transitions, capital gains deferral will help because chaebols drive decisions as controlling shareholders, and capital gains deferral clearly works in the chaebols’ interest. This policy objective, however, is only one of many. The government also has a compelling interest in protecting minority shareholders. In the presence of a multitude of factors that weigh in the chaebol’s favor, including the practical ability to acquire sufficient holding company shares to control the operating subsidiary, minority shareholder interests warrant greater attention in the context of holding company transitions.\textsuperscript{98}

A competing rationale that supports capital gains deferral, besides the promotion of holding company transitions, would be to conceptualize the disposition of subsidiary shares in exchange for holding company shares as maintaining an interest in the conglomerate, albeit in a different corporate vehicle. While it is unclear why such a re-characterization should be made only in the context of holding company transitions, if this is the case, the deferral of capital gains should at least be limited to certain instances where a particular shareholder transforms subsidiary interest into holding company interest of a similar nature, specifically with regard to control.\textsuperscript{99} Stated differently, if a previously non-controlling shareholder of the subsidiary gains control over the holding company through the course of a holding company transition, the relevant disposition of subsidiary shares should be a taxable transaction. This change would serve to prevent the deferral of capital gains taxation for shareholders who engage in holding company transitions to consolidate and amplify control, as opposed to simply switching corporate vehicles.

**IV.D. EXPANSION OF FTC SCRUTINY WITHOUT BRIGHT-LINE SAFE HARBORS**

Lastly, the FTC should be given greater discretion to require reporting from and

\textsuperscript{97} Id.
\textsuperscript{98} See discussion supra Part III.
\textsuperscript{99} In accordance with the larger scheme of the law on holding company transitions, an appropriate threshold for control would be 20% and 40% for public and private subsidiaries, respectively. This is the subsidiary holding requirement for holding companies. See *Fair Trade Act*, Art. 8 Para. 2 (R.O. Korea).
conduct investigations of holding companies. Accordingly, bright-line safe harbors that shield holding companies from scrutiny should not exist. We have seen that shareholders who own 30% or 20% of a public or private company are subject to FTC scrutiny regarding unfair business dealings within the conglomerate to which the shareholder’s company belongs.\(^\text{100}\) This limitation of regulatory power is concerning for two reasons. First, as discussed above, the presence of a bright-line safe harbor facilitates chaebol conduct that violates regulatory objectives in substance and spirit.\(^\text{101}\) The FTC should exercise the ability to regulate all unfair business dealings that it deems substantial according to legislative and executive guidance.\(^\text{102}\)

Second, unfair business dealings are only one means by which chaebol controlling shareholders can conduct wealth transfers. For example, chaebols can also transfer wealth from minority shareholders of subsidiaries by inducing the distribution of excessive subsidiary dividends after seizing control over the holding company. The current tax exemption scheme for dividends received by holding companies add to the incentive to conduct wealth transfers in this manner. By using the cash accumulated in the holding company to fund operations of subsidiaries in which the chaebol holds a relatively greater interest, the chaebol can achieve the same result as conducting a direct wealth transfer through uncompetitive business contracts between the two subsidiaries. However, the intermediate step of dividends distribution to the holding company places this wealth transfer outside of the current scope of the FTC’s authority, which is limited to unfair business dealings.\(^\text{103}\) The FTC’s regulatory scrutiny should be expanded to include all direct and indirect forms of wealth transfers.

If properly equipped and exercised, the regulatory power of the FTC can also give effect to certain internal and external control mechanisms for protecting minority shareholder

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\(^\text{100}\) Fair Trade Act, Art. 23 Para. 2 (R.O. Korea); Fair Trade Act Enforcement Ordinance, Art. 36 Para. 1 (R.O. Korea).

\(^\text{101}\) See supra note 78.

\(^\text{102}\) The relevant legislation delegates to the President to determine this substantive threshold, which is currently set at 30% or 20% of a public or private company within a conglomerate. Fair Trade Act, Art. 23 Para. 2 (R.O. Korea); Fair Trade Act Enforcement Ordinance, Art. 36 Para. 1 (R.O. Korea). While the legislation directs the President to set a threshold ownership percentage, one can also imagine legislation that gives wider latitude for the President to provide guidelines without regard to a specific percentage. Such guidelines may combine standards and rules to define the conditions for wealth transfers (for example, a shareholder owns 30% or 20% of a public or private company within a conglomerate, or otherwise exercises substantial control).

\(^\text{103}\) Fair Trade Act, Art. 23 Para. 2 (R.O. Korea); Fair Trade Act Enforcement Ordinance, Art. 36 Para. 1 (R.O. Korea).
interests. For example, the FTC should prioritize restoring the independence of boards in chaebol conglomerate companies, so that the chaebol family and its holding company do not exert undue influence on subsidiary companies. Recall that in 2017, the 10 largest chaebol families owned 2.5% of their respective conglomerates but commanded control over 58.3%, in part due to their influence over board members. Independent board members would sever a substantial portion of the gap between chaebol family shares and their internally controlled shares.

**CONCLUSION**

Historically, South Korea has struggled with two objectives that frequently create tension: promoting rapid economic growth through the concentration of capital in a few competitive conglomerates, and preventing imprudent investment decisions of such conglomerates. Indeed, the holding company structure was introduced in 1999 as a middle ground solution. The FTC explained that the holding company structure would align these two objectives by increasing corporate governance transparency, facilitating mergers & acquisitions, and simplifying external capital contributions. The legal requirements related to holding companies ensure that holding companies own at least 20% and 40% of public and private subsidiary shares, and not more than 5% of non-affiliated company shares, without excessive reliance on debt.

However, proper consideration of minority shareholder interests was lost in this discussion. During a typical holding company transition, two factors combine to magnify chaebol control over the conglomerate through the holding company vehicle: first, the revival of treasury shares following spin-offs, and second, the different incentives for chaebols and non-chaebols to participate in holding company tenders to exchange newly issued holding company shares for existing subsidiary shares. Business considerations and the current tax relief provisions largely weigh in favor of chaebols’ interests as well.

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104 See discussion supra Part III.B.
105 Id.
106 See supra note 63.
107 See supra 63.
108 Id.
109 Id.
110 See supra note 22.
111 See discussion supra Part I.C.
112 See discussion supra Part II.A-B.
To the extent that valid policy justifications exist to promote holding company structures, such justifications should be balanced against the need to protect minority shareholder interests. This paper recommends four changes to the current law on holding companies. First, the issuance of new shares by holding companies to exchange with existing subsidiary shares should be prohibited, as this is functionally equivalent to a third-party allotment of holding company shares to chaebols.\textsuperscript{113} Second, the current tax relief scheme for dividends received by holding companies should be further gradated to create incremental incentives for holding company transitions, and adjusted downward to reflect the reality that chaebols are unlikely to divest holding company shares.\textsuperscript{114} Third, the current capital gains deferral for a shareholder who exchanges subsidiary shares for holding company shares should be denied in cases where that shareholder obtains control through the course of the holding company transition.\textsuperscript{115} Finally, regulatory scrutiny of the FTC should be expanded beyond the current bright-line safe harbors to cover all conduct that substantively amount to wealth transfers from minority shareholders to chaebols, and to empower internal and external control mechanisms that protect minority shareholder interests.\textsuperscript{116}

\textsuperscript{113} See discussion supra Part IV.A.
\textsuperscript{114} See discussion supra Part IV.B.
\textsuperscript{115} See discussion supra Part IV.C.
\textsuperscript{116} See discussion supra Part IV.D.