

2020 AGM: Concerns about Takeover Defenses in AOI

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Many listed firms in Korea adopted takeover defense provisions such as a golden parachute and a supermajority provision in their articles of incorporation during the 2020 annual general meetings, with some of them facing conflicts around the effectiveness of the provisions. The number of listed firms that opt for at least one takeover defense provision reached 405 or 19.8%, up 121 from a decade ago. Clearly, this is not a trend that could be ignored lightly. However, the appropriateness of those provisions needs revisiting as there is no regulation in place to prevent firms from adopting unrealistic, hard-to-meet terms and conditions.

Annual general meetings (AGM) of companies whose fiscal year ends on December 31 went smoothly at the end of March, 2020 despite unprecedented difficulties amid Covid-19. What particularly stands out during this AGM season was a line of conflicts related to either amending¹⁾ or nullifying part of articles of incorporation (AOI) for defense strategies against hostile takeovers. This article assesses how listed corporations in Korea adopt AOI provisions related to defense against hostile takeovers, and explores potential problems in this issue.

Proposals to amend AOI at 2020 AGM 2020

Among the proposals put to vote at the 2020 AGM of listed firms in Korea, some of them were to amend their AOI for the sake of high-level defense strategies against hostile takeovers. For

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1) Korea Corporate Governance Service reviewed a total of 2,460 proposals from 353 listed firms in the first quarter of 2020, and found that 167 proposals were regarding amendments to AOI (KCGS, April 10, 2020, Proxy review of Q1 2020 annual general meetings, Press Release).

example, a KOSDAQ-listed pharmaceutical firm (firm A) voted for a new AOI provision that pays a financial compensation of KRW 10 billion in addition to a severance pay within seven days after s/he resigns or cannot carry out the post due to a hostile takeover during the tenure. Also, there is a KOSPI-listed aggregate supplier (firm B) who adopted an AOI provision to raise the quorum for the appointment and removal of a director and an amendment to AOI to three-fourths of attending shareholders and two-thirds of outstanding shares. The provision adopted in the former case is called a golden parachute, a classic defense that deters hostile takeovers by awarding a considerable amount of monetary compensation to any resigning director during the tenure. The latter case adopts a supermajority provision, another example of takeover defense by making a quorum for special resolution much tougher than required by the Commercial Act of Korea.

Also notable among the firms adopting a golden parachute and a supermajority provision in the 2020 AGM is their tendency to adopt more than one defense strategies. In above examples, firm B had already adopted a golden parachute provision in AOI even before the supermajority provision. Not only did it newly adopted the supermajority provision in this AGM, it significantly raised the amount of golden parachute payments.²⁾ Another KOSDAQ-listed firm also newly added a golden parachute provision paying out KRW 20 billion and KRW 5 billion to the CEO and the director who resigns during the tenure due to a hostile takeover, on top of their existing supermajority provision. Moreover, another KOSPI-listed firm voted in the 2020 AGM for both the golden parachute and supermajority provisions. This evidences a tendency of the 2020 AGM among firms to select more than one takeover defense strategies.

On the flip side, there were some shareholder activities to nullify the existing defenses under AOI in this AGM season. For example, minor shareholders in a KOSDAQ-related firm filed for an injunction to nullify the amendment to the supermajority provision in AOI, which was later denied by the court.³⁾ In another KOSDAQ-listed firm, the second largest shareholder submitted a shareholder proposal aiming to abolish the golden parachute and supermajority provision, which was successfully put to vote in the AGM. However, it was rejected by the AGM.

2) It raised the amount of golden parachute payments for a CEO and directors whose employment is terminated by a hostile takeover. The payments were raised from KRW 3 billion for the CEO and KRW 2 billion for directors to KRW 10 billion and KRW 3 billion, respectively.

3) The court rejected the injunction citing the principle of private autonomy and the reality where a great number of firms have already adopted the supermajority provision in their AOI. Such a ruling made the amendment to AOI for a supermajority provision effective (Seoul Central District Court, 2020 KaHap 20005).

Defense strategies in AOI of listed firms

It's important to note that the preference over defense strategies among listed firms is not limited to the 2020 AGM. According to the analysis of Nam (2020),⁴⁾ the number of firms adopting one or more defense mechanisms in their AOI⁵⁾ stood at 405 (89 on KOSPI, 316 on KOSDAQ) among a total of 2,049 listed firms (769 on KOSPI, 1,280 on KOSDAQ) as of 2019 (business reports for the year of 2018). Those firms represent 19.8% of listed firms (11.6% of KOSPI, 24.7% of KOSDAQ). Furthermore, the number of firms selecting any defense provision in AOI increased by 121 compared to a decade ago.

Table 1. Firms adopting defense strategies (in number and percent)

	Supermajority provision	Golden parachute	Limit to the number of directors to be removed	Issuance of special-class shares	No. of firms	Total
KOSPI	56 (7.3%)	30 (3.9%)	5 (0.7%)	28 (3.6%)	89 (11.6%)	769
KOSDAQ	226 (17.7%)	177 (13.8%)	37 (2.9%)	43 (3.4%)	316 (24.7%)	1,280
Total	282 (13.8%)	207 (10.1%)	42 (2.0%)	71 (3.5%)	405 (19.8%)	2,049

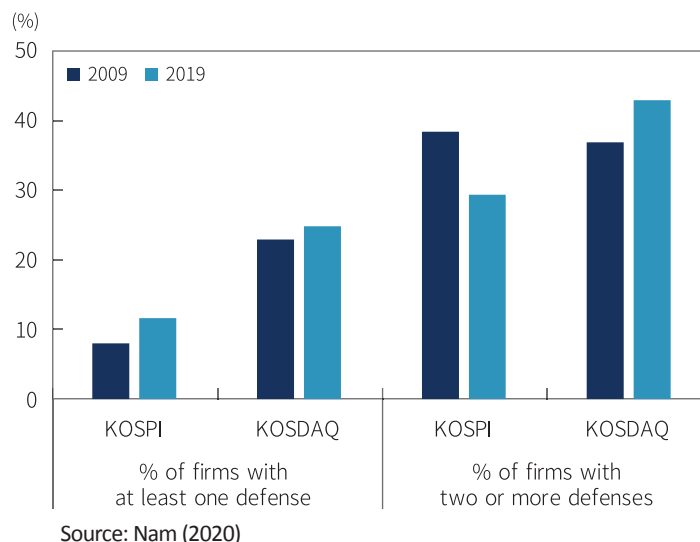
Source: Nam (2020)

Also found in firms adopting a takeover defense in their AOI during the 2020 AGM is a strong tendency to place more than one defense strategies. This is especially evident among KOSDAQ-listed firms. As of 2019, a total of 42.7% of those taking at least one takeover defense have two or more defenses, which is a 5 percentage-point increase from 37.7% a decade ago. This comes as a stark contrast to KOSPI-listed firms where the share of firms taking two or more defenses in those taking at least one defense fell from 38.2% to 29.2% during the same period.

4) Nam, G.N., 2020, Takeover defenses in listed firms' AOI: Current state and implications, KCFI Issue Paper 20-10.

5) Nam (2020) sees takeover defense provisions in AOI include a golden parachute, a supermajority provision, a limit to the number of directors to be removed without legitimate reasons, and issuance of special-class shares that can be converted to common shares.

Figure 1. Percent of firms with at least one vs. more than two defenses



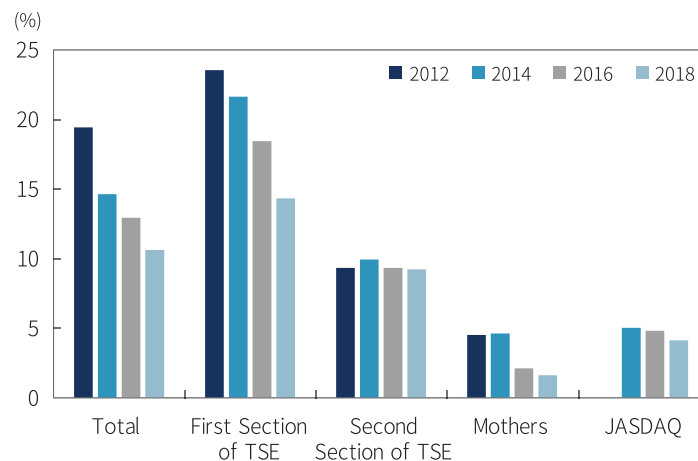
The problem, among others, is that some of the defense provisions in AOI include somewhat extreme terms and conditions that cannot be met in reality. For example, firm A in the above example adopted a golden parachute provision in its 2020 AGM, under which it has to pay KRW 10 billion to any CEO leaving soon due to a hostile M&A. However, its market capitalization stands at KRW 190 billion as of April 17, 2020, with its net profit and cash & cash equivalents (at the end of the 2019 fiscal year) reaching only KRW 9.1 billion and KRW 2.7 billion, respectively. It's not likely for the firm to afford the payment. On average, the maximum of the golden parachute payment stands at KRW 20.3 billion which is equal to 4.2-fold of cash and cash equivalents, and 27.4% of market capitalization (Nam, 2020).

Among the firms with a supermajority provision, quite a few firms have extremely tough resolution conditions that can hardly be met. For example, a total of 16 firms have the rule requiring the percent of favorable votes to be 80% or higher of outstanding shares. However, nine firms among them already have 20% or higher shares if their major shareholders combined, which makes it virtually impossible for any outsider to secure 80% or higher votes. With way too strong defenses against hostile takeovers, those firms are often subject to criticism in that they limit the rights of ordinary shareholder and overly protect the power of controlling shareholders.

A necessary revisit to appropriateness of takeover defenses

Takeover defense provisions in AOI of listed firms often include excessive terms and conditions as mentioned above partly because there is no regulation, except for the Commercial Act, in place to govern AOI provisions of listed firms in Korea. Although AOI in nature are an autonomous rule passed by an AGM, they should be regulated and kept in check to prevent them from overly reducing the rights of ordinary shareholders. Even in the US where autonomy in AOI has fully taken hold, the Corporations Code in California bans any firm with 300 or more staff from adopting a supermajority provision that requires votes over two-thirds of the firm's outstanding shares. On another front, the Tokyo Stock Exchange in Japan reviews AOI to see if there's any poison pill provision. For any firm with such a provision, the TSE can reject its listing application, or take punitive measures that could lead to delisting.⁶⁾ Also notable is that Japan's largest pension fund GPIF takes into account a firm's takeover defenses when calculating the ESG index for the sake of protecting minor shareholders. This partly contributes to the significant decrease in the percentage firms adopting at least one takeover defense among TSE-listed firms from 23.5% in 2012 to 14.3% in 2018.

Figure 2. % of Japanese listed firms adopting takeover defenses



Source: Nam (2020)

6) If a firm with a poison pill provision sets the share acquisition price excessively low, or adopts a dead hand provision, it is subject to sanctions, resulting in being delisted or being rejected to be listed. Furthermore, the TSE obligates any listed firm adopting takeover defense provisions to take into account four principles; sufficient disclosure, transparency, impacts on the secondary market, and shareholder value.

Arguably, it's not all negative about more and more listed firms in Korea adopting a takeover defense provision in their AOI. Jitters about any hostile takeover are a global issue going beyond Korea especially at a time when stock prices are plunging amid the Covid-19 pandemic. Nonetheless, the current reality—more and more defenses with some extreme terms and conditions—certainly makes it all the more necessary to revisit the appropriateness of defense provisions in AOI.